Appendices

Appendices A-F include material that has not previously been published; Appendices G-AB consist of material that has appeared in publication previously.

Appendix A

Survey of Payday Loan Borrowers About the CFPB's Notice of Proposed Rulemaking for Payday, Vehicle Title, and Certain High-Cost Installment Loans

Methodology

In August 2016, on behalf of The Pew Charitable Trusts, the GfK Group conducted a national study of 826 payday loan borrowers. The survey was conducted using KnowledgePanel, a probability-based web panel designed to be representative of the United States. The survey consisted of two stages: initial screening for borrowers and the main survey with the study-eligible respondents. To qualify for the main survey, a panel member must have used a payday loan (at a store or online).

The margin of error including the design effect is plus or minus 4 percent at the 95 percent confidence level. A more detailed methodology is available at www.gfk.com.

Survey Results

Q1a: In choosing where to get a payday loan, how important is the following to you?

	The fee charged	How quickly you can get the money	How easy it is to apply for the loan	The certainty that you will be approved for the loan	The loan amount
Very important	74%	76%	64%	73%	67%
Somewhat important	21%	20%	30%	22%	27%
Not important	4%	2%	5%	4%	5%
Refused	1%	1%	1%	1%	1%

Q1b: You listed the following as "very important" when choosing to get a payday loan. Which one would you rank as the **most important** one?

	Percent
The fee charged	39%
How quickly you can get the money	24%
The certainty that you will be approved for the loan	21%
The loan amount	11%
How easy it is to apply for the loan	6%
Refused	0%

Q2: Should payday loans be more regulated or not?

	Percent
Yes	70%
No	29%
Refused	1%

Q3: If some of the payday loan stores closed in your area, but the remaining stores charged less for loans, would that be a good thing or a bad thing?

	Percent
A good thing	91%
A bad thing	8%
Refused	1%

Q4: If you were equally likely to be approved for a small loan, would you prefer to borrow from a payday lender, or from your bank/credit union?

	Percent
A payday lender	18%
Your bank/credit union	81%
Refused	1%

Q5a: Some banks and credit unions are considering offering a $400, three-month loan with a $60 fee. The same loan from a payday lender has a fee of about $350. If you were looking to borrow a small amount of money, would you be more likely to borrow from your bank/credit union or more likely to borrow from a payday lender?

	Percent
More likely to borrow from bank/credit union	90%
More likely to borrow from payday lender	10%
Refused	1%

Q5b: And is that much more likely or just somewhat more likely?

Bank/credit union

	Percent
Much more likely	85%
Somewhat more likely	14%
Refused	1%

Payday lender

	Percent
Much more likely	50%
Somewhat more likely	45%
Refused	5%

Q6: New regulations are being considered for payday loans. The next few screens are some situations that might result because of the new regulations. Please select whether you think it would be a good thing or a bad thing for you:

Borrowers would be allowed several months to repay in smaller installments rather than having loans due back in 2 weeks.

	Percent
A good thing for you	92%
A bad thing for you	7%
Refused	1%

Banks and credit unions would begin offering small loans at prices 6 times lower than payday lenders.

	Percent
A good thing for you	93%
A bad thing for you	6%
Refused	1%

Banks and credit unions would be allowed to offer you no more than two loans a year.[1]

	Percent
A good thing for you	66%
A bad thing for you	32%
Refused	2%

[1] This response does not match feedback Pew has received from borrowers in focus groups or banks' findings in speaking with consumers. This response may reflect borrowers' reaction to banks and credit unions being allowed to offer them loans at all, rather than the two-loan limit that was intended to be the subject of the question.

Q7: The next few screens are some steps regulators could take to help improve payday and other small loans. For each, please respond by selecting how much of an improvement you think it would be: a major improvement, a minor improvement, or not an improvement.

Enable banks and credit unions to offer small loans at prices 6 times lower than payday lenders

	Percent
Major improvement	80%
Minor improvement	15%
Not an improvement	3%
Refused	2%

Require lenders to pull your credit report and evaluate your debt payments

	Percent
Major improvement	21%
Minor improvement	31%
Not an improvement	46%
Refused	1%

Require lenders to give you several months to repay instead of about 2 weeks

	Percent
Major improvement	79%
Minor improvement	16%
Not an improvement	4%
Refused	1%

Require lenders to give you 3 days' notice before taking money out of your account

	Percent
Major improvement	61%
Minor improvement	30%
Not an improvement	8%
Refused	2%

Allow loans to be repaid in small installments instead of one lump-sum

	Percent
Major improvement	75%
Minor improvement	20%
Not an improvement	3%
Refused	2%

If lenders tried and failed to withdraw money from your bank account twice, they would have to ask permission before attempting to withdraw money again

	Percent
Major improvement	61%
Minor improvement	26%
Not an improvement	11%
Refused	1%

Limit you to using two small installment loans per year

	Percent
Major improvement	34%
Minor improvement	32%
Not an improvement	33%
Refused	1%

Q8: Here is a loan that payday lenders might offer under the new regulations. Please select if you think the terms are fair or unfair.

A $400 loan, repaid in 3 months, for a fee of $120 (meaning you borrow $400 and pay back $520).

	Percent
Fair	38%
Unfair	61%
Refused	1%

A $500 loan, repaid in 5 months, for a fee of $595 (meaning you borrow $500 and pay back $1,095).

	Percent
Fair	9%
Unfair	90%
Refused	1%

A $1,250 loan, repaid in 10 months, for a fee of $2,450 (meaning you borrow $1,250 and pay back a total of $3,700).

	Percent
Fair	9%
Unfair	89%
Refused	2%

Q9: Here is a loan that banks might offer under the new regulations. Please select if you think the terms are fair or unfair.

A $300 loan, repaid in 3 months, for a fee of $35.

	Percent
Fair	91%
Unfair	8%
Refused	1%

A $500 loan, repaid in 4 months, for a fee of $80.

	Percent
Fair	86%
Unfair	12%
Refused	2%

A $400 loan, repaid in 3 months, for a fee of $60.

	Percent
Fair	86%
Unfair	12%
Refused	2%

Q10: The next few screens will show some small loans that last a few months and might be available to people who are looking to borrow money to pay an urgent bill. If you were looking to borrow a small amount of money, please mark whether you would choose Loan A or Loan B.

a)

	Loan A	**Loan B**
Amount of loan	$500	$500
Cost of loan	$125	$750
Type of lender	Bank	Payday lender

	Percent
Loan A	93%
Loan B	5%
Refused	2%

b)

	Loan A	Loan B
Amount of loan	$500	$500
Cost of loan	$125	$750
Time to receive loan funds	3 days	20 minutes

	Percent
Loan A	88%
Loan B	10%
Refused	3%

c)

	Loan A	Loan B
Amount of loan	$500	$500
Cost of loan	$75	$450
How the lender assesses whether you qualify	Based on your checking account history, income, and history with the bank	Based on your credit report, income, and the lender's estimate of your expenses0

	Percent
Loan A	92%
Loan B	5%
Refused	3%

d)

	Loan A	Loan B
Amount of loan	$500	$500
Cost of loan	$60	$450
Likelihood of approval	30%	80%

	Percent
Loan A	87%
Loan B	11%
Refused	2%

Q11: If you were short on cash, how helpful do you think the following loan would be?

A $400 loan, repaid in 3 months, for a fee of $60 (meaning you borrow $400 and pay back $460).

	Percent
Very helpful	68%
Somewhat helpful	22%
Just a little helpful	6%
Not helpful	3%
Refused	1%

A $400 loan, repaid in 3 months, for a fee of $350 (meaning you borrow $400 and pay back $750).

	Percent
Very helpful	5%
Somewhat helpful	10%
Just a little helpful	19%
Not helpful	65%
Refused	2%

Q12: The next few screens are some ways that your bank could offer small loans. Please mark whether you would be very interested in obtaining a loan this way, somewhat interested, or not interested.

	Via an app on your phone	Through online banking on a computer or tablet	Through an automated telephone system	Through the ATM
Very interested	34%	48%	26%	38%
Somewhat interested	35%	33%	37%	35%
Not interested	29%	17%	35%	25%
Refused	2%	2%	2%	1%

Q13: How satisfied are you with your bank's loan options that are available to you today?/When you had a bank account, how satisfied were you with the bank's loan options that were available to you? (The first question was asked of respondents who currently have a checking account and the second question was asked of respondents who do not currently having a checking account, but had one in the past.)

	Percent
Very satisfied	18%
Somewhat satisfied	41%
Somewhat dissatisfied	26%
Very dissatisfied	14%
Refused	2%

Q14: What would it say to you about your bank if they started offering small loans you could qualify for, repaid in a few months at a price six times lower than payday lenders?/Thinking back to the last time you had a checking account, what would it say to you about your bank if they started offering small loans you could qualify for, repaid in a few months at a price six times lower than payday lenders? (The first question was asked of respondents who currently have a checking account, and the second question was asked of respondents who do not currently have a checking account, but had one in the past.)

Since this was an open-ended question, we have included only a handful of actual responses:

- This is a good step to help the already stretched wallets of poor (A)mericans.

- They would be offering innovative and flexible solutions.

- I would prefer to use a bank or credit union -- they seem to be more reliable.

- They are willing to help people who are experiencing difficulties.

- It says that my bank is interested in being fair.

- (T)hat would be awesome. I would stop going to payday lenders.

- They care about their customers and are reasonable.

- Very good, however they shouldn't have stringent criteria in order to get it.

- BRING MORE PEOPLE into the mainstream banking.

- I think that would be very helpful to some who are desperately in need.

- It would be a good service, especially for short term money short falls.

- About time banks started loaning money again. Isn't that what they used to do?

- THE BANK I BANK AT IS A VERY GOOD BANK.

- This is how it should have been always. Payday loans were a license to steal.

- It would say that my bank cares about me more than a payday lender.

Q15: Today, banks typically charge a fee of around $35 for each overdraft. Do you think that's fair or unfair?

	Percent
Fair	24%
Unfair	75%
Refused	1%

Q16a: Half of respondents were asked: If you found yourself short on cash, how likely would you be to take this loan?

Loan amount	$350
Term	3 months
Fee	$52
Monthly payment	$134
Annual Percentage Rate (APR)	87%

	Percent
Very likely	21%
Somewhat likely	36%
Just a little likely	22%
Not likely	19%
Refused	2%

Q16b: The other half of respondents were asked: If you found yourself short on cash, how likely would you be to borrow this loan?

Loan amount	$350
Term	3 months
Fee	$52
Monthly payment	$134

	Percent
Very likely	28%
Somewhat likely	40%
Just a little likely	20%
Not likely	11%
Refused	1%

Appendix B

Survey of American Adults About the CFPB's Notice of Proposed Rulemaking for Payday, Vehicle Title, and Certain High-Cost Installment Loans

Methodology

On behalf of The Pew Charitable Trusts, Social Science Research Solutions (SSRS) conducted a nationally representative random-digit-dialing (RDD) telephone survey of 1,205 adults. Interviews were conducted August 12 – August 21, 2016. The survey included an oversample of approximately 200 African-American and Latino respondents. The oversample was weighted to match the demographic incidence of the RDD sample. The margin of error including the design effect is plus or minus 3.37 percent at the 95 percent confidence level. A more detailed methodology is available at www.ssrs.com.

Survey Results

Q1: Now I'd like to ask you some questions about payday lending. Payday lenders are companies that generally operate through storefronts or the Internet. They make small loans, often at high interest rates that are usually due back on the borrower's next payday.

Which of these statements comes closer to your point of view?

	Percent
Payday loans should be more regulated	70%
Payday loans should not be more regulated	17%
Don't know/Refused	12%

Q2: Today, banks generally do not make loans to people with low credit scores. Do you want to see banks begin to offer small loans of a few hundred dollars to their customers who have low credit scores, or do you not want to see that?

	Percent
Want to see	70%
Do not want to see	23%
Don't know/Refused	7%

Q3: Some banks are considering offering a $400, three-month loan with a $60 fee. Payday lenders charge about $350 for the same loan, while using a credit card would usually cost less than $60. If a bank began offering a $400, three-month loan for a $60 fee, would your view of that bank be more favorable or less favorable?

	Percent
More favorable	70%
Less favorable	20%
Don't know/Refused	9%

Q4: The government agency that regulates payday lending has proposed some new regulations. I'd like to get your opinion on some of the possible outcomes of the new regulations. For each, please tell me if you would view it as mostly a good outcome or mostly a bad outcome.

a. If most people who use payday loans got more time to repay them, but the annual interest rates continued to be around 400 percent

	Percent
Mostly a good outcome	15%
Mostly a bad outcome	80%
Don't know/Refused	5%

b. If most people who use payday loans could get loans from their banks and credit unions that cost six times less than payday loans

	Percent
Mostly a good outcome	86%
Mostly a bad outcome	10%
Don't know/Refused	4%

c. If some payday lenders went out of business, but the remaining lenders charged less for loans

	Percent
Mostly a good outcome	74%
Mostly a bad outcome	19%
Don't know/Refused	7%

Q5: Here are two possible outcomes of the proposed regulations for payday lending. Please tell me which of the two you would view as a better outcome for a $400, 3-month loan.

	Percent
If lenders pulled borrowers' credit reports, estimated their expenses, and issued that loan for about $350 in fees	13%
If lenders reviewed customers' checking account histories and issued that loan for about $60 in fees	79%
Don't know/Refused	8%

Q6: Here are some examples of small loans that might be available to people who have low credit scores. For each, please tell me whether you think the terms seem fair or unfair. (Insert item.) Do you think the terms seem fair or unfair?

a. $500 for a fee of $100 paid back over 4 months, so a person who borrows $500 will pay back $600

	Percent
Fair	61%
Unfair	37%
Don't know/Refused	3%

b. $500 for a fee of $600 paid back over 4 months, so a person who borrows $500 will pay back $1,100

	Percent
Fair	7%
Unfair	91%
Don't know/Refused	2%

c. $400 for a fee of $60 paid back over 3 months, so a person who borrows $400 will pay back $460

	Percent
Fair	80%
Unfair	18%
Don't know/Refused	2%

Q7: Here are two views regarding small loans that banks might begin offering. Please tell me which of the two you agree with more.

	Percent
It would be a good thing if banks started offering small loans to their customers who use payday loans today because the prices would be six times lower than payday loans	77%
It would be a bad thing if banks started offering small loans to their customers who use payday loans today because the interest rates would be higher than credit cards	16%
Don't know/Refused	6%

Appendix C

Using research to define affordable small-loan payments: The 5 percent payment standard

A conventional payday loan takes up one-third of the typical borrower's bi-weekly paycheck. Most borrowers cannot afford to lose this much from their paycheck and still make ends meet. Instead, research shows that borrowers need several months to repay loans of a few hundred dollars, with affordable installment payments limited to about 5 percent of the borrower's paycheck. For a typical borrower earning $30,000 annually ($2,500 monthly) that would mean payments close to $60 every two weeks or $125 a month.

Data supporting a 5 percent payment standard:

Research shows that lenders who do not condition credit on the ability to collect from a customer's checking account conduct an assessment of a borrower's income and major expenses, and set monthly payments near 5 percent of monthly income.

1. **Credit bureau data:** 85 percent of underwritten installment loans have monthly payments of 5 percent or less of borrowers' monthly income. In 2016, Pew obtained a national random sample of several hundred thousand installment loans ranging from $100 to $3,000 from one of the largest credit bureaus. This sample consists primarily of loans issued by finance companies—state-licensed nonbank lenders—to subprime to and near-prime customers who are similar to payday loan borrowers. An analysis of these data revealed that 8 in 10 loans had monthly payments ranging from $50 to $150, which for most payday borrowers comes under 5 percent of their monthly gross income.

2. **CFPB's payday and auto title installment loan data:** Loans with installment payments greater than 5 percent of a borrower's monthly income have higher default rates. The CFPB's analysis of 2.5 million payday and auto title installment loans shows that default is more likely to occur in loans with higher payment-to-income ratios. The study concludes that for loans where the loan origination channel is known (vehicle title and online payday installment loans) higher payment-to-income ratios are generally associated with higher rates of default.

3. **AFSA installment loan data:** 79 percent of surveyed installment loans had monthly payments of $150 or less. This finding was published in a paper commissioned by the American Financial Services Association (AFSA),[1] the national trade group for installment lenders. The survey collected information on the characteristics of 3.1 million installment loans that were primarily issued to subprime borrowers (85 percent of loans were issued to borrowers with credit scores below 620). The study found that 78 percent of the surveyed loans had monthly payments ranging from $50 to

[1] Durkin, et al (2014), *Findings from the AFSA Member Survey of Installment Lending*, American Financial Services Association, http://www.masonlec.org/site/rte_uploads/files/Manne/11.21.14%20JLEP%20Consumer%20Credit%20and%20the%20American%20Economy/Findings%20from%20the%20AFSA%20Member%20Survey%20of%20Installment%20Lending.pdf

$150. AFSA has also reported that their member lenders have average loan payments of $120 per month, which represents about 5 percent of income for a typical borrower earning $30,000 annually.[2]

4. **Existing installment lending market data:** 76 percent of small, underwritten installment loans have monthly payments equal to 5 percent or less of borrowers' monthly income. This finding was derived from Pew's analysis of a sample of small installment loans made by more than a dozen consumer finance companies that offer money to low- and moderate-income borrowers.[3] The loans ranged in size from several hundred dollars to several thousand dollars. These data reveal what payments exist in a small-loan market with traditional underwriting.

5. **A nonbank installment lender:** A consumer finance company that offers underwritten installment loans reviewed its complete customer data for Pew and found that a majority of loans had monthly payments between 4 and 8 percent of monthly income.

Research shows that most payday borrowers cannot afford loan payments that take up more than 5 percent of their gross monthly income.

6. **Nationally representative survey data:** In Pew's nationally representative survey of payday loan borrowers, the average borrower reported being able to afford $50 per two weeks (or $100 per month) out of their paycheck toward a payday loan payment.[4] Comparing this figure with their self-reported income reveals that a majority of borrowers can afford 5 percent of their income or less toward payday loan debt. The median borrower said they could afford 5 percent.

7. **Conventional payday loan fee arrangements:** Conventional, storefront lump-sum payday loans carry an average fee of $55.[5] This fee, which customers pay each time they reborrow, is approximately *5 percent* of an average payday borrower's gross biweekly paycheck. Data show that 4 out of 5 loans are renewed within 14 days because borrowers can afford to pay the $55 fee, but not the entire loan amount.[6]

8. **Colorado payday installment loans:** The monthly payment charged under Colorado's new law for a $500 loan is about $131. The average monthly income of a Colorado payday loan borrower is $2,477 ($29,724 annually), according to state regulatory data. Thus, a monthly payment on a $500 payday installment loan in the state takes up approximately 5 percent of a borrower's gross monthly income.

[2] Bill Himpler, "*A Message to Congress, Regulators: Installment Loans Work,*" Roll Call, February 11, 2015, http://www.rollcall.com/news/a_message_to_congress_regulators_installment_loans_work_commentary-240032-1.html.
[3] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 35, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=35
[4] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 13, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=13.
[5] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 15, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=15.
[6] The CFPB Office of Research, *CFPB Data Point: Payday Lending* (2014), http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.

The average actual loan size of $389 requires a monthly payment of about $105, or 4 percent of a borrower's monthly income on average.

Loans from banks and credit unions demonstrate that a 5 percent payment standard works for borrowers. Kinecta Federal Credit Union, Rio Grande Valley Multibank, St. Louis Community Credit Union, and Spring Bank already offer fully amortizing installment loans with payments set at 5 percent of monthly income.[7] In addition, more than 30 banks and credit unions stated that their customers could afford loans with monthly payments set at 5 percent of income. And at least three large banks were planning to offer loans at prices six to eight times lower than payday lenders using the 5 percent payment standard, pending regulatory approval.[8]

[7] Kinecta Federal Credit Union, https://www.youtube.com/watch?v=mBTxOpGpKLI; St. Louis Community Credit Union, http://reddough.com/loans/; Spring Bank, http://springbankny.com/wp-content/uploads/2015/02/Borrow-and-Save-Loan-Application-February-2015_DUAL_PDF_Fillable.pdf

[8] 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.

Appendix D

An underwriting requirement is not enough—the CFPB needs to set clear product safety standards for small-dollar loans.

Ensuring that payday and auto title loan payments are affordable is essential to protecting consumers, and there are multiple ways to determine affordable payments. Lenders underwrite loans to manage risk, but in the payday loan market, they also have access to borrowers' checking accounts and car titles to improve their ability to collect on the loans. **Because of this extraordinary power to compel repayment, an underwriting-only approach from regulators is insufficient to protect consumers. Clear safeguards are needed to ensure affordable payments and a reasonable time to repay.**

CFPB's underwriting-only approach will not adequately protect consumers, and most borrowers will still qualify for high-cost loans

The CFPB published a draft rule in June that requires lenders to document borrowers' income and certain expenses. This underwriting-only approach will ensure that 400% APR installment loans continue to exist without limits on the cost, term, or how long lenders can access borrowers' checking accounts or car titles. Further, 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. This discrepancy exists in part because the CFPB is not requiring all expenses to be documented. That is why high-cost installment loans that currently exist in 26 of the 39 states with payday or car title lending will remain permissible.

Banks Can Offer Affordable Loans With Much Lower Prices Than Payday Lenders

		Payday Installment Loans		5%-Payment Bank Loans	
Principal Borrowed	Loan Duration	Monthly Payment	Finance Charges	Monthly Payment	Finance Charges
$300	6 months	$184	$805	$65	$90
$400	4 months	$198	$391	$120	$80
$500	6 months	$170	$520	$108	$150

Clear product safety standards will result in safer, lower-cost loans

Payday and car title lenders will pass on the cost of completing extensive paperwork to borrowers and take on regulatory risk to issue loans of a few hundred dollars, but lower-cost providers will not.

Banks and credit unions will enter the market at scale only if they have clear regulatory standards that enable them to use the type of ***automated underwriting*** they normally conduct for smaller consumer loans. Research shows that small-loan borrowers fare better when loans are repaid in installments limited to an affordable 5 percent of their paycheck with terms of no more than six months. If regulators enacted such standards, banks could offer their own customers who use payday loans **the same credit at prices six times lower** (see 5%-Payment Bank Loans in table above).

The CFPB should enact clear product safety standards for the small-dollar loan market, such as limiting each installment payment to 5 percent of a borrower's paycheck and giving borrowers up to six months to repay. These are the two essential safeguards that will result in prices six times lower, will give borrowers a reasonable time to repay a loan, and ***save millions of borrowers billions of dollars annually.***

Appendix E

High-cost covered loans thrive in 28 states; others are vulnerable

- The CFPB's new rule lets 300-400% APR payday loans flourish while locking out lower-cost loans from banks.
- 300% APR installment loans and lines-of-credit already exist in **26 of the 39 states** with payday or car title lending, and two previously restrictive states where such high-cost loans did not exist.
- At least **6 other states** (IN, ME, MI, NE, NH, WA) are at risk: Lenders may attempt to issue installment loans via Credit Services Organization (CSO) statutes, as they have already in Ohio and Texas.
- Lenders will continue making loans that have no restrictions on fees, 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 and some expenses.
- Most payday loan borrowers will pass an underwriting test according to industry analysts.

CFPB-Compliant Installment Loans Will Still Be Available in At Least 28 States

State	Principal Borrowed	Duration (Weeks)	Biweekly Payment	Finance Charges	APR
Alabama	$500	26	$84	$589	337%
Arizona	$500	78	$41	$1,111	204%
Arkansas	Lender offers high-cost auto title loans using CSO statute (rates are not disclosed)				
California	$2,550	52	$228	$3,376	196%
Colorado	$500	26	$61	$290	180%
Delaware	$500	20	$109	$595	447%
Florida	Lenders offer high-cost auto title loans (rates are not disclosed)				
Georgia	Lenders offer high-cost auto title loans (rates are not disclosed)				
Idaho	$500	24	$86	$533	349%
Illinois	$500	16	$113	$406	404%
Kansas	$500	26	$84	$589	337%
Louisiana	$500	10	$119	$96	130%
Maryland	$500	26	$82	$563	324%
Minnesota	Lenders offer high-cost auto title loans (rates are not disclosed)				
Mississippi	$800	26	$123	$801	290%
Missouri	$500	26	$78	$520	316%
Nevada	$500	12	$133	$300	399%
New Mexico	$600	26	$114	$880	393%
North Dakota	$500	9	$182	$321	487%
Ohio	$500	16	$126	$511	507%
Rhode Island	$500	26	$87	$635	360%
South Carolina	$650	24	$112	$691	348%
South Dakota	$500	24	$86	$533	349%
Tennessee	$500	26	$75	$477	279%
Texas	$500	24	$153	$1,342	575%
Utah	$500	26	$84	$589	337%
Virginia	$500	24	$100	$701	204%
Wisconsin	$500	20	$109	$595	447%

Appendix F

The Implications of Income Volatility Among Low and Moderate-Income Americans for the CFPB's Small-Dollar Loan Rulemaking – September 21, 2015

Executive Summary

The research summarized in this memo indicates that low- to moderate-income earners experience significant income volatility, which creates challenges when trying to determine the ability to repay credit over periods longer than several months. Higher-cost loans that include a preferred repayment position expose borrowers to a great deal of risk, especially considering that typical borrowers earn less than $40,000 annually, struggle to make ends meet, and seek the loans for consumption-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.

To guard against loans where lenders' ability to collect will exceed borrowers' ability to repay, the CFPB's rule for payday and similar loans should require stricter underwriting standards for loans lasting more than six months. Specifically, for these longer-term loans, lenders should be required to verify the borrower's financial condition retroactively for a period of time that is proportional to the duration of the loan. However many months a loan lasts, lenders should ensure that its payments would have been affordable for that length of time in each of the preceding months. So for a 10-month loan, the lender should ensure that a borrower had a sufficient buffer between income and expenses to make the required loan payment in every one of the past 10 months.

Underwriting, Income Volatility, and Preferred Repayment Position

Lenders' access to borrowers' bank accounts and car titles (a "preferred repayment position") gives them the ability to collect on loans even when borrowers cannot reasonably afford the payments. Underwriting can help mitigate this imbalance by requiring lenders to make a reasonable determination that payments are affordable. But for longer-term loans, underwriting that took place more than six months in the past will often be insufficient to determine what payments are affordable because many borrowers experience volatile incomes.

To prevent decoupling of a borrower's ability to repay from a lender's ability to collect, any high-interest loan secured with a preferred repayment position that lasts a long time (such as more than six months), should only be issued if the underwriting process indicates that a borrower shows a high degree of financial stability. To evaluate this, lenders should engage in a longer lookback process before issuing a loan lasting longer than six months. For example, a 12-month assessment is appropriate for a 12-month loan, and so on. This review will help ensure that any income drop, whose timing is unpredictable but whose occurrence generally is not, does not leave a borrower unable to repay a loan.

For borrowers with volatile incomes, this underwriting procedure will result in a larger buffer between income and expenses as part of the lender's reasonable determination. For example, the Financial Diaries research discussed below indicates that in approximately one month out of five, subjects' incomes drop more than 25 percent below an average month. Requiring a larger buffer for longer-term loans would limit the risk of harm from loan payments that borrowers could not afford with this type of income drop (or expense increase of similar magnitude), because a cushion would be built into the underwriting to allow for the types of changes that borrowers have experienced in the past. This safeguard may lead some lenders to issue underwritten loans with terms of six months or shorter because the ability to repay test will be significantly more difficult to pass for loans lasting longer than six months. Or to streamline the underwriting process, an alternative strategy would be to require that before issuing a loan lasting longer than six months, lenders must ensure that borrowers could afford loan payments after experiencing a 25 percent decline in income, to comport with the standard definition of income volatility.

Measuring Income Volatility

Income volatility is defined as significant gains or losses to individual earnings or household income relative to their average over a specified period of time. A common benchmark is a fluctuation of at least 25 percent.[1] Studies use administrative data, survey data, or a combination of both to identify income changes. Administrative data—which may include earnings records from the Social Security Administration and the Longitudinal Employment and Household Dynamics administrative dataset (LEHD) cannot capture informal or "under the table" jobs. Therefore, for households living paycheck to paycheck, administrative data probably underestimate the level of volatility they experience, particularly for jobs in agriculture, household services, and construction, as well as for households who are at least partially paid in cash.[2]

Conversely, survey data often show much higher levels of volatility. The most commonly used national surveys are the Census' Survey of Income and Program Participation (SIPP); and the University of Michigan's Panel Study of Income Dynamics (PSID). These surveys use various time periods in order to differentiate between people who have volatile incomes over long periods of time and those who have relatively stable incomes marked by occasional severe drops or spikes in income.

A number of articles on income volatility show it has increased steadily since the 1970s, and at a higher rate for low-income households. Other research shows that volatility has existed at a fairly constant rate over the past several decades, including research from Pew that finds more than half of households have experienced a gain or drop of more than 25 percent in a two-year span.[3] In addition, financial instability was further exacerbated by the Great Recession, which saw home equity plummet and public

[1] 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; and The Pew Charitable Trusts which looks at gains and losses of 25 percent. Others use the standard deviations (SD) of percent changes, including DeBacker, Heim, Panousi, and Vidangos (2012) who look at the SD of one- and two-year percent changes and Winship who looks at the SD of two-year percent changes. And still others analyze variances in monthly income compared to average income (Bania and Leete, 2007) or fluctuations in income (Gosselin, 2008). For earnings income, for which there is a larger body of research, many have looked at the SD of percent change, including Celik, Juhn, McCue, and Thompson (2012); the Congressional Budget Office (2008), Ziliak, Hardy, and Bollinger (2010); and Shin and Solon (2011). Other techniques include analyzing the weighted average of the absolute earnings growth rate (Abras, 2010); looking at the percent change in earnings (Congressional Budget Office, 2007 and 2008); and earlier research often analyzed the variance of transitory earnings (Cameron and Tracy, 1998; Moffitt and Gottschalk, 2002; and Omin, Groshen, and Rabin, 2006).

[2] Sule Celik, Chinhui Juhn, Kristin McCue, and Bureau Jesse Thompson, "Recent Trends in Earnings Volatility: Evidence from Survey and Administrative Data," (2012), The B.E. Journal of Economic Analysis & Policy (12)2, DOI: 10.1515/1935-1682.3043.

[3] Sharon Wolf, Lisa A. Gennetian, Pamela A. Morris, Heather D. Hill, "Patterns of Income Instability Among Low- and Middle-Income Households with Children" (2014), Family Relations 63: 397–410, DOI:10.1111/fare.12067; Karen Dynan, Douglas Elmendorf, and Daniel Sichel, "The Evolution of Household Income Volatility" (2012), The B.E. Journal of Economic Analysis & Policy 12(2), DOI: 10.1515/1935-1682.3347; Neil Bania and Laura Leete, "Monthly household income volatility in the U.S., 1991/92 vs. 2002/03" (2009), Economics Bulletin, AccessEcon, 29(3), 2100-2112, http://www.accessecon.com/Pubs/EB/2009/Volume29/EB-09-V29-I3-P59.pdf; Peter Gottschalk and Robert Moffitt, "The Rising Instability of U.S. Earnings," (2009), Journal of Economic Perspectives (23)4, 3–24, http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.23.4.3. Other research that has found high levels of income volatility also documented it several decades ago, such as 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.

assistance funding decrease.[4] These findings demonstrate that the difficulty for families lies in the uncertainty and inability to plan when a percentage of income is unpredictable. As we discuss later, data show the impact is even more challenging for low-income households.

An analysis of the Panel Study of Income Dynamics (PSID) reveals that between 1979 and 2011, almost half of households experienced income volatility, facing an income gain or loss of more than 25 percent in any given two-year period.[5] Using the PSID, Dynan et al. also found a 30 percent increase in income volatility between 1971 and 2008, and results show this rise was attributable to both hourly income and number of hours worked.[6] In general, many studies attribute the bulk of household financial volatility to income shocks, specifically changes in wages and hours worked, rather than consumption shocks, whereby a household significantly increases or decreases spending.

Annual Income Volatility Measures Fail to Capture Monthly Swings

Many studies that rely on annual datasets or surveys cannot capture month-to-month swings, particularly if income is annualized.[7] This is especially important because monthly income is more likely to fluctuate in lower-income rather than higher-income households.[8]

Thus, a growing body of research has focused on analyzing monthly income changes. A May 2015 report by the JPMorgan Chase Institute found that many individuals experience substantial income volatility, including over relatively short periods of time. That report found income volatility "was even greater on a month-to-month basis than on a year-to-year basis."[9] Dynan et al. analyzed monthly income and found that, on average, households experienced volatile incomes about five months of the year.[10] Several studies have analyzed SIPP data and found an increase in monthly income volatility. Bania and Leete found that from 1992 to 2003, monthly income volatility not only grew substantially for poor households, but was higher for poor households than non-poor households. Their findings suggest the reason for increased volatility is due to a shift from steady public benefits to labor earnings.[11] Similarly,

[4] Sharon Wolf, Lisa A. Gennetian, Pamela A. Morris, and Heather D. Hill, "Patterns of Income Instability Among Low- and Middle-Income Households with Children" (2014), Family Relations (63)3, 397-410, DOI:10.1111/fare.12067.

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

[6] Karen Dynan, Douglas Elmendorf, and Daniel Sichel, "The Evolution of Household Income Volatility" (2012), The B.E. Journal of Economic Analysis & Policy 12(2), DOI: 10.1515/1935-1682.3347. The PSID dataset measures volatility as the standard deviation of percent changes in annual household income over two-year periods.

[7] Hannagan, Anthony and Jonathan Morduch, "Income Gains and Month-to-Month Income Volatility: Household evidence from the US Financial Diaries," (2015), 4, https://static1.squarespace.com/static/53d008ede4b0833aa2ab2eb9/t/553521dae4b048e6faa46cdb/1429545456581/paper1.pdf. The authors summarized income volatility by an average coefficient of variation of monthly income, which was 55% for those below the poverty line and 34% for those from 100% to 300% of the poverty line.

[8] Constance Newman, "The Income Volatility See Saw" (2006), USDA Economic Research Service, http://www.ers.usda.gov/media/1038421/err23.pdf; Sharon Wolf, Lisa A. Gennetian, Pamela A. Morris, and Heather D. Hill, "Patterns of Income Instability Among Low- and Middle-Income Households with Children" (2014), Family Relations 63 (3) 397-410, DOI:10.1111/fare.12067. The authors found monthly volatility within and across income levels, which annual measures may not capture.

[9] JPMorgan Chase Institute, "Weathering Volatility: Big Data on the Financial Ups and Downs of U.S. Individuals" (2015), 5-11, http://www.jpmorganchase.com/content/dam/jpmorganchase/en/legacy/corporate/institute/document/54918-jpmc-institute-report-2015-aw5.pdf.

[10] Karen Dynan, Douglas Elmendorf, and Daniel Sichel, "The Evolution of Household Income Volatility" (2012), The B.E. Journal of Economic Analysis & Policy 12(2), DOI: 10.1515/1935-1682.3347. The PSID dataset measures volatility as the standard deviation of percent changes in annual household income over two-year periods.

[11] Neil Bania and Laura Leete, "Monthly household income volatility in the U.S., 1991/92 vs. 2002/03" (2009), Economics Bulletin, AccessEcon, 29(3), 2100-2112, http://www.accessecon.com/Pubs/EB/2009/Volume29/EB-09-V29-I3-P59.pdf.

Morris et al. found that the poorest households in the SIPP data had increasing monthly income volatility between 1984 and 2008.[12]

For those who experience a significant income drop, women, the elderly, and individuals whose income doubled in the months before the drop are less likely to return to pre-drop levels than others.[13] Gosselin and Zimmerman find that destabilizing events, specifically the loss of a job for the head of household and a decrease in hours worked, are the main factors that contribute to income volatility.

The U.S. Financial Diaries Project tracked over 200 low- and moderate-income households for a year to collect data on how these families manage finances. An analysis of income shows substantial monthly fluctuations throughout the year.[14] When looking at volatility above or below 25 percent of average income in a 12-month period, families experienced 2.5 months of large income dips and 2.6 months of large income gains.[15] And when looking at the root of these fluctuations across the income spectrum, labor earnings (not benefits or other public assistance) are a highly volatile component of income.[16]

In the Federal Reserve's SHED data, two-thirds of respondents reported somewhat steady income, but 21 percent said that some months were unusually high or low and another 10 percent said they experienced "quite a bit" of monthly volatility.[17] For these last two groups, the survey asked about reasons for volatility, to which most respondents said irregular work schedules were the main cause of monthly swings.[18]

Income Volatility Especially Affects Lower-Income and Highly Indebted Households

Literature analyzing volatility by income groups shows it is particularly challenging for low-income households that typically have little liquid savings to help them weather income drops. 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.[19]

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[12] Sharon Wolf, Lisa A. Gennetian, Pamela A. Morris, Heather D. Hill, "Patterns of Income Instability Among Low- and Middle-Income Households with Children" (2014), Family Relations 63(3), 397–410, DOI:10.1111/fare.12067.

[13] 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. The authors used the SIPP data to analyze characteristics of families most likely to experience significant income declines.

[14] U.S. Financial Diaries, "Spikes and Dips: How Income Uncertainty Affects Households" (2013), 1, http://www.usfinancialdiaries.org/issue1-spikes.

[15] Anthony Hannagan and Jonathan Morduch, "Income Gains and Month-to-Month Income Volatility: Household Evidence from the U.S. Financial Diaries" (2015), 8-10, 25, http://www.usfinancialdiaries.org/paper-1.

[16] Hannagan, Anthony and Jonathan Morduch, "Income Gains and Month-to-Month Income Volatility: Household evidence from the US Financial Diaries," 2015, https://static1.squarespace.com/static/53d008ede4b0833aa2ab2eb9/t/553521dae4b048e6faa46cdb/1429545456581/paper1.pdf.

[17] Board of the Governors of the Federal Reserve, "Report on the Economic Well-Being of U.S. Households in 2013," (2014), 87, http://www.federalreserve.gov/econresdata/2013-report-economic-well-being-us-households-201407.pdf.

[18] Board of the Governors of the Federal Reserve, "Report on the Economic Well-Being of U.S. Households in 2013," (2014), 87, http://www.federalreserve.gov/econresdata/2013-report-economic-well-being-us-households-201407.pdf. This question was asked only of those who said either that income "varies quite a bit from one month to the next", or is "roughly the same in most months, but some unusually high or low months during the year."

[19] Susan J. Lambert Peter J. Fugiel Julia R. Henly, "Precarious Work Schedules among Early-Career Employees in the US: A National Snapshot," 12, http://op.bna.com/dlrcases.nsf/id/rsmh-9rwpnx/$File/Precarious%20Work%20Schedules-August%202014.pdf.

This instability creates particular risk for those who use high-interest loans because they usually have little savings available to compensate for a loss of income. These swings 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.[20]

Researchers at the Urban Institute analyzed five-month spans across a 17-month timeframe and separated household income into quintiles. They found that the poorest quintile had much higher rates of income volatility than their middle-income counterparts.[21] Further, SIPP data show certain groups are also more likely to experience sharp income declines, including low-income households with children, the lower-earning individual in dual-income households, and people with disabilities.

Recent research has 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. As a result, Scott Baker found that these households cut back on spending on food, transportation, clothing, and other necessities. He found an increase in debt-to-asset ratios also increased the elasticity of consumption by about 25 percent–even when controlling for savings and credit.[22] Pew has also found in focus group research that payday and auto title loan borrowers report skipping meals, missing utility payments, missing credit card payments, borrowing from family and friends, and selling their possessions in order to make payments on loans secured with their checking account or car title. Similar to highly indebted households, payday and auto title loan borrowers, because of their low incomes, low savings, and accumulation of other debt, have little cushion to weather an income drop.

For Loans Lasting Longer Than Six Months, the Proposed Underwriting Requirement Does Not Adequately Account for Income Volatility

As the ability to repay test was outlined in the CFPB's March regulatory framework, most borrowers will pass it. Approximately 80 percent of borrowers in Pew's survey research report being able to afford at least some loan payment. As a former CFPB Assistant Director recently argued, "There is a significant percentage of payday borrowers who have 'room to borrow' an installment loan under a residual income model…. Many of today's payday consumers can likely handle an installment loan, at yields that emulate a payday loan."[23] His analysis suggested that 80 percent of payday loan borrowers will appear to have at least $200 available for a monthly loan payment, far more than the $100 that the median

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[20] Hannagan, Anthony 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. The authors summarized income volatility by an average coefficient of variation of monthly income, which was 55% for those below the poverty line and 34% for those from 100% to 300% of the poverty line.

[21] 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. Coefficient of variation for monthly household income in lowest quintile was 0.499 and 0.321 for middle quintile.

[22] Scott R. Baker, "Debt and the Consumption Response to Household Income Shocks" (2014), http://web.stanford.edu/~srbaker/Papers/Baker_DebtConsumption.pdf.

[23] Rick Hackett, "Report from nonPrime101 Conference: Redesigning Small Dollar Lending to Survive Threatened Regulatory Intervention?" Aug. 3, 2015, https://www.nonprime101.com/blog/report-from-nonprime101-conference-redesigning-small-dollar-lending-to-survive-threatened-regulatory-intervention/.

payday loan borrower self-reports being able to afford.[24] Monthly payments of $200 would also be far larger than the $120 average seen in the traditional installment loan market.[25] The largest online payday lender, which issues loans with APRs typically exceeding 300 percent, appears to agree, stating that under the ATR framework the CFPB has outlined, "Enova is well-positioned for continued success."[26] But to ensure that lenders' success aligns with borrowers of higher-cost loans, who are more likely to experience but less able to withstand income volatility , it is crucial to require a larger buffer for any high-interest loan that has an especially long duration and is secured by a checking account or car title.

For low- to moderate-income individuals and households, one-time underwriting at the outset of a long-term loan will not capture both the potential monthly and yearly swings over the life of the loan. If loans are unsecured, borrowers have the option of defaulting or pressuring the lender into restructuring payments to match their new budgets, but taking these routes is much more difficult for borrowers if lenders have a preferred repayment position.

Recommendation: Before Issuing a Loan Lasting Longer than Six Months, A Lender Must Ensure That a Borrower Has a High Degree of Financial Stability

To prevent lenders' ability to collect from exceeding borrowers' ability to repay for loans lasting longer than six months, the CFPB's rule should require lenders to assess income and expenses for as many months in the past as the loan's term extends into the future and ensure that loan payments would have been affordable in each of those months. For a 10-month, high-interest loan that has a preferred repayment position, assessing 10 months of income and expenses can help guard against payments that would be rendered unaffordable by income drops.

Low-income families that regularly deal with income volatility face difficult choices when deciding whether to cut back on expenses—which few have the room to do—or borrow to make ends meet. Well-structured loans can help smooth consumption, and affordable payments help minimize damage to budgets. However, the risk of loan payments exceeding borrowers' ability to repay increases the further away that these payments occur from the loan's underwriting. If a borrower's income and expenses are volatile, loan terms should be structured accordingly, so that this routine volatility does not prevent borrowers from affording loan payments. Underwriting may indicate affordable payments at a given moment, but it cannot adequately mitigate the risk of allowing very long-term access to a borrower's depository account or car title for borrowers with volatile incomes.

For a $500 loan with an 18-month duration, underwriting that took place upon origination provides little guidance as to what is affordable in the loan's final months.[27] Thus, any reasonable determination of affordability for an 18-month loan should include at least as large a buffer as the borrower would have needed over the prior 18 months. An alternative approach would be to ensure that a borrower could withstand a 25 percent drop in income and still afford loan payments. Including a larger buffer as part of

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[24] The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans," 14, http://www.pewtrusts.org/~/media/Assets/2013/02/20/Pew_Choosing_Borrowing_Payday_Feb2013-(1).pdf.

[25] Bill Himpler, *Roll Call*, "A Message to Congress, Regulators: Installment Loans Work," Feb. 11, 2015, http://www.rollcall.com/news/a_message_to_congress_regulators_installment_loans_work_commentary-240032-1.html.

[26] Enova International, Inc., "Fourth Quarter and Full Year 2014 Earnings Conference Call Transcript," February 3, 2015, accessed Sept. 16, 2015, http://www.sec.gov/Archives/edgar/data/1529864/000156459015000544/enva-ex991_2015020370.htm.

[27] Speedy Cash, Online Rates and Terms, Arizona, accessed Sept. 9, 2015 https://www.speedycash.com/rates-and-terms/arizona/.

any reasonable determination of affordability for loans lasting longer than six months will substantially reduce the chances of payments' exceeding borrowers' capability.

Appendix G

AMERICAN BANKER.

Banks' Secret Plan to Disrupt the Payday Loan Industry

By IAN MCKENDRY
May 6, 2016

At least three U.S. banks are preparing to go to market with new small-dollar installment loan products in a move that could potentially disrupt the payday lending industry.

Their plans, the details of which were provided to and confirmed by American Banker on condition the institutions not be named, depend on the upcoming Consumer Financial Protection Bureau proposal that would place new restrictions on payday-lending-type products.

The proposal may exempt lenders from having to conduct certain underwriting requirements as long as the loan term is between 46 days and six months and the monthly payments do not exceed 5% of the borrower's gross monthly income, according to an outline released last year. That exemption is key for the banks, two of which are among the top 10 banks in the country by number of branches.

"If we get the go ahead to do this, we are going to want to introduce it very quickly" an executive at one of the three banks said on condition of anonymity. "I think banks can make a return on it. It is not going to be significant, but it is really beneficial for the community, it is beneficial for so many consumers and I think if banks handle it correctly they can make a positive return."

Banks have largely stayed away from small-dollar consumer loans since the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency discouraged deposit advance products in 2013 because they viewed them as expensive to consumers and carried reputational risks.

But the banks said if the 5% exemption is part of the proposal, they believe they can offer a product that would satisfy regulators. A mockup of what the product could look like would be a $500 five-month loan for a borrower with an annual income of $30,000 and monthly payments of $125 (or 5% of the borrower's $2,500 average monthly income). After assuming a 6% loss rate (which would be comparable to similar installment loans currently on the market), automation expenses and servicing fees, a bank could net roughly $70 while the borrower would be on the hook for $125. The average cost of a similar payday loan product would be closer to $750.

"The 5% payment option is the only part of the CFPB proposal that could save millions of borrowers billions of dollars," said Nick Bourke, director of the small-dollar loans project at the Pew Charitable Trusts. "It would enhance underwriting while minimizing compliance costs by capping the monthly payment at 5% of the borrower's income with a term up to six months."

A Pew survey found that consumers viewed a similar product favorably. Seventy-six percent of respondents said a $500 loan with a $80 fee paid back over four months was a "fair" product, while 80% viewed a loan that looks more like a typical payday installment loan with a $500 principal and a $450 fee paid back over five months as an "unfair" product.

However, a possible hang-up for banks could be that the 5% option outlined by the CFPB would limit a customer draw to twice per year.

"If you went to the 5% option and raised that percentage and also didn't limit the draw so severely, you would have a product that would look like something that could be sustainable," said Dave Pommerehn, senior counsel and vice president at the Consumer Bankers Association.

Josh Wright, a former Treasury Department official and executive director of ideas42, a consultancy that deals in behavioral insights, said "the 5% is one of the key components of a good product."

Wright said a small-dollar loan has to be "designed for repayment from the beginning" but that "there needs to be some way for banks to make a judgement about that, but it cannot be so burdensome that they would have to go through a very expensive or very labor-intensive underwriting process that would just make the loan too costly for them."

Another potential problem is if the FDIC and OCC would sanction the product.

"It seems like the CFPB is going to try and force banks to serve those markets and see if that is sustainable to meet the demands," said Todd Zywicki, a law professor at George Mason University. He added that whether banks will be able to do so "depends on the extent to which banks can be consistent with their safety and soundness obligations to enter into a business where they know they are going to lose money from the get-go."

Pommerehn said the FDIC and OCC would have to issue supervisory guidance if the CFPB proposal looks like the outline.

"It would be our sincerest hope that the OCC and the FDIC would work jointly with the CFPB on these decisions," he said.

The banks plotting to offer the loans, however, believe they can make a small margin while meeting a customer need. They could improve their perception with the public while standing to benefit from potentially on-ramping customers into a fuller suite of products.

"You don't want feel as if the organizations you are using for your daily transactions is crushing people and not contributing in any meaningful way," said Frederick Wherry, a sociology professor at Yale University. "Here are people that are not even on Main Street, they would like to get to Main Street and the banks are helping them."

The executive, whose bank had offered a deposit advance product before the FDIC and OCC's crackdown, said, "This will be a lower return, but we are really looking at the overall value of the relationship and this is kind of one area that we would be generating revenue in addition to other revenue sources."

St. Louis Community Credit Union, a community development financial institution, currently offers a small-dollar loan as a more affordable alternative with a maximum APR of 36%, including fees.

"The spread is pretty thin, but it is something that we believe is doable for our membership compared to the 440% that is on average here in the state of Missouri for payday lending," said Maria Langston, assistant vice president at the credit union.

The 5% payment-to-income option would often calculate to high double digit APRs, however, and banks might not be able to offer such a product in states that have APR caps as low as 36%. Some consumer groups also say that a 5% threshold does not go far enough.

"We support a front-end ability-to-repay requirement and generally oppose exemptions," said Diane Standaert, executive vice president and director of state policy at the Center for Responsible Lending. "We don't think that an income-based assessment is enough to ensure that the loan will be safe."

Appendix H

Big Banks Want To Take The Sting Out Of Payday Loans. Predatory Lenders Are Not Happy About It.

ThinkProgress

By Alan Pyke

May 10, 2016

Federal regulations on payday lending are set to kick in nationwide later this year. When they do, a lot will change for the 12 million Americans who use them each year.

Opponents of any federal rules for the industry have long exploited that uncertainty to try to derail the Consumer Financial Protection Bureau's efforts to curb payday lending's most abusive business practices. If the anti-regulators are to be believed, the rules will flat-out kill the industry—leaving 12 million vulnerable people with no legitimate source of credit to make ends meet.

Industry Cassandras conjure images of rampant loan-sharking throughout the poorest pockets of the United States. But that fearmongering has never made sense.

The Consumer Financial Protection Bureau's (CFPB) proposed rules were explicitly tailored to allow for-profit payday and auto title lending to continue. The rules will shrink the industry's wide profit margins and end its pattern of drawing billions of dollars each year out of the relative minority of customers who get trapped in repeat borrowing cycles. But they are no headshot to the business—and indeed, should some lenders decide the new rules don't let them make enough money, the firms that remain active will have a chance to absorb that market slack and earn more money.

Now comes news that traditional brick-and-mortar banks are eager to jump back into the market once the rules are finalized. And they have a specific product in mind to help the millions of people who currently turn to payday loans—one they will only offer if the agency's regulations go through as expected.

At least three major American banks are planning to offer comparable loans at far lower cost once the rules are finalized, the American Banker reports. The banks would only discuss their plans anonymously, but the business model they sketched out to the trade paper illustrates the potential power of the rules—and the weakness of the most common arguments against them.

Still Room To Profit From Poverty

Anything that leaves millions of people to rely on high-cost short-term loans to cover their living expenses is suboptimal from a progressive policy perspective, of course. Truly big ideas to lift payday loan customers into economic security would require ambitious wealth redistribution or utopian ideas like a universal basic income. And moderate alternatives like postal banking or greater investment in non-profit community financial organizations would also reduce borrowing costs while recycling revenues into public uses rather than private profit.

But absent the political will to go big on economic security, millions of struggling families will continue to need some version of what storefront payday lenders currently offer. And getting old-school depository institutions back into that market segment to serve that demand could be a major positive step, based upon the plans these banks are quietly circulating.

The new products would only launch if the CFPB's rules go into effect as expected, because they rely upon one of the two separate regulatory tracksthe agency proposes. Rather than two-week payday loans with fixed fee structures, the banks propose longer-term loans where borrowers never owe more than 5 percent of their gross income in any given month.

That would mean a monthly pricetag of about $125 a month for a hypothetical borrower earning $30,000 a year, or roughly one sixth what such a borrower would likely pay under the business practices that the CFPB's opponents are trying to protect. The banks would expect to net just $70 per month on the loan product they are contemplating, according to the American Banker—and even lower profit for borrowers below that income level.

That's exactly the kind of severe dropoff in revenue CFPB opponents insist would kill the industry. But it's a good enough return to entice major banks back into the field.

"I think banks can make a return on it. It is not going to be significant, but it is really beneficial for the community, it is beneficial for so many consumers and I think if banks handle it correctly they can make a positive return," one of the bank executives told the trade publication.

Desperate And Deceptive

Such enthusiasm for providing a public service at a slender profit puts the lie to the alarmist reaction to the CFPB rules. Libertarians accuse the agency of trying to kill the industry and harm the poor. The industry itself warns of amass exodus from the market. In Congress, similar smears about the agency's proposal are now bipartisan—despite overwhelming statistical evidence tocontradict one of their favorite talking points—and lawmakers use backroom hearings to try to kill equivalent protections even for military families.

If the agency were really setting out to kill the industry, it would have simply instituted a hard cap on interest rates nationwide. Its two-track regulation is explicitly designed to allow continued for-profit lending of this sort, while shrinking profit margins and curbing the industry's worst abuses.

The prospect of banks re-entering this market also illustrates the public value of the modest regulatory curbs the agency has designed.

Banks' previous small-dollar credit offerings, in the form of deposit advance loans, ended up being nearly as harmful for consumers as payday loans from a storefront shop. When banks abandoned deposit-advance products amid scrutiny from the Federal Deposit Insurance Corporation and other regulators, many more low-income customers were pushed into the arms of storefront lenders.

Those lenders knowingly rely on the minority of borrowers who fall into a "debt trap" reborrowing cycle to capture the vast majority of their profits—which measure in the billions of dollars annually today. And payday lenders who operate online rather than from storefronts can be even more abusive, often flouting state law in the relatively few jurisdictions that have tried to make payday lending less harmful.

If the CFPB rules only succeeded in chasing the most unscrupulous actors out of the industry, that would probably still be a good outcome. But it would also mean these products are somewhat harder to get than they are today. At the margin, some families who need such a loan to cover their bills for the month could conceivably be harmed.

It's tough to predict exactly how the financial industry will respond to the new rules. But for every lender that decides to quit the game because modest profits aren't good enough, there will be others who see a chance to expand their market share on the still-profitable form of the loans that the agency's anti-gouging rules promote.

It is good news that some of the same banks who fled this market a few years back are now feeling drawn back into it, not because they see a high-profit loophole in the rules but because the rules create an opportunity for steady, modest returns.

Business gravitating to the 5 percent payment cap in this way "could save millions of borrowers billions of dollars" each year, Pew Charitable Trusts small-dollar credit expert Nick Bourke told the Banker.

Appendix I

Highlights from Selected Editorials

"When the bureau announced its intent to regulate payday lenders last year, it said that it was considering several safety measures, the most important of which would limit monthly payments to no more than 5 percent of the borrower's expected gross income for the same period. This would have the effect of spreading the costs and fees over the life of the loan, instead of having them come due all at once. The bureau dropped the 5 percent measure from its current proposal — after protests by lenders and others — but should resurrect it in the final version."

- New York Times Editorial Board, "A Lame Response to Predatory Loans," June 2, 2016

"Pew proposed a standard whereby loan payments would be limited to 5 percent of a borrower's monthly income. This would have enabled banks to offer a $500 loan for five months at a total cost of $125 in fees and interest, compared with $750 for an equivalent loan from a payday lender.

This might have the advantage of simplicity as compared with the CFPB's 1,300-plus-page proposed rule. Fortunately, the CFPB also declined to rule out the idea and has said it's willing to consider comments and data in support of it between now and a September deadline."

- Washington Post Editorial Board, "Regulators need to strike the right balance in limiting payday lending," June 7, 2016

"The CFPB lacks the power to cap finance charges like Colorado did, but it could do something similar. Set a ceiling of gross income — say, 5 percent — below which it will presume loan payments to be affordable. This would be straightforward, because payday lenders typically already require a pay stub or other proof of income. A clear and simple rule of that kind could attract traditional banks into the small-sum lending business — helping to lower annualized interest rates even more."

- Bloomberg Editorial Board, "Regulate Payday Lending, But Not Like This," June 14, 2016

"The experts at Pew Charitable Trusts think that the new federal rule should limit a customer's monthly payment to 5 percent of monthly income. That would allow regulated banks to be more competitive in lending to Americans, at a lower price to them."

- Kansas City Star Editorial Board, "Get tougher in reforming the disgraceful payday loan industry," June 3, 2016

"Perhaps most important, a proposal to cap payments on short-term installment loans at 5 percent of a borrower's gross income was dropped from the current draft. The Pew Charitable Trusts, which studies payday loans, notes that such a provision would bring traditional banks into this piece of the short-term loan market, making it more competitive with better rates. Without the 5 percent cap, Pew notes, a $400 three-month loan from a payday lender would carry $360 in fees. The same loan from a bank would cost $50 to $60 in fees."

- Tampa Bay Times Editorial Board, "Stronger payday loan rules protect borrowers," July 1, 2016

"This newspaper has advocated for policymakers to:

- Limit payday payments to an affordable percentage of a borrower's income. Research indicates that monthly payments above 5 percent of gross monthly income are unaffordable.

- Spread costs evenly over the life of the loan.

- Guard against harmful repayment or collection practices.

- Require concise disclosures that reveal both periodic and total costs."

- The Dallas Morning News Editorial Board, "Finding innovative alternatives to payday lenders," September 15, 2014

"One critical need is for the bureau to ban loans requiring periodic payments larger than 5 percent of a borrower's pre-tax income. Another must: rules that spread the cost of a payday loan evenly over its life. Now, because lenders' profits are typically front-loaded, they have an incentive to induce borrowers to refinance before a loan's term ends, a fee-maximizing practice known as flipping."

- The Plain Dealer Editorial Board, "Consumer Financial Protection Bureau must do its part to rein in payday-lending abuses," January 3, 2015

"Under Pew's proposal, a $400 loan, paid back over three months, would cost the borrower $50 to $60 in total fees. That's an option that many in this state would welcome."

- The Herald (WA) Editorial Board, "Tougher rules needed on payday loans," June 2, 2016

"Minnesota should also consider following the lead of Colorado, whose 2010 payday lending statute won praise from the Pew Charitable Trust last month. The law requires lenders to offer payday borrowers a six-month installment repayment plan in addition to the standard lump-sum repayment. Pew recommended capping the size of installments at 5 percent of gross periodic income."

– Star Tribune Editorial Board, "Better policing needed for payday lending," November 15, 2013

"A payday loan can devour one-third a borrower's paycheck, according to a 2013 report from the Pew Charitable Trusts -- which limits cash to pay other bills. Most borrowers can only afford to spend 5 percent of their income on a loan and still be able to pay their basic expenses, according to the report."

– The Times-Picayune Editorial Board, "Legislature needs to rein in payday loan costs," March 7, 2014

"While Heider's bill is yet to be written, there's a good chance it will offer real reform of the destructive payday lending industry. It should follow Colorado's lead, and Pew's conclusions, and require payday lenders to adopt installment payment systems designed to keep borrowers from sinking underwater."

- Times-News Editorial Board, "With Sen. Heider's Legislation, Real Payday Loan Reform Could Come," December 22, 2013

"Under Orr's bill — which is modeled largely on successful reform legislation in Colorado — payday loan customers would benefit from a six-month installment payback system instead of having their loans due in 14 days. The lenders' 456 percent APR would be trimmed by 300 percentage points. And, according to research by the Pew Charitable Trusts, Orr's bill, if passed, would inject $50 million back into the state's economy as customers retain more of their own cash."

- The Anniston Star Editorial Board, **"Loan sharks and Alabama lawmakers,"** April 5, 2016

"Sen. Kathy Campbell of Lincoln has proposed reasonable restrictions on the most extreme of the predatory practices used by payday lenders, while allowing them to stay in business. The Legislature could help Nebraskans work their way out of poverty by putting the restrictions into law. Passing LB1036 would require payday lenders to allow borrowers to pay back loans over time, rather than in a lump-sum payment that comes due after two weeks…

When a similar law was passed in Colorado, payday lenders still were able to turn a profit by becoming more efficient, according to Nick Bourke, director of small dollar loan projects for Pew Charitable Trusts. Pew says that about half of the payday lenders went out of business under the 2010 law. The remaining payday lenders serve about twice as many customers at each location. Ninety-one percent of residents still live within 20 miles of a payday lender.

Campbell's bill would remove some of the obstacles that can keep families mired in poverty as they live paycheck to paycheck -- without unduly regulating the market place. Legislators should enact it into law."

- Lincoln Journal Star Editorial Board, "Improve Payday Loans," February 20, 2016

Appendix J

THE PEW CHARITABLE TRUSTS

PAYDAY LENDING IN AMERICA:

Who Borrows, Where They Borrow, and Why

This report series, *Payday Lending in America*, presents original research findings from the Pew Safe Small-Dollar Loans Research Project on how to create a safe and transparent marketplace for those who borrow small sums of money.

www.pewtrusts.org/small-loans

THE PEW CHARITABLE TRUSTS

SAFE SMALL-DOLLAR LOANS RESEARCH PROJECT

JULY 2012

The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and stimulate civic life.

The Safe Small-Dollar Loans Research Project focuses on small-dollar credit products such as payday and automobile title loans, as well as emerging alternatives. The project works to find safe and transparent solutions to meet consumers' immediate financial needs.

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For additional information, visit www.pewtrusts.org/small-loans

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Contents

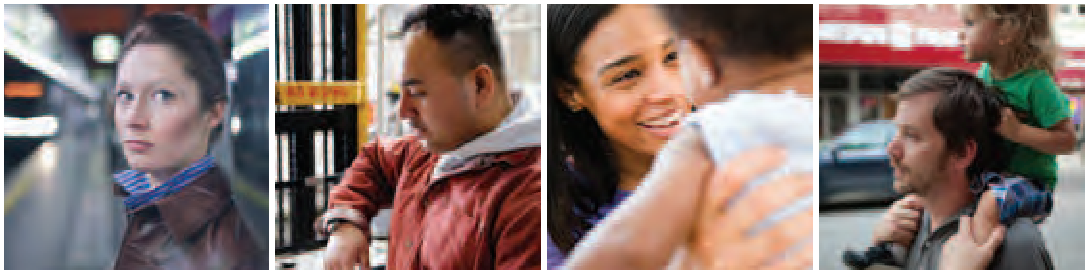
Executive Summary

Payday loan borrowers spend approximately $7.4 billion[1] annually at 20,000 storefronts and hundreds of websites, plus additional sums at a growing number of banks. The loans are a highly controversial form of credit, as borrowers find fast relief but often struggle for months to repay obligations marketed as lasting only weeks.[2] While proponents argue that payday lending is a vital way to help underserved people solve temporary cash-flow problems, opponents claim that the practice preys on overburdened people with expensive debt that is usually impossible to retire on the borrower's next payday.

Many state officials have acted to curb payday lending. However, there has been little opportunity for federal policy on payday lending until now. Resolving the debate over the ways in which payday loans and lender practices may help or harm borrowers will fall to the Consumer Financial Protection Bureau (CFPB), which Congress recently created and charged with regulating payday lending. Other federal agencies, such as the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Federal Trade Commission (FTC), also will have important roles to play as banks and online providers continue to enter the payday loan field.[3]

Existing data show that, in at least two significant respects, the payday lending market does not function as advertised. First, payday loans are sold as two-week credit products that provide fast cash, but borrowers actually are indebted for an average of five months per year. Second, despite its promise of "short-term" credit, the conventional payday loan business model requires heavy usage to be profitable—often, renewals by borrowers who are unable to repay upon their next payday. These discrepancies raise serious concerns about the current market's ability to provide clear information that enables consumers to make informed decisions.

This report, *Who Borrows, Where They Borrow, and Why*, is the first in Pew's *Payday Lending in America* series. The findings provide policy makers with research to address concerns about small-dollar loans and to promote a safe and transparent marketplace. In addition to discussing Pew's focus groups, the report presents selected results from a first-ever nationally representative telephone survey of payday borrowers. The report answers six major questions: Who are borrowers, demographically? How many people are borrowing? How much do they spend? Why do they use payday loans? What other options do they have? And do state regulations reduce payday borrowing or simply drive borrowers online instead?



Key Findings

1 Who Uses Payday Loans? Twelve million American adults use payday loans annually. On average, a borrower takes out eight loans of $375 each per year and spends $520 on interest.

Pew's survey found 5.5 percent of adults nationwide have used a payday loan in the past five years, with three-quarters of borrowers using storefront lenders and almost one-quarter borrowing online. State regulatory data show that borrowers take out eight payday loans a year, spending about $520 on interest with an average loan size of $375. Overall, 12 million Americans used a storefront or online payday loan in 2010, the most recent year for which substantial data are available.

Most payday loan borrowers are white, female, and are 25 to 44 years old. However, after controlling for other characteristics, there are five groups that have higher odds of having used a payday loan: those without a four-year college degree; home renters; African Americans; those earning below $40,000 annually; and those who are separated or divorced. It is notable that, while lower income is associated with a higher likelihood of payday loan usage, other factors can be more predictive of payday borrowing than income. For example, low-income homeowners are less prone to usage than higher-income renters: 8 percent of renters earning $40,000 to $100,000 have used payday loans, compared with 6 percent of homeowners earning $15,000 up to $40,000.

2 Why Do Borrowers Use Payday Loans? Most borrowers use payday loans to cover ordinary living expenses over the course of months, not unexpected emergencies over the course of weeks. The average borrower is indebted about five months of the year.

Payday loans are often characterized as short-term solutions for unexpected expenses, like a car repair or emergency medical need. However, an average borrower uses eight loans lasting 18 days each, and thus has a payday loan out for five months of the year. Moreover, survey respondents from across the demographic spectrum clearly indicate that they are using the loans to deal with regular, ongoing living expenses. The first time people took out a payday loan:

- 69 percent used it to cover a recurring expense, such as utilities, credit card bills, rent or mortgage payments, or food;
- 16 percent dealt with an unexpected expense, such as a car repair or emergency medical expense.

3 What Would Borrowers Do Without Payday Loans? If faced with a cash shortfall and payday loans were unavailable, 81 percent of borrowers say they would cut back on expenses. Many also would delay paying some bills, rely on friends and family, or sell personal possessions.

When presented with a hypothetical situation in which payday loans were unavailable, storefront borrowers would utilize a variety of other options. Eighty-one percent of those who have used a storefront payday loan would cut back on expenses such as food and clothing. Majorities also would delay paying bills, borrow from family or friends, or sell or pawn possessions. The options selected the most often are those that do not involve a financial institution. Forty-four percent report they would take a loan from a bank or credit union, and even fewer would use a credit card (37 percent) or borrow from an employer (17 percent).

4 Does Payday Lending Regulation Affect Usage? In states that enact strong legal protections, the result is a large net decrease in payday loan usage; borrowers are not driven to seek payday loans online or from other sources.

In states with the most stringent regulations, 2.9 percent of adults report payday loan usage in the past five years (including storefronts, online, or other sources). By comparison, overall payday loan usage is 6.3 percent in more moderately regulated states and 6.6 percent in states with the least regulation. Further, payday borrowing from online lenders and other sources varies only slightly among states that have payday lending stores and those that have none. In states where there are no stores, just five out of every 100 would-be borrowers choose to borrow payday loans online or from alternative sources such as employers or banks, while 95 choose not to use them.

Introduction

Deborah is a young mother who works full time as a teacher and is studying for a graduate degree. She has struggled to make ends meet. "It just seems like one thing after another," she said; "I can't seem to catch up." A few years ago, Deborah needed money when she could not afford both her monthly bills and her daughter's routine vaccinations. Deborah said that she has used student loans, bank loans, and credit cards when she was short on money. When she needed more, she thought she could get help from family or friends, but "I didn't want to ask somebody for it." Instead, Deborah borrowed a couple hundred dollars from a payday lender. "I was scared when I went in there, but I needed the money, and I knew it was a fast fix," she said. Deborah's loan was due in full on her next payday, but she could not come up with enough extra cash to pay the lump sum and meet her other expenses. So she renewed the loan, paying fees to push the due date to her next payday but receiving no reduction in the principal owed. It took nearly six months of renewals before she had enough money for a payment large enough to eliminate her payday loan debt. "Once my taxes came in, I just paid it off and walked away," said Deborah. "I was like 'I'm done.'"[4]

Like Deborah, a former payday loan borrower in one of Pew's focus groups, millions have turned to payday lenders when finances are tight, finding fast relief but struggling for months to repay loans that, according to marketing, are supposed to last only weeks. Payday loans are small-dollar credit products that typically range from $100 to $500, though may be larger depending on state law; the average loan is about $375.[5] Lenders usually charge about $15 per $100 borrowed per two weeks (391 percent Annual Percentage Rate or APR).[6] The loans are secured by a claim to the borrower's bank account with a post-dated check or electronic debit authorization.

Payday loans are due in full on the borrower's next payday; yet if the borrower cannot pay off the full loan plus interest, she pays a fee to extend the due date, or pays back the loan but quickly takes out a new one to cover other expenses. The loans do not amortize, so this payment does not reduce the loan principal owed. For example, a person who borrows $400 for a $60 fee for two weeks would have paid approximately $480 in fees after renewing the loan for four months, but would still owe the original $400. Most payday loans come from storefront providers with specialized state lending licenses, but similar types of small-dollar loan products are available elsewhere, including from online lenders and banks that offer "deposit advance" loans.[7]

Existing data show there are two clear problems in this market. First, payday loans are sold as two-week credit products that provide fast cash for emergencies in exchange for a fee. But the lump-sum repayment model appears to make it difficult for borrowers to avoid renewal. Pew's analysis of state and industry data indicates that borrowers are indebted for an average of about five months of the year.[8] According to one study, 76 percent of these loans, including renewals, are borrowed within two weeks following an existing payday loan's due date, meaning the borrower could not pay back the loan and make it to the next payday without another loan.[9] In addition, Pew's analysis of data from Oklahoma finds that more borrowers use at least 17 loans in a year than use just one.[10]

Second, the conventional[11] payday loan business model depends upon heavy usage—often, renewals by borrowers who are unable to repay upon their next payday—for its profitability.[12] Researchers at the Federal Reserve Bank of Kansas City concluded that, "the profitability of payday lenders depends on repeat borrowing."[13] According to industry analysts, "In a state with a $15 per $100 rate, an operator … will need a new customer to take out 4 to 5 loans before that customer becomes profitable."[14] For example, an analysis of North Carolina data found that 73 percent of lender revenue came from borrowers using seven or more loans per year.[15] Despite these realities, payday loans continue to be packaged as short-term or temporary products.

Pew's research seeks to explore these discrepancies between packaging and reality, and to demonstrate borrower experiences and outcomes. The survey discussed in this report is a first-ever nationally representative telephone poll of payday loan borrowers about their usage, conducted in two parts. Demographic data derive from 33,576 responses, representative of all adult Americans, while information about why borrowers used payday loans and what alternatives they have come from 451 interviews representative of all storefront payday loan borrowers.

PROFILE

Borrower A: **Female, white, married, non-parent, disabled, homeowner, high school, age 39, $28,000**

A slight majority of payday loan borrowers are female, and a slight majority of borrowers are also white. Those who are unable to work because of a disability have used a payday loan at higher rates than those who are employed, unemployed, homemakers, students, or retired.

1 Who Uses Payday Loans?

Twelve million American adults use payday loans annually. On average, a borrower takes out eight loans of $375 each per year and spends $520 on interest.

The Pew survey found that 5.5 percent[16] of American adults report having used a payday loan in the past five years.[17] In addition, using the most recent available data,[18] we calculate approximately 12 million[19] Americans used a storefront or online payday loan in 2010, a figure that is consistent with the 5.5 percent finding.

Although Pew's survey reveals that borrowing is concentrated among younger, low-to-moderate-income individuals, people of most ages and incomes use payday loans. Importantly, while these findings indicate which individuals are most likely to borrow, they do not imply that a given characteristic *causes* people to use payday loans.

Pew's survey found that borrowers are 52 percent women and 55 percent white; 58 percent rent their homes; 85 percent do not have a four-year college degree; 72 percent have a household income of less than $40,000; and 52 percent fall in the 25 to 44 age category. (See Appendix A for a complete demographic breakdown of payday loan borrowers.) However, these figures do not necessarily reflect the likelihood of payday loan usage among different demographic groups. For example, while slightly more women use payday loans than men, gender is not a significant predictor of payday loan usage. Similarly, like the general population, most payday loan borrowers are white, but white respondents are less likely to have used a payday loan than people of other races or ethnicities. The results presented in this section are largely consistent with prior research.[20]

WHAT DO BORROWERS SPEND?

Lenders sell payday loans as a temporary bridge to the next payday, though in reality most borrowers are indebted for much longer than one pay cycle. Payday loan consumers take out an average of eight payday loans a year,[21] often renewing an existing loan or taking out a new loan within days of repaying the previous one. Data from Florida indicate that borrowers who take at least 12 loans in a year use 63 percent of all payday loans.[22] The average loan is about $375.[23] Three-quarters of payday loans come from storefronts, with an average fee of $55 per loan, and roughly one-quarter originate online, with an average fee of $95. Using these figures, we calculate that the average borrower spends about $520 on interest each year.[24]

How much borrowers spend on loans depends heavily on the fees permitted by their state. The same $500 storefront loan would generally cost about $55 in Florida, $75 in Nebraska, $87.50 in Alabama, and $100 in Texas, even if it were provided by the same national company in all of those states. Previous research has found that lenders tend to charge the maximum permitted in a state.[25]

For an analysis of how borrowers in each demographic group obtain their loans (i.e., from storefronts versus online), see Exhibit 13 on page 28. For more information on the findings regarding these groups, see our website at www.pewtrusts.org/small-loans.

Which demographic traits best predict loan usage, after controlling for other factors?

Pew researchers developed a logistic regression model to evaluate how certain characteristics relate to usage, while controlling for other factors. Among these characteristics, the odds of payday loan usage are:

57 percent higher for renters than for homeowners;

62 percent higher for those earning less than $40,000 annually than for those earning more;

82 percent higher for those with some college education or less than for those with a four-year degree or more;

103 percent higher for those who are separated or divorced than for those of all other marital statuses (single, living with a partner, married, or widowed); and

105 percent higher for African Americans than for other races/ethnicities.

For more on the model and the characteristics tested, see Appendix B.

EXHIBIT 1:

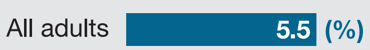
PAYDAY LOAN USAGE BY DEMOGRAPHIC

Percentage of Each Subgroup Reporting Payday Loan Usage

Certain demographic groups are more likely than others to have used a payday loan in the past five years.

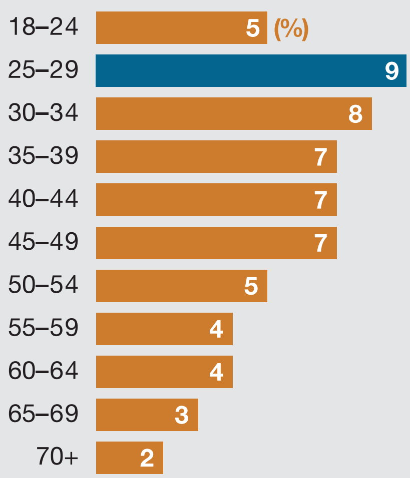
OVERALL

5.5 percent of all adult Americans have used a payday loan.



AGE

9 percent of adults aged 25-29 have used a payday loan.



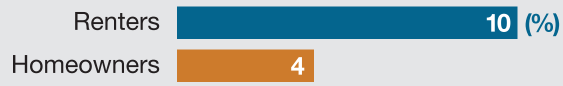
People ages 25 to 49 have used payday loans at a higher rate than the general population. By contrast, loan use is below average among 18-to-24-year-olds and those age 50 or older. There is relatively little usage by senior citizens, with just 2 percent of those 70 and older having used payday loans.

NOTE: Data represent percentage of adults in each category who report having used a payday loan in the past five years. Results are based on 33,576 interviews conducted from August through December 2011.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

RENTERS VS. HOMEOWNERS

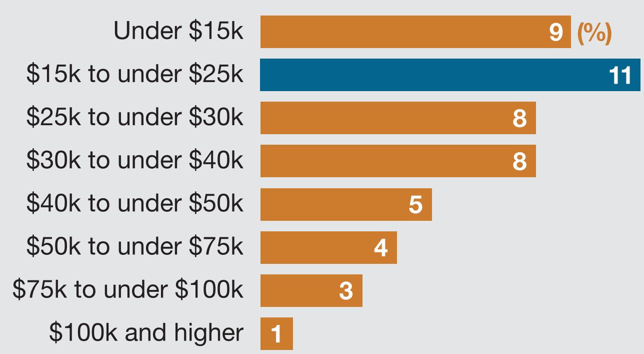
10 percent of renters have used a payday loan.



Renters have used payday loans at more than double the rate of homeowners. This sharp difference in usage between homeowners and renters persists in every age cohort. While payday loan usage is largely concentrated among those ages 25 to 49, among 50-to-69-year-old renters, fully one in 10 has used a payday loan, more than triple the rate for 50-to-69-year-old homeowners. Furthermore, renters' usage of payday loans is far higher than that of homeowners across the income distribution. For example, 8 percent of renters earning $40,000 to $100,000 have used payday loans, compared with 6 percent of homeowners earning $15,000 up to $40,000.

INCOME

11 percent of those earning $15,000 up to $25,000 have used a payday loan.



Respondents with household incomes less than $40,000 are almost three times as likely to have used payday loans as respondents with household incomes of $50,000 or more. Respondents from every income group report using payday loans, with loan usage the highest (11 percent) for those earning $15,000 up to 25,000 and lowest (1 percent) for those earning over $100,000. Except for those earning under $15,000, the relationship between income and payday loan usage is an inverse one, with borrowing decreasing as income increases.

EXHIBIT 1:

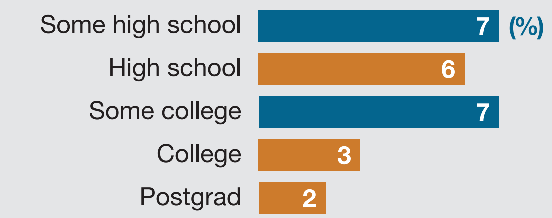
PAYDAY LOAN USAGE BY DEMOGRAPHIC

Percentage of Each Subgroup Reporting Payday Loan Usage

(CONTINUED)

EDUCATION STATUS

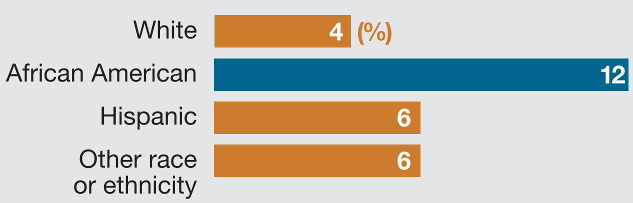
7 percent of those with some high school or some college have used a payday loan.



Those without a four-year college degree are much more likely to have used payday loans than those who have a degree. But among those without a four-year degree, further differences in education level do not correspond with significant differences in payday loan usage.

RACE AND ETHNICITY

12 percent of African Americans have used a payday loan.



African American respondents are more than twice as likely as others to have used a payday loan but make up less than a quarter of all payday borrowers, as compared with whites who comprise 55 percent of all borrowers.

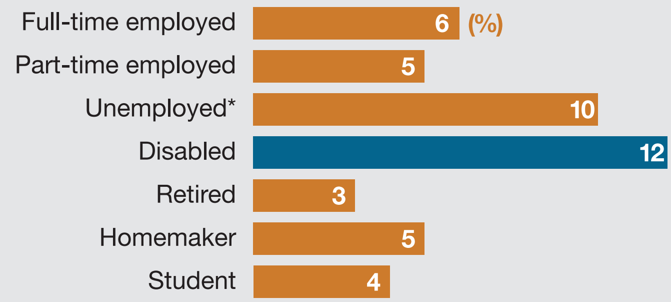
PARENTAL STATUS

8 percent of parents have used a payday loan.

Parents are more likely to have used payday loans than those who are not parents, especially among those earning less than $50,000. Twelve percent of parents earning less than $50,000 have used a payday loan, compared with just 4 percent of parents earning $50,000 or more.

EMPLOYMENT STATUS

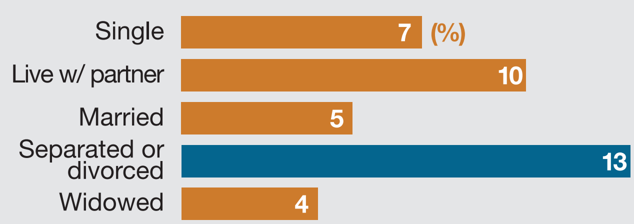
12 percent of those who are disabled have used a payday loan.



Those who are currently disabled or unemployed have used payday loans at the highest rates in the past five years, although it is possible that they were employed at the time they borrowed. However, those who are employed make up a majority of all payday borrowers, and an income stream is a requirement for obtaining a payday loan.

MARITAL STATUS

13 percent of those who are separated or divorced have used a payday loan.



Those who are separated or divorced are most likely to have borrowed. Thirteen percent of separated or divorced individuals report payday loan usage, a rate twice that of all other respondents.

*Payday lenders generally will lend only to someone with an income stream. It is possible that unemployed people were employed at the time of their last payday loan, or they are receiving a loan based on some other form of income, such as a benefits check.

NOTE: Data represent percentage of adults in each category who report having used a payday loan in the past five years. Results are based on 33,576 interviews conducted from August through December 2011.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

PAYDAY LOAN USAGE BY GEOGRAPHY

Pew's survey revealed that payday loan usage is highest in parts of the South and Midwest Census regions (e.g., 13 percent of adults have borrowed in Oklahoma and 11 percent in Missouri, two of the leading payday loan states) and is significantly higher in urban areas as compared with the suburbs. A major factor causing the significant variation in payday loan usage by Census region and division is the difference in how states regulate payday loans, detailed on page 20.

EXHIBIT 2:

PAYDAY LOAN BORROWING MORE COMMON IN CITIES

7 percent of those living in cities have used a payday loan.

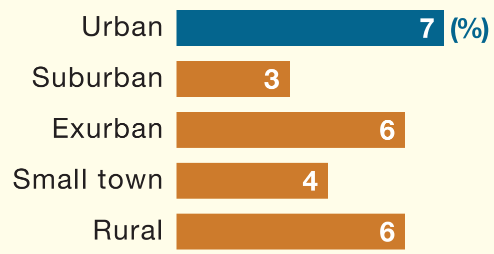
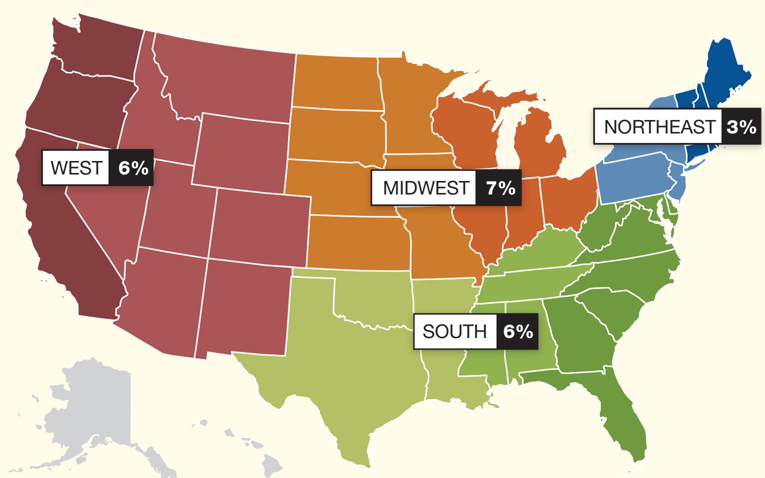
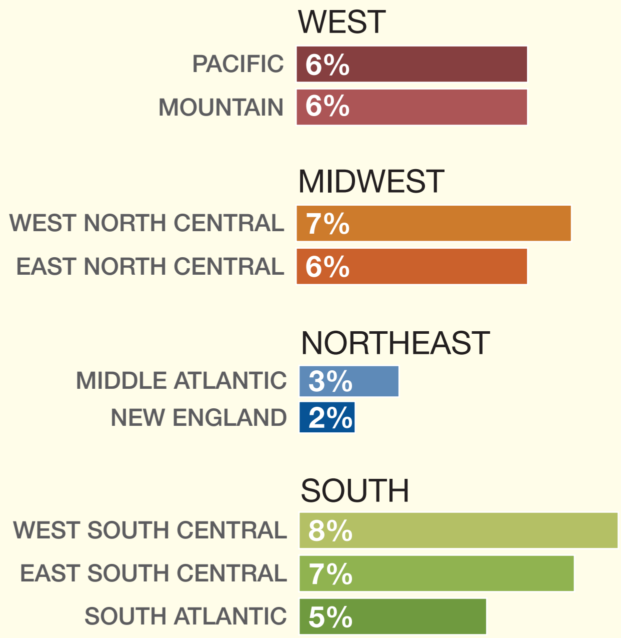


EXHIBIT 3:

PAYDAY LOAN USAGE BY GEOGRAPHIC GROUPING





NOTES: Exhibit 2: **Exurban** (Inside a Suburban County of the MSA); **Small town** (In an MSA that has no Center City); **Rural** (Not in an MSA), **Urban** (In the Center City of an MSA), **Suburban** (Outside the Center City of an MSA, but inside the county containing the Center City). The Office of Management and Budget classifies geographic areas into Metropolitan and Micropolitan Statistical Areas (MSA), and these groupings are used by the U.S. Census Bureau. The higher usage in cities is consistent with previous research demonstrating that, historically, payday lending has been tied to relatively densely populated areas, as described in Robert Mayer's *Quick Cash*. This rate is significantly higher than the 3 percent of suburban-area residents who report having used payday loans. Data represent payday loan usage by geographic area in the contiguous United States.

Exhibit 3: Regions and divisions are those used by the U.S. Census Bureau. Data represent payday loan usage by geographic area in the contiguous United States. For state-level data, see www.pewtrusts.org/small-loans.

No surveys were conducted in AK and HI.

Results from Exhibits 3 and 4 are based on 33,576 interviews conducted from August to December 2011.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

2 Why Do Borrowers Use Payday Loans?

Most borrowers use payday loans to cover ordinary living expenses over the course of months, not unexpected emergencies over the course of weeks. The average borrower is indebted about five months of the year.

Pew's survey asked borrowers why they first took out a payday loan. As illustrated in Exhibit 4, borrowers' initial reasons stem from an ongoing need for income, rather than a short-term need to cover an unexpected expense.[26] Four times more storefront borrowers used their first payday loans for a recurring expense (69 percent) than for an unexpected expense (16 percent).

These findings provide a sharp contrast with the conventional image of payday loans, which are advertised as short-term, small-dollar credit intended for emergency or special use. Industry, advocates, and regulators all suggest that using payday loans for recurring expenses is not an effective use of high-cost credit and that, rather, such credit should be used to cover unexpected expenses for a short period of time.[27] Yet, 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,[28] and much of this borrowing comes in relatively quick succession once someone begins using payday loans.[29] Pew's analysis of existing data found that an average borrower is in payday loan debt for five months per year, using eight loans that last 18 days each.[30]

PROFILE

Borrower B: **Male, Hispanic, divorced, non-parent, full-time employed, renter, associate's degree, age 44, $17,000**

Divorced or separated men are more likely to have used a payday loan than their female counterparts. Renters are three times more likely to have used a payday loan than homeowners, while those earning $15,000-$25,000 are the most likely to have used a payday loan.

■ Regular, Ongoing Expenses

Female borrower, Chicago:
"I was behind on my mortgage and cable bill."

Male borrower, Chicago:
"Just need to get to the next paycheck. And I need, you know, either pay the bill to keep the lights on, or need some food, or whatever it is."

Female borrower, San Francisco:
"If I have bills to pay, or say I need food on the table, I am going."

Male borrower, San Francisco:
"Well, I was a little short and was thinking I could use some more money and I was at the ATM actually, and it was there, offering me a direct deposit advance. So, I thought I would try it."

■ Unexpected Emergency/Expense

Male borrower, New York:
"I got mine because my son got in a car accident."

Male borrower, New York:
"I had to get money for my car to get fixed."

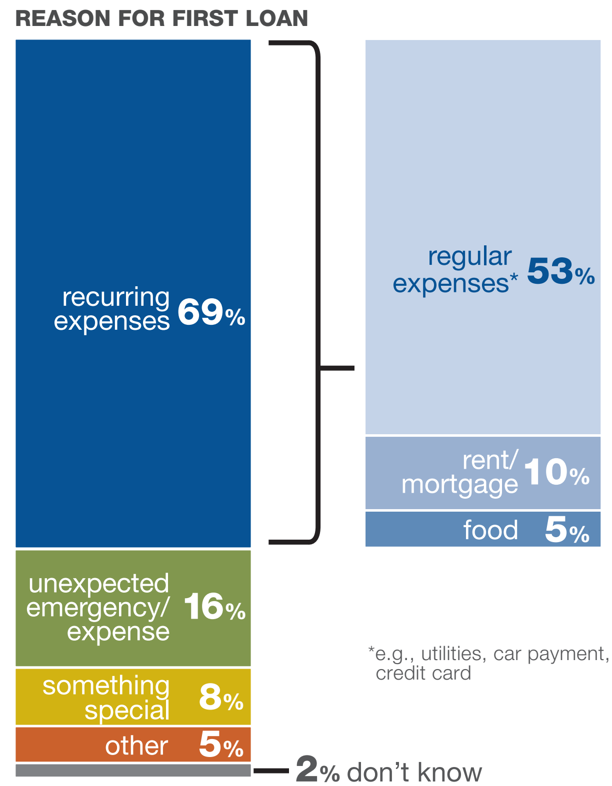
■ Something Special

Female borrower, San Francisco:
"It was the holidays and I just needed some extra cash to get gifts and help out with Christmas dinner and do my part."

Male borrower, San Francisco:
"It was a frivolous expense. Some friends wanted us to accompany them on an out-of-town trip… and I thought, 'why not?'"

EXHIBIT 4:

MOST BORROWERS USE PAYDAY LOANS FOR RECURRING EXPENSES



NOTES: Data represent percentage of borrowers who reported the reason for using their first payday loan based on 451 interviews. December 2011 - March 2012. Sampling error for the full-length survey of storefront payday loan borrowers is +/- 4.6 percentage points.

Survey participants were asked: Thinking back now to (that FIRST/the) time you took out a (online payday loan/payday loan/auto title loan), which of the following best describes what specifically you needed the money for?

1 To pay rent or a mortgage
2 To pay for food and groceries
3 To pay a regular expense, such as utilities, car payment, credit card bill, or prescription drugs
4 To pay an unexpected expense, such as a car repair or emergency medical expense
5 To pay for something special, such as a vacation, entertainment, or gifts
6 (Do not read) Other (specify)

The combined results for "Recurring Expenses" include Regular Expense (53 percent), Rent or Mortgage (10 percent), and Food (5 percent) and add to 69 rather than the expected 68 because of rounding decimals. The response options were randomized in this and other survey questions, so the order in which the respondent heard them varied to eliminate order bias.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

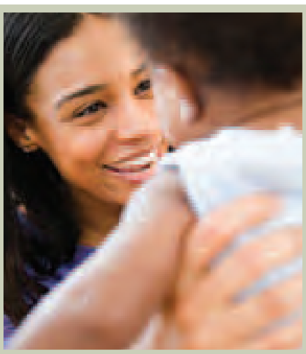
PAYDAY LOAN MARKETING VS. PRACTICE

Payday loans are frequently described as short-term credit for unexpected expenses, and marketing materials sometimes inform borrowers that payday loans are not intended for long-term use.[31] The industry advertises this small-dollar form of credit as a product that offers borrowers "access to a financial option intended to cover small, often unexpected, expenses," but states that a payday loan "is not meant to be a long-term solution."[32] A large payday lender warns in its direct mail advertisements: "Short-term loans are not intended to be long-term financial solutions."[33] Another warns: "Payday advances should be used for short-term financial needs only, not as a long-term financial solution."[34]

Despite these warnings, repeat borrowing is the norm. Prior research indicates that borrowers are indebted for an average of five to seven months of the year.[35] As a report by the Federal Reserve Bank of Kansas City Economic Research Department concluded, "The profitability of payday lenders depends on repeat borrowing."[36]

The dependence on repeat borrowing is illustrated by the reaction of payday lenders to a recent Washington State law limiting borrowers to eight loans per year. The largest storefront lender in the United States "decided to close an additional 30 centers in the State of Washington where changes in the law there have greatly affected our ability to operate profitably in that state."[37] Similarly, according to industry analysts, "In a state with a $15 per $100 rate, an operator … will need a new customer to take out 4 to 5 loans before that customer becomes profitable."[38]

The industry's stated best practices include limiting rollovers to four per person (or the state maximum) and providing extended repayment plans to borrowers who are unable to repay their loan within the original term.[39] Despite the promotion of these standards, marketing practices differ greatly. One key area of inconsistency is the practice among lenders of offering incentives to encourage habitual loan usage, such as discounts for repeat borrowing and referral bonuses.[40] As an example, one of the largest online payday lenders, which is affiliated with the largest storefront lender, offers a "Preferred Member Bonus" (Silver Status after five payday loans, Gold Status after 10 payday loans, and Platinum Status after 15 payday loans).[41]



PROFILE

Borrower C: **Female, African American, married, parent, part-time employed, renter, some college, age 28, $32,000**

African Americans are more likely than people of other races to have used a payday loan. People ages 25-29 are more likely to have used payday loans than those in any other age group. Parents are much more likely than non-parents to have used a payday loan, regardless of marital status.

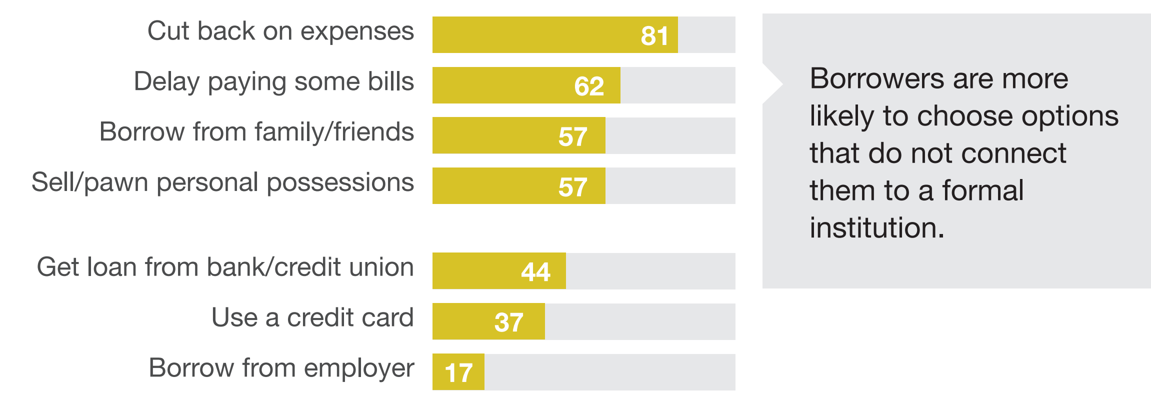
3 What Would Borrowers Do Without Payday Loans?

If faced with a cash shortfall and payday loans were unavailable, 81 percent of borrowers say they would cut back on expenses. Many also would delay paying some bills, rely on friends and family, or sell personal possessions.

Even though most borrowers use payday loans for recurring expenses, rather than for emergencies, survey respondents indicated they would use a variety of options to deal with those needs if payday loans were no longer available. In general, borrowers are more likely to choose options—such as adjusting their budgets, delaying bills, selling or pawning personal items, or borrowing from family or friends—that do not connect them to a formal institution. Eighty-one percent of payday borrowers say they would cut back on expenses if payday loans were unavailable.

EXHIBIT 5:

ALTERNATIVES IF PAYDAY LOANS WERE UNAVAILABLE



NOTES: Data represent percentage of borrowers who would use each of these strategies if payday loans were unavailable, based on 451 interviews, December 2011 to March 2012.

Survey participants were asked: “I'm going to read you several options. For each, tell me whether you would use this option if you were short on cash and short-term loans of any kind no longer existed. How about (method)? Would you use this option or not?” The “borrow from employer” item was only asked of employed respondents.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

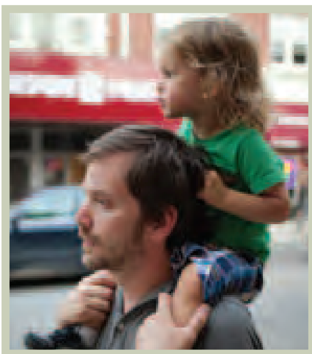
These survey findings are consistent with tactics described by former payday loan borrowers in a focus group Pew conducted in late 2011 near Manchester, New Hampshire, to find out what residents are doing now that there are no longer storefront payday lenders there. In that group, payday loan borrowers discussed various strategies they use in place of payday loans, such as re-budgeting, prioritizing bills, pawning or selling belongings, borrowing from family members, or, as one borrower stated, working out "payment plans with utility companies." Another borrower discussed prioritizing money: "I budget. I do my best, but the main thing that has to get paid is that mortgage . . . I pay that mortgage, I pay my car, I pay my insurance, and whatever is left over, that's what everything else gets paid with."

While a majority of surveyed borrowers said they would not take out a loan from a bank or credit union, many focus group participants throughout the country expressed that they would rather borrow from a bank or a credit union than from a payday lender if that option were available to them. The fact that a majority of survey respondents failed to list banks or credit unions as options may reflect an expectation, demonstrated among many focus group members, that they would not be approved for a loan.

Similarly, the fact that most survey respondents would not use credit cards may reflect a sentiment that those products are not available to them. Most, though not all, focus group participants nationwide indicated that they had maxed out their credit cards or believed they would not qualify. The reluctance to view credit cards as an alternative also may stem from confusion among some borrowers about whether the interest rate on a credit card is higher or lower than the interest rate on a payday loan. On several occasions, borrowers in focus groups equated the simple interest rate (e.g., 15 percent for a loan with a $15 per $100 fee for two weeks) with the Annual Percentage Rate disclosed for a credit card (which might be 15 percent on an annual basis). For example, a borrower from Alabama stated: "Because the interest on . . . some credit cards [is] 23.99 percent. So if you go charge $300, and then you don't pay that $300 off at the end of the month . . . they're going to tack that 23.99 percent on to it, so you're going to still be paying more than you would if you had to [get a payday loan]."

Previous surveys have found similar results to Pew's findings about payday loan alternatives. A study of former storefront payday loan borrowers in North Carolina found households have other ways to cope with cash shortfalls. For example, borrowers who experienced a shortfall within the previous three years chose instead to delay expenses (52 percent), use savings (44 percent), or borrow from family or friends (42 percent).[42] A study of

California payday loan borrowers found that of those who decided not to take out a payday loan explicitly because of the interest rate or fee, 47 percent chose to borrow from family or friends and 26 percent elected to wait until payday. In addition, for borrowers who were unable to obtain the full amount they needed from a payday lender, most chose to borrow the additional amount from family or friends.[43] Another survey of low- to moderate-income people in parts of Texas revealed that while 23 percent had used a payday loan, far more (60 percent) had borrowed from family or friends. Among payday loan borrowers in that study, 45 percent indicated they also borrowed from family or friends.[44]



PROFILE

Borrower D: **Male, white, separated, parent, full-time employed, renter, associate's degree, age 32, $41,000**

Separated people are far more likely to have used a payday loan than those of any other marital status. People who do not have a four-year college degree are much more likely to have used a payday loan than college graduates.

4 Does Payday Lending Regulation Affect Usage?

In states that enact strong legal protections, the result is a large net decrease in payday loan usage; borrowers are not driven to seek payday loans online or from other sources.

Modern payday loans owe their existence to efforts, mostly in the 1990s, to create custom exemptions to state laws that otherwise would prohibit such small-dollar loans or apply usury interest rate caps. Since then, the wisdom of allowing payday lending has been a hotly contested issue among state policy makers and stakeholders. States have deployed a variety of strategies designed to prohibit, control, or enable this form of small-dollar credit.

EXAMPLES OF STATE LAW TYPES

MISSOURI (PERMISSIVE)

Missouri permits single-repayment payday loans with finance charges and interest not to exceed 75 percent of the borrowed principal. The 2011 payday lending report from Missouri's Division of Finance cites a fee of $52.45 for a 14-day loan of $307.56 (444.61 percent APR).[45] Payday loans are available for up to $500.

Incidence: 9.7 percent storefront, 1.5 percent online

FLORIDA (HYBRID)

Florida permits single-repayment payday loans with fees of 10 percent of the borrowed principal, along with a $5 fee for borrower verification with a state database of payday loan users. Payday loans are available for up to $500 and each borrower may have out only one payday loan at any given time.

Incidence: 6.6 percent storefront, 0.6 percent online

GEORGIA (RESTRICTIVE)

Georgia state statute prohibits payday lending in most forms. As in other jurisdictions, many banks and credit unions are exempt from the restriction on payday lending in the state.

Incidence: 1.9 percent storefront, 0.5 percent online

In the past decade, some states—most recently including Arizona, Arkansas, Montana, and New Hampshire—have revived consumer protections and rolled back laws that authorized payday loans. These states have reimposed usury interest rate caps or discontinued payday lenders' exemptions from these usury limits. Other states have limited the number of high-cost loans or renewals that a lender may offer to an individual, in an attempt to enhance borrowers' ability to repay debts in a timely fashion.[46]

Following a thorough review, Pew identified three categories of state payday loan regulation. (See Exhibit 6 for a complete breakdown of the states. See www.pewtrusts.org/small-loans for a compilation of relevant laws by state and a short history of payday lending law.)

- **Permissive states are the least regulated and allow initial fees of 15 percent of the borrowed principal or higher.** Most of these states have some regulations, but allow for payday loans due in full on a borrower's next payday with Annual Percentage Rates (APRs) usually in the range of 391 to 521 percent ($15 to $20 per $100 borrowed per two weeks). Payday loan storefronts are readily available to borrowers located in these states.[47] Most Americans—55 percent—live in the 28 Permissive states.

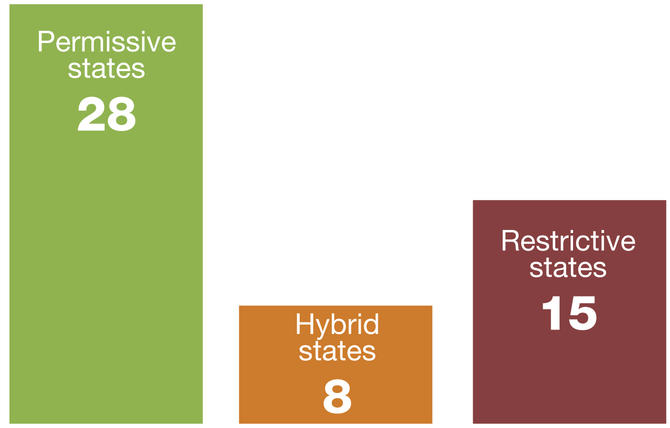
- **Hybrid states have relatively more exacting requirements than Permissive states,** with at least one of the following three forms of regulation: (1) rate caps, usually around 10 percent of the borrowed principal, which are lower than most states but still permit loans to be issued with triple-digit APRs; (2) restrictions on the number of loans per borrower, such as a maximum of eight loans per borrower per year; or (3) allowing borrowers multiple pay periods to repay loans. Storefronts that offer payday loans exist in substantial numbers in these states,[48] though the market may be more consolidated and per-store loan volume may be higher here than in less restrictive states.[49] Sixteen percent of Americans live in the eight Hybrid states.

- **Restrictive states either do not permit payday lending or have price caps low enough to eliminate payday lending in the state.** This rate cap often is 36 percent APR. Generally, payday loan storefronts are not found in these states. This category includes states where deferred presentment transactions (post-dated checks) are not authorized, are not specifically exempted from general state laws on usury, or are explicitly prohibited by state statute. Twenty-nine percent of Americans live in the 14 states and the District of Columbia that have a Restrictive payday loan regulatory structure.

EXHIBIT 6:

HOW STATES REGULATE PAYDAY LENDING

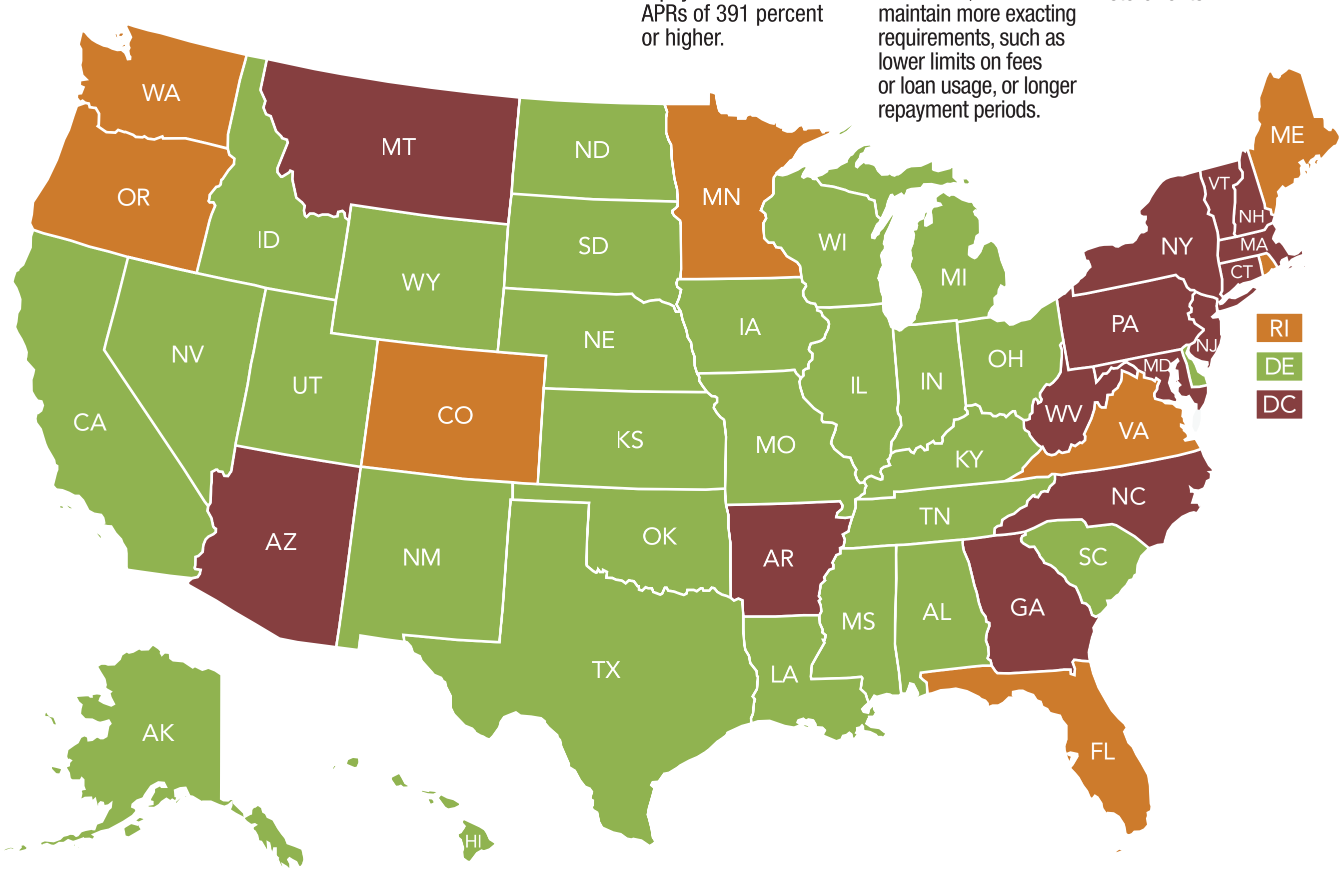
States have deployed a variety of strategies designed to prohibit, control, or enable this form of small-dollar credit.



Allow single-repayment loans with APRs of 391 percent or higher.

Have payday loan storefronts, but maintain more exacting requirements, such as lower limits on fees or loan usage, or longer repayment periods.

Have no payday loan storefronts.



SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

Payday Lending Regulation Not Leading to Increased Online Borrowing

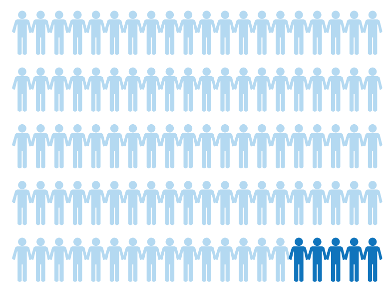
A key issue being discussed in state legislatures is whether restricting storefront payday lenders will lead borrowers to obtain loans from the Internet or other sources instead.[50] Consumer advocates[51] and some storefront lenders[52] have warned that other forms of lending, particularly online payday lending, could harm borrowers because they often occur outside the reach of state regulators. (Pew has seen evidence of fraud, abuse, and other problems with online payday lending, and will explore these later in this report series.)

However, Pew found that in Restrictive states, payday loan usage from all sources combined is far lower as compared with other states (see Exhibit 8).[53] Storefront payday loan usage is 75 percent lower in Restrictive than in Permissive states,[54] while online and other payday loan usage is only slightly higher (this difference is not statistically significant). Thus, the vast majority of would-be storefront borrowers in Restrictive states are not going online or to other providers to obtain payday loans instead.

Our data show that, in states that enact strong legal protections, the result is a large net decrease in payday loan usage (see page 23).

EXHIBIT 7:

In states that restrict storefront payday lending, 95 of 100 would-be borrowers elect not to use payday loans at all—just five borrow online or elsewhere.



SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

- Restrictive payday loan laws lead to 393 fewer storefront borrowers per 10,000 people;
- Of these, just 21 (5 percent) go online or elsewhere to get a payday loan; and
- The remaining 372 (95 percent) do not use payday loans.

In other words, in states that restrict storefront payday lending, 95 of 100 would-be borrowers elect not to use payday loans at all—just five borrow online or elsewhere.

PAYDAY BORROWING FAR LOWER IN RESTRICTIVE STATES THAN IN PERMISSIVE STATES

There is significantly less payday loan usage in states with strong legal protections because most people are not getting payday loans from the Internet or other sources instead. Although online payday lending and other sources may continue to experience substantial growth in coming years, these data give no indication that regulation of payday loan storefronts would fuel this growth. While online borrowing often is discussed as a problem in states without storefronts, it is nearly as prevalent in states with payday loan stores. In Permissive states, fully one-third of online borrowers also have borrowed from stores, choosing both methods rather than one or the other.

EXHIBIT 8:

NUMBER OF BORROWERS PER 10,000 POPULATION

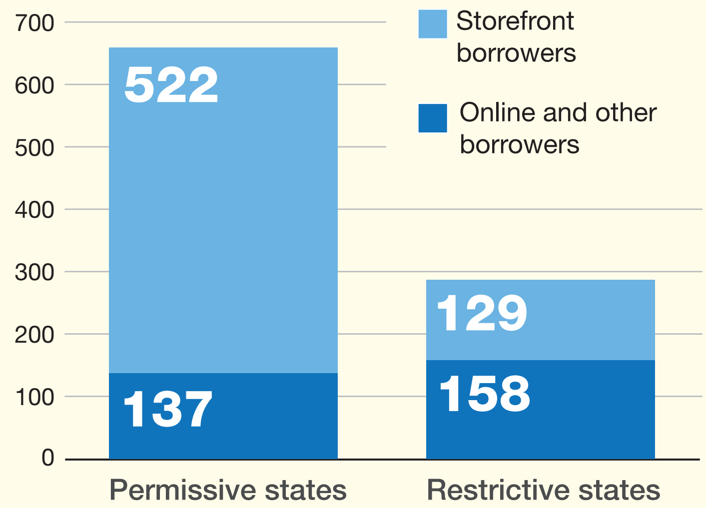


EXHIBIT 9:

METHOD OF ACQUIRING PAYDAY LOANS BY STATE LAW TYPE

Percentage of adults reporting payday loan usage in the past five years

	BORROW FROM STOREFRONT ONLY	BORROW FROM ONLINE OR OTHER*	NUMBER OF INTERVIEWS
National	**4.01%**	**1.48%**	33,576
Permissive states	**5.22%**	**1.37%**	17,881
Hybrid states	**5.06%**	**1.28%**	5,565
Restrictive states	**1.29%**	**1.58%**	10,130

NOTES: *Online or other represents all borrowers who have indicated online usage (including those who have borrowed both online *and* from a storefront), plus usage from other lenders that may include banks, credit unions, or employers, among others. Results are reported to two decimal places, but this reporting is not intended to imply such a detailed level of precision. Rather, two decimal places are used in order to avoid inaccurate calculations between groupings that could be caused by rounding. Because of sampling error, it is possible that the true level of usage in any of these groupings is slightly higher or lower.

Restrictive states are those that have no payday loan storefronts. Permissive states allow single-repayment loans with APRs of 391 percent or higher. Hybrid states have payday loan storefronts, but maintain more exacting requirements, such as lower limits on fees or loan usage, or longer repayment periods.

Data represent percentage of adults in each category who report having used a payday loan in the past five years. Results are based on 33,576 interviews conducted from August 2011 through December 2011.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

This analysis makes an evidence-based assumption backed by strong empirical data that inherent demand for payday loans is similar in Restrictive and Permissive states. Store counts from 2006 in the four states that have most recently adopted a Restrictive regulatory strategy after previously being Permissive—Arkansas, Arizona, Montana, and New Hampshire—show a similar number of stores per capita as in the other then-Permissive states: 5.5 percent fewer stores (0.64 fewer stores) per 100,000 residents in 2006 than their counterparts that remain Permissive (see Exhibit 10).[55] This fairly small difference in payday lenders per capita suggests there is not large variation between these two state groupings in demand for payday loans.[56] Other Restrictive states, such as North Carolina and Georgia, that were previously Permissive, also had heavy payday loan activity before changing their laws.[57]

EXHIBIT 10:

PAYDAY LOAN STOREFRONTS

STATE LAW TYPE	STOREFRONTS PER 100,000 RESIDENTS IN 2006
PERMISSIVE IN 2012 (WERE PERMISSIVE IN 2006)	11.57
RESTRICTIVE IN 2012 (WERE PERMISSIVE IN 2006)	10.93

NOTES: These figures are based on our analysis of state-by-state storefront data from Steven Graves and Christopher Peterson. Restrictive states are those that have no payday loan storefronts. Permissive states allow single-repayment loans with APRs of 391 percent or higher.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012; Graves and Peterson (2008).

Pew also conducted a logistic regression analysis to examine the effect of state law type on the odds of payday borrowing, controlling for borrower demographic characteristics. The findings are that the odds of payday loan usage for people who live in a Permissive or Hybrid state are 169 percent higher than for those who live in a Restrictive state, meaning a person's state of residence is a highly significant factor in predicting payday loan usage, even after controlling for borrower demographics.

To examine whether these data were considerably impacted by changes in state laws during the period of inquiry in our survey, Pew compared incidence in states that changed their laws during the past five years and those that did not.[58] There was relatively little difference in incidence of payday loan usage between states that had Restrictive regulation prior to 2007 (2.93 percent) and those five states that implemented Restrictive regulation after January 2007 (2.46 percent). Usage rates are similarly close for states with Hybrid regulation prior to 2007 (6.14 percent) and the five states that implemented Hybrid regulation in 2007 or later (6.43 percent).

Prior research has found "no evidence that prohibitions and price caps on one AFS (Alternative Financial Services) product lead consumers to use other AFS products."[59] Our research builds on that finding, revealing that the vast majority of would-be borrowers do not even substitute a new method (using the Internet instead of a storefront) to obtain the same AFS product, which in this case is a payday loan.[60]

Payday Lending Regulation Not Driving Increase in Borrower Complaints

Another issue that state legislators and regulators have considered is whether payday lending restrictions could be driving an increase in borrower complaints.[61]

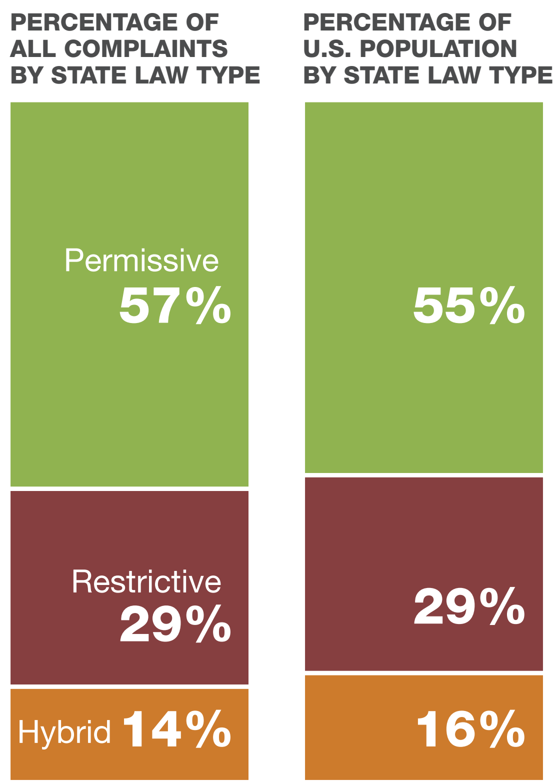
Consumer advocates also have been concerned that an increase in complaints may be driven by online lenders.[62] Given that online borrowing is nearly as prevalent in Permissive states (1.08 percent) as in Restrictive ones (1.21 percent), the rate of complaints increasing more in one type of state than another seems unlikely.

The Better Business Bureau reports that complaints against payday lenders are on the rise.[63] While online borrowing generally may indeed be driving this increase, there is no indication that the increase is attributable to efforts to regulate storefront payday lending. As shown in Exhibit 11, Pew's analysis of the complaints received by the Better Business Bureau in 2011 finds state regulations are not driving complaints against payday lenders. Twenty-nine percent of all complaints against payday lenders were filed by residents of Restrictive states, identical to the 29 percent of Americans who live in those states. Similarly, 55 percent of Americans live in Permissive states, and they filed 57 percent of complaints against payday lenders. Sixteen percent of the population lives in Hybrid states, and they filed 14 percent of payday lending complaints.

EXHIBIT 11:

STATE LAWS ARE NOT DRIVING PAYDAY LOAN COMPLAINTS

The percentage of complaints against payday lenders received by the Better Business Bureau in each state law grouping closely mirrors the percentage of the population living in those states, suggesting that regulation is not driving complaints.



NOTE: Complaints are those received by the Better Business Bureau about payday lenders in 2011.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012; Better Business Bureau.

More evidence that complaints are not driven by consumer protections comes from Washington State, where complaints have been increasing, but the increase does not coincide with the recent change from a Permissive to a Hybrid regulatory model. Complaints increased 76 percent from 2008 to 2009, when there was no change in the law, and 50 percent from 2009 to 2010, when a change in the law took place.[64] Similarly, data Pew collected from state regulators show that from 2009 to 2011, Arkansas (Restrictive) had a 128 percent increase in complaints, Maine (Hybrid) had a 52 percent increase, and Missouri (Permissive) had a 107 percent increase.[65]

FORMER BORROWERS SPEAK ABOUT THE CHOICE BETWEEN STOREFRONT AND ONLINE

During a focus group in New Hampshire, former storefront payday loan borrowers dismissed the online option:

> **"I won't leave my information there."**
>
> **"There's no face-to-face contact … [I]f my identity was to be stolen, well who stole it?"**
>
> **"It's too risky, in my opinion."**
>
> **"With the identity theft the way it is … who's going to see it?"**
>
> **"I'm not going to put [my] information out there."**

Another former borrower noted that she had used online payday loans in New Hampshire when storefronts were still present, in order to pay off her storefront payday loans:

> **"I had to come up with money [when] my husband was out of work, and I actually was up to $900 [in storefront payday loan debt] ... My entire check was gone the next two weeks, so that's when I went to the online ones ... And then after I did the online ones, and got in that loop, and got stuck in there, I went back to the store again, and, yeah, it got bad. And my [checking] account ended up pretty negative. I had to close it out totally."**

NOTE: The focus group comprised only those people who had taken payday loans from storefronts before a recent New Hampshire law eliminated storefront payday lending.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

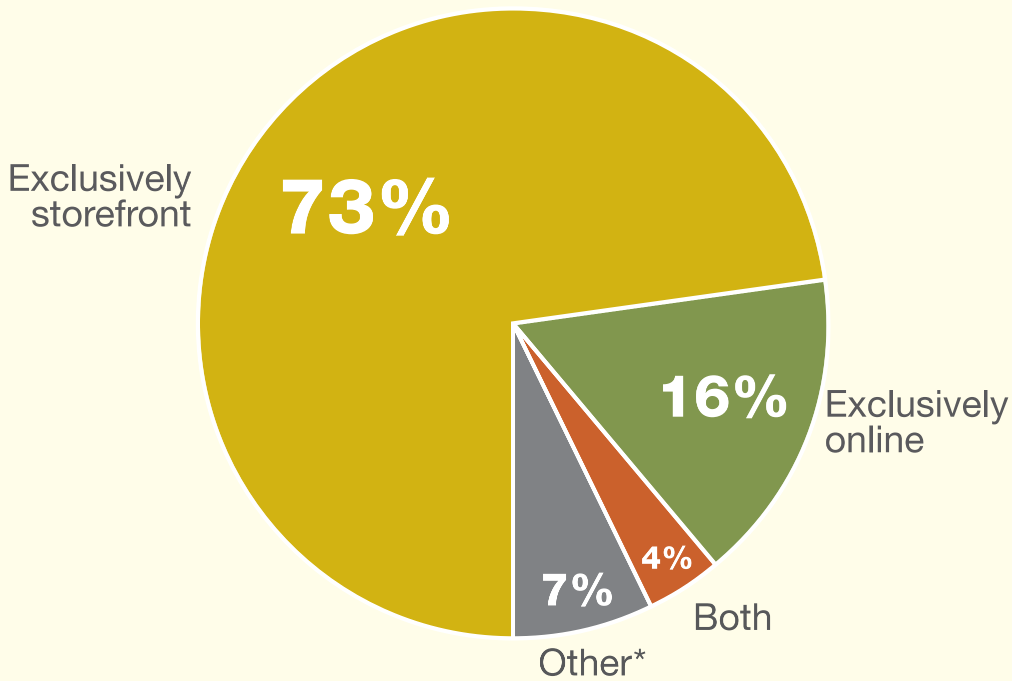
Pew's survey shows that retail storefronts are the exclusive source of payday loans for nearly three out of every four borrowers, while only one in six borrowers reports having used online providers exclusively (see Exhibit 12). About one in 10 borrowers has used both storefront and online providers or other types of providers, which may include banks or employers.[66]

While the overwhelming majority of borrowers use storefronts to get payday loans, certain groups are more likely than others to use online lenders (see Exhibit 13). Those who most often go online for loans tend to be younger, have incomes above $50,000, and have a college degree (for example, 41 percent of payday loan borrowers with a college degree used online lenders, and 66 percent used storefront lenders). These are the groups that use the Internet at higher rates generally throughout the population.[67]

The groups that are heavily skewed toward storefront borrowing are older, do not have a college degree, and have incomes below $50,000. White borrowers are especially likely to borrow from storefront lenders, as are disabled borrowers.

EXHIBIT 12:

HOW PEOPLE OBTAIN PAYDAY LOANS

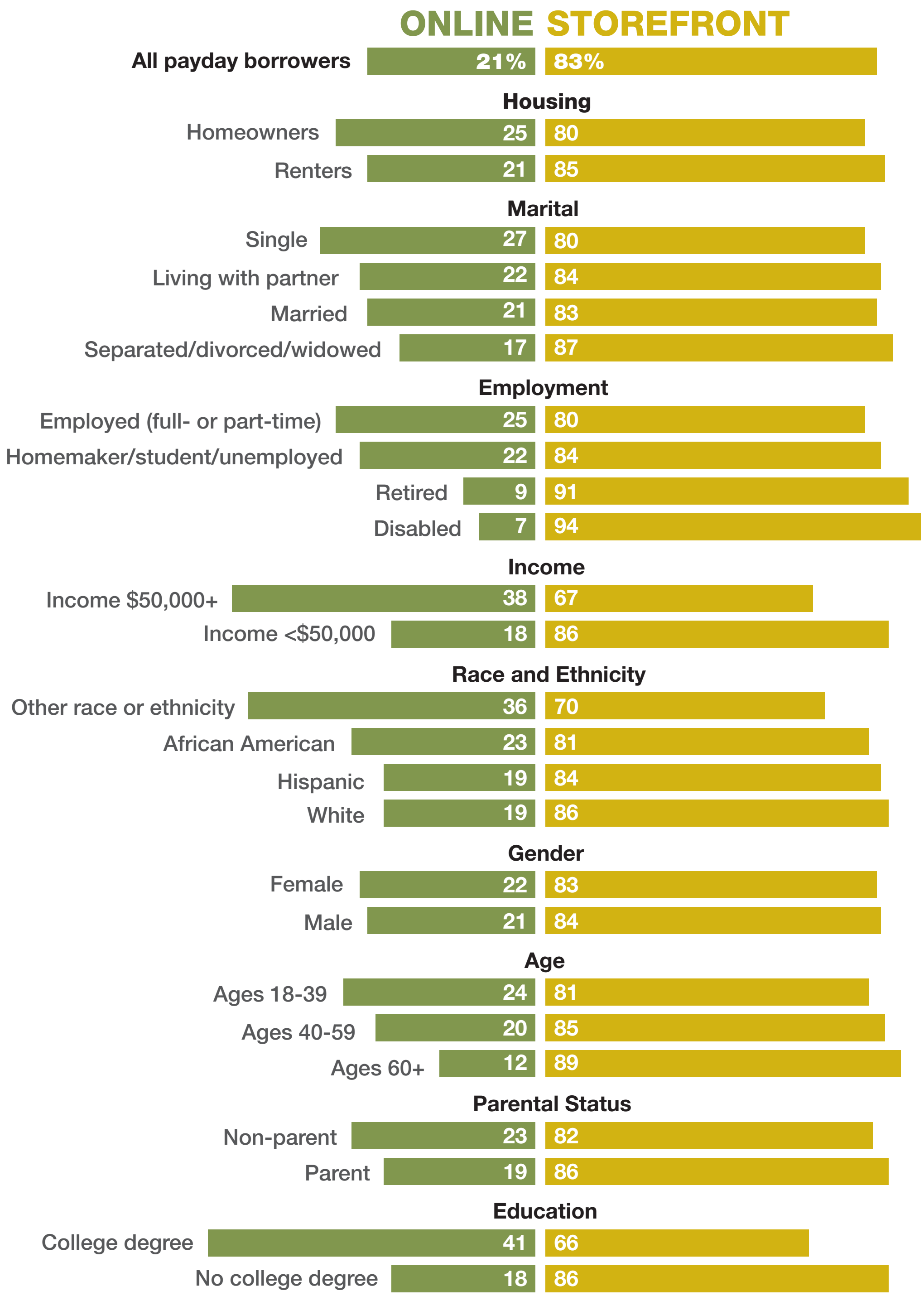


NOTES: In absolute terms, 4.0 percent of all survey respondents have used payday loans exclusively from storefronts, 0.9 percent have used payday loans exclusively from the Internet, 0.2 percent have used payday loans from both storefront locations and the Internet, and 0.4 percent of respondents have used payday loans that were neither storefront-based nor Internet-based. *Other sources may include banks, credit unions, or employers, among others.

Data represent percentage of payday borrowers who have used this type of provider in the past five years. Results are based on 33,576 interviews conducted from August 2011 through December 2011.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

EXHIBIT 13:
METHOD OF ACQUIRING PAYDAY LOANS BY BORROWER DEMOGRAPHIC GROUP



NOTES: Numbers add to greater than 100 percent because of borrowers who have borrowed both from a storefront and online; they are counted in both columns and exist in greater numbers in some subgroups. The 7 percent of borrowers who have taken a payday loan from another source, such as a bank or employer, are excluded from this section, as are the 1 percent of borrowers who declined to state which method of borrowing they utilized. Results represent the percentage of payday loan borrowers in each category who report having used the specified type of payday loan in the past five years. Results are based on 33,576 interviews conducted from August through December 2011.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

Conclusion

Payday loans are marketed as short-term credit products intended for emergency use, and they usually are depicted as a fix for an unexpected expense. However, Pew's first-of-its-kind survey reveals that seven in 10 borrowers use payday loans to deal with recurring expenses, while only one in six uses the loans for unexpected emergencies. Pew's analysis shows that the vast majority of borrowers use the loans on a long-term basis, not a temporary one. Thus it seems that the payday loan industry is selling a product that few people use as designed and that imposes debt that is consistently more costly and longer lasting than advertised. This circumstance is especially troubling because the conventional payday loan business model fundamentally relies on repeat usage—often, renewals by borrowers who are unable to repay the full loan amount upon their next payday—for its profitability.

Pew's research shows that certain demographic groups are more likely to use payday loans, including those without a four-year college degree; African Americans; those who rent rather than own a home; people earning below $40,000 annually; and those who are separated or divorced. However, it also clearly demonstrates that the payday loan is a product that crosses lines of gender, race and ethnicity, income, and education, touching most segments of society.

These findings raise serious concerns about payday lending, including whether a two-week product with an APR typically around 400 percent is a viable solution for people dealing with a chronic cash shortage.

To date, payday loans have been regulated primarily at the state level. Pew's findings show that states that have chosen to implement statutory controls on these products have been successful in realizing policy makers' goal of curbing payday lending, with 95 out of 100 would-be borrowers electing not to use payday loans rather than going online or finding payday loans elsewhere. These findings are particularly important as policy makers discuss what happens to payday borrowers when storefront lenders are not present because of regulatory action.

Moving forward, the recently created Consumer Financial Protection Bureau has the authority to regulate the payday loan market at the federal level. With this ongoing series, *Payday Lending in America*, and other research, Pew will present in-depth findings to help identify the features of a safe and transparent marketplace for such consumer financial services, to inform efforts to protect consumers from harmful practices, and to promote safe and transparent small-dollar credit.

Methodology: Opinion Research

Findings in this report are based on a screening survey to measure incidence and identify payday loan borrowers, a full-length survey of people who answered that they had used a storefront payday loan in the past five years, and a series of 10 focus groups with small-loan borrowers, as described below.

Survey Methodology

Social Science Research Solutions (SSRS) Omnibus Survey

The Pew Safe Small-Dollar Loans Research Project contracted with SSRS to conduct the first-ever nationally representative in-depth telephone survey with payday loan borrowers about their loan usage. To identify and survey a low-incidence population such as payday loan borrowers, SSRS screened 1,000 to 2,000 adults per week on its regular omnibus survey, using random-digit-dialing (RDD) methodology, from August 2011 to April 2012. The term "omnibus" refers to a survey that includes questions on a variety of topics. This survey likely minimized payday loan borrowers' denying their usage of this product, because the omnibus survey included mostly non-financial questions purchased by other clients, and the payday loan questions were asked after other, less sensitive questions, giving interviewers a chance to establish a rapport with respondents.

If during the months of August through mid-December, respondents answered that they had used a payday loan, they were placed in a file to be recontacted later. Once the full-length survey was ready to field, in order to maximize participation, people who had used a payday loan were then given the full-length survey and paid an incentive of $20 for participating. Because of their relative scarcity, online payday loan borrowers were given an incentive of $35 for participating. Respondents were told about the compensation only after having indicated that they had used a payday loan. Further, online payday loan borrowers identified during the early months of screening were sent a letter with a five-dollar bill informing them that they would be recontacted to take the full-length survey. The second phase of the research involved recontacting all respondents who answered that they had used a payday loan, and immediately giving the full-length survey to anyone newly identified in the weekly omnibus survey as a payday loan borrower.

Sample and Interviewing

In the first phase of the survey, The Pew Safe Small-Dollar Loans Research Project purchased time on Social Science Research Solutions' omnibus survey, *EXCEL*, that covers the continental United States. Analysis of the incidence was conducted after 33,576 adults had been screened and answered a question about payday loan usage.

Sampling error for the omnibus survey of borrowers is +/- 0.24 percentage points. In the second phase, another 16,108 adults were screened in order to find a sufficient number of storefront payday loan, online payday loans, and auto title loan borrowers to complete a 20-minute survey about their usage and views. A total of 451 adults completed the full-length storefront payday loan survey, and two questions from that survey were included in this publication. Sampling error for the full-length survey of storefront payday loan borrowers is +/- 4.6 percentage points. In total, 49,684 adults were screened to complete the research.

EXCEL is a national weekly, dual-frame bilingual telephone survey. Each *EXCEL* survey consists of a minimum of 1,000 interviews, of which 300 interviews are completed with respondents on their cell phones and at least 30 are conducted in Spanish, ensuring unprecedented representation on an omnibus platform. Completes are representative of the U.S. population of adults 18 and older.

EXCEL uses a fully replicated, stratified, single-stage, RDD sample of telephone households, and randomly generated cell phones. Sample telephone numbers are computer-generated and loaded into online sample files accessed directly by the Computer-Assisted Telephone Interviewing (CATI) system. Within each sample household, a single respondent is randomly selected. Further details about *EXCEL* and its weighting are available at www.pewtrusts.org/small-loans.

Question Wording—Omnibus Survey

The data from the nationally representative omnibus survey of 33,576 adults are based on responses to the following questions. Wording for demographic and other questions is available at www.pewtrusts.org/small-loans.

Screening Phase (measuring incidence and compiling sample for callbacks):

- In the past five years, have you used payday loan or cash advance services, where you borrow money to be repaid out of your next paycheck?
- And was that physically through a store, or on the Internet?

Recontact Phase (calling back respondents who answered affirmatively, and identifying additional borrowers to take the full-length survey immediately):

- In the past five years, have you or has someone in your family used an in-person payday lending store or cash advance service?

Question Wording—Full-Length Survey of Storefront Payday Loan Borrowers

The data from the nationally representative, full-length survey of 451 storefront payday loan borrowers are based on responses to the following questions, which Pew designed with assistance from SSRS and Hart Research Associates. All other questions from this survey are being held for future release. The sample for this telephone survey was derived from the RDD omnibus survey.

Thinking back now to (that FIRST/the) time you took out a (online payday loan/payday loan/auto title loan), which of the following best describes what specifically you needed the money for? (READ LIST. ACCEPT ONE RESPONSE.)

(IF MORE THAN ONE, ASK:) Well, if you had to choose just one, which best describes what specifically you needed the money for?

1 To pay rent or a mortgage

2 To pay for food and groceries

3 To pay a regular expense, such as utilities, car payment, credit card bill, or prescription drugs

4 To pay an unexpected expense, such as a car repair or emergency medical expense

5 To pay for something special, such as a vacation, entertainment, or gifts

7 (DO NOT READ) Other (SPECIFY)________________

D (DO NOT READ) Don't know

R (DO NOT READ) Refused

I'm going to read you several options. For each, tell me whether you would use this option if you were short on cash and short-term loans of any kind no longer existed. How about (INSERT)?

a. Borrow from family or friends

b. Borrow from your employer

c. Sell or pawn personal possessions

d. Delay paying some bills

e. Cut back on expenses such as food and clothing

f. Take out a loan from a bank or credit union

g. Use a credit card

Would you use this option or not?

1 Yes, would use

2 No, would not use

D (DO NOT READ) Don't know

R (DO NOT READ) Refused

Focus Group Methodology

On behalf of the Safe Small-Dollar Loans Research Project, Hart Research Associates and Public Opinion Strategies conducted eight two-hour focus groups, with two groups per location in New York City, New York; Chicago, Illinois; Birmingham, Alabama; and Manchester, New Hampshire. Those groups were conducted during weekday evenings from September 7, 2011 through September 19, 2011. The Safe Small-Dollar Loans Research Project conducted two additional groups in San Francisco, California, on November 16, 2011. All quotations come from these 10 focus groups.

EXHIBIT 14:

PAYDAY LOAN BORROWER DEMOGRAPHIC SNAPSHOT

Demographic	Percentage of All Payday Borrowers	Percentage of All American Adults
Renters	58	35
Homeowners	41	65
Single	24	31
Living with partner	14	N/A*
Married	33	50
Separated/divorced	25	13
Widowed	4	6
Full-time employed	49	59**
Part-time employed	13	
Unemployed	14	6
Disabled	8	N/A*
Retired	8	23
Homemaker	5	6
Student	3	5
Income <$15,000	25	13
Income $15,000 to under $25,000	24	11
Income $25,000 to under $30,000	11	
Income $30,000 to under $40,000	13	25**
Income $40,000 to under $50,000	8	
Income $50,000 to under $75,000	10	19
Income $75,000 to under $100,000	5	12
Income $100,000+	1	21
White (non-Hispanic)	55	64
African American (non-Hispanic)	23	12
Hispanic	14	16
Other race/ethnicity	6	8
Ages 18-24	12	13
Ages 25-29	16	9
Ages 30-34	12	9
Ages 35-39	11	9
Ages 40-44	13	9
Ages 45-49	11	10
Ages 50-54	10	10
Ages 55-59	5	8
Ages 60-64	5	7
Ages 65-69	3	5
Ages 70+	3	12
Parent	38	30
Non-parent	62	70
<High school	16	15
High school	38	29
Some college	31	30
College	11	16
Postgrad	3	9
Male	48	49
Female	52	51

This table describes the demographic characteristics of payday loan users overall, based on responses to Pew's survey. For example, 58 percent of all payday loan users rent (as opposed to own) their homes. For more on the survey, see the Methodology.

NOTES: All payday borrower data come from payday borrowers identified through 33,576 interviews conducted from August through December 2011 on behalf of Pew's Safe Small-Dollar Loans Research Project.

All comparative data except for employment status come from the Census Bureau's 2010 Decennial Census, the 2006–2010 American Community Survey 5-Year Estimates, and the 2008–2010 American Community Survey 3-Year Estimates. Employment status data come from a three-month average (March, April, and May 2012) of the NBC News/*Wall Street Journal* Survey, a nationally representative monthly telephone survey.

Data may not equal 100 percent due to rounding or because respondents declined to answer.

Marital status is based on residents 15 years of age and older. Educational attainment is based on adults 25 to 64 years of age. Other data, including Pew's survey data, represent adults 18 years of age and older.

*N/A Certain data were unavailable and/or are not comparable to Pew's survey.

**The Census uses slightly different income and employment categories in its survey.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012; U.S. Census Bureau; NBC News/*Wall Street Journal* Survey.

Modeling the Likelihood of Borrowing by Demographics

To test the relationship between specific demographics and payday loan usage, Pew developed a statistical model to analyze the predictive strength of each demographic while holding all others constant. For example, the model tests whether there is a strong relationship between renting a home and borrowing a payday loan, regardless of a borrower's other characteristics such as income. The following eight demographics were examined and compared with those people who were not in the selected category (e.g., those who have annual household incomes below $40,000 are compared with those who have annual household incomes of $40,000 or higher).

- Ages 25 to 34
- Annual household income below $40,000
- Parents (with minor, financially dependent children)
- Some college education or less
- Renters
- African Americans
- Females
- Marital status is separated or divorced

It is important to reiterate that a limitation of our analysis is the time frame. While the survey recorded current demographics, payday loan borrowers were asked about loans they had taken out in the past five years. We are not implying any causality, and it would be incorrect to assume that certain characteristics are necessarily causing an increase in payday loan usage. Rather, the findings show strong relationships between certain characteristics and payday loan usage, many of which previous studies also have identified.[68]

In interpreting the logistic regression, the analysis focuses especially on the odds ratio, which shows the likelihood of payday loan usage based on the presence of a particular characteristic.

All relationships are significant at the 99 percent confidence level, with the exception of gender. This is not a surprising finding, as differences between males and females in Pew's initial analysis were slight and sometimes decreased when other variables were introduced. Thus, it is likely that the initial difference in usage by gender is being caused by other characteristics that correlate with gender, such as parental status or income.

Again, the baseline for payday loan usage is 5.5 percent across all adults. The figures resulting from this analysis describe only how much more likely it is that one type of person is to have used payday loans relative to another.

EXHIBIT 15:

LOGISTIC REGRESSION ANALYSIS OF LIKELIHOOD OF PAYDAY LOAN USAGE BY SELECT DEMOGRAPHICS

The percentages described in the body of the report as coming from a logistic regression model are derived from the Odds Ratio, and are calculated by subtracting 1 from the Odds Ratio. Thus, those who are Separated or Divorced, with an Odds Ratio of 2.034, are 103.4 percent more likely to have used a payday loan.

	Coefficient ß	S.E. ß	Wald's X^2	Odds Ratio
AfAm	0.717***	0.073	95.322	2.048
SepDiv	0.71***	0.072	96.729	2.034
NonCollege	0.6***	0.088	46.295	1.823
Income<$40k	0.479***	0.071	45.167	1.615
Rent	0.452***	0.066	47.118	1.572
Parent	0.352***	0.065	29.246	1.422
Age25to34	0.349***	0.071	23.786	1.417
Female	-0.122**	0.062	3.928	0.885
Constant	-3.94	0.093	1781.417	0.019

NOTE: * p<.10, ** p <.05, and *** p<.01.

SOURCE: Pew Safe Small-Dollar Loans Research Project, 2012.

Endnotes

1 David Burtzlaff and Brittny Groce. “Payday Loan Industry,” (2011). Stephens Inc.

2 Marketers of payday loans routinely characterize the products as short-term solutions that are not meant to be used for long periods of time. For example, the Financial Service Centers of America (FiSCA), an industry trade group, describes a payday advance as a “short-term loan to cover expenses between paydays.” “FiSCA Consumer Financial Services Factsheet,” available at http://www.fisca.org/Content/NavigationMenu/ConsumerCenter/ConsumerFactSheet/CONSUMERCENTER-ConsumerFactSheet_Final_withlogo.pdf (accessed March 30, 2012).

3 Pew’s research shows that the vast majority of borrowers report obtaining their loans from retail storefronts, which are non-bank, state-licensed entities that specialize in this form of lending. However, payday and similar types of loans are available online and from a growing number of banks. A small number of national and regional banks have developed small-dollar loan products that mimic or closely resemble conventional payday loans. These bank products are sometimes called “deposit advance” loans. The acting chairman of the Federal Deposit Insurance Corporation (FDIC) recently expressed “deep concern” about banks engaging in payday lending and announced an intention to investigate this trend. See FDIC letter at www.responsiblelending.org/payday-lending/policy-legislation/regulators/fdic-invests-bank-payday-lending.html.

4 In the fall of 2011, Pew contracted with research firms to hold focus groups of current and former payday loan borrowers. Participants told their stories and discussed a variety of questions related to their use of payday loans and other financial products. Deborah’s story and her quotations are taken from one such focus group, which was conducted in New Hampshire (Deborah discussed experiences with storefront payday lenders that occurred prior to 2009, when New Hampshire enacted a 36 percent annual interest rate cap that effectively eliminated storefront payday lending in that state). “Deborah” is not the borrower’s real name. We have used a pseudonym to protect the participant’s privacy, but all other details are unaltered.

5 In 2011, the average payday loan at the nation’s largest payday lender—Advance America—was $375, based on its annual report. Industry analyst Stephens Inc. uses Advance America as a proxy for the payday lending industry. Stephens Inc., “Payday Loan Industry,” (2011).

6 Fees from online lenders often are higher, averaging $25 per $100 borrowed per two weeks, or 652 percent APR. Consumer Federation of America, “CFA Survey of Online Payday Loan Websites,” (2011). See www.pewtrusts.org/small-loans for more information on state payday lending laws.

7 Although payday loans are not a new form of credit, the modern payday lending industry arose in the 1990s when a number of states modified their consumer lending laws, enacting special exceptions to interest rate caps and other laws that had traditionally regulated credit. See www.pewtrusts.org/small-loans for more information on the history of payday lending laws.

8 This calculation is based on a borrower using eight loans (the average number used annually according to state reports) for 18.2 days (the average duration of a payday loan, according to Advance America’s annual (10-K) report). Multiplying these figures indicates an average of 146 days of indebtedness per year.

9 Leslie Parrish and Uriah King, "Phantom Demand," (Center for Responsible Lending, June 2009), http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf.

10 Oklahoma probably is not an outlier, as the average number of loans used by borrowers in Oklahoma per year (8.7) is similar to the average from other states, based on state reports. Calculations use data in "Oklahoma Trends in Deferred Deposit Lending, 2010," www.ok.gov/okdocc/documents/2010_10_OK%20Trends_Final_Draft.pdf.

11 Payday and similar types of loans are available online and from a growing number of banks; however, Pew's research shows that the vast majority of borrowers report obtaining their loans from retail storefronts, which are non-bank, state-licensed entities that specialize in this form of lending.

12 A study funded by the payday lending industry found that 78 percent of borrowers take out five or more payday loans each year; Gregory Elliehausen, "An Analysis of Consumers' Use of Payday Loans," *Financial Services Research Program Monograph* No. 41, (George Washington University, 2009). Another study by consumer advocacy group Center for Responsible Lending found that Oklahoma borrowers who use payday loans take out an average of nine loans in their first year of borrowing; Uriah King and Leslie Parrish, "Payday Loans, Inc.: Short on Credit, Long on Debt," (Center for Responsible Lending, 2011). See also: "Report on the Business of Providing Deferred Presentment Service Transactions in Michigan," (2007), www.michigan.gov/documents/cis/OFIS_DPST_REPORT_204749_7.pdf; and "Florida Trends in Deferred Presentment," (2010), www.veritecs.com/Docs/2010_06_FL_Trends-UPDATED.pdf.

13 Robert DeYoung and Ronnie J. Phillips. "Payday Loan Pricing," (Federal Reserve Bank of Kansas City Economic Research Department, 2009), www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf.

14 Stephens Inc., "Payday Loan Industry," (2011).

15 Michael A. Stegman and Robert Faris, "Payday Lending: A Business Model that Encourages Chronic Borrowing," *Economic Development Quarterly* (2003), www.ccc.unc.edu/abstracts/0203_Payday.php.

16 Our 5.5 percent payday loan usage number closely mirrors the 5 percent number found by the FINRA Foundation in their telephone survey conducted in 2009; Applied Research and Consulting, "Financial Capability in the United States," prepared for the FINRA Investor Education Foundation, (2009). It is somewhat higher than the 3.5 percent of households who reported ever having used payday loans in the 2009 FDIC supplement to the Current Population Survey; "Addendum to the 2009 FDIC National Survey of Unbanked and Underbanked Households: Use of Alternative Financial Services," (2010), www.fdic.gov/householdsurvey/AFS_Addendum.pdf). The number also is higher than the 3.9 percent of households who reported having used a payday loan in the past year in the Federal Reserve Board's Survey of Consumer Finances, although that survey asked just about the past year, whereas our survey asked about the past five years; www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf. Earlier research has found and discussed evidence of known payday loan borrowers denying their usage of these loans in survey research: Gregory Elliehausen and Edward Lawrence, "Payday Advance Credit In America: An Analysis Of Customer Demand," (Monograph #35, 2001); Dean Karlan and Jonathan Zinman, "Lying About Borrowing," *Journal of the European Economic Association Papers and Proceedings* (2007); and Applied Management & Planning Group and Analytic Focus, "2007 Department of Corporations Payday Loan Study," (2008). To minimize underreporting in this survey, borrowers were asked about payday loan usage as part of an omnibus poll that covered mostly non-financial topics. In addition, the questions about payday loans were asked well into the survey, giving the interviewer a chance to establish a rapport with respondents before asking about this relatively sensitive issue.

17 The margin of error for payday loan usage in the omnibus survey is +/-0.2 percentage points. Margins of error for subgroups are included on our website at www.pewtrusts.org/small-loans.

18 We calculate the number of unique payday loan borrowers in 2010 using three different methods that all point toward roughly 12 million people having used payday loans that year. Based on our survey data, 18 percent of traditional payday loan borrowers (storefront or online, not other sources such as employers or banks) are borrowing exclusively online. All of these calculations refer to storefront data and then treat that population as 82 percent of the universe of payday loan borrowers, adding in the online-only borrowers afterwards. All of these calculations also utilize the Stephens estimate that there were 19,700 payday lending stores in the U.S. in 2010. Numbers have been rounded to avoid giving the impression that these calculations are precise, because they all involve reliance on data that are either incomplete or from a handful of states. Thus, each of these calculations is likely flawed because of data limitations, but the results cluster around, and average, 12 million borrowers.

Method 1: *Estimating transactions per store, multiplying by the number of stores, and dividing by the number of loans per borrower.*

We used the data from the 2010 published state payday loan reports that include number of transactions and number of storefronts: California, Florida, Oklahoma, and Washington. States that had reports from previous years but not reports based on 2010 data were reviewed but not included, such as Illinois, Michigan, North Dakota, and Virginia. Dividing the number of payday loan transactions by the number of payday loan stores yields 4,236 payday loans per store in 2010. Multiplying that figure by 19,700 yields 83.4 million loans. Dividing this figure by the eight loans per borrower figure, which is the average in the state reports, implies just over 10.4 million borrowers. Adding back in the 18 percent of borrowers who are borrowing only online adds to roughly 12.7 million.

Method 2: *Using the state reports to record or derive the number of unique borrowers in each state, and dividing by the number of stores in those states to create a borrowers per store ratio.* This calculation, based on the three states with published 2010 data on unique borrowers (Florida, Oklahoma, and Washington), yields a figure of approximately 486 unique borrowers per store. We then multiply that ratio by the number of stores in the country to reach roughly 9.6 million. Adding back in the 18 percent of borrowers who are borrowing only online adds to roughly 11.7 million.

Method 3: *Recording the number of unique borrowers in the reported states, dividing that figure by the adult population to determine a usage rate, and then multiplying that figure by the population in all of the states where payday loans are allowed.* Using this method gives us a usage rate of 4.8 percent in the states that publish detailed reports. Seventy-one percent of the population lives in states that have payday loan stores, while 29 percent do not. We multiply the 4.8 percent by the 163 million adults who live in states with stores, and then multiply the other 66 million adults by 1.2 percent, because our survey data show that storefront usage in restrictive states is one-fourth the level that it is in other states. This calculation suggests 8.7 million storefront borrowers, somewhat lower than the other methods. One reason for this disparity may be that most of the highest-usage states do not publish reports, so the 4.8 percent usage figure we derived may be slightly lower than the true usage figure in nonrestrictive states. Adding back in the 18 percent of borrowers who are only online would yield an estimate of 10.6 million borrowers per year.

19 This figure of 12 million borrowers is lower than some earlier estimates of payday loan usage, which may be partially explained by the fact that payday lenders have left some states because of regulations, and by high unemployment (given that a regular income stream is a prerequisite for obtaining a payday loan). Social insurance programs for individuals out of work also may provide an income stream on which a payday loan can be secured. Nonetheless, the high rate of unemployment in recent years and particularly the unprecedented rates of the unemployed who have been out of work for an extended period of time likely have a dampening effect on overall payday loan usage. The estimate of 12 million borrowers refers only to those using payday loans from storefronts or the Internet, not those using payday loans from banks, employers, or other sources.

20 Amanda Logan and Christian E. Weller, "Who Borrows from Payday Lenders?" (2009); Gregory Elliehausen, "An Analysis of Consumers' Use of Payday Loans," *Financial Services Research Program,* Monograph #41. (2009).

21 This figure is the average number of loans used based on the 2010 state reports from Florida, Oklahoma, and Washington. It also is consistent with data released by other states that either lack a database or did not publish a 2010 report, such as Michigan's 2007 data, Virginia's 2008 data, and California's data from 2006-2010.

22 "Florida Trends in Deferred Presentment," Program Status Report, (May 2010), www.veritecs.com/Docs/2010_06_FL_Trends-UPDATED.pdf.

23 In 2011, the average payday loan at the nation's largest payday lender—Advance America—was $375, based on its annual (10-K) report. Industry analyst Stephens Inc., uses Advance America as a proxy for the payday lending industry. Stephens Inc. "Payday Loan Industry," (2011).

24 This figure is based on using the average loan size ($375 in Advance America's 2011 Annual Report), the average number of times (eight—based on data in state reports) in a year. Three quarters of these are storefront loans, charging an average of $55 per loan, based on the average fee disclosed in Advance America's 2011 Annual Report, and similar fees in the other publicly traded lenders' annual reports. Roughly one-quarter are online loans, charging an average of $95 for an equivalent loan, based on the rates cited by industry analyst Stephens Inc., in its 2011 report. Six fees of $55 and two fees of $95 yield our estimate of $520 spent by each borrower. If all eight loans came from a storefront, this figure would be $440, while if all eight loans were obtained online, the figure would rise to $760. These calculations assume the borrower does not incur any extra fees. The Center for Responsible Lending has made similar calculations in its publications, finding that a typical borrower pays back $793 on a $325 loan, spending $468 on interest. This calculation was based on storefront lending and was made before online lending had expanded to its present level with higher interest rates charged. See Uriah King, Leslie Parrish, and Ozlem Tanik. "Financial Quicksand: Payday Lending Sinks Borrowers in Debt with $4.2 Billion in Predatory Fees Every Year," (November 2006), http://www.responsiblelending.org/payday-lending/research-analysis/financial-quicksand-payday-lending-sinks-borrowers-in-debt-with-4-2-billion-in-predatory-fees-every-year.html.

25 Robert DeYoung and Ronnie J. Phillips, "Payday Loan Pricing," (Federal Reserve Bank of Kansas City Economic Research Department, 2009), www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf.

26 Previous surveys also have found that a substantial percentage of borrowers use payday loans to cover regular household expenses and other nonemergency needs. A 2007 study conducted for the California Department of Corporations reports that half of borrowers (50.2 percent) selected "pay other bills" as their reason for using a payday loan (an additional 22.3 percent selected "groceries/necessary household goods"). The "pay other bills" category is separate from groceries/necessary household goods, emergency situations, car repairs, and medical services. While categories differ slightly between each survey, both surveys separate regular expenses from food/groceries, emergencies, car repairs, and other, therefore providing a comparable benchmark for usage; Applied Management Planning Group and Analytic Focus, "2007 Department of Corporations Payday Loan Study," (2008), www.corp.ca.gov/Laws/Payday_Lenders/Archives/pdfs/PDLStudy07.pdf. Also, the Federal Reserve's 2010 Survey of Consumer Finances (SCF), which asks about the most recent payday loan, found 42.4 percent of borrowers indicated it was for an emergency "and similar urgent needs or a lack of other options." The difference in overall incidence (3.9 percent payday usage in the 2010 survey) between Pew's results and results from the SCF may be explained by differences in time period queried (five-year versus one-year time span). The large difference in reason for usage in the "emergency" category is likely a result of survey wording, or including "a lack of other options" in the SCF question, which makes its emergency category far broader. Pew's survey question was seeking to capture something different than the SCF, to ascertain the purpose of the loan ("emergency"), without attempting to combine that with why the borrower chose a payday loan provider ("lack of other options"). A borrower may have both a regular

expense and a lack of other options, or an emergency expense but multiple options, so we did not seek to pair the reason for a loan with the reason for choosing a payday loan provider. SCF data are available at http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf.

27 The industry's largest trade association, Community Financial Services Association of America (CFSA), as well as many payday loan companies, note on their websites and in advertisements that payday loans are an expensive form of credit and intended for short-term or emergency use, and not as long-term solutions. For examples, see websites for CFSA (http://cfsaa.com), QC Holdings (www.QCholdings.com), and Cash America (www.cashamerica.com/loanoptions/cashadvances.aspx). See also: Gregory Elliehausen and Edward C. Lawrence, "Payday Advance Credit in America: An Analysis of Customer Demand," (April 2001), 37, 40; and Gregory Elliehausen, "An Analysis of Consumers' Use of Payday Loans," (January 2009). "While payday loans might rarely if ever make sense for financing household investment directly, payday loans may provide rationed borrowers with a source of emergency funds that allows greater levels of debt-financed investment," as quoted from www.cfsaa.com/portals/0/RelatedContent/Attachments/GWUAnalysis_01-2009.pdf.

28 See endnote 12.

29 Parrish and King, "Phantom Demand," (2009).

30 The exact figure is 18.2 days, and comes from the 2011 Annual Report (10-K) filed with the Securities and Exchange Commission by the largest storefront payday lender, Advance America.

31 For example, the website of Check Into Cash, one of the largest payday lenders, notes that a payday loan "is not intended to be used as a long-term budget solution." Available at: http://checkintocash.com/faq/how-often-do-most-people-use-cash-advance-services/.

32 The industry's largest trade association, Community Financial Services Association of America (CFSA), provides a detailed overview of the industry and product on its website (http://cfsaa.com).

33 Quoted from Advance America direct mail piece "Your Line's Slowed. Your Bills Haven't," (2011).

34 Quoted from QC Holdings website, www.QCholdings.com.

35 These estimates vary somewhat based on the law, and especially the minimum loan term, in the state analyzed, but the most detailed analysis is the Center for Responsible Lending's finding of 212 days of indebtedness for Oklahoma borrowers in *Payday Loans, Inc.*

36 Robert DeYoung and Ronnie J. Phillips, "Payday Loan Pricing," (Federal Reserve Bank of Kansas City Economic Research Department, 2009), www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf.

37 James A. Ovenden, "Quarterly Earnings Call, Advance America," Q2, (2011), http://seekingalpha.com/article/283283-advance-america-cash-advance-centers-ceo-discusses-q2-2011-results-earnings-call-transcript.

38 Stephens Inc., "Payday Loan Industry," (2011).

39 Community Financial Services Association of America (CFSA) Member Best Practices, http://cfsaa.com/cfsa-member-best-practices.aspx.

40 California Department of Corporations "Table 7: Amount of Referral Bonus Offered," www.corp.ca.gov/Laws/Payday_Lenders/Archives/pdfs/PDLStudy07.pdf.

41 Information from CashNetUSA website, www.cashnetusa.com/rewards.html.

42 UNC Center for Community Capital, "North Carolina Consumers After Payday Lending," (2007), www.ccc.unc.edu/documents/NC_After_Payday.pdf.

43 Applied Management & Planning Group and Analytic Focus, "2007 Department of Corporations Payday Loan Study," (2008), www.corp.ca.gov/Laws/Payday_Lenders/Archives/pdfs/PDLStudy07.pdf.

44 Texas Appleseed, "Short-term Cash, Long-term Debt: The Impact of Unregulated Lending in Texas," (2009), www.appleseednetwork.org/Portals/0/Documents/Publications/Center%20Pubs/TX%20Payday%20Lending.pdf.

45 Missouri Division of Finance. "Report to General Assembly on Survey of Payday Lenders," (2011), http://finance.mo.gov/consumercredit/documents/2011PaydayLenderSurvey.pdf.

46 Subsequent to passing legislation authorizing payday lending, Arizona, Arkansas, the District of Columbia, Georgia, Montana, North Carolina, and New Hampshire reimposed double-digit usury caps on deferred presentment transactions, allowed the authorizing legislation to expire, or prohibited the transaction. Colorado, Florida, Maine, Minnesota, Oregon, Rhode Island, Virginia, and Washington have lowered permissible loan fees while retaining triple-digit annual percentage rates, implemented structural requirements to permit borrowers multiple pay periods to repay their loans, or limited to the single digits the number of payday loans per borrower per year. Ohio passed legislation and also passed a ballot initiative restricting interest on payday loans to 28 percent APR, but payday lending has continued with effective loan terms and APRs that often are similar to those before the law change.

47 Stephens Inc., "Payday Loan Industry," (2011).

48 Steven Graves and Christopher Peterson, "Usury Law and the Christian Right: Faith-Based Political Power and the Geography of American Payday Loan Regulation," *Catholic University Law Review*, Vol. 57, 2008: 637.

49 Robert B. Avery and Katherine A. Samolyk, "Payday Loans versus Pawn Shops: The Effects of Loan Fee Limits on Household Use," (preliminary draft, 2011).

50 For example, "House Mulls Reviving Payday Loans," *New Hampshire Business Review*, www.nhbr.com/businessnewsstatenews/935663-257/house-panel-mulls-reviving-payday-loans.html.

51 Consumer Federation of America, "CFA Survey of Online Payday Loan Websites," (2011).

52 "Analysis: U.S. Payday Lenders Point Fingers to Blunt Crackdown," *Reuters,* (January 20, 2012), www.reuters.com/article/2012/01/20/us-financial-regulation-payday-idUSTRE80I04R20120120.

53 This section includes results reported to two decimal places, but this reporting is not intended to suggest a greater level of precision. Rather, two decimal places are used in order to avoid inaccurate calculations between groupings that could be caused by rounding to one decimal place or the nearest integer. Even with these large sample sizes, there is a degree of sampling error. It is possible, therefore, that the actual number of would-be storefront borrowers who are going online is slightly lower or higher, because the results reported are based on survey research, and thus have a margin of error. These figures are fairly consistent with estimates from Stephens Inc., that roughly one-quarter of payday loan volume is online. Our survey data suggest just under one-quarter of traditional (storefront or online, but not "other") payday loan borrowers have borrowed online. Note that the 7 percent "other" finding may include products from banks or employers but should not be taken as a general estimate of bank payday or "deposit advance" lending.

54 This finding that storefront payday borrowing is lower in Restrictive states is consistent with prior research. Examples include: Applied Research & Consulting, "Financial Capability in the United States," (2009); and "Addendum to the 2009 FDIC National Survey of Unbanked and Underbanked Households: Use of Alternative Financial Services," (2010), www.fdic.gov/householdsurvey/AFS_Addendum.pdf.

55 These figures are based on our analysis of state-by-state storefront data from Graves and Peterson, "Usury Law and the Christian Right," (2008). Peterson and Graves' data were used because of the level of detail, recording individual storefronts by ZIP code. The same calculations using Stephens' 2006 data yield similar results, with 10.71 storefronts per 100,000 residents in now-Restrictive states, and 11.50 storefronts per 100,000 residents in now-Permissive states, or 6.9 percent fewer. To calculate storefronts per capita, we obtained population estimates from the 2006 American Community Survey (available at www.factfinder2.census.gov). We selected 2006 because none of these states had begun to change their regulatory structure yet, and detailed data on storefronts by state were available. Restrictive states either cap payday loan interest rates at double-digit APRs or prohibit deferred presentment transactions. Permissive states either do not cap interest rates or tend to cap them at 391 percent APR or higher, and generally allow the entire loan to be due on a borrower's next payday. Alaska and Hawaii are included in this example and in all exercises that do not rely on the survey data.

56 Similarly, there is little difference in Internet access between Restrictive and Permissive states. Data from the U.S. Census Bureau's 2012 Statistical Abstract (Table 1156) show that at least 70 percent of people in every state report having Internet access. In both the average Permissive state and average Restrictive state, exactly 80 percent of residents report having Internet access either inside or outside the home. If this calculation is limited to in-home access, in the average Restrictive state 72 percent of residents have Internet access, compared with 71 percent in the average Permissive state. Data available at www.census.gov/compendia/statab/cats/information_communications/internet_publishing_and_broadcasting_and_internet_usage.html.

57 For example, the North Carolina Commissioner of Banks report using 1999 data notes more than 2.9 million payday loan transactions were made in the state, www.nccob.gov/Public/docs/News/Pub%20And%20Research/Check%20Cashers%20Report%20to%20Gen%20Assembly.pdf. Or for a discussion of payday lending in North Carolina and Georgia, including figures on stores in those states operated by major national lenders, see Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans," (2007).

58 During the period of inquiry in our survey, the five years prior to the survey being administered, or roughly late 2006 to early 2012, 10 states implemented substantial changes to the laws regulating payday lending in their state. Five jurisdictions—Arizona, Arkansas, the District of Columbia, Montana, and New Hampshire—became newly Restrictive between January 2008 and January 2011. In Arizona, the legislation authorizing payday lending in the state expired; the other four jurisdictions implemented double-digit APR rate caps. Five additional states moved into the Hybrid category in recent years. Colorado and Virginia implemented longer minimum loan terms, among other regulations, and Rhode Island lowered the fees that may be charged for a payday loan. Washington State capped at eight the number of loans borrowers may take out each year. Oregon reduced allowable fees and now requires a 31-day minimum loan term.

59 Signe-Mary McKernan, Caroline Ratcliffe, and Daniel Kuehn. "Prohibitions, Price Caps, and Disclosures: A Look at State Policies and Alternative Financial Product Use" Urban Institute, (November 2010).

60 This publication does not present data related to the issue of whether borrowers could be substituting other forms of credit for storefront payday loans.

61 For example, "House Mulls Reviving Payday Loans," *New Hampshire Business Review*, www.nhbr.com/businessnewsstatenews/935663-257/house-panel-mulls-reviving-payday-loans.html.

62 For example, Alexandra Alper, "Complaints vs. Banks Drop, Payday Lenders Rise," *Reuters,* (March 1, 2012), www.reuters.com/article/2012/03/01/financialregulation-bbb-idUSL2E8E1FMB20120301.

63 The Better Business Bureau reports that complaints against payday lenders increased 159 percent from 2010 to 2011. Figure available at: http://tulsa.bbb.org/article/Complaints-Down-But-Huge-Jump-in-Inquiries-Means-Shoppers-Are-Doing-Their-Homework-33509.

64 "Washington State Department of Financial Institutions, 2010 Payday Lending Report," www.dfi.wa.gov/cs/pdf/2010-payday-lending-report.pdf.

65 Data obtained by Pew in telephone calls and e-mails with state regulators.

66 These figures are fairly consistent with estimates from Stephens Inc., that roughly one-quarter of payday loan volume is online. Our survey data suggest just under one-quarter of traditional (storefront or online, but not "other") payday loan borrowers have borrowed online. Note that the 7 percent "other" finding may include products from banks or employers but should not be taken as a general estimate of bank payday or "deposit advance" lending.

67 "Digital Differences," Pew Internet & American Life Project, (2012), www.pewinternet.org/~/media//Files/Reports/2012/PIP_Digital_differences_041312.pdf.

68 McKernan, Ratcliffe, and Kuehn. "Prohibitions, Price Caps, and Disclosures," (2010).

The Safe Small-Dollar Loans Research Project focuses on small-dollar credit products such as payday and automobile title loans, as well as emerging alternatives. The project works to find safe and transparent solutions to meet consumers' immediate financial needs.

The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and stimulate civic life.

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Appendix K

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PAYDAY LENDING
IN AMERICA:
REPORT 2

How Borrowers Choose and Repay Payday Loans

February 2013

This is the second report in a series, *Payday Lending in America*, that presents original research findings from Pew's safe small-dollar loans research project on how to create a safe and transparent marketplace for those who borrow small sums of money.

www.pewtrusts.org/small-loans

FEBRUARY 2013

The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and stimulate civic life.

The safe small-dollar loans research project focuses on small-dollar credit products such as payday and automobile title loans, as well as emerging alternatives. The project works to find safe and transparent solutions to meet consumers' immediate financial needs.

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Travis Plunkett, deputy director

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For additional information, please visit www.pewtrusts.org/small-loans.

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Contents

Introduction

Twelve million Americans take out payday loans each year when they are in difficult financial situations. As they weigh choices for addressing a cash shortfall, payday borrowers consider both formal credit and informal options, including cutting back on expenses, borrowing from family or friends, delaying bills, or selling or pawning items, as described in Pew's first payday lending report.[1] Borrowers mostly describe themselves as trying to keep up with their expenses, often by using noncredit alternatives rather than explicitly comparing credit options. They are very familiar with debt and are not eager to take on more.

In deciding whether to borrow from a payday lender, more than 3 in 4 borrowers rely on lenders to provide accurate information about the product, and lenders describe loans as "safe,"[2] "a sensible financial choice,"[3] and "the best alternative to meet their current needs"[4] for a "one-time fixed fee."[5] The product's stated two-week duration appeals to the borrower's desire for a quick cash infusion as well as the conflicting desire not to be in ongoing debt. In reality, both desires cannot be met. But a payday loan's unrealistically short repayment period suggests otherwise by enabling people in difficult situations to think that the loan can solve their problem at an affordable fixed cost so they can avoid asking for help, cutting back further, or creating another ongoing bill.

The ultimate cost and duration of the loans are highly unpredictable and bear little resemblance to their two-week packaging. Average borrowers end up indebted for five months, paying $520 in finance charges for loans averaging $375,[6] largely because they see their only choices as making a lump-sum repayment retiring their entire debt, which they cannot afford, or paying fees to continuously pay back and re-borrow the loan, which they can afford but which does not reduce what they owe. Once they have borrowed, neither choice is viable, leaving them indebted far beyond their next payday. This experience leaves borrowers torn—grateful to have received respectful customer service and credit when they sought it, but feeling taken advantage of by the loan's cost and frustrated by the difficulty of repayment.

This report, "How Borrowers Choose and Repay Payday Loans," the second in Pew's *Payday Lending in America* series, answers several important questions: If payday loans are unaffordable, why do people choose them? How can they eventually pay them back at all? And what are the consequences of using a loan that is so difficult to repay?

This report looks at individuals' decision processes to see why they borrow instead of cutting back expenses or choosing other options, and how they fare using the loans. The results indicate that the choice to use a payday loan often leaves borrowers needing to use these other alternatives to ultimately pay off the loan. Many payday borrowers find themselves overdrafting their checking accounts, indebted for the long term, or borrowing from family and friends anyway to repay their loan—options that were available to them instead of a payday loan in the first place.

The findings will demonstrate to policymakers and other readers the significant failures in the small-dollar loan marketplace, where millions of cash-strapped individuals are using payday loans that they cannot afford to repay in full by the nominal due date. Yet the loans continue to be marketed as a fixed-price, short-term solution. The Consumer Financial Protection Bureau has the authority to regulate payday lending at the federal level, along with prudential bank regulators such as the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. As these regulators are aware, some banks are also participating in the small-dollar lending market through their deposit advance loan products. At the state level, policymakers have several options. Some have chosen to eliminate payday lending stores, and these policies have been effective at reducing payday loan usage without driving an increase in online or other forms of payday lending. In other states, policymakers have sought to mitigate the potential harm of high-interest credit by capping rates below the industry average, limiting usage, or requiring that borrowers be allowed more than two weeks to repay the loan. But in a majority of states, none of these protections are in place.

Key Findings of this Report

1 Fifty-eight percent of payday loan borrowers have trouble meeting monthly expenses at least half the time. These borrowers are dealing with persistent cash shortfalls rather than temporary emergencies.

2 Only 14 percent of borrowers can afford enough out of their monthly budgets to repay an average payday loan. The average borrower can afford to pay $50 per two weeks to a payday lender—similar to the fee for renewing a typical payday or bank deposit advance loan—but only 14 percent can afford the more than $400 needed to pay off the full amount of these non-amortizing loans. These data help explain why most borrowers renew or re-borrow rather than repay their loans in full, and why administrative data show that 76 percent of loans are renewals or quick re-borrows while loan loss rates are only 3 percent.

3 The choice to use payday loans is largely driven by unrealistic expectations and by desperation. Borrowers perceive the loans to be a reasonable short-term choice but express surprise and frustration at how long it takes to pay them back. Seventy-eight percent of borrowers rely on lenders for accurate information, but the stated price tag for an average $375, two-week loan bears little resemblance to the actual cost of more than $500 over the five months of debt that the average user experiences. Desperation also influences the choice of 37 percent of borrowers who say they have been in such a difficult financial situation that they would take a payday loan on any terms offered.

4 Payday loans do not eliminate overdraft risk, and for 27 percent of borrowers, they directly cause checking account overdrafts. More than half of payday loan borrowers have overdrafted in the past year. In addition, more than a quarter report that overdrafts occurred as a result of a payday lender making a withdrawal from their account. Although payday loans are often presented as an alternative to overdrafts, most payday borrowers end up paying fees for both.

5 Forty-one percent of borrowers have needed a cash infusion to pay off a payday loan. Many of these borrowers ultimately turn to the same options they could have used instead of payday loans to finally pay off the loans, including getting help from friends or family, selling or pawning personal possessions, or taking out another type of loan. One in six has used a tax refund to eliminate payday loan debt.

6 A majority of borrowers say payday loans take advantage of them, and a majority also say they provide relief. The appreciation for urgently needed cash and friendly service conflicts with borrowers' feelings of dismay about high costs and frustration with lengthy indebtedness.

7 By almost a 3-to-1 margin, borrowers favor more regulation of payday loans. In addition, two out of three borrowers say there should be changes to how payday loans work. Despite these concerns, a majority would use the loans again. In a state where payday storefronts recently stopped operating, former borrowers are relieved that payday loans are gone and have not sought them elsewhere.

Summary of Report 1—Who Borrows, Where They Borrow, and Why (2012)

Although payday loans are characterized as a short-term solution for unexpected expenses, most borrowers use them for everyday bills. The average borrower is in debt for five months during the year, spending $520 on interest.

1 Who Uses Payday Loans? Twelve million American adults use payday loans annually. Pew's survey found that most payday loan borrowers are white, most are female, and most are 25 to 44 years old. However, after controlling for other characteristics, there are five groups that have higher odds of having used a payday loan: home renters, those earning below $40,000 annually, those without a four-year college degree, those who are separated or divorced, and African Americans.

2 Why Do Borrowers Use Payday Loans? Sixty-nine 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.

3 What Would Borrowers Do Without Payday Loans? If faced with a cash shortfall and payday loans were unavailable, 81 percent of borrowers say they would cut back on expenses such as food and clothing. Majorities also would delay paying bills, borrow from family or friends, or sell or pawn possessions.

4 Does Payday Lending Regulation Affect Usage? In states that enact strong legal protections, the result is a large net decrease in payday loan usage (overall usage is 2.9 percent in the most stringently regulated states, compared with 6.6 percent in states with the least regulation). Borrowers are not driven to seek payday loans online or from other sources as a result of state regulation. In states with no stores, just 5 out of every 100 would-be borrowers choose to obtain payday loans online or from alternative sources, while 95 choose not to use them.

Report 1 findings were based largely on 33,576 interviews from an omnibus survey, 451 follow-up interviews with storefront payday loan borrowers, and state regulatory and industry data. For more information and a copy of Report 1, see www.pewtrusts.org/small-loans.

1 Payday Borrowers Routinely Struggle to Meet Expenses

"I'm like everybody else, living paycheck to paycheck, still not having enough to come through at the end."

—Online borrower, Manchester, NH

Most payday borrowers are dealing with persistent cash shortfalls. The Pew survey found that 58 percent of payday loan borrowers have trouble meeting their regular bills at least half the time, including more than one-third who say they have trouble meeting their bills most of the time. Just 1 in 7 never have trouble meeting their regular monthly bills and expenses.

These findings reinforce those of Pew's first paper in the *Payday Lending in America* series: Although payday loans are frequently described as intended for unexpected expenses, keeping up with regular bills is the primary reason that borrowers use payday loans.[7] That study found that 69 percent of storefront borrowers reported using their first payday loan to meet a recurring expense, and just 16 percent said it was for an unexpected expense. Pew's survey data specifically covering online borrowers show similar results, at 73 percent and 16 percent, respectively.

"For instance, like today is what, sixth, seventh? The rent is due on the first. I didn't pay it. I will in the next few days, but it seems like I'm always struggling to catch up in order to stay afloat."

—*Online borrower, New York*

"It seems like you never catch up, and it, it's just check-to-check, and something breaks down, and the house needs work, kids have school, just never catch up." [And how long have you felt that way?] "Twenty years."

—*Storefront borrower, Chicago*

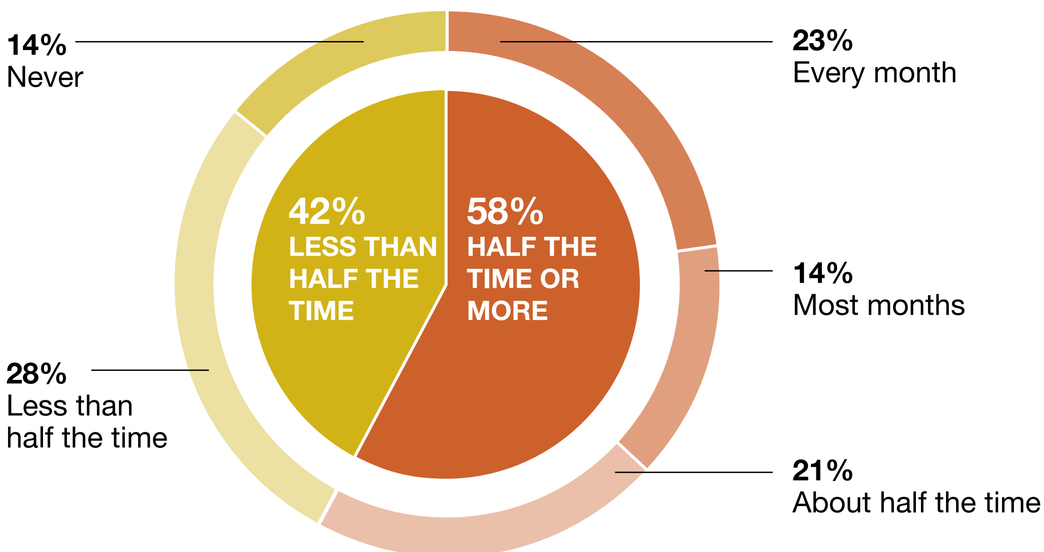
Borrowers Split on How They Rate Their Own Economic Situation

Half of payday borrowers describe their economic situation as "good," and half describe it as "bad," based largely on how often they can keep up with their bills. In focus groups, very few borrowers

EXHIBIT 1:

MAJORITY OF PAYDAY BORROWERS HAVE TROUBLE MEETING BILLS AT LEAST HALF THE TIME

FREQUENCY OF TROUBLE MEETING BILLS:



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "How often, if ever, do you have trouble meeting your regular monthly bills and expenses?" Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

described themselves as having savings or a financial cushion, and many felt that in their current economic situation, it was not possible to "catch up" or save for the future.

Among employed payday loan borrowers, 20 percent have multiple jobs, and in focus groups, several borrowers explained that a second job was critical to allow them to meet basic expenses. Others with one job were dependent on the income of another household member and said the loss of a second household income would leave them unable to pay regular bills. Previous research has found that 25 percent of small-dollar loan borrowers reported a loss of income, such as a job loss or reduction in hours, as a reason for a shortage of funds.[8]

"I work a couple jobs, and I have my teenagers that I put through Catholic high schools and colleges. … And then the bills just keep coming, too, just constant bills."

—Storefront borrower, Chicago

"I don't want to look anybody in the eye and admit that I can't even break even."

—Online borrower, Manchester, NH

"My husband has been unemployed for the last two years, and it's been a struggle to make it. I hope that he gets a job any day so we don't have to be quite so tight on the budget. And my son is leaving to go into the Air Force."

—Storefront borrower, Birmingham, AL

"[I have a] full-time job at the sheriff's office [where] I'm taking a 20 percent pay cut, but I have a security job on the side."

—Storefront borrower, Birmingham, AL

"I've had a part-time job like for the last four years after my divorce, [but] the finances aren't like they were. … I got a second job."

—Storefront borrower, Birmingham, AL

"[The] only light bulbs in my house are in the kitchen, the bathroom, and … none in the bedroom. No bill in there is going to be over $100, no bill at all."

—Storefront borrower, Chicago

WHAT IS A BANK DEPOSIT ADVANCE LOAN?

A deposit advance loan is a payday loan for up to $500 that some banks offer to customers who have direct deposit. The structure mimics a conventional payday loan, with the entire loan plus interest due on the borrower's next payday. The cost—$7.50 to $10 per $100 per pay period, resulting in annual percentage rates (APRs) of 196 to 261 percent for a 14-day loan—is somewhat lower than that of a typical storefront loan ($10 to $20 per $100 per pay period, or 261 to 521 percent APR). The loans are secured by the customer's next direct deposit, and the bank repays itself immediately when that deposit is received. Depending on the bank, the loans may be advertised in branches, by direct mail, through email, at ATMs, or on a bank's website.

Previous research indicates that although bank deposit advances are advertised as two-week products, average customers end up indebted for nearly half the year, similar to the experience of payday loan customers borrowing from storefronts.[i] In Pew's focus groups, bank deposit advance borrowers explained that, once the bank has withdrawn the full amount plus interest, they frequently cannot meet their expenses and, like store-front and online payday borrowers, must re-borrow the loan amount.

EXHIBIT 2:

BANK DEPOSIT ADVANCE LOANS MIMIC PAYDAY LOAN MODEL

	CONVENTIONAL PAYDAY LOAN	BANK DEPOSIT ADVANCE LOAN
Advertised term	**One pay period with lump-sum repayment (about two weeks)**	**One pay period with lump-sum repayment (about two weeks)**
Amount loaned	**Usually up to $500**	**Usually up to $500**
Most common advertised price	**$15 per $100 per pay period**	**$10 per $100 per pay period**
Annualized interest rate on a 2-week loan (APR)	**391 percent**	**261 percent**
Security provided to lender	**Post-dated check or electronic debit authorization for borrower's account at third-party institution**	**Electronic debit authorization for borrower's account held by the lender**
Requirements to borrow	**Income stream, checking account**	**Income stream, checking account with direct deposit at this bank**
Borrower experience	**Average borrower indebted 5 months during year; ¾ of loans are quick re-borrows**	**Available evidence shows similar patterns as conventional payday loans**

SOURCES: "Payday Lending in America: Who Borrows, Where They Borrow, and Why." The Pew Charitable Trusts. (2012); "Big Bank Payday Loans." Center for Responsible Lending. (2011); Consumer Financial Protection Bureau."Examination Procedures: Short-Term, Small-Dollar Lending." January 19, 2012. Available at: http://files.consumerfinance.gov/f/2012/01/Short-Term-Small-Dollar-Lending-Examination-Manual.pdf; Fed. Reg. 76. 33409-33413. Guidance on Deposit-Related Consumer Credit Products. Notice by the Comptroller of the Currency. June 8, 2011; Bank-specific cost information comes from the websites of banks offering deposit advance loans. Pew's safe small-dollar loans research project, 2013.

i Center for Responsible Lending. "Big Bank Payday Loans." (2011). Available at: http://www.responsiblelending.org/payday-lending/research-analysis/big-bank-payday-loans.pdf

2 Renewing Payday Loans Is Affordable, but Paying Them Off Is Not

"If you can't pay that money back when you … agreed to, they let you just pay the interest, and then it gets easier and easier for you to renew that loan, because you're saying, well, I need to do this with this money, and I can pay this $17.50 or $35 and go ahead on."

—Storefront borrower, Birmingham, AL

The vast majority of payday loan users are repeat borrowers who pay fees to renew or re-borrow the loans, accounting for nearly all of lender profitability.[9] Available data demonstrate the depth of this problem:

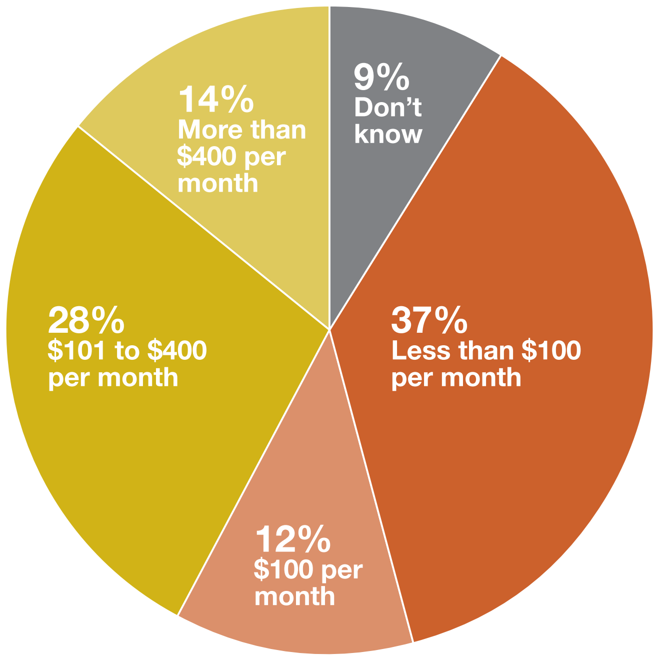
- The average payday borrower is indebted for five months during the year.[10]
- Four in five borrowers use three or more loans per year and account for 97 percent of all loans.[11]
- One in five borrowers use payday loans only once or twice per year, accounting for just 3 percent of all loans.[12] Notably, these borrowers are not profitable for lenders and are not the focus of the payday loan business model.[13]
- More than 60 percent of all loans go to people using 12 or more loans per year.[14]
- Seventy-six percent of loans are renewals or quick re-borrows.[15]

Lump-Sum Repayments Far Exceed Borrowers' Means

Pew's survey asked how much borrowers can afford to pay toward their payday loan debt and still afford their regular bills and expenses. As shown in Exhibit 3, the average borrower reported being able to pay $100 per month, or about $50 per two weeks. However, the typical borrower owes $430 ($375 plus a fee of $55) in two weeks for a storefront loan.[16] Only 14 percent of borrowers can afford enough out of their monthly budgets to pay off an

EXHIBIT 3:

AVERAGE PAYDAY BORROWER CAN AFFORD $100 PER MONTH



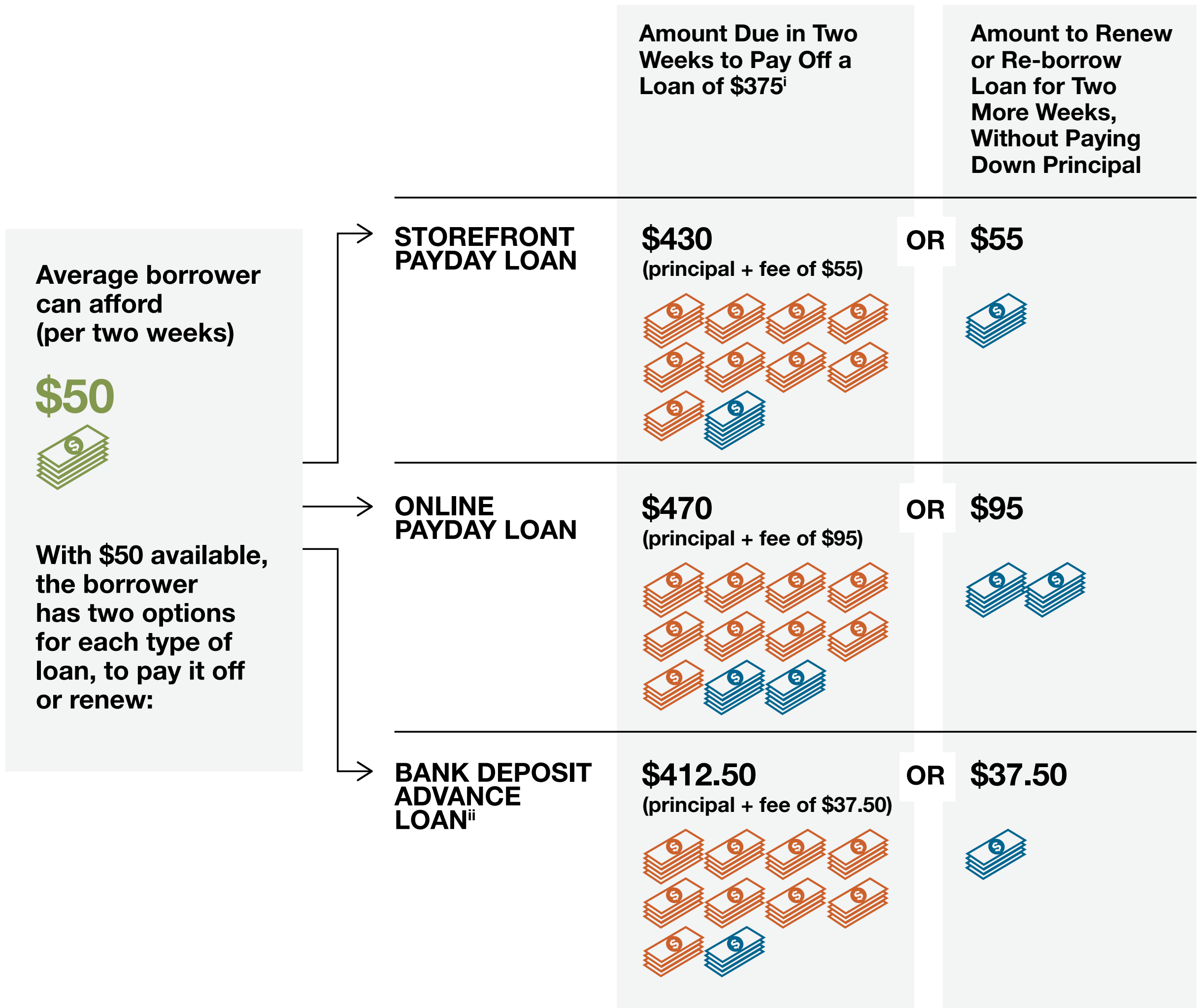
NOTE: Data represent percentage of payday borrowers who gave an answer that fell in this range. Respondents were asked: "How much can you afford to pay each MONTH toward (an online payday loan/a payday loan) and still be able to pay your other bills and expenses?" All responses were volunteered and not read aloud as options to select. Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

average payday loan. As Exhibit 4 shows, the average borrower can barely afford just the $55 fee required to renew an average storefront loan for another two weeks.

Even among those who describe their financial situation as very or fairly good, only 15 percent can afford to pay more than $400 toward their payday loan debt in a month. Borrowers explained in focus groups that this incompatibility between the loans' required payment and their ability to pay caused them to renew or re-borrow the loans for months before they could pay them off. This finding about unaffordability helps explain why the average borrower ends up indebted for five months of the year.[17]

EXHIBIT 4:
RENEWALS ARE AFFORDABLE, REPAYMENT IS NOT



NOTE: Respondents were asked: "How much can you afford to pay each MONTH toward (an online payday loan/a payday loan) and still be able to pay your other bills and expenses?" Results are based on 703 interviews conducted from December 2011 through April 2012.

[i] The average cost of storefront and online payday loans is discussed in Pew's first report in this series and comes from Stephens Inc. (2011).

[ii] "Big Bank Payday Loans." Center for Responsible Lending. (2011). Bank-specific cost information can also be found at https://www.usbank.com/checking/caa/index.html, https://www.wellsfargo.com/checking/direct-deposit-advance/, http://www.regions.com/personal_banking/ready_advance.rf, https://www.53.com/doc/pe/pe-eax-faq.pdf, http://www.guarantybanking.com/SiteContent/5871/final%20ea%20service%20agreement%20(gb)%207-31-10.pdf, and https://www.bankofoklahoma.com/sites/Bank-Of-Oklahoma/asset/en/theme/default/PDF/Bank%20of%20Oklahoma%20FastLoanSM%20Terms%20and%20Conditions.pdf.

SOURCE: Pew's safe small-dollar loans research project, 2013.

"It only costs me $45, but I can't live without that $255 at the same time. I've got to take out the loan again every paycheck. 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."

—Storefront borrower, San Francisco

"Paying $500 now, I mean, that's where the, kind of the vicious circle comes in. Now you almost have to at least get some of it back so you have enough to make it to the end of the month."

—Storefront borrower, Birmingham, AL

"I mean, to all of a sudden, 'Oh, you owe us $500. You got to pay now.' That's tough for anybody; you know what I mean? It's hard to come up with $500."

—Storefront borrower, Chicago

"Well, Friday came, you gave them your pay, what you owed them, which cleared off that loan, but now you have nothing, so you have to re-borrow to survive the week or two weeks."

—Former storefront borrower, Manchester, NH

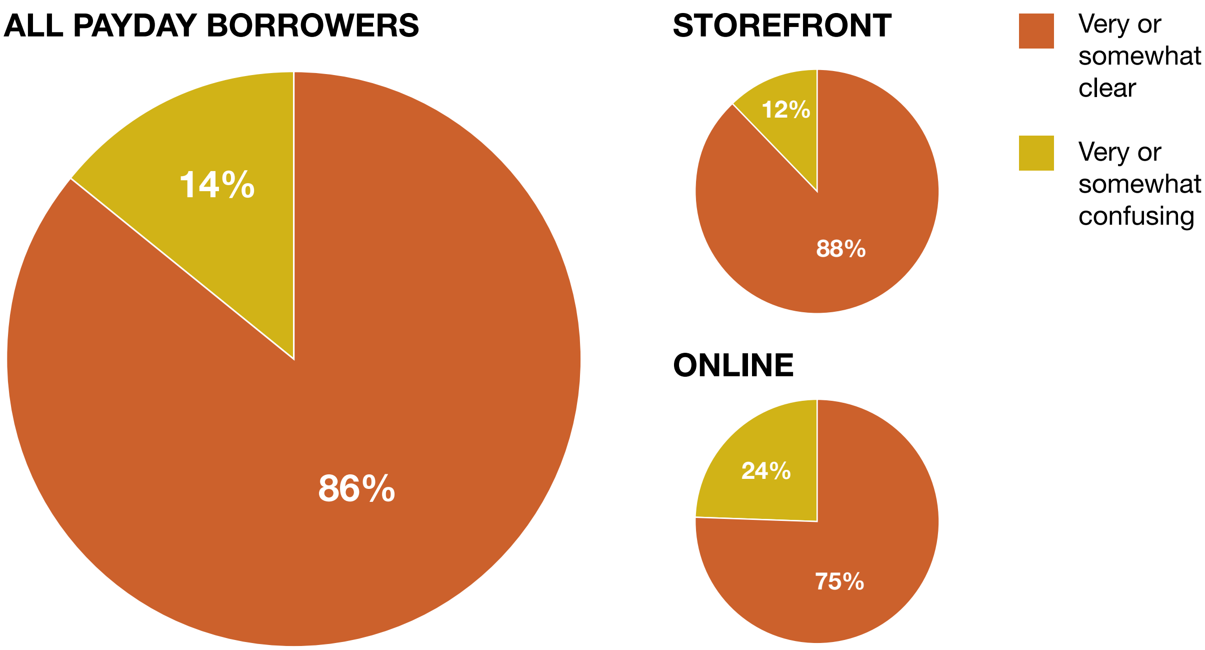
Most Borrowers Say Terms Are Clear but Still Struggle to Repay

Although most borrowers cannot afford to repay their payday loans, large numbers state that the terms and conditions were clear. Focus group participants often described the terms as unfair, usually meaning very expensive, but most said they understood what the fee was and when the loan was due, and in that way they thought the terms were clear. A significantly higher number of storefront borrowers than online borrowers thought the terms were clear.

The average storefront payday loan requires a $430 repayment in two weeks. Pew's survey found that even among those who said the loan terms were very clear, just 46 percent of borrowers could afford a repayment of more than $100 a month, and just 14 percent said they could pay more than $400 a month.

EXHIBIT 5:

SIX IN SEVEN BORROWERS SAY TERMS AND CONDITIONS ARE CLEAR



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "When you took out (that FIRST/the) (online payday loan/payday loan), would you say the terms and conditions of the loan were very clear, somewhat clear, somewhat confusing, or very confusing?" Data for online do not add to 100% because "Don't know" and "Refused" were omitted from this chart. Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

"It's really basic. If you're taking out $300 and they're charging you $90, you pay $390. If you do not pay it back in two weeks, you're paying $90 out of your check every two weeks until you pay the full amount."

—Online borrower, New York

"I do agree [with other borrowers that loans take advantage of you], but you know up front what you're getting into."

—Storefront borrower, Birmingham, AL

"You know the interest rate is 17 percent. I mean, so you know before you get it what you're going to have to pay back."

—Storefront borrower, Birmingham, AL

"I think they're honest, but I don't think it's really fair. I mean, it's a really high interest rate."

—Storefront borrower, Chicago

PAYDAY LOAN LOSS RATES

Loss rates at the larger payday lenders are about 3 percent of funds ($2.98 per $100 lent), according to industry analyst calculations,[i] suggesting that 97 percent of payday loans (including extensions and renewals) are eventually repaid.[ii] No comparable data are available for deposit advance loans, but given that the loans are secured by the borrower's direct deposit to an account owned by the lender, it is likely that the loss rate is even lower.

In focus groups, borrowers stated they were eager to pay back loans, both to meet their obligations and to maintain future access to credit. These sentiments are consistent with relatively high rates of repayment and with prior research that found little evidence of strategic default.[iii]

i Stephens Inc. "Payday Loan Industry." (2011)

ii 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 re-borrow a loan, or experience temporary defaults by bouncing checks and incurring nonsufficient funds fees while still paying back a loan eventually. Advance America has made a similar point, stating, "97 percent of our customers pay us back." http://www.ncsl.org/portals/1/documents/fiscal/Jamie_Fulmer_PowerPoint.pdf

iii Paige Marta Skiba and Jeremy Tobacman. "Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default." (2008). Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319751

3 Why People Borrow When They Can Afford Only to Renew, Not to Repay

"You don't know that it's going to take you six months when you're going into it, to pay."

—Online borrower, New York

Payday borrowers renew or re-borrow loans because they cannot afford to repay them in full. But why do people choose to borrow unaffordable loans in the first place? The answer is not the same for every borrower, but our research reveals several contributing factors.

One clear reason is desperation. More than one-third of borrowers say they have been in such a difficult situation that they would take a payday loan on any terms offered. Another reason is that many borrowers struggle with the temptation of having cash readily available to them, describing payday loans as "too easy" to obtain.

Borrowers also hold unrealistic expectations about payday loans. In focus groups, people described struggling to accommodate two competing desires: to get fast cash and to avoid taking on more debt. They cited the "short-term" aspect of payday loans as a reason for their appeal and described how a payday loan appeared to be something that could provide needed cash, for a manageable fixed fee, without creating another ongoing obligation. However, this perception does not match reality: Borrowers typically experience prolonged periods of debt,[18] paying more than $500 in fees over five months.[19]

Lenders benefit from this misperception, because they rely on borrowers to use the loans for an extended period of time. Prior research shows that the payday loan business model requires repeat usage in order to be profitable,[20] with nearly all loans going to repeat users. (Ninety-seven percent of loans go to people using three or more loans per year, and 60 percent go to those using at least 12 loans per year.[21]) Yet lenders continue to structure their loans as a two-week fixed-fee product. They routinely promote the loans as a short-term solution that should not be used on a long-term basis,[22] even though the loans' unaffordability makes this long-term use widespread. These efforts help shape the expectations of borrowers, who say they rely on lenders to give them accurate information by a nearly 4-to-1 margin. When asked to reflect on their experiences, borrowers expressed surprise over how long it actually took to pay off the loans, as well as frustration about how difficult that was to predict.

Taken together, these and other findings presented below help explain why people select an unaffordable loan.

Some Borrowers Have Been in Situations Where They Would Accept Any Terms Offered

Thirty-seven percent of payday borrowers have at some point felt that they would take a loan on any terms offered. This figure rises to 46 percent among those who rate their financial situation as fairly or very bad.

EXHIBIT 6:

SIX REASONS WHY PEOPLE USE PAYDAY LOANS THEY CANNOT AFFORD

1 **Desperation**
More than one-third of borrowers say they have been in such a difficult situation that they would take a payday loan on any terms offered.

2 **Perception**
Borrowers perceive that payday loans do not create ongoing debt, or are “not another bill,” although the loans do in fact create high-cost, ongoing debt.

3 **Reliance**
Borrowers rely on lenders for accurate information. Lenders sell payday loans that are packaged as a two-week product, although the borrower ends up indebted for five months on average.

4 **Focus on fee**
Borrowers focus on being able to afford the finance fee, rather than on how the lump-sum repayment will affect their budget.

5 **Trust**
Some bank deposit advance borrowers believe that bank payday loans are safer or more regulated than other payday loans.

6 **Temptation**
Some borrowers consider the loans “too easy” to obtain, because they are readily available, and borrowers have a consistent cash shortfall.

SOURCE: Pew's safe small-dollar loans research project, 2013.

These borrowers accept an unaffordable loan for the simple reason that it allows them to stay solvent for two more weeks, regardless of cost. Previous research has also found that most customers do not comparison shop for small loans and instead focus on obtaining money quickly, demonstrating that when people are in an urgent situation, speed rather than affordability is paramount.[23]

EXHIBIT 7:

37%

of borrowers would have taken a payday loan on any terms offered

NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "Have you ever felt you were in such a difficult situation that you would take (an online payday loan/a payday loan) on pretty much any terms offered or have you never felt that way?" Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

"If you're that desperate then you almost do any terms."

—*Storefront borrower, Manchester, NH*

"You don't think about the cost of funds in an emergency. That's basically it."

—*Storefront borrower, San Francisco*

"I mean you cannot choose—not as completely as you probably should. … I am going to have to pay more later when I pay this off but we'll cross that bridge in two weeks. Right now I think it's just that whole immediacy moment."

—*Storefront borrower, San Francisco*

"Like the first time I did it, and maybe like the second time, getting the loan wasn't really going to help me out too long term, because I was spending more than I was bringing in. So I got into a real hard spot the first time I did it. And then the second time I did it, because I was desperate, where I ended up having to like extend it, because I needed that money to live on, and then extend it again. And I got in sort of over my head, where it's like now I owe all this money, and you're going to take basically my whole check."

—*Storefront borrower, Chicago*

"It hurts me to be in a situation where I have to go and accept those types of conditions."

—*Former storefront borrower, San Francisco*

Borrowers Perceive Payday Loans as 'Not Another Bill'

To some focus group respondents, a payday loan, as marketed, did not seem as if it would add to their recurring debt, because it was a short-term loan to provide quick cash rather than an additional obligation. They were already in debt and struggling with regular expenses, and a payday loan seemed like a way to get a cash infusion without creating an additional bill. Despite this appeal, the reality is that the average borrower ends up indebted to the payday lender for five months of the year.

It is highly unrealistic for borrowers to think that they will repay the loan on their next payday and not need to re-borrow the money (more people use 17-plus loans per year than use just one). But this optimism is consistent with previous research from the behavioral economics field.[24] Previous research has found that people across income levels express unrealistic optimism in assessing their financial prospects in areas such as investment returns, future earnings, or ability to repay loans quickly.[25]

"I thought, 'No I don't want to charge it,' at the time, because I had enough [other bills] to pay. I was already, you know, my limit was getting kind of there."

—Online borrower, New York

"I don't want to prolong it too much, and then it becomes another bill, because that's essentially what will happen. If I'm paying over six months, it's just another bill, like I have another extra cable bill or something."

—Online borrower, New York

"Because when I kept getting those statements and so forth, I made a decision to pay [the credit cards] off, and I'm not going to get another one … because I don't want to keep paying all that interest."

—Storefront borrower, Birmingham, AL

"By my next paycheck, I should be done."

—Online borrower, New York, who has had a loan out for three months

"And I think, 'Oh, it'll just be fine next paycheck, just need to get to the next paycheck.' And I need, you know, either pay the bill to keep the lights on, or need some food, or whatever it is."

—Storefront borrower, Chicago

Other research in the field has found that people experience "confirmation bias," looking for information to confirm their already-held hope or belief.[26] A loan from a state-licensed lender or federally chartered bank that is marketed as a two-week product serves to confirm an overly optimistic perspective, signaling to borrowers that it is realistic for them to receive quick cash without creating ongoing debt.

Borrowers Rely Heavily on Payday Lenders, Whose Loans Appear to Last for Just Two Weeks

More than three-quarters of borrowers in Pew's survey stated that they rely on the payday lender to provide accurate information, but information is provided only about a two-week product, even though borrowers end up indebted for an average of five months. Because the loans do not amortize, paying just the fee—the salient price that borrowers are instructed to pay if they cannot afford full repayment—does not reduce the amount owed, leaving them no closer to eliminating the debt. Therefore relying on the lender for accurate information makes the ultimate cost and duration of the debt extremely difficult to predict.

Lenders' advertising heavily promotes the concept of relying on and trusting them. One bank describes itself in a payday loan advertisement as "your trusted source"[27] and suggests you "work with a lender you trust."[28] A large storefront payday lender advertises itself as "the name millions trust"[29] and promises, "We're here for you."[30] Other lenders call themselves "a company you can trust"[31] or "someone you can rely on"[32] and explain that they are "here to help you,"[33] encouraging people to "stop by to borrow … money from your friends."[34]

EXHIBIT 8:

MAJORITY COMPLETELY RELY ON PAYDAY LENDERS FOR ACCURATE INFORMATION

NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "How much do you rely on (online payday lenders/payday lenders) to give you accurate information?" Results are based on 703 interviews conducted from December 2011 through April 2012. Data do not add to 100 percent because "Don't know" and "Refused" were omitted from this chart.

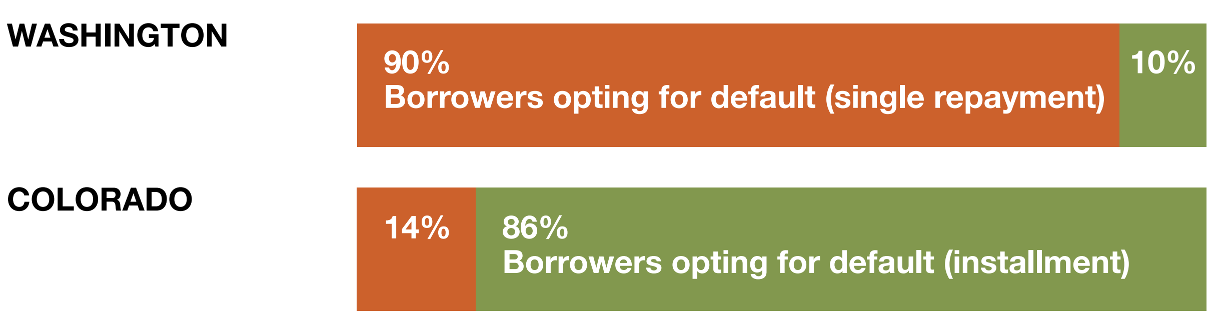
SOURCE: Pew's safe small-dollar loans research project, 2013.

The meaning and implications of this reliance are perhaps best illustrated by comparing how borrowers use payday loans in Washington and Colorado. In Washington, a payday loan's term is for two weeks with a lump-sum repayment, and, as in most states, the majority of payday users re-borrow the loans multiple times.[35] But unlike most states, Washington gives borrowers a no-cost option to convert the loan immediately into a far more affordable[36] 90- to 180-day loan, payable in installments.[37] In 9 of 10 instances, however, borrowers fail to do so, instead accepting the unaffordable default loan structure provided by the lender.[38] This striking data point demonstrates that even when a payday loan could become affordable for borrowers through conversion to an installment loan, the default structure provided by the lender is so influential that most borrowers do not alter that structure.

It would be possible to interpret this inaction as a borrower preference for single-repayment loans, were it not for the example of Colorado, where the default loan structure is for a 180-day term, but borrowers can pay back the loans (with no pre-payment penalty) in two weeks or any other amount of time. Only 1 in 7 pay the loans back in full within a month, with the majority instead accepting the default installment loan structure.[39] As has been found repeatedly in the behavioral economics literature,[40] people tend to accept financial products as they are offered, relying on the structure and choices the provider has established as the default. Payday borrowers are no exception, overwhelmingly accepting the default loan structure that the lender provides them and demonstrating a tremendous degree of reliance on the lender, even when they cannot afford the terms the lender is offering.

EXHIBIT 9:

BORROWERS RELY HEAVILY ON LENDER, ACCEPTING DEFAULT LOAN STRUCTURE



SOURCES: State of Colorado Department of Law; Washington State Department of Financial Institutions; Pew's safe small-dollar loans research project, 2013.

Previous research also found that borrowers do not know the annual percentage rates (APRs) on payday loans,[41] although they are posted in stores and on websites. Instead, borrowers generally know the fee charged per $100 borrowed per pay period. Not knowing a loan's APR makes it hard to compare products, leading to further reliance on lenders. Some in focus groups expressed difficulty in comparing the cost of a payday loan with that of other loan products, such as a credit card. Several borrowers mistook the two-week fee on a payday loan for an interest rate and erroneously compared that with the APR of a credit card.[42] (More information on payday borrowers' use of credit cards is featured on Page 30.)

"I honestly did not think about the fact that once I got paid again ... that it was going to take that money out that I owed them plus with the fee for it. So when that happened I was just like, 'Okay, so now what? I still have to pay [the bills]. … What do I do?' That's when I had to do it again. I honestly just needed to get that done in that moment and did not think about the consequences too well."

—*Bank deposit advance borrower, San Francisco*

"They just say it in big terms. ... I get real confused when they start talking about the numbers, and I don't read it. I'll be honest, I don't read it. She just said initial here, initial here, initial here, initial here."

—*Storefront borrower, Birmingham, AL*

"Should I pay this whole loan back, or pay the little fee they told me to pay a month? I'm going to pay them a little money."

—*Storefront borrower, Chicago*

"And there's a lot of, there's a lot of nice talk going back and forth, but not a lot of like, you know, understand the steps that are here."

—*Storefront borrower, Chicago*

ALMOST ALL PAYDAY BORROWING IS FOR PERSONAL, NOT BUSINESS, EXPENSES

In developing countries, economists and academics have documented the widespread use of high-cost credit to finance investment in a small business.[i]

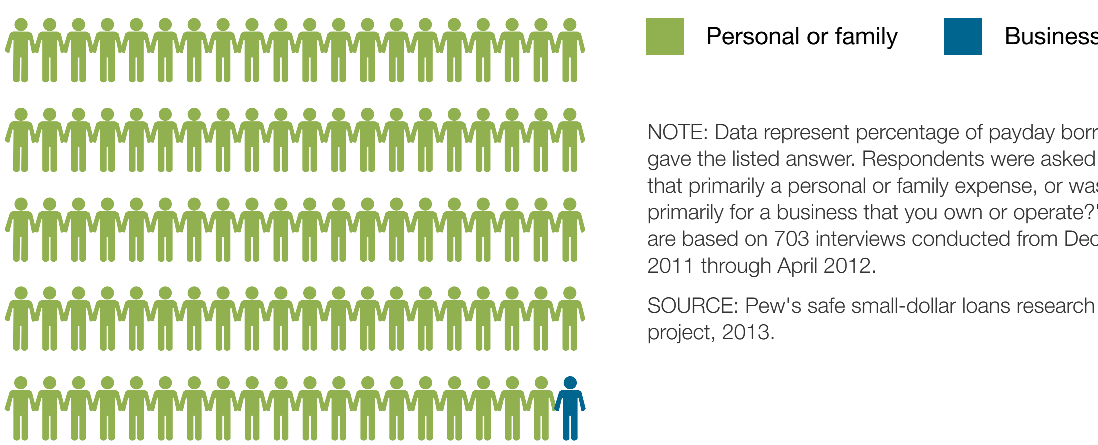
Domestically, some business and policy leaders have suggested that small businesses are using payday and other high-cost, very short-term loans to finance their operations.[ii] However, Pew's data show that borrowers almost universally use payday loans to cover personal or family—rather than business—expenses, even among the 6 percent of storefront payday loan borrowers who are self-employed.

i A great deal has been written about the self-employed poor borrowing from money lenders to finance their business operations in developing countries. For example, David Bornstein discusses this practice in "The Price of a Dream: The Story of the Grameen Bank" (2005), and Esther Duflo and Abhijit Banerjee discuss it in "Poor Economics" (2011).

ii The Hispanic Chamber of Commerce argued that small-business owners are using overdraft services and direct deposit advances as credit to finance business operations in a letter from the organization's president, Javier Palomarez, to the Office of the Comptroller of the Currency (OCC) on July 18, 2011. http://www.regulations.gov/#!documentDetail;D=OCC-2011-0012-0038. See also Jim Hawkins, "Credit on Wheels: The Law and Business of Auto Title Lending" (2011), which notes that those claiming that significant numbers of title loan borrowers are using the loans for business reasons have included industry leaders, elected officials, and academics.

EXHIBIT 10:

ALMOST ALL PAYDAY BORROWING IS FOR A PERSONAL OR FAMILY EXPENSE



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "And was that primarily a personal or family expense, or was that primarily for a business that you own or operate?" Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

Borrowers Focus on the Fee, Rather Than the Whole Repayment

A number of focus group participants explained that when using payday loans, they concentrated just on the fee, which they could afford, rather than the entire repayment, which they usually could not afford without having to borrow again to meet their expenses. Some borrowers talked about the loan fee being affordable, but they had not realized that the full loan repayment would then make it impossible to meet their expenses.

"You can afford that little bit [the loan fee]. It doesn't hurt you."

—*Former storefront borrower, San Francisco*

"Once my paycheck came, it was like, 'Okay, we're taking this out.' I was like, 'Dang, I should have never done this.' And it was like it took me a while to pay it back. It took me … six months. … Because every two weeks it was something, their amount of money, then I had to pay this, and I had to pay bills."

—*Online borrower, New York*

"It's just playing with the money. I hand it to you, you hand it back. I hand it to you, you hand it back, you know, and it's only the interest. … Just as long as you pay me $17 on every $100, we're good, you know."

—*Storefront borrower, Birmingham, AL*

"The first one I paid off in full. That's the thing. I paid it off. I said, 'Here's $400, whatever it was.' … But then that month, okay, here's my paycheck, $400 gone, and now I have this much left, but I have all these bills. All of a sudden, you're already like, 'Hmmm, I got the short end of the straw.'"

—*Online borrower, New York*

"You need that money from the next paycheck that is coming, but they take it all, and then you're going to have to find another way to get the money from somewhere to cover that amount."

—*Former storefront borrower, San Francisco*

"I think [it's safe] because they are through the bank and the bank has FDIC insurance. I don't know. I am just assuming that. I would assume so."

—Bank deposit advance borrower, San Francisco

"Well they've got usury laws, don't they? I think probably the payday loans aren't subject to usury laws, but the banks, because they're chartered by federals, they've got a lot of pressure on them to stay within the usury laws."

—Bank deposit advance borrower, San Francisco

"For the banks, on the door it says FDIC, so you know it's governed."

—Bank deposit advance borrower, San Francisco

"I found out about it because when you do the online banking there is this thing. I hadn't heard about it, and it just says that I can do a direct deposit advance. And I clicked on it, like 'Oh! Really?' And then, well, it's very quick and easy."

—Bank deposit advance borrower, San Francisco

"Well, I was a little short and was thinking I could use some more money and I was at the ATM actually, and it was there, offering me a direct deposit advance. So, I thought I would try it. They did it for me. They put it right on the ATM where I was at, so I went for it."

—Bank deposit advance borrower, San Francisco

Some Borrowers Believe Bank Deposit Advances Are Safer or More Regulated

Several borrowers in focus groups believed that bank deposit advance products (see Page 12), which have the same lump-sum repayment structure as payday loans, were safer than other types of payday loans and were more inclined to use them. Some focused on the fact that the loan was offered by the bank where they already did business, making it both familiar and convenient. Others mistakenly believed that the products were covered by special federal regulatory protections and therefore were relatively safe to use compared with other payday loan options. In reality, nationally chartered banks that offer deposit advance loans may disregard state usury rate limits and other consumer protection laws, and so far there is relatively little federal regulation of payday and deposit advance lending.[43]

"It could be a little too easy."

—Storefront borrower, Chicago

"It [was] tempting when you were just in that dire need."

—Former storefront borrower, Chicago

"We press click, we press okay, we say submit, and you know, I agree. But I think it's, it makes it too convenient. It's too easy to do it."

—Online borrower, Manchester NH

"It's contradictory, but it's like I wouldn't fall into the trap if I didn't have the option."

—Online borrower, New York

"When I paid them off … they'd send me stuff in the mail, we'll give you this, we'll give you this, we'll give you this, you know, and they'd call me on the phone. … I knew what they were up to, you know, because it was so easy to fall right back into that."

—Former storefront borrower, Manchester, NH

"It was that quick fix that was too easy."

—Former storefront borrower, Manchester, NH

Some Borrowers Describe Getting Payday Loans as 'Too Easy'

In focus groups, borrowers appreciated how easy it is to obtain a payday loan, but in many instances, they described it as "too easy" and said they had difficulty resisting the temptation to borrow. Interestingly, both storefront and online borrowers expressed this sentiment, even though these two groups are different, and they think of storefront and online payday loans as two very different products.

CREDIT CARD USAGE AMONG PAYDAY BORROWERS

Credit cards can be an important source of liquidity for cash-strained households. Although a large portion of payday loan applicants have credit card accounts, many have exhausted their limits.[i] Pew's survey found that 2 in 5 payday borrowers used a credit card in the past year, and most had "maxed out" their credit at some point during the same period.

Among payday borrowers who do not have a credit card, nearly half do not want one, and almost as many have been turned down or expect they would be turned down. In focus groups, many borrowers reported having incurred substantial credit card debt in the past and said that is why they intentionally avoid them. Other borrowers discussed feeling overextended by debt already and said payday loans seemed like a different kind of choice compared with a credit card or longer-term loan, because they expected payday loans to last only a short time.

Still others were confused about the relative costs of credit cards compared with payday loans. For example, one participant mistakenly believed that a credit card's annual percentage rate (APR) of 23.99 would cost more per month than a payday loan (which in his state costs $17.50 per $100 borrowed, or 17.5 percent every two weeks), and others did not disagree.

"Because the interest on … some credit cards [is] 23.99 percent. So if you go charge $300, and then you don't pay that $300 off at the end of the month … they're going to tack that 23.99 percent on to it, so you're going to still be paying more than you would if you had to [get a payday loan]."

—Storefront borrower, Birmingham, AL

"I just never got one because I've seen what it did to my sister."

—Storefront borrower, Chicago

"Well, I got my first credit card when I, I think I was 18, and was probably working like a minimum wage job, and I've not had one since. … I'm still paying it off."

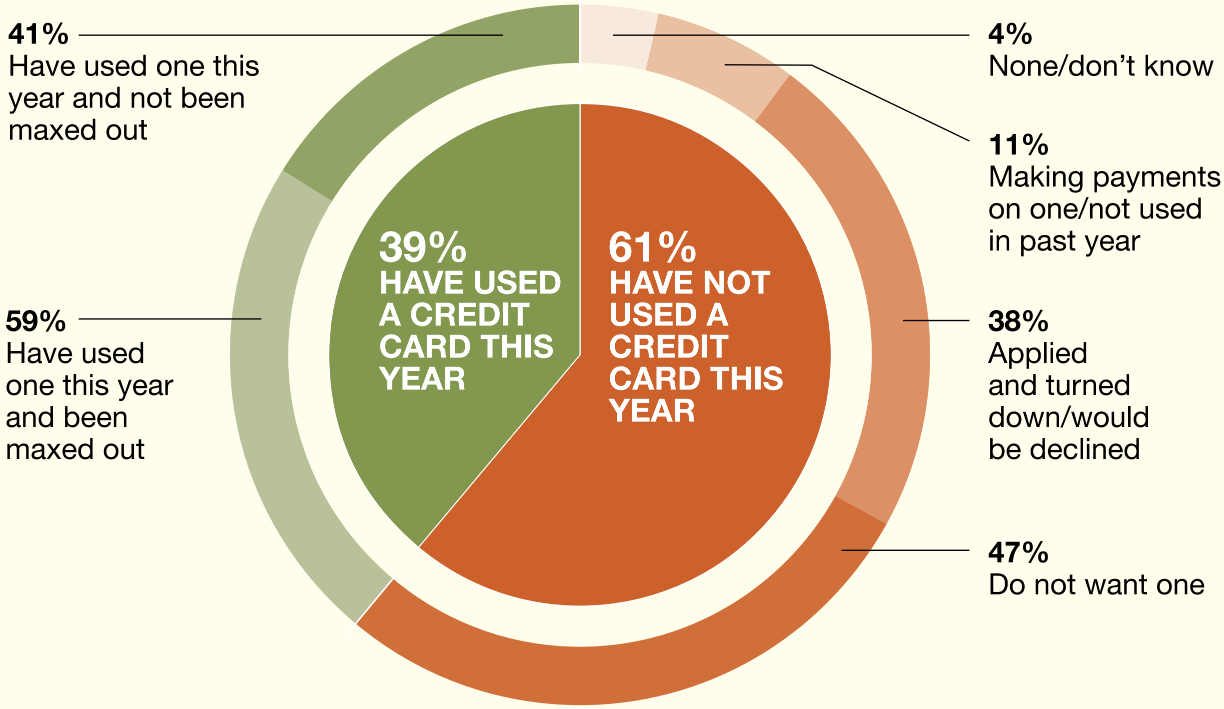
—Storefront borrower, Chicago

"I've had them, and … I just can't deal with it, you know. It's a false money. You pay for it later and more than you plan to."

—Storefront borrower, Birmingham, AL

i Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman (forthcoming). "Payday Loan Choices and Consequences." This research finds that almost all payday applicants have a credit score, and a majority have credit cards but are mostly maxed out on their credit limits at the time they apply for a payday loan. Available at: http://assets.wharton.upenn.edu/~tobacman/papers/Payday%20Loan%20Choices%20and%20Consequences%2020121010.pdf. Overall, approximately 68 percent of all American adults utilize credit cards (2010 Survey of Consumer Finances. Federal Reserve Bulletin. 2012. http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf).

EXHIBIT 11:
CREDIT CARD SITUATION OF PAYDAY LOAN BORROWERS



NOTE: Data represent percentage of payday loan borrowers who gave the listed answer. Respondents were asked: "I'm going to read several types of financial products and services. For each one, please tell me whether you have used that product or service in the past year. Have you used a credit card in the past year?" (If "Yes") "In the past year, have you maxed out or been at the top of your credit limit on any of your credit cards?" (If "No") "Have you not used a credit card in the past year because you do not want one, because you think you would not be approved to get one, you are already making payments on one, or did you apply for one and were turned down?" Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

4 Most Payday Borrowers Are Also Overdrafting Their Checking Accounts

"And even if you tell them the money is not there, guess what? They're going to put that check through and it's going to bounce two times before they come back and say, 'well, can you send us another check?' So now you have two extra fees on your bank account."

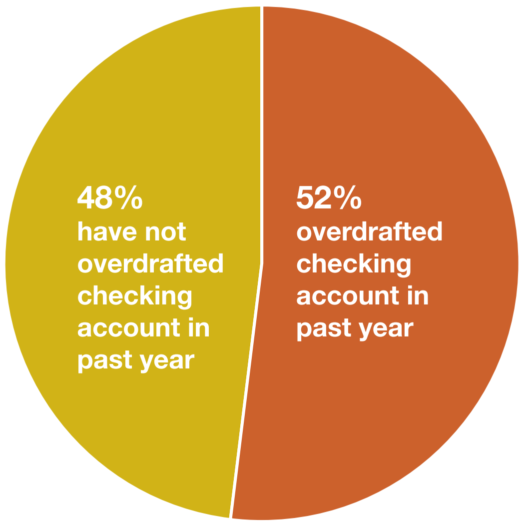
—Storefront borrower, Chicago

Payday loans are sometimes promoted as a cost-effective alternative to checking account overdrafts. (A major storefront and online payday lender encourages borrowers to "use payday loans to stop a bank overdraft or NSF fee,"[44] and a prominent online payday loan website states, "avoid costly overdraft fees and charges!"[45]) However, more than half of payday loan borrowers report having overdrafted their accounts in the past year,[46] and 27 percent report that a payday lender making a withdrawal from their bank account caused an overdraft. Moreover, Pew's prior research has shown that the vast majority of those who overdraw their accounts do so by mistake, not by intention. Although people choose payday loans in order to avoid overdrafts, many end up paying payday loan fees and overdraft fees as well.[47]

Payday Loans Not Eliminating Overdrafts

Although it is unclear how much payday borrowing may reduce or increase the likelihood of checking account overdrafts, Pew's research shows that payday loans do not eliminate overdraft risk. Prior research has found that some payday loan borrowers are explicitly choosing to use the loans to avoid overdrafts and bounced checks,[48] but Pew's survey research demonstrates that borrowers are incurring overdraft fees anyway.

EXHIBIT 12:
MAJORITY OF PAYDAY BORROWERS HAVE OVERDRAFTED IN THE PAST YEAR



NOTE: Data represent percentage of payday loan borrowers who gave the listed answer. Respondents were asked: "I'm going to read several types of financial products and services. For each one, please tell me whether you have used that product or service in the past year. Have you used overdrafting on your checking account in the past year?" Results are based on interviews with the 565 payday borrowers in the survey who still had a checking or savings account at the time they took the survey. Interviews were conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

There is less evidence about overdrafts related to bank deposit advance loans, but those loans' single-repayment structure makes it likely that they will be of limited help to customers trying to avoid overdrafts. Corroborating evidence comes from a large financial services consultant that developed a deposit advance loan program for banks and originally promoted the program as a new source of revenue that would result in little to no "overdraft revenue cannibalization."[49] Its analysis indicates that deposit advance loans provide little to no value in helping borrowers avoid overdrafts.

Previous research on the relationship between payday loan usage and overdrafts has yielded mixed results. One study looked at county-level data nationwide and found that access to payday loans was associated with increased levels of involuntary bank account closures, generally because of overdrafts.[50] Another

Twenty-seven percent of borrowers report that a payday lender making a withdrawal from their bank account *caused* an overdraft.

study found that when payday loans were no longer available in two states, bounced checks increased in one state but not the other.[51] A third study showed similar levels of nonsufficient funds (NSF) and overdraft fees paid per household in states that had payday loan stores and in states that did not.[52]

In focus groups, borrowers overwhelmingly agreed that they would not use overdrafts as an alternative to payday loans because, as a credit source, they would be too expensive. These sentiments are consistent with a national survey from Pew's Safe Checking in the Electronic Age Project, which found that 90 percent of those who overdrew their accounts did so by mistake rather than by choice.[53]

PAYDAY LOAN BORROWERS USE PREPAID CARDS AT THREE TIMES THE NATIONAL RATE

Thirty-eight percent of payday loan borrowers report having used a prepaid debit card[i] in the past year, triple the rate at which the general population uses these products.[ii] Prepaid cards are often advertised as a way to avoid checking account overdraft fees and credit card debt, perhaps explaining their appeal to payday loan users, who are eager to avoid both of these.[iii] Prepaid cards also can function much like a checking account for those who do not have one and can be used to budget and compartmentalize spending. For more on prepaid cards, please visit www.pewtrusts.org/prepaid.

i This data point refers to usage of general purpose reloadable (GPR) prepaid cards.

ii Javelin Strategy & Research found that 13 percent of American adults used a prepaid card in 2011. http://www.businessweek.com/news/2012-04-11/prepaid-card-use-up-18-percent-as-consumers-drop-debit-study

iii For example, one of the largest providers of prepaid debit cards, Green Dot, focuses its marketing on the fact that its cards do not have overdraft fees or lead to credit card debt: https://www.greendot.com/greendot

Payday Loans Causing Overdrafts

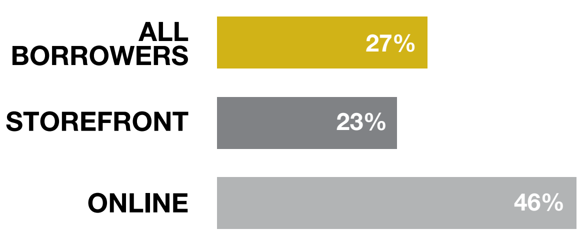
Among storefront borrowers, 23 percent report that a payday lender attempting to make a withdrawal from their account caused an overdraft. Among online borrowers, 46 percent had this experience.[54] This significant difference was reflected in Pew's focus groups: Online borrowers experienced many more problems as the result of payday lenders accessing their bank accounts.

> "When I was actually out of town, we had a family member that passed away, and then I missed the date to pay it back, and then I was gone longer than I expected, so I missed a payment. And then they, it was two weeks, and they went and they took it out of my account. And then the overdrafts killed me."
>
> *—Storefront borrower, Chicago*

These findings—that 52 percent of payday borrowers also report overdrafting their checking accounts, and that for 27 percent of borrowers, payday loans are actually causing overdrafts—reveal that payday loans frequently fail to help borrowers avoid overdrafts.

EXHIBIT 13:

PAYDAY LOANS CAUSING OVERDRAFTS



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Storefront payday borrowers were asked: "For each one I read, please tell me whether it has happened to you. How about Had a payday lender attempt to make a withdrawal that overdrew your bank account?" Online payday loan borrowers were asked: "For each one I read, please tell me whether it has happened to you. How about Had an online payday lender make a withdrawal that overdrew your bank account?" Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

5 Some Borrowers Use the Same Options to Repay Loans That They Could Have Used Instead of Borrowing

"I finally paid those off, but I would probably still be doing it if it wasn't for my parents helping out with things."

—Online borrower, Manchester, NH

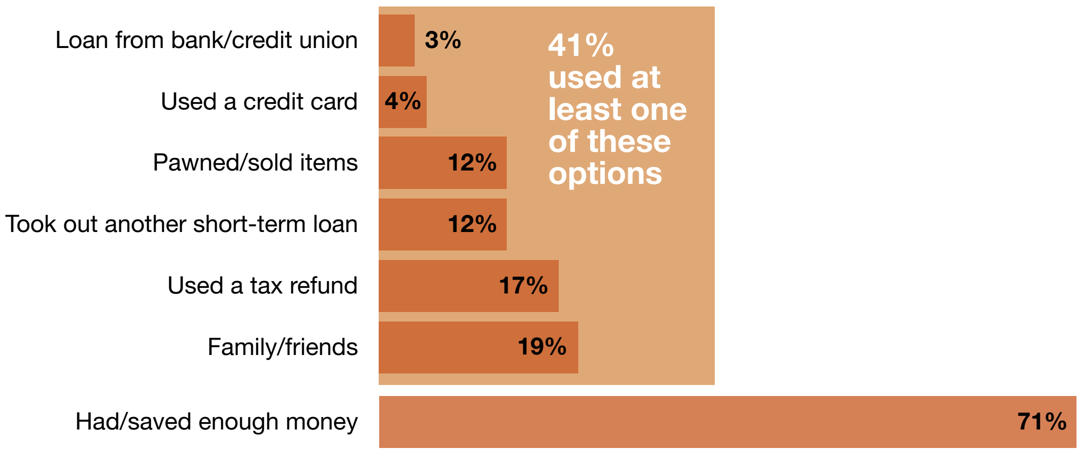
Access to credit is an important tool for people dealing with a cash shortfall, but it would be a mistake to think that people are choosing solely among credit options. Pew's first *Payday Lending in America* report identified a variety of informal or noncredit options that a majority of borrowers said they would employ if payday loans were unavailable: cutting back on expenses, borrowing from family or friends, delaying bills, and pawning or selling items.[55] As explained below, many ultimately turn to the same options they could have used instead of payday loans as a way to pay off the loans.

Pew's survey asked borrowers which methods they have used to pay back a payday loan. Seven in 10 payday borrowers have repaid loans from regular income or savings at least once. Although most borrowers have had or saved enough money to repay a loan at some point, 41 percent have used some other method—asking family or friends for help, waiting for a tax refund, or using another credit product—at least once. Three in 10 borrowers have never been able to repay with income or savings, relying exclusively on one or more alternative strategies.

Some borrowers repaid loans using strategies that they had available to cover their expenses before taking a payday loan in the first place. For example, 19 percent of borrowers received help from family or friends to pay back the loans, and almost all of them report that borrowing from family or friends is an option that would be available to them instead.[56] Similarly, some focus group participants said they chose a payday loan instead of other options but then turned to those same alternatives later to help them resolve their payday loan debt.

EXHIBIT 14:

TWO IN FIVE PAYDAY BORROWERS REPAY USING HELP, WINDFALL, OTHER LOANS



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Survey participants were asked: "Please tell me whether you have or have not used each of the following methods to pay back (an online payday loan/a payday loan). How about (INSERT)? Have you used this method or not?" Data do not add to 100% because each item was asked separately. Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

Also of note is the use of tax refunds. One in six borrowers have used a tax refund to pay off a payday loan, a finding that is consistent with prior research showing that outstanding payday debt decreases when tax refunds are issued.[57] The large windfall provided by a tax refund enables borrowers to repay loan principal that their regular paychecks are not sufficient to cover.[58] Both storefront and online borrowers have used these alternative methods of repayment, demonstrating that this problem applies to both types of loans, and several bank deposit advance users in Pew's focus groups reported the same experience.

Many borrowers ultimately turn to the same options they could have used instead of payday loans as a way to pay off the loans.

"Sometimes I would have good fortune and pay it off, you know, income tax time or whatever."

—Storefront borrower, Birmingham, AL

"I got a credit union loan to pay off all those [online payday loans]."

—Online borrower, New York

"I ended up having to call my parents to bail me out."

—Online borrower, New York

"I mean, we were taking out payday loans to pay payday loans [and that] doesn't make any sense."

—Online borrower, Manchester, NH

"[I paid off the payday loan by] asking some other person for the money, that I know I don't have to worry about this interest, you know, let me pay you back a few dollars at a time."

—Storefront borrower, Chicago

"Let me just do it until I get some kind of windfall to stop at the end."

—Bank deposit advance borrower, San Francisco

"I only did it because I didn't want to ask for any money, ask to borrow from … a friend or anything. I kind of wish I did, you know, because I ended up paying more than I actually borrowed."

—Online borrower, New York

6 Borrowers Feel Relief, but They Also Feel That Payday Loans Take Advantage of Them

"It can be lifesaving, but, yes, it is a trap that's hard to get out of."

—Storefront borrower, Birmingham, AL

Payday borrowers' experiences—receiving credit to cover expenses but then ending up spending far more than suggested by the loan's two-week price tag—lead to complicated and conflicted feelings: gratitude that credit is available to them, appreciation for friendly service, dismay with the high cost, and frustration with lengthy indebtedness.

Borrowers See Loans as Taking Advantage of Them

A majority of borrowers say payday loans take advantage of them, and online borrowers and those who describe their financial situation as "bad" feel this most strongly. Sixty-four percent of this latter group said the loans take advantage, compared with 47 percent of borrowers who rated their financial situation as "good." In focus groups, borrowers who described payday loans as taking advantage focused on the high cost of the loans and the difficulty they have in paying them back.

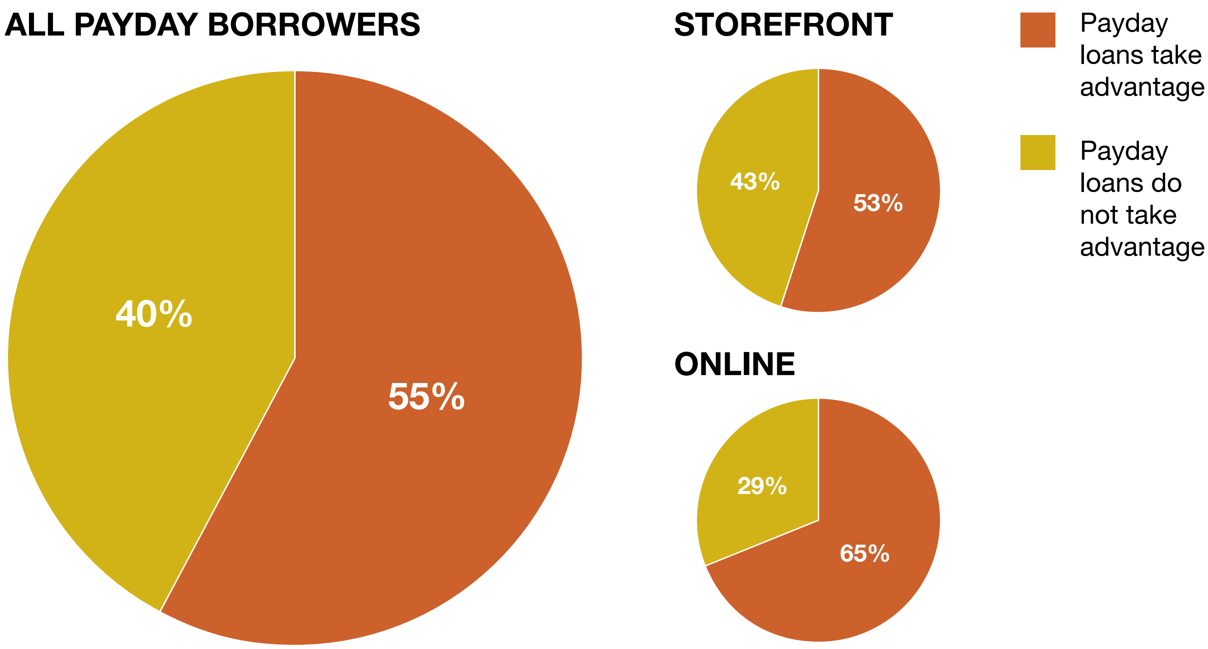
Similarly, 82 percent of those who found the loan terms and conditions "confusing" think the loans take advantage, compared with 51 percent of those who felt the terms and conditions were "clear."

However, 4 in 10 believe that the loans do not take advantage. In focus groups, borrowers who recounted more positive experiences often focused on the friendly relationships they have with individual employees at the payday loan stores they visit. Previous research has also found that storefront payday lenders win high marks for respectful and friendly customer service.[59]

The payday loan industry works hard to create a friendly and respectful atmosphere that customers appreciate. Many describe good relationships with those who work in the stores, even when the product leaves them indebted for an extended period of time.

EXHIBIT 15:

MAJORITY FEEL PAYDAY LOANS TAKE ADVANTAGE OF BORROWERS



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "Some people say (online payday loans/payday loans) take advantage of borrowers, while other people do not think (online payday loans/payday loans) take advantage of borrowers. What do you think, do (online payday loans/payday loans) take advantage of borrowers or not?" Data do not add to 100% because "Some of both/Neither," "Don't know" and "Refused" were omitted from this chart. Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

"So you feel like when, oh, when you go into a place like that, it's like Norm from 'Cheers.' … You're back. I mean, they're happy to see you, because you're a regular."

—Storefront borrower, Birmingham, AL

"They always … speak to you by first name and say, 'hello, how you doing' when you first come in the store, and are good with remembering your name and your face."

—Storefront borrower, Chicago

"But they're the same as you, the people that work there. … They're the same as you, they're just, they're struggling, too."

—Storefront borrower, Chicago

"It's like they're gouging people. … It's like they're just trying to take advantage of them in that situation."

—Storefront borrower, Birmingham, AL

Lenders tend not to compete on price, often all charging the same amount in a given market,[60] but they instead compete on customer service, seeking to maintain long-term relationships with borrowers. Payday loan advertisements promote "outstanding customer service,"[61] "fast, friendly service,"[62] "courteousness,"[63] "smiling,"[64] and "dedication to our customers."[65]

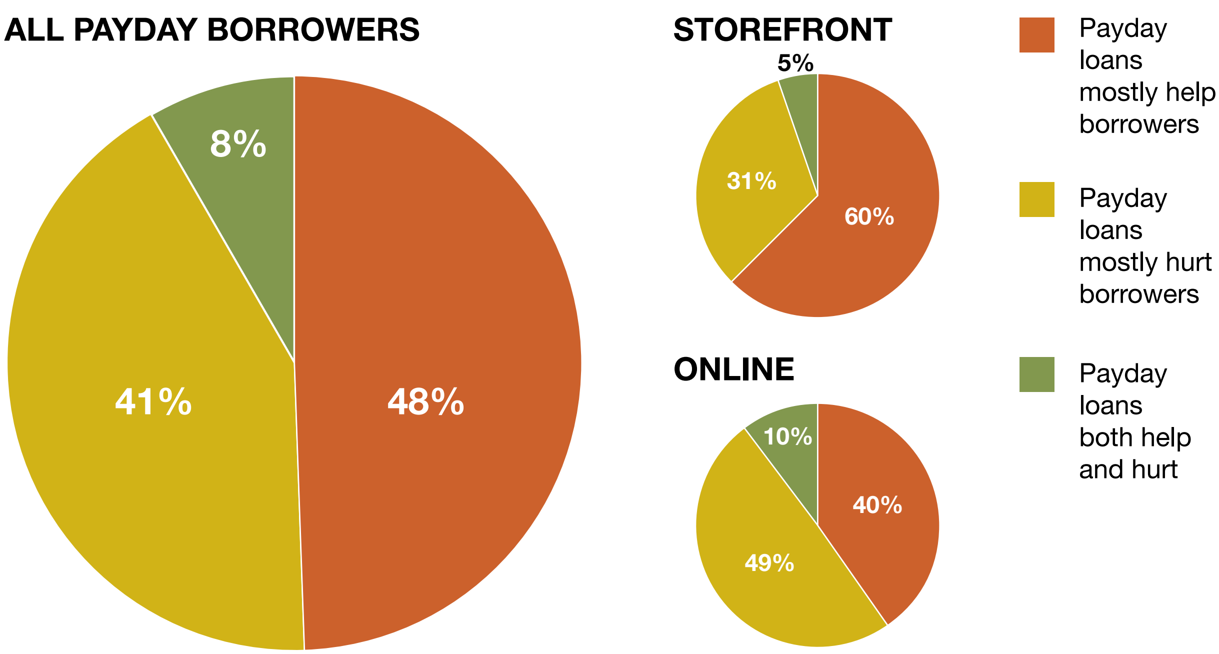
Borrowers Mixed on Whether Loans Help More Than Hurt

Borrowers are torn about whether payday loans mostly help or mostly hurt them, with slightly more saying that the loans help. In focus groups, most who talked about the loans being helpful spoke of the relief they felt when they were able to get a loan. In contrast, most of those who talked about the loans hurting concentrated on the difficulty of paying off the debt and the length of time it took to get out of a loan that had been advertised as lasting for two weeks.

These feelings also correspond to respondents' attitudes about their own financial situations, with those who have more frequent trouble meeting expenses more likely to say the loans hurt.

EXHIBIT 16:

SLIGHTLY MORE SAY LOANS HELP THAN HURT



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "Overall, do you think that (online payday loans/payday loans) MOSTLY help borrowers like you or MOSTLY hurt borrowers like you?" (IF "BOTH," ASK:) "I know it can be hard to say, but generally do you think they MOSTLY help or MOSTLY hurt borrowers?" "Payday loans both hurt and help" was a volunteered response and not read aloud. Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart. Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

"So they're quick and they'll dish out the money to anybody, but do not rub that lamp the wrong way because you do not want to see that genie, forget it."

—Online borrower, Manchester, NH

"I just think that loan kind of, it didn't help. I mean, it helped, but it didn't in the long run."

—Online borrower, New York

"It was a short-term fix that I'm continually paying off."

—Online borrower, Manchester, NH

"I'm no better off than I was when I first applied, I'm actually worse off, because I'm deeper in debt than I was when I first started."

—Online borrower, Manchester, NH

HOW BORROWERS DESCRIBE PAYDAY LOANS

As a focus group exercise, borrowers were asked for a word or phrase to describe payday loans. They used more negative terms than positive ones, but some focused on the loan being helpful when they were in a tight spot.

Interestingly, most borrowers did not disagree with others who offered opposing terms. This exercise revealed borrowers' conflicted feelings, including appreciation for credit in a tough time while also feeling trapped by the difficulty of repaying the loan.

Among the descriptions respondents used are:

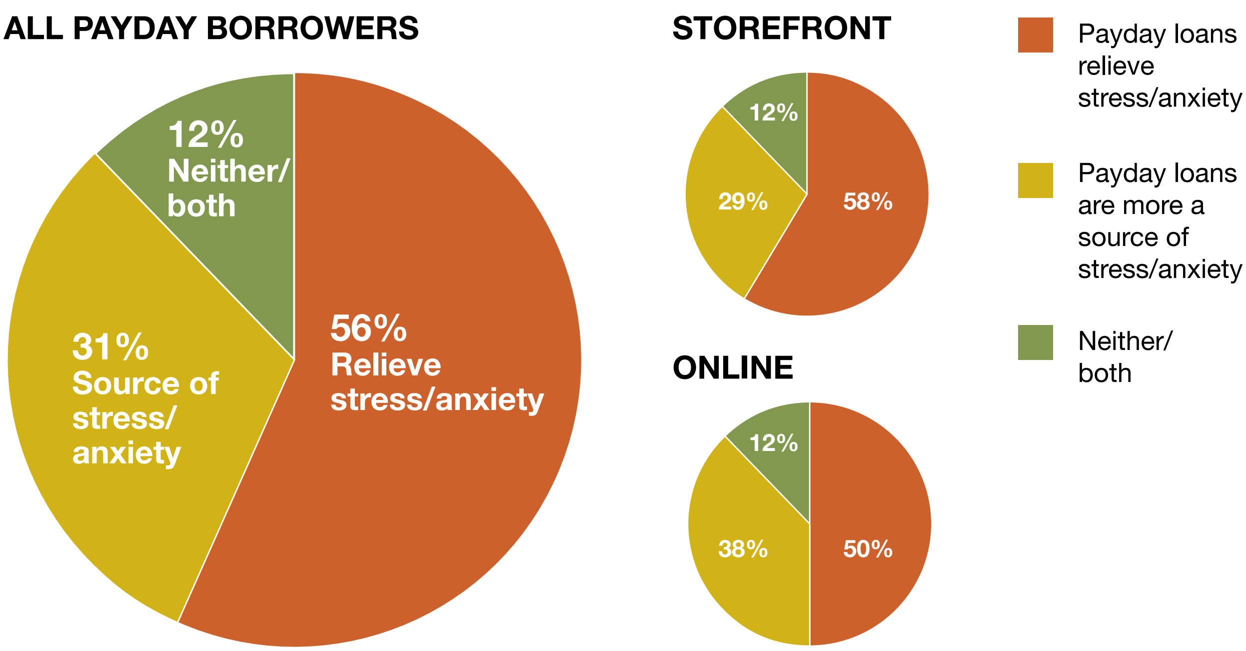
- Convenient
- Rip off
- Evil
- Never-ending
- Money hungry
- Lifesaver
- Should be abolished
- Takes advantage
- Emergency rescue
- Friendly
- Helpful
- Good in an emergency, but dangerous
- Predatory
- Sweet and Sour: Sweet when they give it to you, sour when you've got to pay it back
- Simple
- Desperate
- Helpful but very dangerous
- Tempting
- Expensive
- Panic
- Mistake
- Scary
- Too easy
- Accessible

More Say Loans Relieve Stress and Anxiety Than Cause It

More borrowers describe the loans as relieving—rather than causing—stress and anxiety, although online borrowers and those who report having trouble meeting their expenses more than half the time are more closely divided on this issue.

EXHIBIT 17:

MORE SAY LOANS RELIEVE STRESS AND ANXIETY THAN CAUSE IT



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "(Have/Was) the (online payday loan(s)/payday loan(s) (been) more a SOURCE of stress and anxiety or more something that has RELIEVED stress and anxiety?" "Neither/both" was a volunteered response and not read aloud. Data for storefront and all payday borrowers do not add to 100% because "Don't know" and "Refused" were omitted from this chart. Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

"It's good because it's there when you need it, but it's not good if you don't have the strategy down. You have to pay it back right away, and then if you can pay it back right away, why would you go and get it to begin with?"

—Storefront borrower, Chicago

"All I know is I got the money that I needed to pay the rent that I needed to pay. And so, you know, it's … a Catch-22."

—Online borrower, New York

"You pay it off, and then you panic because you know you have to go back, and you don't want to because you're going to lose the money, and you try to think of other options first, and if you don't have any, then you're right back in the same boat pretty much, panic, you know."

—Former storefront borrower, Manchester, NH

"That's where I go if I'm in a panic, the payday loans."

—Online borrower, Manchester, NH

PROFILES OF 'SATISFIED' CUSTOMERS

In a questionnaire as part of Pew's focus groups, the following borrowers all described themselves as "satisfied" with payday loans, as are most payday borrowers, according to industry surveys. To understand more thoroughly the experiences of these borrowers, and what it means to be satisfied with a payday loan, several quotes from each borrower are included below. Names have been changed to protect their privacy.

CHRISTINE (ALABAMA STOREFRONT BORROWER)

- Satisfaction level: "Very satisfied."
- Words to describe payday loans: "Emergency rescue."
- "I met a girl that worked at a payday loan store. Her kids go to school with my kids, and we were at a football game. And I had some medical bills that needed to be paid, and so I asked her about it. I always use her, and we've become friends, so, I mean, it's all pleasant."
- "I think they are fairly trustworthy. I mean, I think you have to use your own personal judgment about which one you use and the relationship you develop with the people there, because like you say, when you walk in, you deal with the same person every time. So in that aspect, it's trustworthy, but I also think they take advantage in the high interest rates."
- "So I went and got one for like $300. And I carried it for a couple of months … and then paid it off with the income tax refund."
- "I don't use it as a longer term, but, I mean, I've kept it for longer than two weeks. I mean, I kept one for two months. I've kept one for six months."

ROBERT (ILLINOIS STOREFRONT BORROWER)

- Satisfaction level: "Very satisfied."
- Words to describe payday loans: "Expensive, yeah. But convenient."
- "[It's] going to be that emergency help you need right now."
- "You can show them the paycheck, but they don't know what are you spending on your expenses outside of that money."
- "They closed my bank account that I had. I wasn't paying them back in full at the particular time, and I kept trying to delay them, and giving them partial payment, and they just went in, and they took their money. Which caused me to default, and I was behind in a lot of other areas, and I wasn't able to take care of that particular area."

PROFILES OF 'SATISFIED' CUSTOMERS

CORI (CALIFORNIA BANK DEPOSIT ADVANCE BORROWER)

- Satisfaction level: "Very satisfied."
- "It was the holidays and I just need some extra cash to get gifts and help out with Christmas dinner and do my part. It just seemed like a good option."
- "But then it started the cycle. Because once you do it once, then it takes that money out of your paycheck, and my paychecks were pretty well budgeted to the dollar, so once they take that money back out to pay off the advance, then I'm short again. So, then I have to do it again to keep up with my regular bills."
- "I got to the point that I couldn't do any more direct deposit advances, and I had to go to the [payday loan] store."
- "I paid back the payday lending store. My sister helped me do that and then she also helped me get caught up. Then once I was able to cash out my PTO (paid time off from work), I was able to pay her back and get myself on track. So I was living back within my biweekly paycheck means."

MATTHEW (NEW YORK ONLINE BORROWER)

- Satisfaction level: "Somewhat satisfied."
- Words to describe loans: "Expensive." "Helpful."
- "I don't want to go to my brother. I don't want to go to my sister, you know. And it's for me. I don't have to go talk to nobody. I just, online, boom."
- "I don't think it's the best way. It's not. But my options are limited."
- "So I wound up probably paying a fortune. … I think I took like $300. So they charged me every month, $30 on each $100. So you can pay $90 in three, four months, and you haven't even touched the principal yet. So that's why, again, I'm not going to cry over it because I knew the options and the choices, and they're what I made. But on the other hand, it's a pretty expensive way to get a few extra dollars."

7 Payday Customers Want Changes and More Regulation but Expect to Borrow Again if Loans are Available to Them

"I don't want to do it again. I don't want to, but I don't know, so I can't say I won't do it again because I might need to."

—Online borrower, New York

Borrowers' feelings about payday loans are somewhat complicated, but a general consensus emerges on three points:

(1) Borrowers want changes to how payday loans work.

(2) They want payday loans to be more regulated.

(3) Even if neither (1) nor (2) occurs, they will continue to use payday loans if they are in an especially difficult situation and the loans are available.

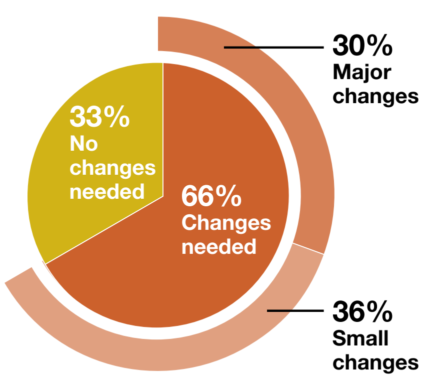
Although these findings provide only general feelings rather than specific solutions, they demonstrate that borrowers are not satisfied with the status quo and invite government oversight as part of the solution.

By a 2-1 Margin, Borrowers Want Changes to Payday Loans

Overall, borrowers are divided into three fairly even groups as to whether there should be major changes, small changes, or no changes to payday loans. Pew is conducting further research on the nature of changes that borrowers want to see.

EXHIBIT 18:

MOST WANT CHANGES TO PAYDAY LOANS



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "Which of the following best describes your view? 1. (Online payday loans/Payday loans) should be kept as they are now with no changes 2. There should be small changes to (online payday loans/payday loans) 3. There should be major changes to (online payday loans/payday loans)." Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart. Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

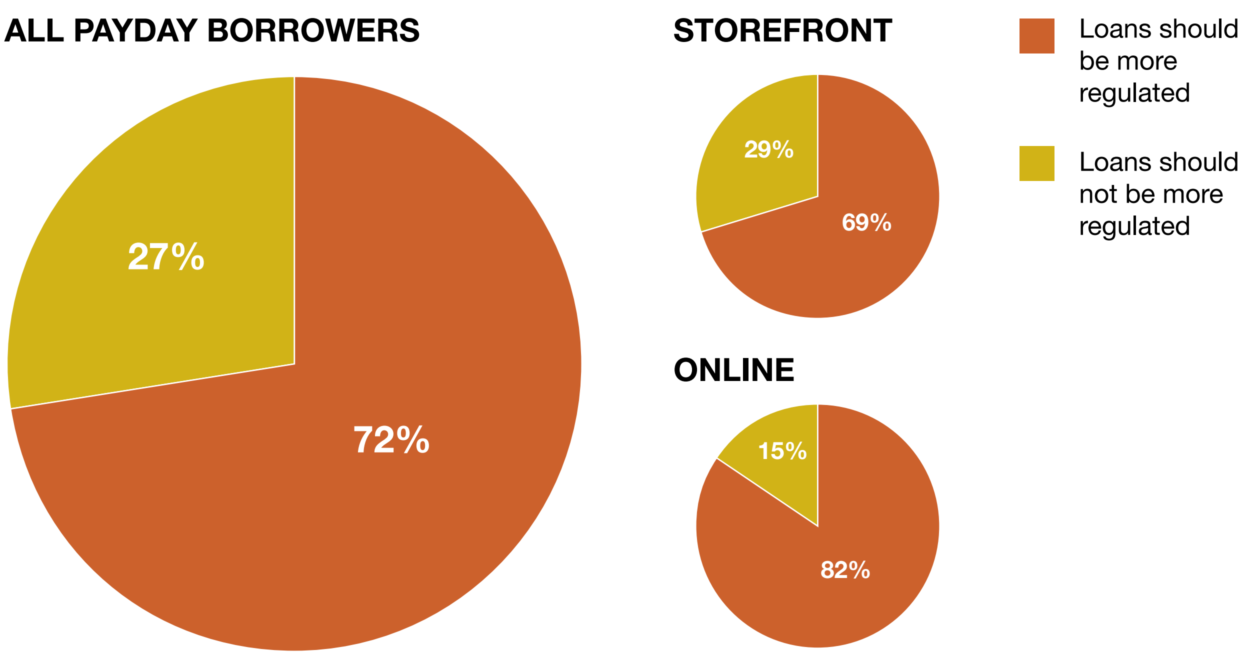
By an Almost 3-1 Margin, Borrowers Want More Regulation

Borrowers hold divergent views on many aspects of payday lending and its impact on them, but there is strong consensus for more regulation of payday loans across key payday borrower groupings, including:

- Those who have trouble meeting their expenses, and those who do not.
- Those who describe their financial situation as good, and those who describe it as bad.
- Those who say the loans mostly help, and those who say they mostly hurt.

Online borrowers are even more adamant than storefront borrowers, preferring greater regulation by a 5-1 margin.

EXHIBIT 19:
BORROWERS FAVOR MORE REGULATION



NOTE: Data represent percentage of payday borrowers who express the listed opinion. Respondents were asked: "Which of these statements comes closer to your point of view? 1. (Online payday loans/Payday loans) should be more regulated. 2. (Online payday loans/Payday loans) should not be more regulated." Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart. Results are based on 703 interviews conducted from December 2011 through April 2012.

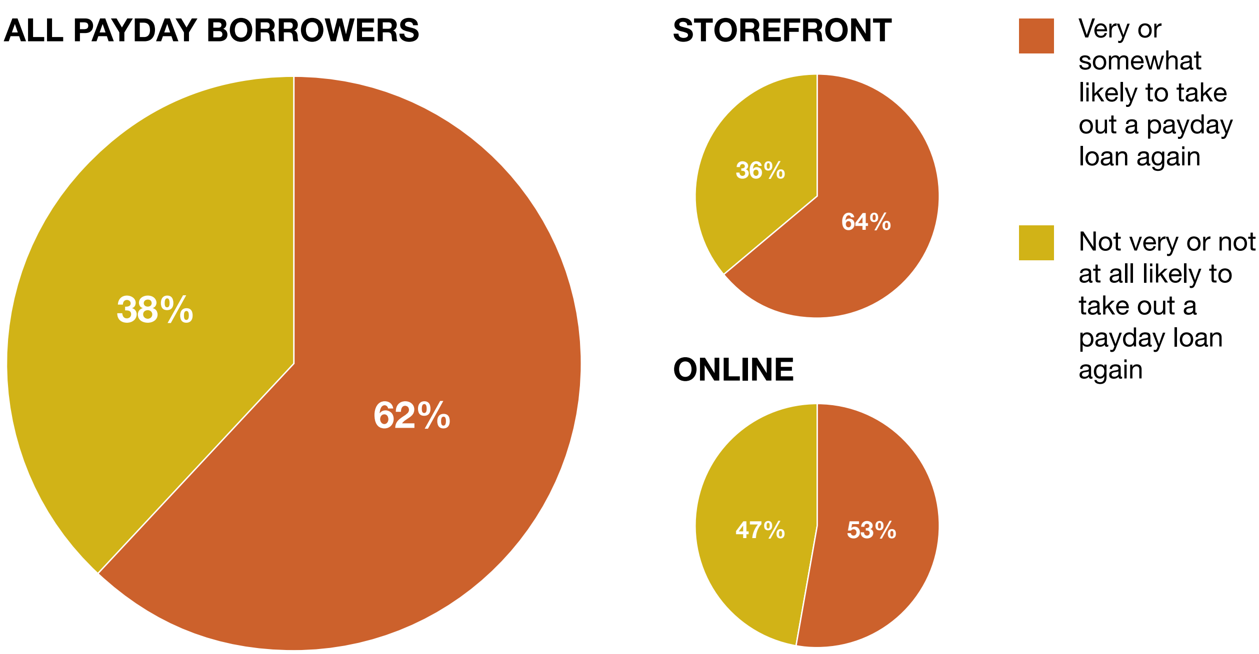
SOURCE: Pew's safe small-dollar loans research project, 2013.

3 in 5 Are Likely to Use Loans Again Regardless

Despite this desire for more regulation and changes to how payday loans work, 3 in 5 borrowers say they are likely to use the loans again if they are in a financial bind. Only one-fifth of borrowers say they are "not at all likely" to take out another loan. In focus groups, even borrowers who were unhappy that their payday loan debt had lasted much longer than expected thought they might use payday loans again with a better outcome. More storefront than online borrowers said they were likely to take out another payday loan. The tension between borrowers wanting changes and regulation, and the likelihood that they will use the loans again, is consistent with previous research that most borrowers would use the loans again, but few would do so without hesitation.[66]

EXHIBIT 20:

MAJORITY SAY THEY LIKELY WOULD TAKE ANOTHER PAYDAY LOAN



NOTE: Data represent percentage of payday borrowers who gave the listed answer. Respondents were asked: "If you find yourself in a financial bind again, how likely is it that you would take out (an online payday/a payday) loan?" Results are based on 703 interviews conducted from December 2011 through April 2012.

SOURCE: Pew's safe small-dollar loans research project, 2013.

"I still would rather go to them than my family, and so I feel like they need me, I need them at some point in time. You never know where you're going with this economy being the way it is. I think that they should redo, you know, their interest rates and their rules and all of that."

—Storefront borrower, Birmingham, AL

"If I had to get a loan out, I would go to one."

—Storefront borrower, Birmingham, AL

"When you need it, you've got to get it."

—Storefront borrower, Birmingham, AL

Some Are Relieved When Payday Stores Are Gone

Pew's research has shown that potential borrowers tend not to use payday loans when storefronts are not available in their communities. In states without payday stores, just 5 percent of would-be borrowers sought loans online or elsewhere, and the remaining 95 percent elected not to use payday loans at all.[67] Previous research conducted in North Carolina, where a state law eliminated payday loan stores, similarly found that people had not sought out payday loans elsewhere when the stores closed, and those who had previously borrowed from payday storefronts "were glad they no longer had the temptation."[68]

Participants in Pew's focus group of 10 former storefront borrowers in New Hampshire expressed similar feelings. Although payday stores once operated there, they are no longer available because of a change in state law.[69] Participants acknowledged that they had used the loans when they were in the state, but they had not gone online to borrow after the storefronts closed. Instead, these former borrowers mostly expressed relief, but some acknowledged they would probably use the stores if they returned to the state.

"I think they need to find other ways to help people out than just make it so easy to do that, because that's why people do it."

—Former storefront borrower, Manchester, NH

"I'm glad they're gone. I hope they never come back."

—Former storefront borrower, Manchester, NH

"[Now that payday lenders are gone] you can't get stuck in it."

—Former storefront borrower, Manchester, NH

"Just keep them out, we don't need them."

—Former storefront borrower, Manchester, NH

"Because there's too many little things to worry about now, you know. They're out, leave them out, and you know what I mean? Then you don't have to worry about it."

—Former storefront borrower, Manchester, NH

Conclusion

Understanding why people choose expensive credit products that they will have difficulty paying back, and how they eventually do pay them back, is vital for any effort to improve the utility and transparency of payday loans as well as other small-dollar credit products. One reason people choose payday loans, instead of cutting back on expenses or using informal options, is that they perceive the loans as affordable because lenders sell them as a short-term fix. The information provided describes just two weeks of indebtedness, although most borrowers end up having a loan out for far longer. Borrowers have conflicting desires—they want to receive a cash infusion but do not want to create ongoing debt—and a payday loan's short repayment term makes it seem as if both these desires can be met. The loan's unaffordable lump-sum repayment structure effectively means that borrowers pay only interest, so the principal is not reduced; this structure makes predicting the ultimate duration and cost of the loan extremely difficult. The loan is packaged as a two-week product that is described as safe and preferable to costly options such as overdrafts. Borrowers tend to focus on the loan's advertised price, a fee they can afford, and not the impact that a lump-sum repayment will have on their monthly budget. The more than $400 required to repay an average loan is so incompatible with the $50 that the average payday customer can afford that the customer ends up re-borrowing repeatedly, paying a fee every two weeks to take the same money back out to cover basic expenses.

Proponents of payday lending tend to talk about overdrafts as the primary alternative to a payday loan; borrowers instead mostly describe their alternatives as taking on long-term debt, cutting back on expenses, or borrowing from family or friends. But even within this narrow range of options, it is nearly impossible to comparison shop, because a payday loan's ultimate cost and duration are vastly different from the stated loan terms.

The implication of a payday loan's unaffordability for most borrowers is that when people choose a payday loan instead of other options, they often end up turning to those very same options in order to pay back the payday loan. Among those who choose a payday loan, most overdraft their bank accounts anyway. Further, 27 percent of payday borrowers say a withdrawal by a payday lender has caused an overdraft, while others borrow from family or friends to pay off the loans, or use them long term. These findings indicate that many of the potential benefits—avoiding other debt, fees, or cutting back—do not materialize. Payday loans end up leaving borrowers in the same financial bind in which they started, despite having spent $520 annually on average.

This inconsistency is reflected in the sentiments of payday borrowers, who describe themselves as "satisfied" but are also deeply conflicted. They express relief upon receiving credit during a tough time, appreciation for friendly and respectful service, and say they might use payday loans again if they are in a difficult-enough situation. But they also state that the loans take advantage of them, need changes, and should be more regulated.

Federal regulators, including the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and especially the Consumer Financial Protection Bureau, have the authority to regulate the payday loan market. This ongoing series by The Pew Charitable Trusts, *Payday Lending in America*, presents in-depth findings to help identify the features of a safe and transparent marketplace for consumer financial services, to inform efforts to protect consumers from harmful practices, and to promote safe and transparent small-dollar credit.

Methodology

Opinion Research

Findings in this report are based on a survey conducted among storefront payday loan borrowers and online payday loan borrowers. The sample for this survey was compiled over the course of eight months of screening on a nationally representative weekly survey. Borrower quotations in this report come from a series of 10 focus groups with small-loan borrowers, as described below.

Survey Methodology

Social Science Research Solutions (SSRS) omnibus survey

The Pew Safe Small-Dollar Loans Research Project contracted with SSRS to conduct the first-ever nationally representative in-depth telephone survey with payday loan borrowers about their loan usage. To identify and survey a low-incidence population such as payday loan borrowers, SSRS screened 1,000 to 2,000 adults per week on its regular omnibus survey, using random-digit dialing (RDD) methodology, from August 2011 to April 2012. The term "omnibus" refers to a survey that includes questions on a variety of topics. This survey took steps to minimize payday loan borrowers' denial of their usage of this product, because the omnibus survey included mostly nonfinancial questions purchased by other clients, and the payday loan questions were asked after other, less sensitive questions, giving interviewers a chance to establish a rapport with respondents.

The first phase of the research, to identify payday borrowers, asked respondents to the omnibus survey whether they had used a payday loan. If respondents answered that they had, they were placed in a file to be re-contacted later. Once the full-length survey was ready to field, in order to maximize participation, people who had used a payday loan were then given the full-length survey and paid an incentive of $20 for participating. Because of their relative scarcity, online payday loan borrowers were given an incentive of $35 for participating.

Respondents were told about the compensation only after having indicated that they had used a payday loan. Further, online payday loan borrowers who were identified during the early months of screening were sent a letter with a $5 bill informing them that they would be re-contacted to take the full-length survey. The second phase of the research involved re-contacting all respondents who answered that they had used a payday loan and immediately giving the full-length survey to anyone newly identified in the weekly omnibus survey as a payday loan borrower.

Sample and Interviewing

In the first phase of the survey, the Pew Safe Small-Dollar Loans Research Project purchased time on SSRS's omnibus survey, EXCEL, which covers the continental United States. Analysis of the incidence of payday borrowing was conducted after 33,576 adults had been screened and answered a question about payday loan usage. An additional 16,108 adults were screened in order to find a sufficient number of storefront payday loan, online payday loan, and auto-title loan borrowers to complete a 20-minute survey about their usage and views, for a total of 49,684 screens to complete the research. The sampling error for those incidence estimates from the omnibus survey of borrowers is plus or minus 0.24 percentage points.

In the second phase, a total of 451 adults completed the full-length storefront payday loan survey, and 252 adults completed the full-length online payday loan survey, for a total of 703 payday borrowers. The sampling error for the full-length survey of payday borrowers is plus or minus 4.2 percentage points. The sampling error for the full-length survey of storefront payday loan borrowers is plus or minus 4.6 percentage points, and it is plus or minus 6.2 percentage points for the full-length survey of online payday loan borrowers.

EXCEL is a national weekly, dual-frame bilingual telephone survey. Each EXCEL survey consists of a minimum of 1,000 interviews, of which 300 interviews are completed with respondents on their cellphones and at least 30 are conducted in Spanish, ensuring unprecedented representation on an omnibus platform. Completed surveys are representative of the continental United States population of adults 18 and older. EXCEL uses a fully replicated, stratified, single-stage, random-digit-dialing (RDD) sample of land-line telephone households and randomly generated cellphones. Sample telephone numbers are computer-generated and loaded into online sample files accessed directly by the Computer-Assisted Telephone Interviewing (CATI) system. Within each sample household, a single respondent is randomly selected. Further details about EXCEL and its weighting are available at www.pewtrusts.org/small-loans. The proportion of storefront to online borrowers was weighted to the ratio at which they occurred naturally in the omnibus. Including 252 online borrowers reflects an oversample of 147 online borrowers, and the online borrower results have been weighted down accordingly so they would not have disproportionate influence over the full results.

Question Wording—Omnibus Survey

Wording for demographic and other questions is available at www.pewtrusts.org/small-loans.

Screening Phase (measuring incidence and compiling sample for callbacks):

- In the past five years, have you used payday loan or cash advance services, where you borrow money to be repaid out of your next paycheck?
- And was that physically through a store, or on the Internet?

Re-contact Phase (calling back respondents who answered affirmatively, and identifying additional borrowers to take the full-length survey immediately):

In the past five years, have you or has someone in your family used an in-person payday lending store or cash advance service?

Question Wording—Full-Length Survey of Storefront and Online Payday Loan Borrowers

The data from the nationally representative, full-length survey of 451 storefront payday loan borrowers and 252 online payday loan borrowers are based on responses to the following questions, which Pew designed with assistance from SSRS and Hart Research Associates. All other questions from this survey are being held for future release. The sample for this telephone survey was derived from the RDD omnibus survey. All questions also included "Don't know" and "Refused" options that were not read aloud.

How would you rate the condition of your personal economic situation these days? Is it … (READ LIST)? (ENTER ONE RESPONSE)

1 Very good
2 Fairly good
3 Fairly bad
4 Very bad

How often, if ever, do you have trouble meeting your regular monthly bills and expenses—do you have trouble with this every month, most months, about half the time, less than half the time, or do you never have trouble meeting your regular monthly bills and expenses?

1 Every month
2 Most months
3 About half the time
4 Less than half the time
5 Never

Thinking back now to (that FIRST/the) time you took out (an online payday loan/a payday loan), which of the following best describes what specifically you needed the money for? (READ LIST. ACCEPT ONE RESPONSE.) (IF MORE THAN ONE, ASK:) Well, if you had to choose just one, which best describes what specifically you needed the money for?

1 To pay rent or a mortgage
2 To pay for food and groceries
3 To pay a regular expense, such as utilities, car payment, credit card bill, or prescription drugs
4 To pay an unexpected expense, such as a car repair or emergency medical expense
5 To pay for something special, such as a vacation, entertainment, or gifts
6 (DO NOT READ) Other (SPECIFY)

And was that primarily a personal or family expense, or was that primarily for a business that you own or operate?

(INTERVIEWER NOTE: If "BOTH," PROBE—) If you had to choose just one, would you say it was primarily for personal or for business reasons?

1 For personal or family reasons
2 For business I own or operate
3 (DO NOT READ) Both

When you took out (that FIRST/the) (online payday loan/payday loan), would you say the terms and conditions of the loan were very clear, somewhat clear, somewhat confusing, or very confusing?

1 Very clear
2 Somewhat clear
3 Somewhat confusing
4 Very confusing

Please tell me whether you have or have not used each of the following methods to pay back (an online payday loan/a payday loan). How about (INSERT)?

Have you used this method or not?

1 Have used

2 Have not used

a. Friends or family helped pay it off

b. Took out another short-term loan of any type to pay it off

c. Got a loan from a bank or credit union to pay it off

d. Had or saved enough money to pay it off

e. Used a tax refund to pay it off

f. Pawned or sold items to pay it off

g. Used a credit card to pay it off

Are you currently employed? (IF "NO," ASK:) Are you a student, a homemaker, retired, or unemployed?

1 Yes, employed

2 Student

3 Homemaker

4 Retired

5 Unemployed

6 (DO NOT READ) Volunteer

7 (DO NOT READ) Disabled

(ASK ONLY OF EMPLOYED STOREFRONT BORROWERS)

Are you self-employed or a small business owner, or not?

1 Yes, self-employed

2 No, not self-employed

3 (DO NOT READ) Both, self-employed/small business owner and work for someone else

How much can you afford to pay each MONTH toward (an online payday loan/a payday loan) and still be able to pay your other bills and expenses?

____________ ($0 to $1,000)

Overall, do you think that (online payday loans/payday loans) MOSTLY help borrowers like you or MOSTLY hurt borrowers like you? (IF "BOTH," ASK:) I know it can be hard to say, but generally do you think they MOSTLY help or MOSTLY hurt borrowers?

1 Mostly help

2 Mostly hurt

3 (DO NOT READ) Some of both/neither

(Have/Was) the (online payday loan(s)/ payday loan(s)) (been) more a SOURCE of stress and anxiety or more something that has RELIEVED stress and anxiety?

1 More a source of stress and anxiety

2 More something that has relieved stress and anxiety

3 (DO NOT READ) Neither/both

I'm going to read you several options. For each, tell me whether you would use this option if you were short on cash, and short-term loans of any kind no longer existed. How about (INSERT)?

a. Borrow from family or friends

b. Borrow from your employer

c. Sell or pawn personal possessions

d. Delay paying some bills

e. Cut back on expenses such as food and clothing

f. Take out a loan from a bank or credit union

g. Use a credit card

Would you use this option or not?

1 Yes, would use

2 No, would not use

Which of the following best describes your view? (READ LIST. ACCEPT ONE RESPONSE.)

1 (Online payday loans/Payday loans) should be kept as they are now with no changes

2 There should be small changes to (online payday loans/payday loans)

3 There should be major changes to (online payday loans/payday loans)

(Asked of storefront borrowers only)

I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about had a payday lender attempt to make a withdrawal that overdrew your bank account? Has this happened to you or not?

1 Has happened

2 Has not happened

3 (DO NOT READ) Does not apply

(Asked of online borrowers only)

I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about had an online payday lender make a withdrawal that overdrew your bank account? Has this happened to you or not?

1 Has happened

2 Has not happened

3 (DO NOT READ) Does not apply

Which of these statements comes closer to your point of view?

(READ STATEMENTS)

1 (Online payday loans/Payday loans) should be more regulated
2 (Online payday loans/Payday loans) should not be more regulated

If you find yourself in a financial bind again, how likely is it that you would take out (an online payday loan/a payday loan)? Is it very likely, somewhat likely, not very likely, or not at all likely?

1 Very likely
2 Somewhat likely
3 Not very likely
4 Not at all likely

Have you ever felt you were in such a difficult situation that you would take (an online payday loan/a payday loan) on pretty much any terms offered, or have you never felt that way?

1 Yes, have felt that way
2 No, have not felt that way

How much do you rely on (online payday lenders/payday lenders) to give you accurate information—completely, somewhat, not much, or not at all? (ENTER ONE ONLY)

INTERVIEWER NOTE: ONLY READ IF RESPONDENT VOLUNTARILY ASKS A QUESTION SUCH AS, "WHAT KIND OF INFORMATION?" Say: "Information about the terms of the loan, including how much you pay in interest or fees, and when and how you will need to repay the loan."

1 Completely
2 Somewhat
3 Not much
4 Not at all

Some people say (online payday loans/payday loans) take advantage of borrowers, while other people do not think (online payday loans/payday loans) take advantage of borrowers. What do you think, do (online payday loans/payday loans) take advantage of borrowers or not?

1 (Online payday loans/payday loans) take advantage of borrowers
2 (Online payday loans/payday loans) do not take advantage of borrowers
3 (DO NOT READ) Some of both/neither

I'm going to read several types of financial products and services. For each one, please tell me whether you have used that product or service in the past year. Have you used (INSERT) in the past year?

1 Yes, used

2 No, have not used

a. A personal checking or savings account at a bank or credit union

b. A credit card

c. A prepaid card that works like a debit card but is not attached to an actual bank account

d. Overdrafting on your checking account (IF NECESSARY: Overdrafting is when your checking account balance becomes negative because more money has been withdrawn than was in the account)

(ASK ONLY OF THOSE WHO HAVE USED A CREDIT CARD IN THE PAST YEAR)

In the past year, have you maxed out or been at the top of your credit limit on any of your credit cards?

1 Yes, have maxed out

2 No, have not maxed out

(ASK ONLY OF THOSE WHO HAVE NOT USED A CREDIT CARD IN THE PAST YEAR)

Have you not used a credit card in the past year because you do not want one, because you think you would not be approved to get one, you are already making payments on one, or did you apply for one and were turned down? (ENTER ONE ONLY)

1 Do not want one

2 Would not be approved for one

3 Already making payments on one

4 Applied and was turned down

5 (DO NOT READ) Have credit card, but haven't used it in past year

6 (DO NOT READ) None of these

Focus Group Methodology

On behalf of the Safe Small-Dollar Loans Research Project, Hart Research Associates and Public Opinion Strategies conducted eight two-hour focus groups, with two groups per location in New York City; Chicago; Birmingham, AL; and Manchester, NH. Those groups were conducted during weekday evenings from Sept. 7, 2011, through Sept. 19, 2011. The Safe Small-Dollar Loans Research Project conducted two additional groups in San Francisco on Nov. 16, 2011. All quotations come from these 10 focus groups.

Endnotes

1 The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), available at: http://www.pewstates.org/research/reports/who-borrows-where-they-borrow-and-why-85899405043.

2 CashNetUSA. https://www.cashnetusa.com/payday/articles/safe-secure-payday-loans-best-found-online.html.

3 Jamie Fulmer's presentation on behalf of the Consumer Financial Services Association available at: http://www.ncsl.org/portals/1/documents/fiscal/Jamie_Fulmer_PowerPoint.pdf.

4 Fisca website: http://www.fisca.org/Content/NavigationMenu/AboutFISCA/FAQs/default.htm.

5 See note 3, above.

6 The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), p. 9.

7 These figures are from Pew's first report in this series, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012). The data for online borrowers have not been previously published.

8 Center for Financial Services Innovation. "A Complex Portrait—An Examination of Small-Dollar Credit Consumers." 2012. Available at: http://cfsinnovation.com/system/files/A%20Complex%20Portrait-%20An%20Examination%20of%20Small-Dollar%20Credit%20Consumers.pdf.

9 Industry analyst Stephens Inc. in its 2011 report estimates that borrowers do not become profitable for lenders until they have borrowed four or five times. Robert DeYoung and Ronnie J. Phillips of the Federal Reserve Bank of Kansas City Economic Research Department also conclude that "the profitability of payday lenders depends on repeat borrowing." http://www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf. An analysis of North Carolina data found that 73 percent of lender revenue came from borrowers using seven or more loans per year. Michael A. Stegman and Robert Faris, "Payday Lending: A Business Model that Encourages Chronic Borrowing," Economic Development Quarterly (2003), www.ccc.unc.edu/abstracts/0203_Payday.php. See also: The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), p. 15.

10 Pew's first report in this series, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), found that borrowers are indebted for an average of five months, using eight loans (based on state regulatory data) that last 18.2 days (based on the Annual Report from Advance America, the largest storefront lender, which industry analysts use as a proxy for the storefront payday lending industry).

11 "Oklahoma Trends in Deferred Deposit Lending, 2011." 2011. http://www.ok.gov/okdocc/documents/2011_10_OK%20Trends_Final_Draft.pdf.

12 See note 11, above.

13 See note 9, above.

14 "Florida Trends in Deferred Presentment." 2010. https://www.veritecs.com/Docs/2010_06_FL_Trends-UPDATED.pdf. "Oklahoma Trends in Deferred Deposit Lending, 2011." 2011. http://www.ok.gov/okdocc/documents/2011_10_OK%20Trends_Final_Draft.pdf.

15 Leslie Parrish and Uriah King, "Phantom Demand: Short-term due date generates need for repeat payday loans, accounting for 76% of total volume." Center for Responsible Lending. June 2009. http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf.

16 In 2011, the average payday loan at the nation's largest payday lender—Advance America—was $375, based on its annual (10-K) report. Industry analyst Stephens Inc. uses Advance America as a proxy for the payday lending industry. Stephens Inc., "Payday Loan Industry" (2011). The average fee reported in Advance America's 10-K was $55, yielding a repayment of $430 in two weeks ($375+$55). Stephens also reports an average fee of $25 per $100 borrowed for online loans, implying a $95 fee for $375 borrowed, yielding a repayment of $470 in two weeks ($375+$95).

17 See note 10, above.

18 See note 14, above.

19 See note 6, above, p. 15.

20 See note 9, above. Most borrowing occurs in rapid succession (see note 15, above).

21 See note 11, above.

22 A trade group website includes a section titled "Is a Payday Advance Appropriate for You," which states, "A payday advance should be used responsibly and for only the purpose for which it is intended: To solve temporary cash-flow problems by bridging the gap between paydays. A payday advance is designed to provide short-term financial assistance. It is not meant to be a long-term solution." http://cfsaa.com/what-is-a-payday-advance/is-a-payday-advance-appropriate-for-you.aspx (accessed December 26, 2012).

23 Center for Financial Services Innovation. "A Complex Portrait—An Examination of Small-Dollar Credit Consumers." 2012. Available at: http://cfsinnovation.com/system/files/A%20Complex%20Portrait-%20An%20Examination%20of%20Small-Dollar%20Credit%20Consumers.pdf.

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28 U.S. Bank printed advertisement, September 2012. On file at The Pew Charitable Trusts.

29 Advance America. http://www.advanceamerica.net/community-outreach/witfy.

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31 CashNetUSA. http://www.cashnetusa.com/fast-cash/fast-cash-payday-loan.html.

32 Quik Cash printed advertisement. September 2012. On File at The Pew Charitable Trusts.

33 We Loan Cash. www.weloancash.net.

34 Reliable Finance printed advertisement. September 2012. On file at The Pew Charitable Trusts.

35 Washington State Department of Financial Institutions. 2011 Payday Lending Report. http://www.dfi.wa.gov/cs/pdf/2011-payday-lending-report.pdf.

36 For example, a $500 loan in Washington carries a $75 fee, so the default loan structure would require a $575.00 payment, while the installment structure would provide for up to 12 payments of $47.92 each over 180 days.

37 Details governing Washington's installment options on payday loans are available at http://apps.leg.wa.gov/Rcw/default.aspx?cite=31.45.084.

38 See note 35, above.

39 This calculation is made by dividing the 40,367 loans that were paid in full within a month by the 297,985 loans that were made. Data are available at: http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/annual_reports/2011%20DDL%20Composite.REV_.pdf.

40 For example, Raj Chetty et al. classify 85 percent of people as "passive savers" who are heavily influenced by defaults as to whether to use a retirement savings account, but not by tax incentives to save. "Active vs. Passive Decisions and Crowdout in Retirement Savings Accounts: Evidence from Denmark." 2012. According to John Beshears et al., "recent research has highlighted the important role that defaults play in a wide range of settings: organ donation decisions (Johnson and Goldstein 2003; Abadie and Gay 2004), car insurance plan choices (Johnson et al. 1993), car option purchases (Park, Jun, and McInnis 2000), and consent to receive e-mail marketing (Johnson, Bellman, and Lohse 2003)." Beshears et al. find that defaults have "tremendous influence" on "savings plan participation, contributions, asset allocation, rollovers, and decumulation." "The Importance of Default Options for Retirement Savings Outcomes," published in Social Security Policy in a Changing Environment. 2009.

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42 The Pew Charitable Trusts. "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012).

43 National Consumer Law Center. "300% Bank Payday Loans Spreading." http://www.nclc.org/images/pdf/banking_and_payment_systems/ib_bank_payday_spreading.pdf.

44 CashNetUSA. http://www.cashnetusa.com/payday/articles/use-payday-loans-to-stop-a-bank-overdraft-or-nsf-fee.html. (2012).

45 MoneyMutual. www.moneymutual.com. (2012).

46 These results refer to those borrowers who have had an account at a bank or credit union in the past year. Because these are questions about extended periods of time, it is impossible to say whether borrowers were overdrafting at the same times they were using payday loans, but the underlying point remains valid that payday loans do not eliminate overdraft risk.

47 It should be noted that bank customers can avoid overdraft fees on debit card transactions and ATM withdrawals by not opting in to overdraft coverage when they open an account, or by opting out at a later point. But a study by Pew's safe checking in the electronic age project, "Overdraft America: Confusion and Concerns about Bank Practices" (2012), found that a majority of customers who had paid an overdraft penalty fee in the last year did not realize that they had opted in to these fees.

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49 FiServ brochure. "Relationship Advance." 2009. On file at The Pew Charitable Trusts.

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51 Donald P. Morgan and Michael R. Strain. "Payday Holiday: How Households Fare after Payday Credit Bans." 2007. Available at: http://www.newyorkfed.org/research/staff_reports/sr309.pdf.

52 Bretton Woods Inc. 2008 Fee Analysis of Bank and Credit Union Non-Sufficient Funds and Overdraft Protection Programs. 2009. Available at: http://bretton-woods.com/media/Bretton$20Woods$2C$20Inc.$202008$20NSF-ODP$20Fee$20Analysis$2C$2001-09-2009.pdf Analysis by Center for Responsible Lending. "Payday Loans Put Families in the Red." 2009. Available at: http://www.responsiblelending.org/payday-lending/research-analysis/payday-puts-families-in-the-red-final.pdf.

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55 The Pew Charitable Trusts. "Payday Lending in America: Who Borrows, Where They Borrow, and Why." (2012).

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59 See note 48, above.

60 Robert B. Avery and Katherine A. Samolyk, "Payday Loans Versus Pawn Shops: The Effects of Loan Fee Limits on Household Use." (preliminary draft, 2011).

61 ACE Cash Express. https://www.acecashexpress.com/services.

62 Dollar Financial Group. http://www.dfg.com/mobile/products.asp.

63 Check into Cash. http://checkintocash.com/Testimonials/.

64 Check into Cash. http://checkintocash.com/Testimonials/.

65 Dollar Loan Center DBA www.dontbebroke.com; Quik Cash. Printed advertisement, downloaded September 2012.

66 Center for Financial Services Innovation. "A Complex Portrait." 2012. Forty-four percent of payday borrowers would use the loans again only if they have no better options, 33 percent would use the product again without hesitation, and 22 percent would not use payday loans again.

67 Pew's first report in this series found that in states that restrict storefront lending, 95 out of 100 would-be borrowers elect not to use payday loans at all—just five borrow online or elsewhere. "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), pps. 22-23.

68 Jannekke Ratcliffe and Kim Manturuk. "North Carolina Consumers after Payday Lending: Attitudes and Experiences with Credit Options" UNC Center for Community Capital. (2007). Available at: http://www.nccob.gov/public/docs/News/Press%20Releases/Archives/2007/NC_After_Payday.pdf.

69 Information on laws in New Hampshire and other states is available at http://www.pewstates.org/research/data-visualizations/interactive-state-payday-loan-regulation-and-usage-rates-8589940569.

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Appendix L

A report from THE PEW CHARITABLE TRUSTS | Oct 2013

Report 3 in the *Payday Lending in America* series

Payday Lending in America: **Policy Solutions**

The Pew Charitable Trusts

Susan K. Urahn, *executive vice president*
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External Reviewers

The report benefited from the insights and expertise of five external reviewers: Glenn Firebaugh, professor of sociology and demography, The Pennsylvania State University; Timothy Guinnane, professor of economic history, Yale University; Mike Mokrzycki, independent survey research expert; Alan M. White, professor of law at the City University of New York; and Lauren E. Willis, professor of law, Loyola Law School (Los Angeles). Although they have reviewed the report, neither they nor their organizations necessarily endorse its findings or conclusions.

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For further information, please visit:

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1 2 3

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1. Dornveek Markkstyrn **2.** Jamie Grill **3.** Getty Images

The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and stimulate civic life.

About the *Payday Lending in America* series

The following report is the third in a series on payday lending. The first two reports detailed fundamental problems with the loans, which are due in full on the borrower's next payday. In reality, however, the loans' ultimate cost and duration bear little resemblance to advertised terms. This wide gap between the loans' packaging and borrowers' experience is endemic with lump-sum repayment payday loans.

That research showed that those who take out short-term, small-dollar loans routinely struggle to keep up with living expenses. Most often, they use the loans to pay rent, utility bills, and other routine obligations (as opposed to spreading the cost of purchases over time, which is a more traditional use of credit). Repeat borrowing is the norm, because customers usually cannot afford to pay the loans off on payday and cover their other expenses, so they repeatedly pay fees to renew or reborrow the money for an average of five months of the year.

Lenders depend on this repeat borrowing, because they would not earn enough revenue to stay in business if the average customer paid off the loan within a few weeks. They offer these loans to almost anyone with a checking account and a source of income—without assessing the borrower's ability to repay the loan—in exchange for the right to take full repayment directly from the borrower's checking account on his or her next payday. This ability to collect payment before the customer pays other bills, such as rent or utilities, is unique to payday lenders, and it allows them to thrive even as they make loans to borrowers who cannot afford them.

This report discusses an alternative small-dollar loan product: one repaid in affordable installments over time. This type of loan was ubiquitous in the United States for most of the 20th century. Beginning in the early 1990s, new state laws allowed for today's payday loans, on which a lump-sum payment is due in full on the borrower's next payday. Pew's research examines a 2010 law change in Colorado that alters this paradigm. Colorado's unique six-month installment loan includes a variety of carefully designed protections, works better for consumers than a lump-sum payday loan, and is viable for lenders. These conclusions are buttressed by extensive nationwide research that provides guidance on making the small-dollar loan marketplace more safe, transparent, and predictable, as well as opinion research on how consumers want to see it change.

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Overview

About 20 years ago, a new retail financial product, the payday loan, began to spread across the United States. It allowed a customer who wanted a small amount of cash quickly to borrow money and pledge a check dated for the next payday as collateral. Twelve million people now use payday loans annually, spending an average of $520 in interest to repeatedly borrow an average of $375 in credit. In the 35 states that allow this type of lump-sum repayment loan, customers end up having to borrow again and again—paying a fee each time. That is because repaying the loan in full requires about one-third of an average borrower's paycheck, not leaving enough money to cover everyday living expenses without borrowing again.

In Colorado, lump-sum payday lending came into use in 1992. The state was an early adopter of such loans, but the situation is now different. In 2010, state lawmakers agreed that the payday loan market in Colorado had failed and acted to correct it. Legislators forged a compromise designed to make the loans more affordable while granting the state's existing nonbank lenders a new way to provide small-dollar loans to those with damaged credit histories. The new law changed the terms for payday lending from a single, lump-sum payment to a series of installment payments stretched out over six months and lowered the maximum allowable interest rates.

As a result, borrowers in Colorado now pay an average of 4 percent of their paychecks to service the loans, compared with 36 percent under a conventional lump-sum payday loan model. These loans remain costly—with fees and interest, the average annual percentage rate is 129 percent—but individual borrowers are spending 42 percent less money than they did under the old law. Payday lenders in Colorado opposed the state's move toward installment lending with affordable payments, yet after considerable storefront consolidation, credit remains widely available. The Colorado law has transformed a payday lending business with low-volume stores into one that serves more customers at each location, with borrowers spending less on loans annually.

Such a solution to the problems in today's payday loan markets—requiring loans to have affordable payments that pay down principal as well as interest—follows the path taken a century ago by the Russell Sage Foundation and an industry trade group, the American Industrial Lenders Association. They partnered to create the Uniform Small Loan Law, which was eventually adopted by a majority of states. But the protections that law provided were largely undone by the introduction of the lump-sum repayment payday loan in the early 1990s. There is growing recognition of the need to shift back to affordable lending policies for *all* small-dollar loans.

People who use payday loans are struggling financially, and they usually have trouble covering ordinary living expenses from month to month. Most are paying bank overdraft fees, most carry credit card or other debt, and almost all have credit scores that are at the lowest end of the scale. Policy discussion in recent years has focused on whether payday loan customers need more access to credit, and what rate of interest is appropriate for such loans. These are valid questions, but there is insufficient evidence to know whether consumers are better off with or without access to high-interest loans (even if the loans have affordable payments). There is, however, sufficient evidence to conclude that conventional lump-sum payday loans harm consumers compared with loans that have affordable payments. It is clear that the lump-sum payday loan has inherent structural flaws that make it unaffordable and dangerous for consumers, and that new policies to eliminate this failed product are warranted. Thus, policymakers in the 35 states that now have conventional payday lending should act urgently. They may elect to prohibit high-cost payday loans altogether (as 15 states have done), or permit them with substantial reforms.

Colorado lawmakers recognized the danger of lump-sum payday lending and made two judgments that shaped their response. First, they decided to allow payday lenders, who had been operating in their state for nearly 20 years, to continue making small loans to those with poor credit histories. This decision led lawmakers to continue allowing interest rates that significantly exceeded the state's traditional usury rate limit. Second, they resolved to transform the loans into installment products that fit more easily into consumers' budgets compared with conventional payday loans. Combined with significant safeguards that protect consumers from unscrupulous practices, this focus on affordability transformed payday lending in Colorado.

Nonetheless, the Colorado law has some considerable shortcomings: It allows interest rates that may be substantially higher than those needed to sustain profitable small-dollar lending, and its overly complicated fee structure makes comparison shopping difficult and price competition unlikely. Further, it is possible that eliminating high-cost lending entirely in Colorado would have served consumers better. But there are many important lessons in the Colorado example. The law change improved payday lending, demonstrating the viability of requiring affordable installments and comprehensive consumer safeguards.

Although credit can be useful for consumers, this report does not determine whether or not borrowing addresses the needs of those who are chronically unable to meet expenses, or exactly what rates of interest are appropriate for small-dollar loans, and there is little research that answers these important questions. Instead, this report shows how small-dollar loans can work better for borrowers while allowing lenders to recoup costs that compensate them for the risk of providing credit to those with poor credit histories. Drawing from the Colorado example and other research, this report's findings demonstrate that small-dollar lending can fit better into a borrower's budget when loans are due in installments based on ability to repay—that is, to make required loan payments and meet other financial obligations without having to borrow again or draw from savings.

Simply adding installment payment plans to payday loans is not enough, however, because installment loans carry significant risks of their own. Small-dollar loan markets generally lack price competition, so the cost of borrowing becomes unnecessarily high in states that do not limit interest rates. Further, when the law allows installment loans to include fees and charges that are front-loaded, data indicate that lenders encourage borrowers to refinance repeatedly, a process known as loan flipping. And although automated repayment plans have certain benefits, the use of postdated checks and electronic access as loan collateral puts consumers at risk of losing control over their checking accounts and being harmed by unscrupulous lenders who abuse the system. This report provides evidence of these consumer risks and advice on how policymakers can control them.

To address the problems caused by unaffordable small-dollar loans, policymakers should prohibit payments that exceed the borrower's ability to repay. The recommendations at the end of this report include a benchmark for ensuring affordability: limiting most loan payments to 5 percent of a borrower's paycheck (individual gross income). They also promote crucial protections against harmful installment loan practices such as loan flipping and aggressive collection techniques.

Consumers want policymakers to act: By a 3-to-1 margin, payday loan borrowers support more regulation of this market. New findings in this report show that 8 in 10 borrowers favor a requirement that payments take up only a small amount of each paycheck, and 9 in 10 favor allowing borrowers to pay back loans in installments over time.

Federal regulators are beginning to respond. Recently, the Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency called on banks that offer payday loans to underwrite them to ensure that borrowers have the ability to repay them while covering other expenses.[1] The Consumer Financial Protection Bureau, which oversees both bank and nonbank lenders, released a white paper on payday loan products, concluding that "the potential consumer harm and the data gathered to date are persuasive that further attention is warranted to protect consumers" and stating its intention to "use its authorities to provide such protections."[2]

Decisive action is required from federal regulators and also from policymakers in the 35 states that permit lump-sum payday lending. Once small-dollar loans have affordable payments and safeguards in place, state lawmakers may reasonably choose to cap interest rates at or below 36 percent APR if they wish to eliminate payday loans, or above this threshold if they want small loans to be widely available to those with poor or damaged credit histories.

Selected findings from previous *Payday Lending in America* reports

- Twelve million people use payday loans annually. The average loan size is $375.
- Although a payday loan is characterized as a short-term solution for unexpected expenses, the reality is different. The average borrower is in debt for five months during the year, spending $520 in interest to repeatedly reborrow the loan. Sixty-nine percent of first-time borrowers use the loan for recurring bills, and just 16 percent deal with an unexpected expense.
- Most payday loan borrowers have trouble meeting monthly expenses at least half the time.
- Payday loans are unaffordable. The average borrower reports being able to afford $50 per two weeks to a payday lender, but only 14 percent can afford the more than $400 needed on average to pay off the full amount of these lump-sum repayment loans.
- Forty-one percent of borrowers have needed a cash infusion, such as a tax refund or help from family or friends, to pay off a payday loan.
- If payday loans were unavailable, 81 percent of borrowers say they would cut back on expenses such as food and clothing. Majorities also would delay paying bills, borrow from family or friends, or sell or pawn possessions.
- In states that enact strong legal protections for borrowers, the result is a large net decrease in payday loan usage. Rates of online borrowing are similar in states with payday loan storefronts and those with none.
- Payday loans do not eliminate overdraft risk. A majority of borrowers overdraw their bank accounts as well.
- A majority of borrowers say payday loans take advantage of them, and a majority also say they provide relief.
- By almost a 3-to-1 margin, borrowers favor more regulation of payday loans.
- Previous reports in the *Payday Lending in America* series, plus videos and other materials, are available at www.pewtrusts.org/small-loans.

Key findings from this report

- **Most small-dollar loan borrowers can afford to put no more than 5 percent of their paycheck toward a loan payment and still be able to cover basic expenses.** Survey and market data show that monthly loan payments exceeding 5 percent of a borrower's individual gross monthly income are unaffordable. Higher payments should be prohibited unless lenders demonstrate, through rigorous underwriting, that borrowers can afford more than that amount.

- **In the 35 states that allow lump-sum payday loans, repayment of these loans requires approximately one-third of an average borrower's paycheck.** In Colorado, where lawmakers required that loans be repayable in affordable installments, payments take up only 4 percent of a borrower's paycheck on average.

- **Safeguards are needed to create successful small-dollar loan markets.** Ensuring that borrowers can repay loans in installments over time will help alleviate the harms of payday lending. But unless policymakers also ensure that loans are structured according to the borrower's ability to repay—and protect against lender-driven refinancing, noncompetitive pricing, excessively long loan lengths, and abusive repayment or collection practices—consumers will remain at risk.

- **These safeguards can be applied in a way that works for lenders. Payday lenders continue to operate in the wake of a recent law change in Colorado, but borrowers are spending less, and payments are far more affordable.** The 2010 state law change required payday lenders to allow borrowers to pay back loans in installments over time with the option to pay them off early without penalty.

- **Payday borrowers strongly support requiring the loans to have affordable installment payments.** Eight in 10 favor a requirement that payments take up only a small amount of each paycheck, and 9 in 10 favor allowing borrowers to pay back loans in installments over time.

- **Policymakers should act now to eliminate the lump-sum payday loan in the 35 states where it currently thrives.** The Consumer Financial Protection Bureau and other policymakers should take steps to make all small-dollar loans safer and more affordable by instituting the following requirements:
    - Limit payments to an affordable percentage of a borrower's periodic income. (Research indicates that monthly payments above 5 percent of gross monthly income are unaffordable.)
    - Spread costs evenly over the life of the loan.
    - Guard against harmful repayment or collection practices.
    - 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.

The current payday lending problem

Payday loans offer small amounts of cash ($375 on average) to people who have an income source and a checking account. In exchange, lenders charge a fee and have the right to withdraw repayment in full from the borrower's checking account on his or her next payday.

Payday loans are advertised as a two-week product, but borrowers end up in debt for an average of five months of the year.[3] The reason for this disconnect between packaging and usage is that the average loan requires a repayment of more than $400 in two weeks, whereas the average borrower can afford only $50. When the loan is due, customers can afford to renew or reborrow the loan for a fee ($55 on average at payday loan stores), but they cannot afford to retire the debt in a lump-sum payment. The unusual ability that payday lenders have to collect payment before the customer may choose to pay other bills such as rent or utilities allows these lenders to thrive even as they make loans to people who cannot afford them.

As a result, to pay off a loan, 41 percent of borrowers eventually need a cash infusion, such as borrowing from family or friends or using a tax refund. Twenty-seven percent say a withdrawal by a lender has caused an overdraft in their bank account, and some make arrangements with other creditors, work more hours, or cut back further on expenses to pay off the loans.[4]

Frequently, the 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.[5] 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.[6] The payday loan, whether offered by a bank,[7] a storefront lender,[8] or an online lender,[9] simply does not work as advertised for the vast majority of borrowers.

Furthermore, the industry's profitability relies on this repeated usage. Industry analysts estimate that customers do not become profitable to lenders until they have borrowed four or five times.[10] When Washington State enacted a cap of eight loans per borrower per year, for example, a major lender in the state said it could not operate profitably under such a limit.[11] Researchers at the Kansas City Federal Reserve found that "the profitability of payday lenders depends on repeat borrowing,"[12] a sharp contrast to official statements from the industry that payday loans are not meant as a long-term solution.[13]

Thus, heavy usage is not a function of overall demand for payday loans but rather of indebtedness caused by unaffordable loan terms, with 76 percent of loans being renewals or quick reborrows.[14] Lump-sum repayment loans are causing borrowers to be indebted far longer and at a far higher cost than advertised. Significantly, the conventional payday loan business model predicts, encourages—in fact, requires—such chronic usage.

How payday lending became a problem

In the early 1990s, states began to allow an experiment with payday loans, at the behest of industry advocates who argued that a new type of small-dollar loan due in full on the next payday would improve borrowers' ability to manage their cash flow. Lawmakers authorized such loans as a special carve-out to otherwise applicable state lending laws, including restrictions on interest rates and fees. Today, 71 percent of the U.S. population lives in states that authorize high-interest payday lending (14 states and the District of Columbia do not have payday lending stores).[15] Twelve million people use the loans annually, spending an average of $520 in interest to repeatedly borrow an average of $375 in credit.[16]

The problems associated with payday loans have caught the attention of researchers, advocates, and policymakers in recent years, but these problems existed at another time when lump-sum repayment loans were widespread—the early 20th century in the United States. This context is especially important because at that time a solution emerged to the chronic indebtedness caused by unaffordable loan terms—allowing borrowers to repay the loans in installments, with each payment reducing the principal.[17] This experience in the first half of the 1900s has enormous and clear implications for the modern payday lending market. (For more on the history of payday and installment lending, see the box on page 6, "The history of installment loans replacing lump-sum repayment loans.")

The history of installment loans replacing lump-sum repayment loans

In the early 20th century, high-interest credit in the United States was readily available from lenders, and often due on the borrower's next payday.[18] A number of consumer finance experts have written about this period.[19] One author notes that the standard "practice was to require the whole amount to be repaid at the end of the week, [and] the consumer found this hard to do. . . . So he renewed the loan each week by paying a fee."[20] Others describe repaying these loans as "daunting,"[21] explaining that repeated borrowing "almost inevitably results,"[22] because this structure means that the loans are "for too short a period of time, making the payments too high"[23] and thus will "keep the borrower in debt by encouraging renewals."[24] One financial writer describes such lenders' practices: "Short maturities are preferred since those will be harder to repay, and renewal and refinancing charges will build up the 'take.' . . . Interest for the [lenders] becomes almost an annuity."[25] Another notes that those making these loans were "more concerned in collecting the interest than the principal."[26] These analysts recognized that many borrowers could afford to pay only the fee to reborrow, and thus could be in debt for extended periods and still owe as much as they did when they first took the loan.[27]

Around the same time, the Russell Sage Foundation and its expert in the field of small credit, Arthur Ham, recognized the problem with these high-interest, lump-sum repayment loans.[28] A group of unlicensed lenders that offered the loans formed a trade association with the goal of becoming licensed to make small-dollar loans at higher rates than the 6 to 8 percent annualized interest state laws typically permitted at the time.[29] To raise allowable interest rates and end unlicensed lending, this group of lenders and the foundation partnered to create the Uniform Small Loan Law—model legislation that was eventually passed by 34 states to permit licensed lenders to make installment loans.[30]

Legislators enacted the USLL to make small credit affordable, in reaction to the pervasiveness of unaffordable loans from unlicensed lenders, estimated to be used by as many as one in five workers in larger cities.[31] The Russell Sage Foundation and the lenders association agreed upon 42 percent (or 3.5 percent per month) as the annualized interest rate to be permitted for loans of $300 or less. Some states permitted somewhat lower interest rates and still saw a successful market for small credit.[32]

One author explained: "The provision in the law that loans be scheduled for repayment in equal monthly payments was intended to offer the consumer a regular program of amortization, tailor-made for his family budget."[33] A 1938 piece about the impact of the USLL argued, "Insistence upon planned, orderly liquidation of the loan is one of the hallmarks of the honest lender."[34]

This background on the USLL is relevant for improving the contemporary small-credit market, but consumers today, including payday loan borrowers, have had vastly more access to formal credit products, and have dramatically more debt, than their counterparts in the past.[35] Most payday loan borrowers have credit card debt,[36] many are experienced with forms of credit including mortgages and auto loans,[37] and most have recently experienced an overdraft on their bank accounts.[38] The specific dollar and interest figures in the USLL also have limited relevance. Adjusted for inflation, the $300 loans covered by this law in 1916, when it was first drafted, are equivalent to approximately $6,400 in 2013 dollars.[39] Today, consumers (including most payday loan borrowers) use lower-cost credit cards as a primary source of small-sized and midsized credit. The USLL's protections were largely undone by the carve-outs from existing state laws granted to payday lenders in the early 1990s.

Section 1: Colorado's move from conventional to installment payday lending

A dramatic change to the state's payday loan law

In 2010, Colorado lawmakers agreed that the state's 18-year experiment with payday lending had led to unintended and harmful consequences. They dramatically changed the state's payday loan law, shifting from allowing lump-sum repayment loans due in full on the borrower's next payday to requiring that borrowers be allowed at least six months to repay the loans in installments. This major change provided a research opportunity to study the small-dollar loan market and its impact on borrowers before and after the law change. (Throughout this report, the term *small-dollar loan* is used to refer to any cash loan of several thousand dollars or less, whether it is a conventional payday loan due in one lump-sum payment, or repayable in amortizing installments over time, as offered in Colorado, by consumer finance companies, and by some credit unions and banks.)

To understand the impact of the new Colorado law, Pew researchers took a three-step approach:

- Analyzing the annual payday loan data published by the state attorney general's office before and after the law change.[40]
- Conducting four focus groups in Denver and Colorado Springs with 45 borrowers who had used the loans since the law change, many of whom previously used conventional two-week payday loans as well.
- Conducting in-depth interviews in Colorado with 33 people who influenced the law or had seen its impact firsthand, including state senators and representatives, payday lenders, consumer advocates, religious leaders, lobbyists, credit counselors, direct service providers, and legislative staff. The interviews ranged in length from 15 minutes to more than two hours, and 29 participants gave permission for the interviews to be recorded; researchers took notes in the other four. Unless otherwise cited, all quotes about Colorado for the remainder of this report were taken from these interviews and focus groups. All participants were granted confidentiality.

Colorado's situation before the law change

Until August 2010, Colorado, like 35 states today, had conventional payday loans due in full on the borrower's next payday, usually in about two weeks. These loans first emerged in the state in 1992 and were quickly recognized by regulators as extensions of credit under the Uniform Consumer Credit Code, entitling the lender to collect a finance charge.[41] The legislature authorized their exemption from the state's usury interest laws under the Colorado Deferred Deposit Loan Act, enacted in 2000.[42]

Regulatory data from the state demonstrate that borrowers there had the same problems with the loans that borrowers in other states have today—spending far more on the loans than the initial price tag, ending up indebted for months after taking out loans described as lasting two weeks, and being unable to retire their debt without borrowing again soon after.[43] One elected official in Colorado described the business model before the law change as "burn and churn and just keep getting them to pay the fees." A credit counselor described the problems that existed under the old law: "We were working with hundreds of families who were getting in the payday loan cycle . . . that would also spin out their credit cards, it would also spin out their medical bills, and then they'd stop paying their rent on time. . . . And so there was a domino effect."

Colorado previously allowed for a $75 charge per pay period for someone borrowing $500 (similar to what many other states currently allow),[44] and 96 percent of loans were made for the maximum fee permitted.[45]

Consumer advocates, lawmakers, and others in Colorado were concerned about this situation and eager to change the law, focusing especially on ending the repeat borrowing caused by the loans' unaffordable lump-sum structure. One borrower who used loans before the law change explained: "I was taking it out to pay . . . my rent and then when I went . . . my next payday to go pay it off, well then I was $350 short. But I needed that money, so I retook it out. Well, it seemed like every time I'd go pay it off, I'd have to take it right back out. So I did that for about a year."

A social service provider told a similar story about clients she saw before the law change: "People, families, would come in, and they would sort of be caught up in this cycle of debt, and they couldn't get out of it." Because the loans were unaffordable, another Colorado social service provider said borrowers "didn't know how long it would take them or how much it would cost them to pay that back."

In focus groups, borrowers who used the loans before the law change described how they eventually paid them off: "Basically, what I did was worked it out with some other bills. Skipped those . . . skip a credit card payment here and there just to gather that cash to pay that off and get them off your back." Another explained, "[I]f I did not get my income tax [refund] at that time to be able to pay it all back, I probably would have gotten stuck in just paying the interest on and on and on."

Colorado also allowed subprime small installment loans, but at lower interest rates, and the loans required traditional underwriting. Few such loans were made annually, with lenders instead opting to make the higher-interest, higher-payment payday loans.[46]

> The interests of the business and the interests of the individual were moving in opposite directions [under the old payday loan law]. We wanted one that bent those curves back a little bit by saying the businesses do better when the person actually has a route out of debt as opposed to a route deeper in debt.
>
> —*Colorado elected official*

Colorado's policy choices

By 2008, consumer advocates[47] and many state lawmakers in Colorado agreed that conventional payday loans were harmful to consumers, and that the market was not price competitive.[48] Concerned lawmakers supported a bill that would cap the annual interest rate on payday loans at 45 percent, the state's traditional criminal usury rate limit,[49] with no other fees allowed.[50] Many of the bill's supporters expressed a desire for payday lenders to leave the state, and businesses offering lump-sum payday products argued that they could not survive at that price point. Traditional two-week payday lending from storefronts does not exist in states with double-digit caps on interest rates, although some credit unions, a few banks,[51] and consumer finance companies make small installment loans to customers with poor credit in some of those states.[52]

The 2008 bill to repeal payday lenders' exemption from the state's interest rate cap did not pass.[53] In 2010, a similar bill was introduced.[54] A small group of state senators agreed that there were major problems with conventional payday loans, but wanted nonbank small-dollar lending to continue. One senator described that group's mind-set as, "how [could] we put some controls around it, but maintain the business because I felt it served a legitimate purpose?" These legislators insisted that lenders be given a chance to offer a more affordable product to consumers, and the resulting compromise was made to garner their votes.[55] (See box on page 11, "The Colorado policy framework.")

At these senators' behest, the bill was amended, replacing the two-week product with a six-month product with no prepayment penalty.[56] The new product would allow an interest rate of 45 percent annually, plus an "origination" fee, and a monthly maintenance fee that would begin at the end of the loan's second month. The origination fee was refundable on a pro-rata basis for loans that were repaid early (for example, repaying the loan in half the time allotted would result in a refund of half the origination fee). This policy ensured that lenders could not fully earn the origination fee immediately at the outset of the loan, so they had no incentive to encourage borrowers to refinance and generate new origination fees.

Exhibit 1

Loan Payments More Affordable Under Revised Colorado Law

	Before Law Change (Conventional Payday Loans)	After Law Change (Payday Installment Loans)
Maximum loan size	$500	$500
Average annual percentage rate paid	319%	129%
Amortization (payments reduce principal over time)	No	Yes
Deferred presentment loan collateral (postdated check or authorization to debit bank account)	Yes	Yes
Amount due on next payday ($500 loan)	$575	$61
Cost to borrow $500		
For 2 weeks	$75	≈$10
For 3 months	$450	≈$125
For 6 months	$975	$290
For 12 months	$1,950	$580

Note:

Before law change refers to 2009, and after law change refers to 2012. Some numbers have been rounded and all estimates assume a borrower is paid biweekly. Pew's calculations are based on the Colorado Deferred Deposit Loan Act. Cost to borrow for six months and 12 months (equal to two six-month loans) after the law change, and amount due on next payday after the law change, come from Advance America's website. According to Colorado examiner data, lenders have not made loans lasting longer than about seven months.

Sources: Advance America, 2013. Colorado Office of the Attorney General, 2010, 2011, and 2012. Colorado Deferred Deposit Loan Act Rev. Stat. 5-3.1-101 et. seq.

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This new law is complicated, with fees and interest resulting in a contracted effective annual percentage rate typically around 200 percent (effective APR is a measure of cost including interest and fees). People borrowing $500 would pay approximately $290 in finance charges if they kept the loan out for the full six months, billed by the lender as approximately $65 in interest, $75 in origination fees, and $150 in monthly maintenance fees. Someone who makes biweekly payments would repay the loan in 13 installments of just under $61 each.[57]

In practice, state regulatory data show that the average loan is repaid in just over three months and carries a 129 percent APR. Because of the fee structure, a borrower who repays in that time spends less and has a lower interest rate than someone who keeps a loan out for the full six months.[58] The average contracted loan term is just over six months, and the longest is just over seven months.[59] Lenders fully earn the origination fee after six months, and thus there is little incentive to extend loan terms beyond that.

Undoubtedly, these loans are expensive. For those who qualify, credit card cash advances (around 24 percent interest plus fees of up to 4 percent), bank or credit union installment loans (APRs of about 18 to 42 percent, including fees), and consumer finance company loans (averaging approximately 60 percent APR, though for somewhat larger amounts) cost substantially less.[60] But for those using conventional payday loans before the law change, the interest rates of Colorado payday installment loans are comparatively lower—and far lower than those of payday loans in other states.[61] More important, the loans' required payments are far more closely tailored to borrowers' ability to repay, with $61 being a more manageable amount out of a biweekly paycheck (gross individual income) than the $575 required for a $500 loan before—and borrowers are spending far less overall. (See Exhibit 2.)

Interestingly, Colorado did not adopt certain strategies used in other states that similarly tried to preserve payday lending while mitigating its associated harms. Fourteen states have a tracking database in which every payday loan is entered,[62] and in most of these states this information is used to ration how many loans and how much money a person can borrow at a time or in a year, or to impose a "cooling-off" period between loans.

> The law that was passed . . . is not as comprehensive as we wanted it to be. It was a big compromise.
>
> —*Social service provider*

> I'm certainly not a payday lender advocate and honestly would have been fine with seeing them go away altogether. But we were trying to pass a bill that would still be meaningful to the borrowers in our state. . . . We thought this would definitely address that debt cycle. No more balloon payment every two weeks; six months to have some time to get yourself in order and pay back.
>
> —*Consumer advocate*

> We [wanted] there to be a short-term loan package that's available, but we [wanted] it to have a reasonable payback time. We want you to not be able to create an entrapment system that we know is going to make you real revenue from the actual third or fourth turnover in the loan, not from the first one.
>
> —*Colorado elected official*

The Colorado policy framework

As indicated by the roll-call votes in 2010, a majority of state legislators in Colorado agreed that conventional, lump-sum payday lending had failed. The state senators who provided the decisive votes for the final law articulated the following principles in interviews with Pew:

- Payday loans had failed to work as hoped, creating ongoing debt and costing borrowers far more than the stated price tag, and the law authorizing them should be repealed.
- Because Colorado had an existing infrastructure of nonbank lenders, they would be given a chance to provide an alternative small-dollar installment loan that could better serve consumers, even if the loans were far more expensive than mainstream credit products.
- All small-dollar payday installment loans in Colorado would amortize to a zero balance over equal installment payments—over a period long enough to make each payment affordable to the consumer.
- The state's traditional usury rate cap would be acknowledged, but additional fees would be permitted to help nonbank small-dollar lenders stay in business.
- Consumers could choose to repay the loans early without penalty.

Some states with loan-rationing strategies have decreased the volume of borrowing,[63] and have saved consumers money and protected them against some of the financial harm from the long-term use of payday loans. But such measures do not address the loans' fundamental unaffordability. Furthermore, rationing amounts to a tacit admission that the lump-sum repayment payday loan is fundamentally broken or harmful. Rationing requires a database to track and limit loan usage, yet state-administered databases are not typical for other financial products. Instead, credit decisions are generally left to borrowers and lenders, and state governments rarely limit usage or control borrowing behavior.

Colorado legislators explicitly rejected loan rationing, electing instead to address the fundamental unaffordability of the loan rather than preserving the product's unaffordable structure and then trying to mitigate its harm through limiting the number of loans or renewals. One elected official explained the government's intentions in replacing the old law: "They get a loan, two weeks they have to pay $575 back. Well, they didn't have the money to begin with. What changed in two weeks to allow them to deal with that? Nothing. So then they were caught in a cycle. So making it more affordable and allowing them to pay it over six months . . . was key to being able to solve the cycle of debt."

An additional reason for rejecting a loan-rationing approach was a dislike of databases to track loan usage. One elected official said: "People in Colorado don't like those things [databases]. . . . To me, that's like, 'the government wants to know what?' " Another elected official said: "I'm opposed to that kind of micromanagement from the government." A consumer advocate agreed that opposition to a database was widespread: "There's absolutely no support in our legislature for a database from either side. In fact, we had a database built into the bill in '08 initially, and it caught as much flak from people on the left as it did on the right. It was an absolute nonstarter, which was also the problem with the loan restriction bill that caused a great difficulty, and we had to have a database for that in order to make it work."

Officials in Colorado decided to focus on fixing the problems that existed with the product, rather than leaving it intact and placing behavioral constraints on the borrower.

The new law's impact on Colorado borrowers

Lower cost, fewer renewals

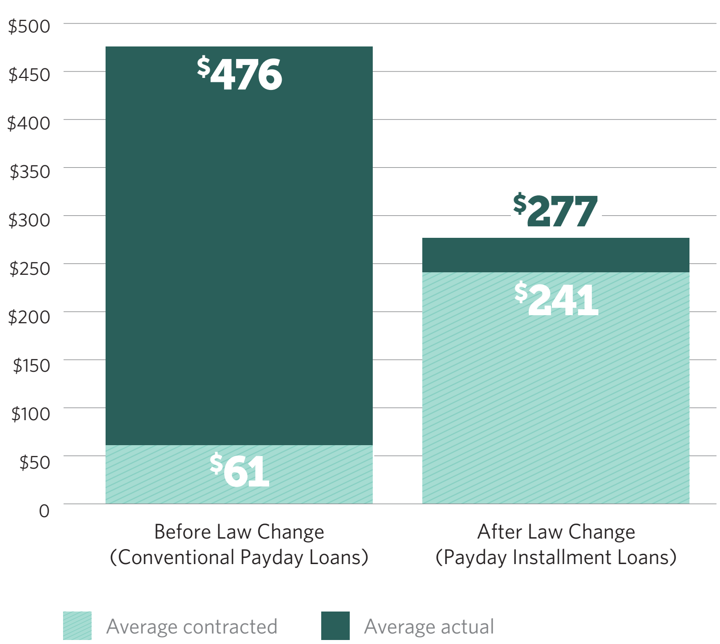
In 2012, the most recent year with data available, borrowers cumulatively spent 44 percent less than they had in 2009 under the conventional payday loan model, saving $41.9 million.[64] Meanwhile, there were no similar declines in other states that published data and did not change their laws.[65] Even with the loans' lower costs, borrowers on average received more credit: 7½ months in 2012, compared with five months in 2009. Additionally, the loan's stated cost for a six-month term gave borrowers a far more representative statement of their likely spending, as shown in Exhibit 2, enabling them to make a more informed decision about whether to borrow.

There were 15 percent fewer borrowers in Colorado in 2012 compared with 2009 (and similar declines did not take place in other states without law changes).[66] One factor that is not primarily responsible for the decline is a lack of access to stores. As shown in Exhibit 9, few stores in the state before the law change closed without one nearby remaining open. Approximately 82 percent of Colorado residents had a payday lender within five miles of their home before the law change, compared with 77 percent after the change.[67] The decline in stores is explained by areas that had many payday lending stores now having fewer, such as a Denver-area zip code that had seven locations and now has three.[68]

It is unclear whether the 15 percent decline in borrowers happened because the ultimate cost of the loan immediately became far more transparent and thus fewer people decided to borrow; because lenders slightly raised borrowing standards; because borrowers who had been unable to retire their debt now had a means to do so and have not continued to borrow; or a combination of these. One lender said a small portion of his borrowers now saw that a $500 loan would cost them $290 or so over six months, and hesitated to borrow. He also said of

Exhibit 2

Increased Transparency Under Installment Law



Under the old law, the average contracted cost represented 13% of fees actually paid. Under the new law, this cost represents 87% of fees actually paid.

Note:

Before law change refers to 2009 and after law change refers to 2012. Indebtedness figures are calculated using the 2009 average loan cost and number of loans (7.84) and the 2012 average loan cost and number of loans (2.3, based on 2011 data because a 2012 figure has not been published).

Sources: Colorado Office of the Attorney General, 2010, 2012, and 2013.

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a few of his long-time customers: "There are people who I never thought would be out of the cycle of debt, I never see anymore." He attributed this to the lower payments under the new law. (See Exhibit 3.)

Exhibit 3

Revised Colorado Payday Law Leads to Lower Cost, Fewer Renewals

	Before Law Change (Conventional Payday Loans)	After Law Change (Payday Installment Loans)	Difference
Average loan size	$368[a]	$389	6%
Cost			
Average annual percentage rate paid	319%	129%	-60%[b]
Amount spent per borrower annually[c]	$476[a]	$277	-42%
Total spent on payday loans by borrowers	$95.1 million[a]	$53.2 million	-44%
Usage			
Loans per borrower in past year	7.84[d]	2.3	-71%
Average loan duration	18.91 days	98.90 days	423%
Average days of credit used[e]	148	227	53%
Percentage of loans that are renewals or taken out the same day a previous loan is paid back	61%	30%	-51%

Note:

Before law change refers to 2009, and after law change refers to 2012. Figures for average number of loans used in past year and percentage of loans that are renewals or taken out the same day a previous loan is back are from 2011 because more recent data are unavailable.

a In inflation-adjusted terms, $368.09 in 2009 dollars is equivalent to $393.92 in 2012 dollars, $95.1 million in 2009 dollars is equivalent to $101.8 million in 2012 dollars, and $476 in 2009 dollars is equivalent to $509.41 in 2012 dollars, using the U.S. Bureau of Labor Statistics inflation calculator.

b While this decline in APR is dramatic, it somewhat understates the difference between the cost of the loans before and after the law change. APR is calculated based on the borrower's outstanding balance. Because the balance never declines on single-repayment payday loans, they are somewhat more expensive compared with installment loans than their APR would indicate. For example, a 400% APR lump-sum repayment loan is more than three times as expensive as a 200% APR six-month installment loan. If borrowers used a $500 lump-sum payday loan for six months that had a standard 400% APR, they would pay about $1,000 in interest. If they used a $500 installment loan for six months that had a 200% APR, they would pay about $300 in interest. Thus, an amortizing loan with an APR of half a lump-sum repayment loan will cost substantially less than half as much.

c These figures are calculated using the 2009 average finance charge ($60.74) and the average number of loans (7.84) and the 2012 average finance charge ($120.62) and 2011 average number of loans (2.3).

d In the first half of 2010, before the law change, the average number of loans used in the past year was 8.5.

e These figures are calculated using the 2009 average loan duration (18.91 days) and number of loans (7.84), and the 2012 average loan duration (98.90 days) and 2011 average number of loans (2.3).

Sources: Colorado Office of the Attorney General, 2010, 2012, and 2013. U.S. Bureau of Labor Statistics, 2013.

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> I don't hear the same stories that I heard prior to the law . . . of consumers who have been harmed by payday lending.
>
> —*Colorado elected official*

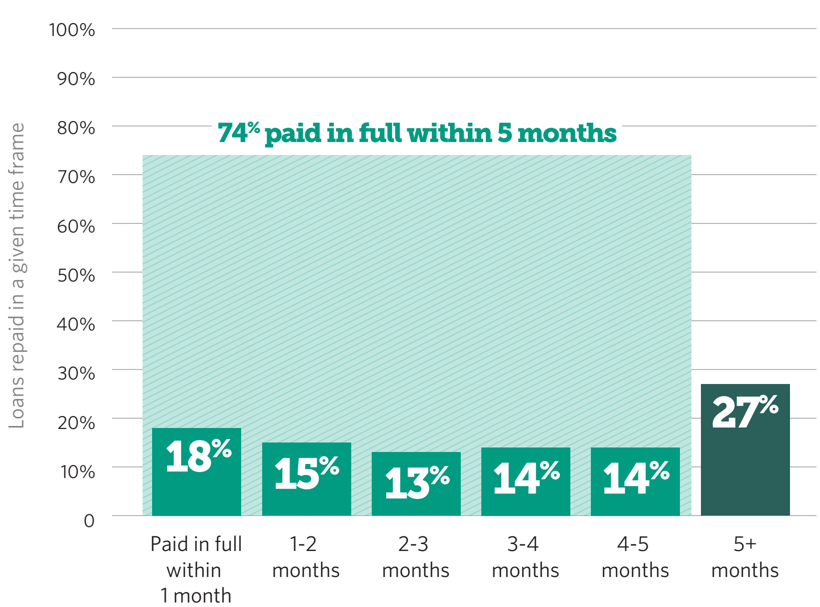
> For us, [the problem] was really the debt cycle, the rolling over. Again, it wasn't an emergency source of cash when people are taking out 12 loans a year, clearly. So . . . we've seen the number of loans go down. . . . Right there, that debt cycle and that phantom demand is gone. Now it's real demand. People who really need a loan are taking them, and we're seeing them pay them back. So we think that it's been addressed.
>
> —*Consumer advocate*

As demonstrated in Exhibit 3, the new loans have lower APRs, and borrowers are spending far less on them annually. If lawmakers had permitted higher rates or fees, the new installment structure would not have necessarily saved borrowers money. If the law had allowed fees and interest that were twice as high (so loans' effective APR averaged 258 percent instead of 129 percent), the same borrowing patterns would have resulted in average annual loan costs of $554—more than before the law change. Alternatively, if lawmakers had required lower interest rates, and lenders had continued to operate, the same borrowing patterns would have resulted in lower costs. This data point indicates the importance of the interest rates that state lawmakers permit if one of their goals is to reduce the total cost of borrowing.

Colorado borrowers are permitted to repay their installment loans at any point without a prepayment penalty. But only 18 percent of loans are repaid within one month, even though borrowers could save substantially on interest

Exhibit 4

Only 18 Percent of Loans Are Repaid Within 1 Month



The average loan is repaid in just over 3 months

Note:

Numbers add to greater than 100% because of rounding. Under the new law, 3.36% of all payday loans were charged off as losses within six months from origination in 2011. According to Colorado examiner data, lenders have not made loans lasting longer than about seven months.

Sources: Colorado Office of the Attorney General, 2012 and 2013.

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and fees,[69] indicating that this choice is not viable because it requires such a large payment. At the same time, nearly three-quarters of loans are paid off before the sixth month, indicating that this becomes more feasible as the principal declines. On average, loans are paid off in just over three months. (See Exhibit 4.)

Borrowers explain how affordable installments are more manageable

Pew conducted four two-hour focus groups with people in Colorado who have used payday installment loans from storefronts. Many had also used lump-sum repayment loans before the law change. They were asked to compare repaying a $500 loan before the law change, when a $575 payment was required, and after the law change, when a payment of approximately $61 was required. A few borrowers said they could afford to repay either loan, and a few could not afford either. Most could afford the smaller payment but not the larger one. (See Exhibit 5.)

Exhibit 5

Colorado Borrowers Describe Impact of Smaller Payments

Colorado's revised payday installment law allows a $61 biweekly payment on a $500 loan, while the previous law allowed a $575 repayment

Before Law Change (Conventional Payday Loans)	**After Law Change** (Payday Installment Loans)
Borrowers' Descriptions of the Impact of a Lump-Sum Repayment on Their Budgets	**Borrowers' Descriptions of the Impact of an Installment Repayment on Their Budgets**
Eats up my paycheck	Would be a bill I could manage
Stressful	Easier
Difficult	Doable
Tough to pay all my bills	Relief
Does not work	An inconvenience but workable
Based on my previous experience, vicious cycle	I'm left with a couple hundred
Ramen (for a) couple weeks	Manageable
Depletes my paycheck	Gives me room to breathe
There is no way	Fits right in where I could pay other bills as well
Decimates my budget	Comfortable

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Indirect benefits

Although the law change in Colorado undoubtedly makes payday loans more transparent and affordable for borrowers, preliminary evidence shows the change to affordable installment payments provides benefits in other areas of customers' financial lives.

Credit counselors in Colorado emphasized that, under the previous law, they regularly made arrangements with lenders on behalf of clients that allowed them to repay loans over several months, similar to the loan term in the new law. "So we were pre-negotiating payment arrangements before it was the law," one credit counselor said.

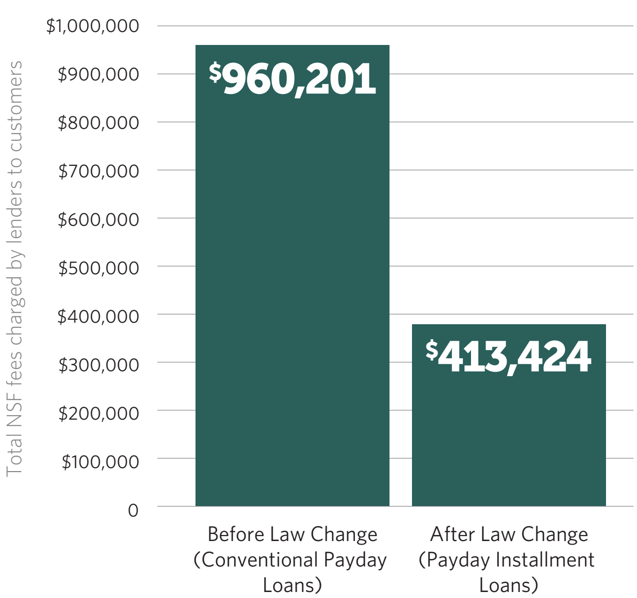
Under the new law, counselors say they are not servicing clients with payday loan debt to the same extent, which they attribute to the new loan structure. "I think it's better to have the option to stretch it out over a longer time than not, just because it takes it off the front burner," one counselor said. "They can keep up with their basic expenses, such as rent. It doesn't end up being an eviction notice." Another counselor said the new law provides borrowers with "an outlet valve" to retire their debt.

Another indirect benefit is borrowers spending less on non-sufficient funds (or NSF) fees. Banks and credit unions charge these fees when a customer's check or electronic debit is declined. If a lender tries to cash a borrower's check or to debit an account for payment and there are insufficient funds, lenders can also charge an NSF fee. The new law permits lenders to charge only one per loan. This protection discourages the repeated presentment of checks or electronic debits, which can trigger fees and checking account problems.[70] Because lenders can charge borrowers only one NSF fee, this restriction encourages them to work with those who are struggling rather than repeatedly presenting postdated checks or attempting to debit accounts. Lender-originated NSF fees have decreased by 57 percent since the law change.[71]

It remains unclear whether the decline in such fees under the new law is a result of lenders being permitted to charge only one NSF fee per loan (with borrowers using fewer loans), or a result of the loans' increased affordability. But in either case, there is an indirect benefit of borrowers spending less on these fees. (See Exhibit 6.)

Exhibit 6

NSF Fees Lower Under Revised Colorado Payday Installment Law



-57% Difference in total NSF fees charged by lenders before and after law change

Note:

Non-sufficient funds (NSF) fees are charged by lenders to customers when a check or electronic debit is declined. Banks and credit unions also charge NSF fees when a check or electronic debit is returned for insufficient funds. Before law change refers to 2009, and after law change refers to 2012.

Sources: Colorado Office of the Attorney General, 2010 and 2013.

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The impact on Colorado's marketplace

More efficient lending is evident in Colorado today, with lenders adjusting their business models to survive in the new marketplace for payday installment loans. This section examines changes in the market under the new law.

Payday loan storefront consolidation

Colorado's law change has resulted in substantial storefront consolidation, with 53 percent fewer payday loan stores in the state in mid-2013 than at the conclusion of 2009. (See Exhibit 7.)

Exhibit 7

Colorado Law Change Leads to Storefront Consolidation

Revised law brings efficiency as lenders cut costs and increase volume per store

	Before Law Change (Conventional Payday Loans)	After Law Change (Payday Installment Loans)	Difference
Total number of individual consumers to whom loans were made in year[a]	279,570	238,014	-15%
Number of licensed locations	505	238	-53%
Borrowers per store[b]	**554**	**1,000**	**81%**

Note:

Before law change refers to 2009, and after law change refers to number of licensed locations in the second quarter of 2013 and number of individual consumers in 2012 because more recent data are unavailable.

a Because a database is not in place, these figures count a customer who borrows from multiple lenders as multiple customers (both before and after the law change).

b Borrowers per store are calculated by dividing the number of total borrowers by the number of stores. The after law change figure relies on the number of stores reported by the Office of the Attorney General during the second quarter of 2013, and uses the number of borrowers from 2012, because a 2013 figure is not yet available. If the 2012 figure on number of stores is used (287), the result is 829 borrowers per store, because consolidation was in an earlier phase.

Sources: Colorado Office of the Attorney General, 2010 and 2013.

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There have not been similar declines in states without law changes,[72] suggesting the consolidation in Colorado is largely a result of the new law. Payday loan storefronts that have remained open are each serving far more customers than before the change. Academic research using data from other states before the Colorado law change identified this phenomenon of lower interest rate limits leading to consolidation and higher volume per store.[73] Colorado has also had this experience.

Lenders still operating in the state say one reason some colleagues have left Colorado is that they can charge more in other states or online. A lender described being approached by consultants and others serving the industry who encouraged him to become an online lender after the law change. Another lender noted that several licensed lenders making loans online in Colorado before the change have stopped because "they can put their money in more profitable states." He summed up the thinking of his counterparts who have closed locations as "'why not put it in another state, where we make more money?'"

Generally, small-dollar lending remains more profitable (on a per-customer basis) in the 35 states that continue to allow conventional short-term payday lending than in Colorado.[74]

> All the doomsday scenarios haven't come to pass, so I think that's been a pretty good metric for success.
>
> —*Colorado elected official*

> Certainly, when you drive down the streets, you still see the signs up. And there are enough of them up there, so they're still obviously [doing] a reasonable business.
>
> —*Colorado elected official*

Access to credit

State regulatory data provide further evidence of the limited impact of consolidation on access to credit, showing a decline of only 15 percent in the number of borrowers overall.[75] Borrowers in Pew's Denver and Colorado Springs focus groups did not report additional difficulties in traveling to or receiving credit from payday lending stores since the new law took effect, and noted that there were still many stores they could use. Payday loans remain readily available from storefronts, as demonstrated by systematic plotting of all stores in the state before and after the law change; in some instances, there are still multiple payday lenders on the same block and in the same shopping center.[76]

Because the payday loan product in Colorado shifted dramatically, from a two-week, lump-sum repayment loan to a six-month installment loan at a lower interest rate, it is important to investigate whether a different type of borrower is using the new product. Data from the Colorado attorney general's office demonstrate that borrowers before and after the law change are quite similar. These demographic data, in combination with the small decline in borrowers, suggest that the new law has not substantially reduced access to credit for payday borrowers. (See Exhibit 8.)

Exhibit 9 plots payday loan stores before and after the new law took effect. As the map demonstrates, few stores closed without one nearby remaining open. Instead, the decline in the number of stores resulted in decreased density of payday loan stores in areas that had many. As a result, geographic access to payday loan stores has been largely unaffected, despite the substantial consolidation.

Efficiency gains under the new law

Since Colorado's new law was implemented, the payday lending industry there has become more efficient than it was previously, or than it is in other states. Nationally, payday storefronts make only about 10 to 13 loans per day,[77] and most of these are renewals or quick reborrows by repeat customers.[78] In other states, payday loan storefronts serve approximately 500 unique customers per year,[79] whereas in Colorado stores now serve nearly twice as many customers as before. Lenders report that with fewer storefronts serving more customers each, revenue per store is about the same as it was before the law change, as of early 2013. Regulatory data corroborate this observation.[80] The Colorado law has transformed a payday lending business with low-volume stores into one that serves more customers at each location, with borrowers spending less annually on loans.

Exhibit 8

Colorado Borrowers Alike Before and After Law Change

	Before Law Change (Conventional Payday Loans)	After Law Change (Payday Installment Loans)
Gross monthly income (mean)	$2,458[a]	$2,477
Gross monthly Income (median)	$2,199[a]	$2,140
Age	38	37
Average time at current job	3.5 years	3.6 years
Female	55%	52%
Married	35%	35%

Note:

Before law change refers to 2009, and after law change refers to 2011, because 2012 demographic data are unavailable.

a In inflation-adjusted terms, $2,458 in 2009 dollars is equivalent to $2,577 in 2011 dollars, and $2,199 in 2009 dollars is equivalent to $2,306 in 2011 dollars using the U.S. Bureau of Labor Statistics inflation calculator.

Sources: Colorado Office of the Attorney General, 2010 and 2012. U.S. Bureau of Labor Statistics, 2013.

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Change in market share

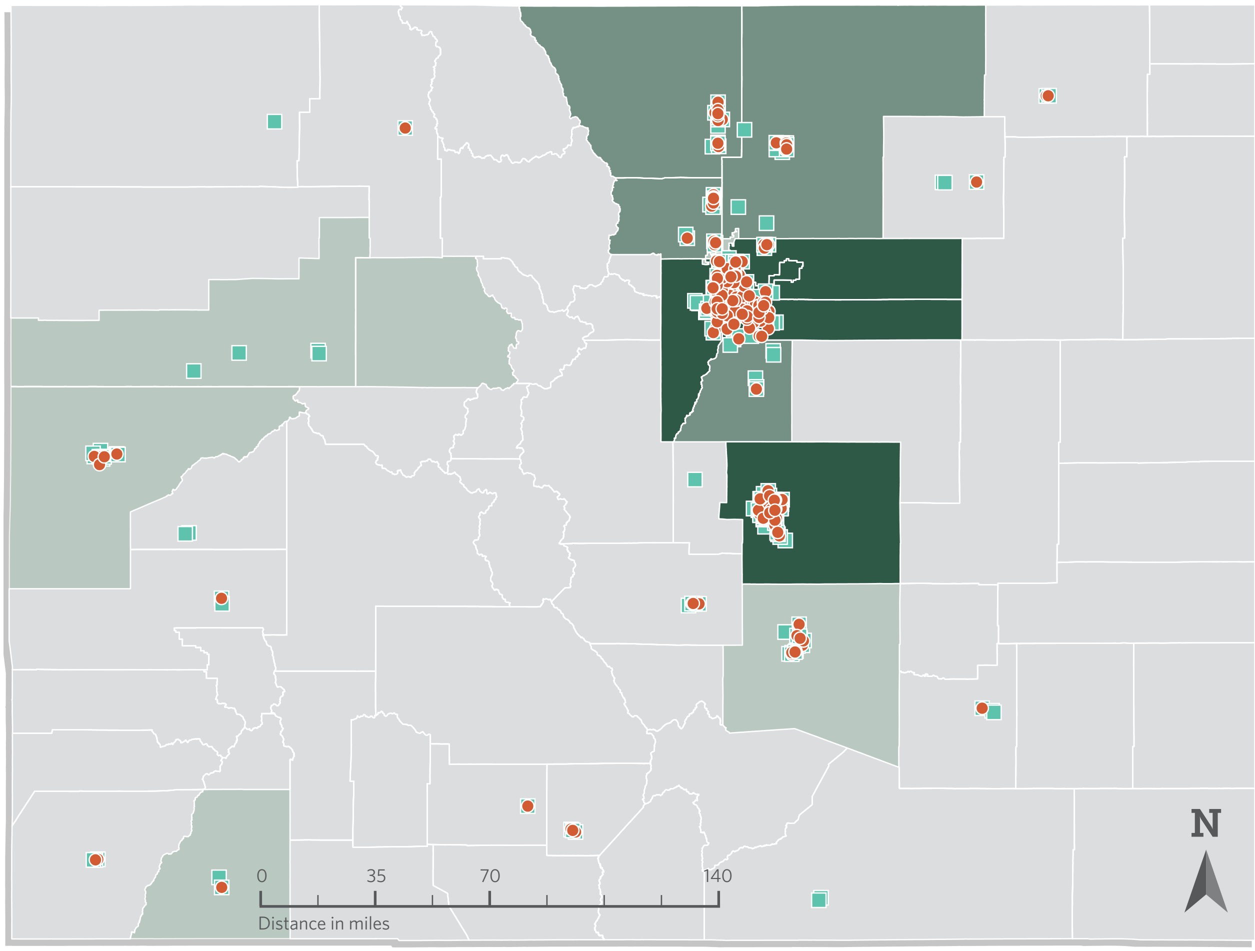
Since the new law went into effect, larger operators have increased their market share in the state. Before the change, seven of the largest operators[81] owned 59 percent of Colorado stores.[82] By the end of 2011, their market share was 69 percent,[83] and more recent data indicate that figure has risen to 73 percent.[84]

Several lenders believe this change occurred because larger lenders could afford to operate at slimmer margins and benefit from economies of scale. One lender said: "It's just the reality of how deep the pockets are or how shallow the pockets are, to be able to make it work." Large lenders have fewer stores than before the law change, but their decline has been outpaced by small operators, who have left the market or who also have fewer stores.

Additionally, large lenders that do not offer check cashing have experienced a 55 percent decline in store count since 2009, much higher than the 17 percent decline for large lenders that offer check cashing. This stark difference suggests that at the lower prices now permitted for payday loans, firms whose revenue comes from multiple products have fared better. Similarly, in Oregon, which requires among the lowest interest rates in states where payday lenders operate, the market is dominated by companies that also provide check cashing and other alternative financial services.

Exhibit 9

Colorado Payday Loan Stores Still Widely Available After Law Change



● Location open after law change (Aug. 1, 2013)

■ Location open before law change (April 1, 2010)

Percent of total population by county

< 1 | 1-4 | 4-8 | 8-12

Note:

Methodology is available on page 52. Before the law change, 82% of the population lived within five miles of a payday lender, compared with 77% afterward. Similarly, 93% of the population lived within 20 miles of a payday lender before the law change, compared with 91% afterward.

Sources: Colorado Office of the Attorney General, 2013. U.S. Census Bureau, 2011. Yahoo, Inc., 2013.

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Substantial adjustments for lenders

The Colorado law has clearly benefitted borrowers, but lenders have had to make significant changes to their business model. In addition to storefront consolidation, several lenders whom Pew interviewed described laying off employees, dealing with lower income themselves, and struggling to gain stability operating under a new set of laws. One said: "We had to lay off . . . employees, renegotiate our leases. Essentially, we had to reduce our overhead by 60 percent, and we had to double our customer count [per store]." Another noted, "To make the same amount of money, you have to have double the volume."

Lenders reported that revenue per store had recovered to previous levels, but profitability had not yet stabilized as they adjusted to the new law. Several lenders said they carry more risk under this loan structure, and now have somewhat higher losses than before the law change. They attributed this shift to there being six months (rather than two weeks) for something to happen that could result in nonpayment. Lenders' loss rates on payday loans nationally are about 3 percent of dollars lent,[85] and in Colorado lenders said their losses were now somewhat higher. Published data on loss rates in Colorado are not available. While not directly comparable, data from the Colorado attorney general's office indicate that 3.36 percent of loans were charged off as delinquent within six months of origination in 2011, and another 6.28 percent remained open with borrowers behind schedule on payments.[86] The other 90 percent of loans were paid in full or were being paid as agreed.[87] Data from the attorney general's office indicate that the number of annual defaults per borrower declined 30 percent under the new law.[88]

Despite concerns about losses, lenders have tightened standards only very modestly. One described customers as having "D or F" credit both before and after the law change. The only changes his company made were to avoid people who had four or more lenders already making withdrawals from their checking account, or people with four or more overdrafts in the past month. Another lender had slightly raised requirements for income and employment longevity. Other lenders Pew interviewed had not made these small changes, and none had begun underwriting in the way that conventional lenders do for more traditional products, such as home mortgages, auto loans, or credit cards.[89] Instead, Colorado payday installment lenders continue to offer loans based on the consumer's income and possession of a checking account that can be accessed to collect payments via electronic debit or postdated check. Accordingly, evidence suggests that the new law has not substantially reduced access to credit for payday borrowers.

Although lenders continue to operate in Colorado, they are not pleased with the law change. In addition to experiencing reduced profitability per customer, lenders had to adapt their computer systems, with one noting that initially "there were no software companies that could calculate the rate." Those with fewer stores have laid off employees and adjusted to earning less. One lender described earning far more in the years before the law change, and said his upper-tier borrowers now have higher incomes than he does.

As another lender said, "We, as an industry, weren't opposed to a longer-term product. But, you know, it has to be viable for us to be able to deliver it." The new Colorado product has proved viable for lenders since its implementation in 2010. But it cannot sustain the number of stores that existed in the state before, so lenders have struggled to reach a new equilibrium as consolidation has continued.

Section 2: Strong support for replacing lump-sum payday loans

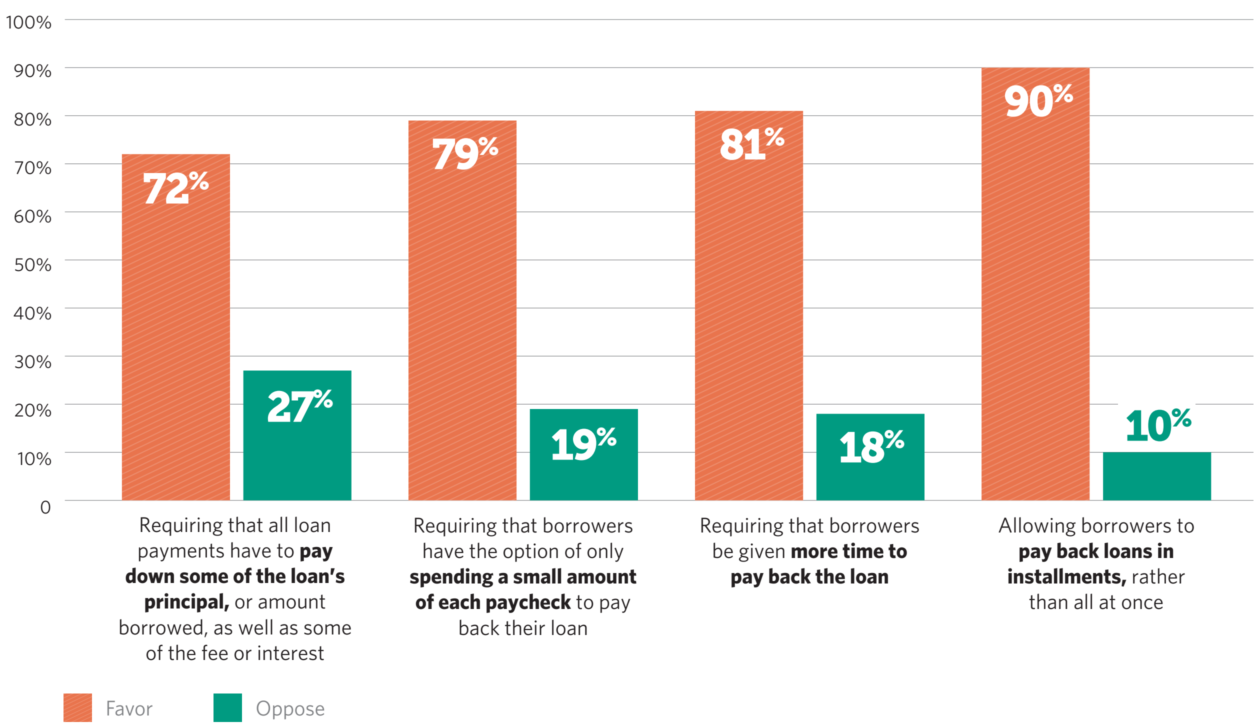
Overwhelming borrower preference for affordable installment loans

Pew conducted 14 focus groups in seven locations around the United States to learn about borrowers' experiences using various types of small-dollar loans. Borrowers of conventional payday loans embraced several changes that would make the loans more transparent and predictable.

Pew then tested reaction to specific changes in a nationally representative telephone survey of payday customers.[90] Seventy-two percent said they wanted more regulation of payday loans, and by a 2-to-1 margin they wanted changes in how the loans work. Pew also asked about four policy changes that could be enacted. All received overwhelming support from borrowers.

Exhibit 10

Overwhelming Borrower Support for Requiring Installment Payment Structure



Note:

Data represent percentage of payday borrowers who gave the listed answer. Results are based on 703 interviews conducted from December 2011 through April 2012. Respondents were asked: "Now I'm going to read you some ideas for how payday loans could be changed or modified. After I read each idea, tell me whether this sounds like something you would favor or oppose. How about ...? Do you favor or oppose this?" Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

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Payday borrowers explain why installment payments work better for them

The following quotes come from borrowers in focus groups held around the United States:
Source: The Pew Charitable Trusts, 2013

Paying principal as well as interest

" I mean, if you pay it in small amounts over time, and all you're doing is paying toward the interest, then there's no point to that.

—Colorado Springs borrower

" I wish they'd start going [after] the principal right at the start.

—New York online borrower

" Otherwise, you never get it paid off, if you're paying interest, interest, interest.

—New Hampshire former storefront borrower

Having more time to repay

" You have that option. You could pay it over time or pay it as much as you want, but it's still a benefit of knowing on payday, I just borrowed $500, so when payday comes, I don't have to worry about going to the bank and they're taking the $500 out.

—San Francisco borrower

" If they took out 100, I wouldn't be in any hole, any financial stress. [Installment loans] give you time. That's the best thing: time to pay it.

—San Francisco borrower

" Give people a little breathing room and the opportunity to get ahead.

—Denver borrower

Limiting payments to a percentage of paycheck

> You know on payday, I'm not going to get there, and I just look at my paystub and it says $798, but then, when I get to the bank, it says $232.
>
> *—San Francisco borrower*

> You need that money from the next paycheck that is coming, but they take it all and then you're going to have to find another way to get the money from somewhere to cover that amount.
>
> *—San Francisco borrower*

> Then I [would not be] stressed out about renewing, like to try to figure out how I am going to make up all that extra money. Whereas if they are just taking out a little bit, I can kind of work around it a little bit better—eat cheaper or maybe I do not drive so many places to waste gas money.
>
> *—Denver borrower*

Paying in installments

> When I went to get that payday loan, I absolutely needed that money that moment. Okay? That's not to say that when they snatch the whole $500 back, at that date, it won't still put me in a hole. I was surprised when [the credit union] said I could make payments. I didn't even believe it. I smiled. I said, 'Really?'
>
> *—San Francisco borrower*

> It allows that person to still have money at the end of that pay period versus having to get that entire amount back. You can see yourself sacrificing $100 or $125 versus . . . $500.
>
> *—Birmingham, AL, borrower*

> It's hard to come up with $500. It's a lot easier to come up with . . . a smaller amount more frequently, every paycheck.
>
> *—Chicago borrower*

Bank, credit union, and regulatory support for installment lending

Some banks, credit unions, and regulators have similarly pointed to installment lending as the only viable way to provide small-dollar loans that consumers can repay as scheduled. The Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, and National Credit Union Administration have emphasized the importance of amortization in creating safe consumer loans in the credit card market.[91]

In 2008, the FDIC created the two-year Small-Dollar Loan Pilot program to explore the feasibility of offering safe and affordable small-dollar loans at banks. The result was a model that banks can use to create a small-dollar loan product, including a minimum 90-day term and maximum annual percentage rate of 36 percent. Although the model included several important features, participating bankers felt the longer loan term was most important "because it provides more time for consumers to recover from a financial emergency than the single pay cycle for payday loans, or the immediate repayment often required for fee-based overdrafts."[92] (As discussed in the next section, the FDIC and Office of the Comptroller of the Currency recently announced proposed guidance that strongly favors the use of affordable installment loan structures.)

Liberty Bank in New Orleans participated in the program and initially offered a loan term of three pay periods, but borrowers had difficulty repaying the loans and renewed them repeatedly. To avoid this loan churning, Liberty Bank increased its term to a minimum of six months, and found that most borrowers needed at least 90 days to repay a loan.[93]

Other banks and credit unions have experimented with versions of small-dollar loans, such as the KeyBasic Line of Credit from KeyBank that can be paid back in installments for up to 60 months.[94] In an interview with *American Banker*, an executive from the bank commented on the long-term repayment schedule: "While theoretically people could go for [five years], it's really about saying that we're not going to take a huge chunk of somebody's pay to force them to pay it."[95]

Similarly, credit unions frequently offer loans with longer terms to create affordable installment payments. North Side Community Federal Credit Union in Chicago offers a six-month loan term.[96] Credit unions in Pennsylvania offer loans with a 90-day repayment term,[97] and loans promoted by the National Federation of Community Development Credit Unions have repayment terms of three months to a year.[98]

Section 3: Ensuring affordability

Pew's second report in this series found that on average, payday borrowers can afford $50 per two weeks toward servicing small-loan debt—enough to renew or reborrow a loan, but not enough to repay the $400 or so typically required to pay it off[99] (as shown in Exhibits 12 and 13, lump-sum payday loans require approximately one-third of a typical borrower's paycheck). Thus, the loans become essentially interest-only, and the loan balance does not decline until a borrower can find a lump sum to pay it off, often a windfall or other loan.[100]

This phenomenon plays out even in states that technically prohibit renewals or have brief "cooling-off" periods, because borrowers cannot afford to meet their obligations after repaying a lump-sum loan and thus quickly take another one. Research sponsored by both consumer advocates and the payday lending industry finds that lump-sum repayments, rather than high interest rates, lead to repeat borrowing.[101] This occurs because the lump sum exceeds the borrower's ability to repay; in other words, typical payday loans are *unaffordable*. The term *ability to repay* is used in this report to mean that a loan payment fits into borrowers' budgets while still allowing them to cover basic expenses without having to borrow again or draw from savings.

Borrowers say the primary reason an installment loan works better than a lump-sum repayment loan is simply that they can afford the payments. A sustainable installment loan is one in which each payment reduces the principal, in affordable increments, so the balance has been reduced to zero at the end of the loan term. At that point, the customer can choose whether to borrow again.

The limited benefits of access to credit

Rather than being "thin file" or "no file" consumers who are creditworthy but lack access to mainstream credit, most payday loan borrowers are "thick file" consumers who have substantial experience with debt. More than half of payday loan applicants carry credit card debt, two in five payday borrowers own homes (many with mortgages), and many also hold student loans, auto loans, and other debt.[102] Typical payday loan applicants have poor credit scores in the low 500s,[103] indicating an assessment by credit reporting agencies that payday borrowers are already overburdened with debt and/or struggling to meet financial obligations.

Fifty-eight percent of payday loan borrowers have trouble paying their bills at least half the time, and 7 in 10 use loans to cover ordinary living expenses, such as rent or utilities.[104] Payday borrowers' having little discretionary income helps explain why 79 percent in Pew's survey support limiting the size of a loan repayment to a small amount of each paycheck.

Whether it is wise to use short-term credit to cope with persistent cash shortfalls is debatable, and policymakers surely will continue to examine the merits of promoting credit for consumers who are already indebted and struggling to make ends meet—especially when that credit comes at significantly higher cost than mainstream products. It is entirely possible that consumers who are already struggling with debt have financial problems that cannot be solved by obtaining more credit. But for those who use credit, requiring loans to have affordable installment payments that predictably amortize to a zero balance can avoid creating an unsustainable reliance on getting new loans to deal with shortfalls caused by repaying old ones. Thus it becomes clear why 90 percent of payday borrowers in Pew's survey favor allowing the loans to be repaid in installments.

Some consumers will struggle to repay any type of loan. In Pew's survey, one in five said they could not afford anything toward the repayment of a loan, which raises questions about whether they should choose *any* loans.

But for the two-thirds of borrowers who *can* afford to make some payment (though less than the full amount due on a typical lump-sum repayment payday loan), a well-designed installment loan is affordable, and a lump-sum loan is not. For the remaining 14 percent of payday borrowers who say they can afford more than $400 out of their monthly budget to pay back their loans, they may choose to repay small-dollar installment loans quickly (like the 18 percent of Colorado borrowers who repay the loans within one month; see Exhibit 4).

Although the net benefit of using high-cost credit to deal with persistent cash shortfalls is not clear, it is clear that if high-interest loans are permitted, consumers fare better with amortizing installment credit than lump-sum repayment credit.

> Although the net benefit of using high-cost credit to deal with persistent cash shortfalls is not clear, it is clear that if high-interest loans are permitted, consumers fare better with amortizing installment credit than lump-sum repayment credit.

The role of underwriting in the small-dollar loan market

Most traditional lenders, including nonbank consumer finance companies that make installment loans of up to several thousand dollars,[105] perform underwriting to determine what payments are affordable based on an analysis of the borrower's income and expenses.[106] Banks, credit unions, specialized auto and mortgage lenders, and others traditionally engage in a similar process to assess what a borrower can afford.

Payday lenders are unique because they do not use traditional underwriting to determine whether the borrower has the ability to repay the loan while fulfilling other obligations.[107] They focus primarily on the ability to collect repayment, using leverage based on a deferred presentment (holding the borrower's postdated check or having electronic access to the borrower's checking account).[108]

Recently, the Office of the Comptroller of the Currency and the FDIC expressed concern that some of the nation's largest banks are providing payday loans, also known as deposit advance loans, without engaging in a proper underwriting process. Like payday loans, deposit advances are lump-sum loans; they are repaid out of the borrower's next direct deposit, and borrowers tend to use them repeatedly because they cannot repay them without taking another to cover expenses.

In a statement of proposed guidance from April 2013, the agencies found that a bank offering deposit advance loans "does not analyze the customer's ability to repay the loan." They further found that: "The decision to advance credit to borrowers, based solely on the amount and frequency of their deposits, stands in contrast to banks' traditional underwriting standards for other products, which typically include an assessment of the ability to repay the loan based on an analysis of the borrower's finances." In response, these regulators concluded that banks should underwrite small-dollar loans based on "the customer's ability to repay a loan without needing to borrow repeatedly from any source, including reborrowing, to meet necessary expenses."[109] This kind of underwriting is important because it requires lenders to assess a borrower's inflows and outflows to determine what residual income is available for loan payments.

It is clear that assessing a borrower's ability to repay must take place to ensure that small-dollar loans are affordable. Banks are experienced in underwriting loans, and many can leverage existing infrastructure to conduct sound underwriting of small-dollar loans. Similarly, many nonbank lenders, such as state-licensed consumer finance companies, have significant experience underwriting such loans.

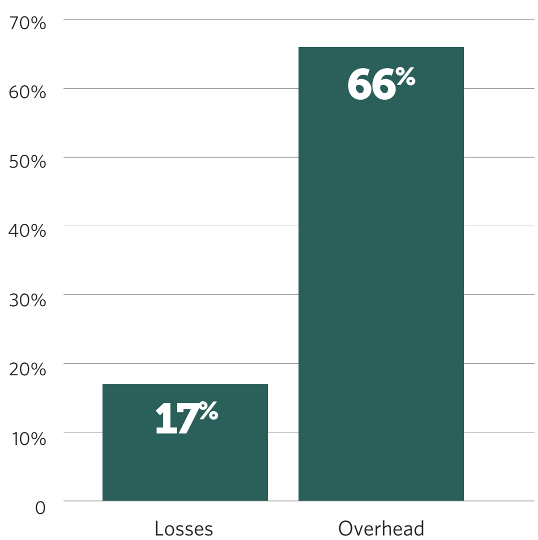
For conventional payday lenders, the transition to proper underwriting will be difficult. Their business model avoids almost entirely this cost of ensuring ability to repay, relying instead on a loan structure that gives the lender the right to collect the loan in full directly from the borrower's checking account on his or her next payday. The transition to underwriting would add complexity and cost to a payday lender's business model,[110] which is already characterized by high overhead costs.[111] (See Exhibit 11.) These costs include storefront locations that average only 10 to 13 loans per day and serve only about 500 unique customers per year.[112] Less detailed information is available for online lenders, but costs include expensive customer acquisition through lead generators,[113] celebrity endorsements, and television commercials to create demand.

Payday loan interest rates are not high simply because lenders must compensate for high losses; they are high primarily because of overhead. Although payday borrowers generally have a damaged credit history, two-thirds of revenue covers storefront and corporate overhead and only one-sixth covers losses. This dynamic helps explain why lenders do not assess ability to repay: Underwriting reduces losses, which are already low, but can increase costs, which are already high.

Exhibit 11

Lender Costs Driven by Overhead More Than Losses

Payday lender expenses as a percentage of revenue



Storefront lenders spend four times more on overhead than on losses

Note:

54% of revenue is used to cover storefront overhead, while 12% is used to cover corporate overhead. As classified in Advance America's 10-K, storefront overhead comprises: salaries and related payroll costs; occupancy costs; center depreciation expense; advertising expense; and other center expenses. Corporate overhead comprises: general and administrative expenses; legal settlements; corporate depreciation and amortization expense; interest expense; loss on disposal of property and equipment; loss on impairment of assets; minus interest income.

Sources: 2011 Annual (10-K) Report from Advance America, the largest storefront lender in the United States, 41.

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The 5 percent affordability threshold

In the vast majority of cases, lump-sum payday loans will not meet any rational ability-to-repay test, requiring lenders instead to provide installment loans that borrowers can pay off over time. But converting a payday loan to an installment loan will not by itself ensure that the payments are affordable. As explained below, four separate data sources suggest that small-dollar loans are not affordable, on average, if payments take more than 5 percent of a borrower's paycheck (for example, a monthly loan payment should not take more than 5 percent of a person's gross monthly income). All figures below refer to individual income unless otherwise noted.[114]

- **Survey data.** In Pew's nationally representative survey of payday loan borrowers, average borrowers said they could afford $50 per two weeks out of their paycheck toward payday loans. Comparing this figure with their self-reported income[115] reveals that 54 percent of borrowers can afford 5 percent of their income or less toward payday loan debt. The median borrower can afford 5 percent.
- **Existing installment lending market data.** Consumer finance companies are state-licensed nonbank lenders that offer money to low- and moderate-income borrowers via installment loans that are underwritten to assess borrowers' cash flows. Pew reviewed a sample of these loans made by more than a dozen companies. The loans ranged in size from several hundred dollars to several thousand dollars. Pew cannot independently assess these loans' affordability, but these data reveal what payments exist in a small-loan market with traditional underwriting.[116] For 76 percent of installment loans in this sample, monthly payments equaled 5 percent or less of borrowers' monthly income.[117] Eighty-six percent of loans had monthly payments that consumed 2 to 7 percent of a borrower's monthly income, and a majority had monthly payments consuming 3 to 6 percent of a borrower's monthly income. Additionally, a consumer finance company reviewed its complete customer files for Pew and found that only one in seven loans had payments greater than 10 percent of a customer's income, with most between 4 and 8 percent.
- **Conventional payday loan fee arrangements.** Conventional, storefront lump-sum repayment payday loans carry an average fee of $55. This fee, which customers pay each time they reborrow, is approximately 5 percent of an average payday user's $1,192[118] gross biweekly income.[119] As detailed in Pew's previous research, borrowers can generally afford to pay this fee, but not the principal in a lump sum to retire their debt.
- **Colorado payday installment loans.** The monthly payment charged under Colorado's new law for a $500 loan is about $131.[120] The average monthly income of a Colorado payday loan borrower is $2,477 ($29,724 annually), according to state regulatory data.[121] Thus, a monthly payment on a $500 payday installment loan in the state takes up approximately 5 percent of a borrower's gross monthly income. The average actual loan size of $389 requires a monthly payment of about $105, or 4 percent of a borrower's monthly income on average.[122]

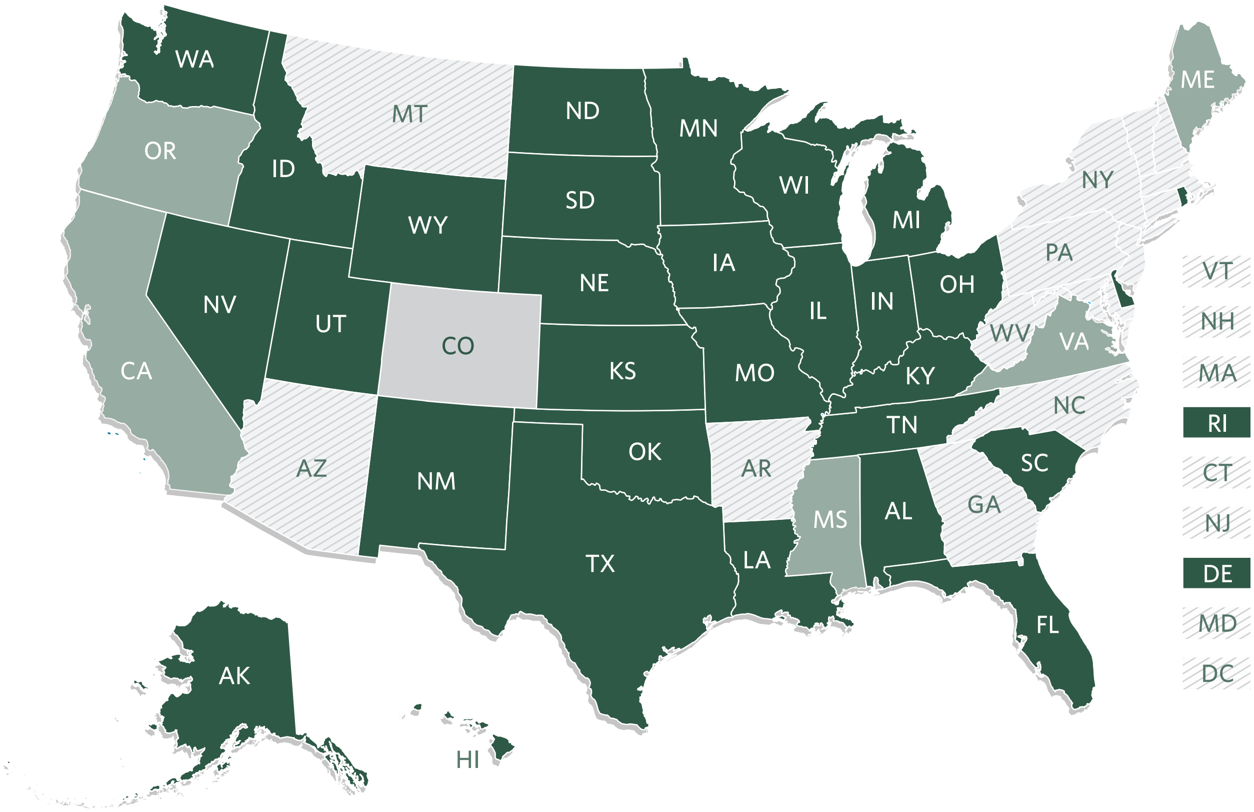
These findings suggest that any loan requiring payments of more than 5 percent of the borrower's paycheck should be treated as unaffordable, unless thorough underwriting demonstrates otherwise.

Data suggest that a loan requiring monthly payments equaling more than 5 percent of monthly gross income would exceed a typical borrower's ability to repay. The same would be true for a loan requiring biweekly payments in excess of 5 percent of the borrower's biweekly income.

Conventional payday loan payments typically take one-third of a borrower's gross income, an amount that far exceeds this affordability threshold. (See Exhibits 12 and 13.) A few states, such as Oregon and Virginia, have statutes that give borrowers about a month on average to repay the loans. Such laws lower the fraction of a paycheck that a loan takes, but the one-month repayments in each exceed $400, far beyond the $100 per month that the average borrower can afford.

Exhibit 12

Conventional Payday Loans Consume One-Third of Income



Percent of biweekly gross income that an average payday loan consumes

- 30-39% (30 states)
- 16-29% (5 states)
- 4% (1 state)
- Do not allow high-interest payday loans (15 states)

Note:

State-by-state data on the percentage of a borrower's paycheck a payday loan takes up are available in Appendix A. Calculations are based on $1,192 biweekly gross income for the median payday loan borrower (paid biweekly), who earns $31,000 annually per the Federal Reserve's Survey of Consumer Finances, and borrows an average $375 payday loan. More detailed information on borrower income is included in endnote 115. A limitation of this analysis is that median payday borrower income likely varies by state, but a national figure is applied to all states because sufficient uniform state-by-state income data for borrowers are unavailable. Fees were calculated using representative terms shown on lender websites. If Advance America makes loans in the state, those terms were used. If not, Check 'n Go was used. In Oregon, where neither of these companies offers loans, ACE Cash Express was used. These companies were chosen because they are among the largest payday lenders in the United States, according to industry analyst Stephens, Inc. In California, payday borrowers may borrow only up to $255 at a time from a lender ($300 minus an immediate $45 fee). In Louisiana, lenders may not charge additional fees for loan proceeds above $350, and thus do not lend more than this amount. In Maine, lenders may not charge more than $25 per loan and do not lend more than $300. Mississippi, Oregon, and Virginia require longer than average minimum loan terms, which usually results in terms covering two pay periods for a borrower, lowering the portion of each paycheck consumed by a loan. In Colorado, the minimum term is six months. Although some states offer payday installment loans as well, this map includes data for lump-sum repayment loans if those are available. For a summary of state payday lending law, see: http://www.pewstates.org/research/data-visualizations/state-payday-loan-regulation-and-usagerates-85899405695.

Sources: Federal Reserve Survey of Consumer Finances, 2012. Advance America, 2013. Check 'n Go, 2013. ACE Cash Express, 2013.
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Exhibit 13

Installment Structures Can Improve Affordability

A 5 percent affordability threshold takes a strikingly smaller portion of a borrower's paycheck than a conventional lump-sum repayment

Policy	Percent of Biweekly Income	Amount Due on Payday
Conventional lump-sum loan repayment		
36% APR	32%	$380
130% APR ($5 per $100)	33%	$394
261% APR ($10 per $100)	35%	$413
391% APR ($15 per $100)	36%	$431
521% APR ($20 per $100)	38%	$450
1 loan at a time[a]	36%	$431
8 loans maximum per year[a]	36%	$431
Cooling-off period between loans[a]	36%	$431
Installment loan repayment		
30-day minimum[a] (2 installments)	18%	$216
6-month minimum (Colorado)	4%	$47
10% of biweekly income	10%	$119
5 percent affordability threshold	**5%**	**$60**

Note:

Calculations are based on $1,192 biweekly gross income for the median payday loan borrower (paid biweekly), who earns $31,000 annually per the Federal Reserve's Survey of Consumer Finances, and borrows an average $375 payday loan. More detailed information on borrower income is included in endnote 115. A limitation of this analysis is that median payday borrower income likely varies by state, but a national figure is applied to all states because sufficient uniform state-by-state income data for borrowers are unavailable.

a Assumes fee of $15 per $100 borrowed.

Sources: Federal Reserve Survey of Consumer Finances, 2012. Colorado Office of the Attorney General, 2012. Washington State Department of Financial Institutions, 2012. Veritec Solutions, LLC Illinois Report, 2013.

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In Colorado, officials elected not to require extensive underwriting for certain loans of $500 or less. Instead, they created tight restrictions on the loan that functionally established a no-cost, synthetic form of underwriting—requiring a six-month repayment term, a maximum loan size of $500, and interest and fee caps that together effectively limit periodic payments to amounts that roughly equal 4 percent of the average borrower's periodic

A 5 percent affordability threshold establishes a benchmark for identifying potentially unaffordable loans as they emerge in the market.

income for an average loan. That law ensures that loans can be paid back in smaller increments without creating underwriting costs for lenders.

A 5 percent affordability threshold establishes a benchmark for identifying potentially unaffordable loans as they emerge in the market. Requiring thorough underwriting to assess ability to repay is the best way of ensuring affordability, as bank regulators have proposed for deposit advance loans.[123] If payday lenders could underwrite easily and without significant expense, requiring this assessment would have little downside. But because of cost and current capabilities, some lenders (especially nonbank lenders) will struggle to perform thorough underwriting. Concerned policymakers may choose to require strict underwriting standards for small-dollar loans that pose the greatest risk to consumers, with more lenient underwriting standards for other types of loans. A 5 percent affordability threshold suggests an appropriate rule of thumb to help identify the small-dollar loans that pose the most risk to consumers. Such a threshold requires little or no additional documentation because lenders already require proof of income.

Section 4: Important considerations for payday loan reform

Evidence points to several issues that policymakers must address when considering reforms to conventional payday lending. One category of reforms should deal with making sure there are successful installment loan markets for small-dollar borrowers. Specifically, policymakers should consider:

- Lender incentives to refinance installment loans create risk of financial harm.
- An installment *option* is insufficient.
- Installments do not guarantee affordability.

Policymakers should also consider issues of pricing, repayment, and disclosure. Specifically:

- Complexity could be a cost of compromise.
- Weak price competition creates a need to limit interest rates.
- Safeguards are needed for loan collateral and automated payments.
- Risk of unnecessarily long loan terms must be contained.
- Financial education and disclosure cannot solve the lump-sum lending problem.

In this section, we will consider these issues in turn.

Ensuring successful installment loan markets

Previous sections identified several benefits to installment repayment plans, but they can be achieved only if sound policies are in place.

Lender incentives to refinance installment loans create risk of financial harm

When lenders can earn nonrefundable fees for originating loans, or when they can front-load interest during the beginning of the repayment period, they have incentive to encourage customers to refinance, or flip, loans. *Flip* is used to describe reborrowing that a lender encourages, whereas *renew* and *reborrow* have been used in this series to describe additional borrowing caused by an inability to cover expenses after repaying a loan.

Loan refinancing can give borrowers access to additional credit when they want it. Take, for example, a borrower in the third month of a six-month installment loan. The borrower might be eligible to refinance the loan because she has paid down some of the principal. Refinancing would provide her with cash in hand. But it would also extend her indebtedness by pushing back the loan's payoff date.

If lenders can use refinancing to earn more fees immediately, or if they can calculate interest to earn a disproportionately high share of revenue during the loan's first few months, they have an incentive to flip loans. This flipping places borrowers at risk of financial harm because of the new fees, interest payments, and additional months of debt. Excessive refinancing also can mask delinquencies, because if borrowers are unable to afford loan payments, lenders can effectively let them skip a payment by agreeing to extend the duration of their loan, a process known as re-aging loans.[124]

There are two lender incentives to encourage refinancing that can cause borrowers financial harm.

Origination fees create the risk of harmful loan flipping

When small loans carry an origination fee, lenders can earn a substantial portion of revenue at the outset of the loan, creating a strong incentive to encourage borrowers to refinance or pay it off and reborrow quickly so the lender earns another origination fee.[125] As a result, refinancing is common in small-loan markets that allow an origination fee to be earned in full when the loan is made.[126]

Lenders may rely on origination fees to provide a measure of predictability in their revenue streams in the event that borrowers repay the loans early. Yet since most small-dollar loan borrowers cannot pay the loans off quickly, lenders can rely on their paying interest charges for several months (as in Colorado, where the average borrower carries a loan for more than three months even though money is saved by paying off earlier). And although lenders might legitimately employ such fees as compensation for the cost of opening new loans (as "origination fee" suggests), policymakers must be aware of the strong link between origination fees and loan flipping.[127]

In this market, lenders' desire to supplement interest income by adding origination fees seems minor compared with the significant risk that loan flipping poses to consumers and the marketplace. Accordingly, policymakers should limit the use of origination fees in small-dollar loan markets. Possible approaches include limiting fees to a nominal amount,[128] restricting the number of fees to one per borrower in a year, or, as Colorado lawmakers have done and as Pew recommends, requiring any fees to be spread evenly over the life of the loan, so they would be refunded on a pro-rata basis if loans are refinanced or repaid early.

Front-loading of interest also creates the risk of harmful loan flipping

In some states, lenders are allowed to use accounting methods that overweight the accrual of interest charges during the loan's early months, meaning that initial payments include a relatively high proportion of interest revenue for lenders, and payments in later months have relatively low interest revenue.[129] Such front-loading methods, often known as the "rule of 78s" or "sum of digits," incentivize refinancing because lenders earn far more interest income at the outset of the loan than they would using the standard actuarial method of calculating interest used for other financial products, such as mortgages or auto loans.

When lenders can book much of the interest revenue during the early months of a loan, they have an incentive to flip loans into new ones, so that more of these lucrative early months occur. This can lead to practices that entice borrowers to refinance loans to receive a fresh infusion of cash, despite the costly net impact of front-loaded interest payments. The harm to borrowers who refinance or pay off their loan early is that more interest and less principal are paid than would be paid under a conventional method of calculating interest.[130] Lawmakers sometimes address this problem by requiring lenders to use the standard actuarial method.[131] Pew recommends this approach as well.

Of course, lenders have a natural incentive to encourage repeat business. Default risk is higher with new borrowers than with existing customers. It also generally costs lenders far more to acquire a new customer than to keep an existing one, giving them an incentive to extend their relationships with customers, as is true with other businesses. If a borrower can pay off a loan and cover other expenses, and then chooses to borrow again, this dynamic might pose no problem. But when a lender maintains a long-term relationship with a borrower by encouraging frequent refinancing, the borrower does not receive the benefits of a nominally closed-end loan. In such cases, a gap between packaging and experience emerges and leads a borrower to spend more and stay in debt longer than the loan's initial terms stated.

In sum, consumers can be harmed by small-dollar installment loans in the absence of regulations that eliminate lender incentives to flip loans. When lenders earn origination fees fully at the start of each loan, they have an incentive to boost revenue by steering borrowers to refinance the loans, which raises borrower cost and extends the term of indebtedness. Similarly, when interest front-loading applies, lenders earn a disproportionate amount of interest income in the early months of the loan, creating an incentive to encourage refinancing.

How Colorado lawmakers addressed the refinancing problem

As part of the state's 2010 payday loan reform, several lawmakers agreed on the goal of authorizing loans that would not encourage refinancing or penalize borrowers for repaying early. They required that fees and interest be spread evenly over the life of the loan or back-loaded instead of front-loaded.[132] The new law eliminated fee-seeking incentives for loan flipping by requiring that the origination fee be refundable on a pro-rata basis whenever loans are refinanced or repaid early.

When the law was enacted, some lenders contended that origination fees were not refundable, and several state officials and advocates noted that these lenders encouraged borrowers to refinance while keeping the entire origination fee for the prepaid loans.[133] But after the Colorado attorney general's office ruled that the origination fee was indeed refundable on a pro-rata basis,[134] the incentive for lenders to steer borrowers to prepay and reborrow disappeared. Neither state officials nor advocates report that loan flipping has persisted.

Similarly, Colorado does not permit interest on loans to be front-loaded, requiring that interest rates are calculated using the standard actuarial method.[135] To further guard against loan churning, Colorado lawmakers required that loans refinanced during the six-month term not carry additional origination or monthly maintenance fees. Thus, any lender who refinances a loan is entitled only to the 45 percent annualized interest, creating a strong disincentive to flip loans.[136]

By preventing the front-loading of fees and interest, Colorado lawmakers ensured that borrowers are not penalized for repaying early and lenders do not have an incentive to refinance. Thus the interests of the borrower and lender are better aligned.

> "The reason for that [disallowing front-loading of fees] was obviously . . . [because we didn't] want to create an incentive where all you're doing is getting one vendor to roll in your loan to another loan. And so the ability to pay off without having incentive to refinance was the goal.
>
> —*Colorado elected official*

> "Without the refundability [of the origination fee], then the bill really wouldn't have had any meaning.
>
> —*Colorado consumer advocate*

> "Some of the industry kept operating with the opinion that the origination fee was not refundable upon prepayment and was . . . encouraging their customers to prepay and take out a new loan and not rebate the origination fee.
>
> —*Colorado government official*

An installment *option* is insufficient

It is reasonable to ask whether consumers and lenders should have the option to choose between an installment loan and a conventional payday loan, but merely providing an installment option is not effective. A core problem with conventional payday loans is that they fail to work as advertised. They put borrowers in unaffordable loans requiring an unknown number of months (not weeks) to repay, and enable lenders to offer two-week loans although they generate profits only when borrowers carry the loans for several months. The most direct way to redress this harm is to eliminate the lump-sum loan model, shifting to an installment loan that reflects these underlying realities.

Moreover, evidence indicates that merely providing an installment option does not alleviate the problems associated with lump-sum repayment loans. The reason is twofold: Lenders still have an incentive to steer borrowers to more profitable lump-sum loans, and the lump-sum repayment loan structure hides from borrowers the ultimate cost and duration of debt.

Regulatory data demonstrate that very few payday borrowers receive installment repayment plans even when they are available[137]—even though the payday industry's trade associations call for participating lenders to offer an installment option to customers who continually reborrow.[138] In Washington State, lenders are required to allow borrowers to convert conventional payday loans to installment loans at no additional cost at any point in the loan process, even immediately after borrowing, yet only 10 percent of loans are converted to an installment plan.[139] Similarly, in Colorado before the law change, only 4.6 percent of loans were converted to installment loans under the extended repayment plan that lenders were required to offer.[140]

Data published in state reports from Florida, Michigan, and Oklahoma show even fewer borrowers taking advantage of such payment options.[141] In Texas, where payday lenders are permitted to make both installment and payday loans, the conventional lump-sum repayment predominates.[142] Consequently, customers repeatedly borrow.[143]

Lenders have little incentive to help borrowers choose more affordable installment loan alternatives when they are paying the fixed costs of the lump-sum payday loan model, and when both they (and their competitors) have the option to promote higher-revenue lump-sum loans.[144] Academic research also notes that even when regulations mandate lower-cost options as the default, financial services providers who benefit from consumers choosing higher-cost options have been successful in selling higher-cost products.[145] Payday lenders have resisted efforts to promote installment loans to repeat borrowers in states that have attempted to allow both models to coexist.[146]

Borrowers, meanwhile, tend to take the standard loan option. As found repeatedly in behavioral economics research, standard (or "default") options matter tremendously, with people overwhelmingly choosing the default option provided.[147] The loan structure as presented is an especially "sticky default" from which few borrowers stray.[148] Borrowers' heavy reliance on payday lenders for accurate information could be influencing their decision to take out a loan they cannot afford. The packaging, or default structure, also strongly influences how they pay back the loan.

In Pew's focus group exercises, lump-sum repayment loans' lower price tag and shorter advertised duration attracted borrowers at first because it was difficult to compare these loans with installment loans that had more realistic terms—higher overall costs compared with the two-week loan, reflected in longer repayment times. In Colorado focus groups, many participants said a two-week loan initially looked more appealing than an installment loan because it had a lower advertised price, and they thought they could get cash quickly without ending up in longer-term debt with another bill to pay.

Even those who had been in long-term, conventional payday loan debt before the law change were tempted by the idea of quick cash without long-term debt—even though these conflicting desires cannot realistically be met, and those in other states who use two-week loans end up in debt for an average of five months. They focused on the seemingly affordable price tag for a two-week loan, and not the impact on their budget when a lump sum would be taken out two weeks hence. This was a difficult comparison to make in the controlled and low-pressure environment of a focus group, and would likely be harder in a storefront when customers are coping with an inability to pay a bill[149] (especially if a lender has incentive to steer customers to the more profitable loan).

Focus group participants next completed a budgeting exercise, in which they wrote down the amount of their paycheck, then subtracted the amount due for a $500 loan under each type of product structure ($575 on the next payday for a conventional payday loan, about $61 for a Colorado payday installment loan). After comparing the amounts left over to the size of their regular bills, many soon explained that paying back $575 at once would lead them to reborrow, and they could afford only the terms set out in the installment product. Several participants said they had no idea how long it would take them to be able to make a $575 payment.

Similarly, one Colorado lender said some borrowers used to come in regularly and pay $75 per two weeks to borrow $500. After the law change, borrowers saw that a $500 loan would now cost them $290 over six months, and some expressed hesitation. The lender was surprised at first, reminding borrowers that they often used loans for extended periods, paying him $300 every two months, or $900-plus for six months—three times the amount due under the revised Colorado law. Under the lump-sum structure, the two-week fee was clear, but the amount the borrower would eventually spend was not. One of the foremost achievements of Colorado's installment lending law is that it has reduced the significant information gap between borrowers and lenders by making the loan's ultimate duration and cost more transparent.

In sum, the confusing and problematic nature of lump-sum repayment loans, combined with research showing that consumers overwhelmingly choose the default options provided to them, demonstrate that it is not sufficient to offer an installment *option*. Lenders should be required to provide loans only in accordance with the borrower's ability to repay.

One of the foremost achievements of Colorado's installment lending law is that it has reduced the significant information gap between borrowers and lenders by making the loan's ultimate duration and cost more transparent.

In most cases, that will require mandatory installment payments, though borrowers may choose to repay early without penalty.

Installments do not guarantee affordability—ability to repay is essential

Installment loans that amortize function more predictably for borrowers and solve many of the problems caused by lump-sum repayment loans, but an installment structure alone is insufficient if the payments are unaffordable. In Texas, installment loans are offered, but a $500 loan there typically requires biweekly payments of $150 (about $300 monthly),[150] far more than an average payday borrower can afford.[151]

Whenever installment loans require payments beyond borrowers' ability to repay, they are at risk of not being able to cover other expenses. That is particularly true when the lender retains the ability to demand instant payment through a postdated check or electronic access to the borrower's checking account (see "Safeguards are needed for loan collateral and automated payments," page 40). Policymakers must ensure that loans are structured to be repaid according to borrowers' ability to pay them back while meeting other obligations, without having to borrow again to make ends meet.

Pricing, repayment, and disclosure issues

Any attempt to reform the payday lending model must include regulation to ensure a safe and transparent marketplace.

Complexity could be a cost of compromise

Political and other considerations could lead lawmakers to authorize installment loan structures with multiple layers of fees and interest charges. Colorado provides an instructive example of an attempt to accommodate industry and advocate interests by acknowledging a traditional state interest rate cap of 45 percent per year, but allowing for additional fees to increase lender revenue (to a maximum, fee-inclusive APR of about 200 percent). This was done to meet lawmakers' goal of helping the state's nonbank small-loan lenders stay in business while offering a better product.

The political rationale for the compromise was evident in Pew's conversations with legislators, who believed that lenders needed more revenue than a flat 45 percent annual rate on a $500 loan would allow, but acknowledged that a law that explicitly permitted interest rates with "these huge numbers" would have been difficult to pass. Some stakeholders not involved with payday lending on a day-to-day basis mistakenly thought of the new law as offering loans with a 45 percent APR, reinforcing the political appeal of an interest-plus-fees combination, rather than a fee-inclusive, explicitly high annual percentage rate.

Such compromise might be politically helpful, but it comes with the added cost of complexity, making it difficult to program lender computer systems, write consumer disclosures, or ensure borrowers' comprehension of loan terms. Lenders, advocates, and others agree that Colorado's law is far more complicated than a simple interest rate would have been.

In the Colorado focus groups, borrowers were unaware of the three separate charges allowed by the new law—interest, origination fees, and monthly maintenance fees—and instead focused on how much their required regular payments were. They did not know the loans' annual interest rates, although borrowers in states that have conventional payday loans rarely know these, either.[152] This complicated pricing system caused problems for lenders, who reported initial difficulties switching over their computer systems, and who say they struggle to explain the three types of charges to customers.

In one important way, Colorado avoided the complexity that has arisen in installment loan markets where ancillary products, such as credit insurance, are prevalent. Such products increase a loan's cost, and frequently are not disclosed as part of its stated APR. Colorado prohibited any additional fees, other than one NSF fee for a bounced check or its electronic equivalent.

Weak price competition creates a need to limit interest rates

Nearly all states have set maximum interest rate limits for some types of loans. All 13 original colonies did so.[153] Today, 46 states and the District of Columbia set limits on the interest rates that may be charged on at least one type of small-dollar loan.[154] Even in the 35 states that allow high-interest, lump-sum payday loans, 28 limit the permissible charges.[155] In other words, small-dollar loan markets normally operate with state-mandated price limitations.

Conventional lump-sum payday loan markets

Previous research finds that payday borrowers do not focus primarily on price when taking out a loan, but rather on convenience and speed.[156] Further, demand for payday loans is not sensitive to price.[157] The United Kingdom's Office of Fair Trading conducted a review of the payday lending industry in that country, which also uses lump-sum repayments. Among its findings: "A significant proportion of payday borrowers have poor credit histories, limited access to other forms of credit and/or a pressing need of money at the point of taking out a loan. As such they may be focused on the speed and convenience of the loan rather than its price. Price insensitivity among consumers is likely to weaken price competition, thereby enabling lenders to raise their prices without losing business."[158] In such circumstances, setting maximum allowable rates can ensure that borrower costs resemble those in a marketplace with price competition.[159]

Payday loan prices vary between states but rarely within states. Prices are determined by individual state laws, and large companies offer the same loan at vastly different prices in different states.[160] In states where conventional payday loans are offered, lenders generally do not compete on price; they tend to cluster prices at the maximum allowed, and then compete on customer service and location.[161] As shown in the accompanying exhibit, a similar pattern emerges for payday lenders that also make installment loans. These lenders charge less in Colorado and Illinois, which require lower interest rates on payday installment loans, and more in the states that allow higher prices. There is little evidence of firms lowering prices to compete for customers—the expected result in a well-functioning marketplace as described in classical economic theory. (See Exhibit 14.)

Traditional (non-payday) installment loan markets

Similarly, a large majority of states set maximum allowable charges on traditional (non-payday) consumer installment loans, which typically are amortizing unsecured loans for amounts of several hundred dollars up to a maximum of $25,000. Consumer installment loans are commonly provided by non-depository financial institutions through their retail storefronts, and are available in almost every state (although consumer access to these loans varies widely, many finance companies serve those with poor or fair credit histories).[162] Compared with payday loans, consumer installment loans have lower interest rates and longer loan lengths, and they are underwritten by lenders to evaluate the borrower's ability to repay. Each state has laws to govern consumer installment loans, so interest and loan terms vary across the country.

For consumer installment loans, 39 states and the District of Columbia mandate a statutory interest rate limit of 36 percent or less. But some states allow lenders to charge additional fees for loan origination, maintenance, and other services, which can create an effective APR that is 100 percentage points or more above the statutory interest rate limit. Effective APRs on loans from installment lenders in Texas generally vary from 58 to 157 percent,[163] and in South Carolina from 43 to 130 percent.[164] In North Carolina, where fees are more constrained, most rates fall below 32 percent, but lenders are permitted to sell ancillary products such as credit insurance, which substantially increase the cost of the loan.[165] To ensure that consumer installment loans do not extend indefinitely, some states impose a maximum loan term in addition to a rate cap.[166] According to recent research, the typical amount of a consumer finance company's installment loan is about $1,000, with a term of 12 months and an APR around 60 percent.[167]

Exhibit 14

Lenders Charge More When Permitted by States

State	Typical APR of an Installment Loan From a Payday Lender (%)
Colorado	129
Illinois	234
Delaware	388
Missouri	389
New Mexico	389
Wisconsin	382
South Carolina	341
Texas	585

Note:

Colorado and Illinois set lower price limits on the rates that may be charged for these types of installment loans than the other states listed. In states where regulatory reports are unavailable, loan costs advertised by Advance America, the largest storefront lender in the United States, are used for the states where they offer installment loans, and assume a borrower receives the lowest rate available by agreeing to authorize electronic debit. These states are Delaware and Wisconsin (AdvanceAmerica.net accessed Oct. 22, 2013). In the other states, Advance America does not advertise in-store installment loans on its website. In Missouri, New Mexico, and South Carolina, its online affiliate CashNetUSA advertises installment payday loans and that information is used (CashNetUSA.com accessed Oct. 22, 2013). In Texas, neither of these lenders advertises installment payday loans, so data from the second-largest lender in the country are used, ACE Cash Express (ACECashExpress.com accessed Oct. 22, 2013).

Sources: Colorado Office of the Attorney General, 2013. Veritec Solutions Illinois Report, 2012. Advance America, 2013. CashNetUSA, 2013. ACE Cash Express, 2013.

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Safeguards are needed for loan collateral and automated payments

Payday loans are sometimes referred to as "deferred presentment" or "deferred deposit" loans because lenders might require a check, postdated for the borrower's next payday when the loan is due, as collateral or security. Some lenders use the electronic equivalent: authorization to debit a borrower's account when payment is due. Similarly, banks typically retain this right when making deposit advance loans. The legal privilege to establish such a deferred presentment interest is unique to the payday lending market.

Postdated checks and electronic access as loan collateral

For payday lenders, the right to collect payment from a customer's checking account limits credit risk and the need to underwrite. (Even if borrowers cannot afford to pay both the loan and other financial obligations, deferred presentment lenders can leverage their access to borrower checking accounts to collect ahead of other creditors.) It can also reduce the difficulty, time, and cost that would normally be associated with formal debt collection.

But deferred presentment creates substantial risk for borrowers. Critics contend that "paper or electronic check holding are the modern equivalent of several practices that the Federal Trade Commission banned over 25 years ago as unfair trade practices," including wage assignments.[168] When a lender has the power to withdraw funds from borrowers' checking accounts on payday, borrowers lose control over their income. This extraordinary arrangement allows payday lenders to collect fees to renew or repeat loans for months while the borrowers cannot afford both the lump-sum repayment and other financial obligations, such as rent or mortgage payments.

For these reasons, deferred presentments are typically authorized, if at all, only for small loans that are understood to serve urgent liquidity needs.[169] Of the 36 states in which deferred presentment loans are available, 27 set the maximum term length at no more than six months, and 21 set the maximum loan amount at $500 or less.[170] Recognizing the potential risk to military service members that such an arrangement poses, the Military Lending Act of 2007 declared it unlawful for lenders to use "a check or other method of access to a deposit, savings, or other financial account maintained by the borrower, or the title of a vehicle as security for the obligation."[171]

In Colorado, lawmakers chose to allow lenders operating under the payday installment loan law to keep this kind of deferred presentment loan collateral, but with three crucial protections in place. First, the law limits the loan to $500. Second, it limits the size of the payments to about $61 per two weeks. Third, Colorado permits lenders to charge only one NSF fee per loan, limiting their incentive to repeatedly attempt to withdraw money from a checking account with insufficient funds and instead work with a borrower who has difficulty making loan payments.

Automated electronic repayment

In the case of installment loans, borrowers sometimes have the option of establishing a plan for automatic electronic repayment. Borrowers can benefit from the convenience of these plans, and lenders can achieve better performance and efficiency. Conceptually, electronic repayment plans differ from deferred presentment arrangements because borrowers can cancel the plans and retain control over the inflows and outflows of their checking accounts. But some lenders steer borrowers to use electronic payments,[172] unscrupulous lenders have not honored borrowers' requests to cancel them,[173] and there can be lag time between the request and when it takes effect,[174] demonstrating that safeguards are needed to protect against aggressive or fraudulent practices.

Lenders value electronic payment plans, as evidenced by their charging higher interest rates for loans that do not grant them the right to withdraw payments automatically from the borrower's bank account.[175] After reviewing the results of its 2008 small-dollar loan pilot program, the FDIC noted that "pilot bankers in general believed that automatic repayments can improve performance for all credit products, not just small-dollar loans."[176] Ideally, lenders would leverage the benefits of direct debit to improve access to credit for consumers with damaged credit histories and reduce the cost of loans.[177]

Yet there is evidence that unscrupulous lenders[178] can abuse the privilege of electronically debiting checking accounts, leading to excessive withdrawals[179] and to borrowers incurring fees or struggling to pay other bills.[180]

To help ensure the integrity of the electronic payments system, and to protect consumer checking accounts and income streams, the Electronic Fund Transfer Act generally prohibits lenders from requiring consumers to repay loans electronically. Consumers also have the right to cancel recurring electronic payments.[181] But when lenders act aggressively to collect payment electronically, they can undermine these protections.

Some banks have recognized the need to take action to protect checking account customers. Reports have shown that consumers are incurring multiple NSF fees because of aggressive and potentially unlawful lender tactics. One bank customer described being charged more than $1,500 in fees by her bank, after six online payday lenders tried to withdraw money from her account 55 times in a month.[182] In response, her bank (JPMorgan Chase) has announced its intention to change policies relating to abusive merchants, such as some online payday lenders, by limiting the number of NSF fees that one merchant can trigger to one per month.[183] Working through the associations that operate the electronic payments network, banks are also evaluating new rules to protect consumers and the system against what are known as "high-risk originators," particularly online payday lenders. These rules might include holding banks accountable for abuse of the electronic payment system by payday lenders with merchant accounts at those banks.[184]

Risk of unnecessarily long loan terms must be contained

Even with affordable installment payments, lenders have an incentive to increase revenue by setting up loans with unnecessarily long terms. For example, in Colorado a $375 loan has periodic payments that are affordable for most borrowers (about $47 biweekly). But if legislators had not limited the fees that can be charged after six months, lenders could require longer loans—with a smaller share of each payment reducing the principal owed—to earn more revenue. Thus, if a loan required monthly payments of the same amount over 12 months instead of six, borrowers would end up repaying twice as much (or three times as much if loans lasted 18 months). Outside Colorado, some lenders have used excessive loan durations to increase the long-term costs paid by borrowers, especially online. One major online lender's loans require monthly payments of $150.72 for 12 months, so that a person who receives $500 will pay back $1,808.64.[185] Another offers loans with 47 required payments of $294.46, so that a borrower who receives loan proceeds of $2,525 will pay back $13,839.62.[186]

Pew recommends that lawmakers monitor and respond to signs of excessively long loan terms—for example, by considering establishing a maximum term. Any such term should take into account a borrower's financial capability, measured by income or ability to repay, as well as the size of the principal.[187] Colorado has demonstrated that even at high interest rates, six months is generally long enough to pay back $500. For consumer finance company loans at high interest rates, approximately one year is usually long enough to repay $1,000.[188] One scalable method to estimate maximum loan duration (in months) would be to divide the loan's principal by the borrower's average daily income.[189]

Financial education and disclosure cannot solve the lump-sum lending problem

Financial education and disclosures are important tools for helping people decide whether a product that many successfully use is appropriate for them. Public explanations and advice on the terms and conditions for a home mortgage, student loan, auto loan, or credit card are commonplace. Many people use these products successfully and as advertised. Some do not, and financial education and disclosures can help consumers avoid the downsides of these products. In contrast, payday loans are not used successfully on a short-term basis by many people, and if they were, the industry would not be profitable.[190]

Neither disclosures nor financial education can solve the problems caused by lump-sum repayment payday loans because their structure hides the most common outcome—repeated reborrowing of the original loan.

Although financial education and disclosure cannot solve the problems with lump-sum payday loans, they will be an important component in a properly functioning marketplace for installment loans. When designed to avoid the pitfalls discussed earlier in this section, such loans can be used successfully by many people, but they will not be appropriate for some. In that case, financial education and clear disclosures can help people decide *whether they should borrow and if so, whether such products are a good choice for them* and *how to use those products successfully.*

One method for measuring the value of financial education and disclosures will be whether consumers comparison-shop and seek out lower prices for loans. If loan pricing is complex, with multiple elements, as it is in Colorado, it will be more difficult to comparison-shop, as research in other markets has documented.[191]

In developing a system from scratch, a clearer one than Colorado's would have simple pricing based solely on an interest rate, or an interest rate plus a standard fee, so it would be easier for consumers to compare costs. Price shopping is a prerequisite for competition to develop, because lenders only have an incentive to charge less if they can gain customers by doing so. It is unclear whether such competition will emerge in an installment small-dollar loan market with clear disclosures, but uniformly stated and transparent pricing improves the likelihood of competition.

Conclusion and initial policy recommendations

Pew's research conclusively shows that payday loans are unaffordable for most borrowers. The loans require payments equal to one-third of a typical borrower's income, far exceeding most customers' ability to repay and meet other financial obligations without quickly borrowing again. Payday lenders have a unique legal power to withdraw payment directly from borrowers' checking accounts on their next payday, prompting those without enough money left for rent or other bills to return to the lenders, repay the loans, and pay an interest-only fee to quickly reborrow, resetting the due date to the next payday. This extraordinary form of loan collateral allows lenders to thrive even as they make loans to those who cannot afford them. The average borrower is in debt for nearly half the year, and the vast majority of lender revenue comes from those who borrow consecutively. Payday lenders achieve profitability only when the average borrower is in debt for months, even though the product is promoted as a short-term bridge to the next payday. These facts demonstrate a significant market failure.

Decisive action is required from the Consumer Financial Protection Bureau and other federal regulators, and from policymakers in the 35 states that now permit lump-sum payday lending. Pew recommends the following for all small-dollar consumer cash loans:

1. Limit payments to an affordable percentage of a borrower's periodic income

Research indicates that for most borrowers, payments above 5 percent of gross periodic income are unaffordable.

- **Any small-dollar cash loan should be presumed to be unaffordable, and therefore prohibited, if it requires payments of more than 5 percent of pretax income** (for example, a monthly payment should not take more than 5 percent of gross monthly income). Lenders should be able to overcome this presumption only by demonstrating that a borrower has sufficient income to make required loan payments, while meeting all other financial obligations, without having to borrow again or draw from savings.

This 5 percent affordability threshold, which is based on survey research and analysis of market data, is a benchmark that policymakers can use to identify small-dollar loans that pose the most risk of harm or unaffordability. It generally will result in installment loans that have terms of months, rather than weeks, but the loan duration can be self-adjusting depending on the income of the borrower. It is also flexible enough to accommodate various policy choices regarding maximum loan size, duration, or finance charge. Normal supervision can assess compliance, so this recommendation does not necessitate a database. Borrowers will remain responsible for deciding how many loans to take and how often to use them.

For calculation purposes, required payments would include principal, interest, and any fees. To discourage loan splitting or other methods of frustrating this policy, payments from all loans by a given lender should be considered together. Examiners should treat frequent refinancing or "re-aging" of loans as evidence of unaffordability and poor underwriting.

2. Spread costs evenly over the life of the loan

It is important to prevent front-loading of fees and interest on installment loans. Experience shows that front-loading practices make the early months of the loan disproportionately more profitable for lenders than the later months, creating incentives for them to maximize profit by encouraging borrowers to refinance loans before they are fully paid off (a process known as loan "flipping" or "churning").

- **If fees other than interest are permitted, require them to be earned evenly over the life of the loan.** Any fees, including origination fees, that lenders fully earn at the outset of the loan create a risk of loan flipping. Therefore, fees should be refundable to the borrower on a pro-rata basis in the event of early repayment.
- **Require all payments to be substantially equal and amortize smoothly to a zero balance by the end of the loan's term.**
- **Prohibit accounting methods that disproportionately accrue interest charges during the loan's early months.** Such front-loading schemes, often known as the "rule of 78s" or "sum of digits" methods, encourage loan flipping, because a lender earns far more interest income at the outset of the loan than in later months.

3. Guard against harmful repayment or collection practices

Payday and deposit advance lenders have direct access to borrowers' bank accounts for collecting loan repayment. Lenders use this access to ensure that they are paid ahead of other creditors, an advantage that allows them to make loans without having to assess the borrower's ability to repay the debt while also meeting other obligations. Although this arrangement shields the lender from certain risks and may facilitate lending to those with poor or damaged credit, it comes at the cost of making consumers vulnerable to aggressive or unscrupulous practices. High rates of bounced checks or declined electronic payments are indicators of such practices. Borrowers lose control over their income and are unable to pay landlords or other creditors first.

- **Treat deferred presentments as a dangerous form of loan collateral that should be prohibited or strictly constrained.** Deferred presentment or deferred deposit loans require borrowers to give the lender the right to withdraw payment from the borrower's bank account. This requirement is fulfilled through a personal check that is postdated to the borrower's next payday or through a non-revocable electronic debit authorization. Because of the inherent dangers, state laws generally authorize deferred presentments only for loans that are understood to serve short-term, urgent liquidity needs. Of the states that have deferred deposit loans, a majority set the maximum term at six months or less, and a majority set the maximum loan amount at $500 or less.

  Policymakers may reasonably choose to prohibit deferred presentments if they do not want payday lenders to operate. If allowed, deferred presentments should never apply for more than six months or for loans of more than $500.
- **Prevent unscrupulous lenders from abusing the electronic payments system, and make it easier for consumers to cancel electronic payment plans.** Some installment lenders establish automatic repayment plans using electronic payment networks. Although this mechanism can help lower the cost of small-dollar loans and make loan management more convenient, evidence shows that it also exposes consumers and their checking accounts to significant risk. Regulators should establish a balance between lender and borrower interests, especially in cases—such as online lending markets—where there is evidence of aggressive lending or collections behavior. Pew recommends making it easier for consumers to stop automatic withdrawals, placing limits on the number of NSF fees that borrowers may pay, and closing the electronic payments system to merchants that abuse it (as evidenced by repeated attempts to withdraw funds from borrower accounts, excessive use of NSF fees, or other aggressive behavior). These goals may be accomplished through regulatory action and stronger oversight of the electronic payments system by the banks that operate it.
- **Monitor and respond to signs of excessively long loan terms.** Some high-interest installment payday lenders set excessively long loan terms, with only a small portion of each payment reducing the loan's balance. Therefore, policymakers should consider establishing maximum loan terms. These should take into account a

borrower's financial capability, measured by income or ability to repay, as well as the size of the loan principal. Colorado demonstrates that for average payday borrowers, six months is long enough to repay $500, and in consumer finance installment loan markets, approximately one year is usually sufficient to repay $1,000.

4. Require concise disclosures that reflect both periodic and total costs

Research shows that small-dollar loan borrowers focus on the periodic cost of borrowing but often struggle to evaluate overall cost, making it difficult to compare other loan options or to decide whether to borrow, adjust budgets, or take other actions. All loan offers should clearly disclose:

- The periodic payment due.
- The total amount to be repaid over the life of the loan.
- The total finance charges over the life of the loan.
- The effective annual percentage rate, or APR, of the loan.

These four numbers should be displayed clearly, and with equal weight, to encourage borrowers to consider both periodic and long-term costs. To facilitate comparison shopping, all loan costs should be stated as interest, or interest plus a standard fee. If a fee is permitted in addition to interest, it should be included in the calculation of finance charges and APR, based on the loan's stated term. As with other consumer financial products such as credit cards, regulators should require simple, standardized disclosures showing maximum allowable charges at the time of application as well.

5. Continue to set maximum allowable charges on loans for those with poor credit

Research shows that lenders generally do not compete on price in these markets serving those with poor credit, which is why almost every state has laws that set maximum allowable rates on small-dollar loans. Without regulations, prices reach levels that are highly disproportional to lender cost, or far higher than necessary to ensure access to credit. Colorado's payday loan law shows it is possible to ensure widespread access to loans of $500 or less for people with poor credit histories, at prices far lower than those charged for conventional payday loans. It is also possible that such credit could be available at rates lower than the average APR of 129 percent in Colorado. In states that have permitted higher interest rates than this, storefronts have proliferated, with no obvious additional benefit to consumers.

States may reasonably choose to set maximum annualized interest rates of 36 percent or less if they do not want payday lenders to operate. States may also reasonably choose to allow interest rates higher than 36 percent if they do want payday lenders to operate. But even when regulations require all loans to have affordable repayment structures, there is insufficient research to know whether consumers will fare best with or without access to high-interest installment loans. Thus Pew does not recommend law changes in the 15 states that do not have payday lending, because such a change may not benefit consumers. In the 35 states that have conventional lump-sum payday lending, lawmakers should require loans to have affordable payments and then set maximum annualized interest rates according to whether they want payday lenders to operate.

These recommendations are intended to apply to all consumer cash loans of several thousand dollars or less, regardless of provider type (bank, nonbank) or product type (payday loan, installment loan, cash advance), exclusive of loans secured through pledge or deposit of property. They are based on findings documented in Pew's Payday Lending in America *series, available at: www.pewtrusts.org/small-loans.*

Borrowers want regulators to act

A nationally representative survey conducted by Pew shows that, by a 3-to-1 margin, payday loan borrowers want more regulation of this market. Eight in 10 favor a requirement that payments take up only a small amount of each paycheck, and 9 in 10 favor allowing borrowers to pay back loans in installments over time.

The limited benefits of access to credit

In circumstances where people are using credit to pay other debts and obligations, it is unclear whether promoting more access to credit is, on net, beneficial as a way to manage expenses or harmful as another burden for people who are already struggling financially. What is clear, however, is that a loan that is used to make ends meet creates danger if it requires payments that exceed a borrower's ability to repay. Payday loans, which typically require one-third of a borrower's biweekly income, *greatly exceed* most borrowers' ability to repay. That is why there is a need for immediate policy change to eliminate unaffordable small-dollar loan payments.

These recommendations are not an endorsement of high-cost credit or a promotion of credit as a means to address persistent cash shortfalls. Instead, they are intended to help policymakers address the problem of unaffordable small-dollar loans in the 35 states that have lump-sum payday lending, while allowing for the evolution of more beneficial and affordable products among the nation's banks and other lenders. That is why, in addition to providing a benchmark for identifying potentially harmful or unaffordable loans, policymakers should define rules for safe and transparent installment lending, collections, disclosures, and pricing.

Methodology

Opinion research

Nationally representative findings in this report are based on a survey conducted among storefront payday loan borrowers and online payday loan borrowers. The sample for this survey was compiled over the course of eight months of screening on a nationally representative weekly survey. Borrower quotations in this report come from a series of 14 focus groups with small-loan borrowers. Quotes from people other than borrowers come from 33 individual interviews conducted with those who influenced the Colorado law and who have seen its impact firsthand. Methodology for these three opinion research components is described below.

Survey methodology

Social Science Research Solutions omnibus survey

The Pew safe small-dollar loans research project contracted with Social Science Research Solutions to conduct the first-ever nationally representative, in-depth telephone survey with payday loan borrowers about their loan usage. To identify and survey a low-incidence population such as payday loan borrowers, the research firm screened 1,000 to 2,000 adults per week on its regular omnibus survey, using random-digit dialing, or RDD methodology, from August 2011 to April 2012.

The term *omnibus* refers to a survey that includes questions on a variety of topics. This survey took steps to minimize payday borrowers' denying using the loans. The omnibus survey included mostly nonfinancial questions purchased by other clients, and the payday loan questions were asked after less sensitive questions, giving interviewers a chance to establish a rapport with respondents.

The first phase of the research, to identify payday borrowers, asked respondents as part of the omnibus survey whether they had used a payday loan. If respondents answered that they had, they were placed in a file to be contacted later. Once the 20-minute survey was ready to field, in order to maximize participation, people who had used a payday loan were then given the 20-minute survey and paid an incentive of $20 for participating. Because of their relative scarcity (under a quarter of borrowers), *online* payday loan borrowers were given an incentive of $35.

Respondents were told about the compensation only after having indicated that they had used a payday loan. Further, online payday loan borrowers who were identified during the early months of screening were sent a letter with a $5 bill informing them that they would be contacted to take the 20-minute survey. The second phase of the research involved contacting respondents who answered that they had used a payday loan and immediately giving the 20-minute survey to anyone newly identified in the weekly omnibus survey as a payday loan borrower.

Sample and interviewing

In the first phase of the survey, the Pew safe small-dollar loans research project purchased time on Social Science Research Solution's omnibus survey, EXCEL, which covers the continental United States. Analysis of the incidence of payday borrowing was conducted after 33,576 adults had been screened and answered a question about payday loan usage. Demographic analysis is based on the 1,855 payday loan borrowers who were identified as part of this nationally representative sample. In order to find enough people who had used storefront payday loans, online payday loans, and auto-title loans to complete a 20-minute survey about their usage and views, an additional 16,108 adults were screened using these weekly omnibus surveys. In total, 49,684 people were screened to complete the research. The sampling error for incidence estimates from the omnibus survey of borrowers is plus or minus 0.24 percentage points. Results from the survey of auto-title-loan borrowers have not yet been published.

All borrowers identified were asked to complete the 20-minute survey. In the second phase, 451 adults completed the 20-minute survey on storefront payday loans, and 252 adults completed the 20-minute survey on online payday loans, for a total of 703 payday borrowers. The sampling error for the 20-minute survey of payday borrowers is plus or minus 4.2 percentage points. The margin of error is based on a standard 95 percent confidence interval.

EXCEL is a national weekly, dual-frame bilingual telephone survey. Each EXCEL survey consists of a minimum of 1,000 interviews, of which 300 are completed on respondents' cellphones and at least 30 are conducted in Spanish, ensuring unprecedented representation on an omnibus platform. Completed surveys are representative of the continental United States population of adults 18 and older. EXCEL uses a fully replicated, stratified, single-stage, random-digit-dialing (RDD) sample of landline telephone households and randomly generated cellphones.

Sample telephone numbers are computer-generated and loaded into online sample files accessed directly by the Computer-Assisted Telephone Interviewing, or CATI, system. Within each sample household, a single respondent is randomly selected. Further details about EXCEL and its weighting are available at www.pewtrusts.org/small-loans. The proportion of storefront to online borrowers was weighted to the ratio at which they occurred naturally in the omnibus. Including 252 online borrowers reflects an oversample of 147 such borrowers, and the online borrower results have been weighted down accordingly so they would not have disproportionate influence over the full results.

Wording of questions in the omnibus survey

Wording for demographic and other questions is available at www.pewtrusts.org/small-loans.

Screening phase—measuring incidence and compiling sample for callbacks:

- "In the past five years, have you used payday loan or cash advance services, where you borrow money to be repaid out of your next paycheck?"
- "And was that physically through a store, or on the Internet?"

Re-contact phase—calling back respondents who answered affirmatively, and identifying additional borrowers to take the 20-minute survey immediately:

- "In the past five years, have you or has someone in your family used an in-person payday lending store or cash advance service?"
- "In the past five years, have you or has someone in your family used an online payday lender or cash advance service?"

Wording of questions in 20-minute survey of storefront and online payday loan borrowers

The data from the nationally representative, 20-minute survey of 451 storefront payday loan borrowers and 252 online payday loan borrowers are based on responses to the following questions, which Pew designed with assistance from Social Science Research Solutions and Hart Research Associates. The wording of the questions is included here only for those whose answers are included in this report. The wording for previously reported results was included in the first two publications in this series. The sample for this telephone survey was derived from the RDD omnibus survey. All questions also included "Don't know" and "Refused" options, which were not read aloud.

INSERT "online payday loans" IF Q.1a = 1

INSERT "payday loans" IF Q.1b = 1

(SCRAMBLE ITEMS)

"Now I'm going to read you some ideas for how [online payday loans/payday loans] could be changed or modified. After I read each idea, tell me whether this sounds like something you would favor or oppose. How about (INSERT)? Do you favor or oppose this?" (GET ANSWER, THEN ASK: "And would you say you strongly [favor/oppose] or somewhat [favor/oppose]?"

1 Strongly favor

2 Somewhat favor

3 Somewhat oppose

4 Strongly oppose

D (DO NOT READ) Don't know

R (DO NOT READ) Refused

a. Requiring that all loan payments have to pay down some of the loan's principal, or amount borrowed, as well as some of the fee or interest
b. Requiring that borrowers be given more time to pay back the loan
c. Allowing borrowers to pay back loans in installments, rather than all at once
d. Requiring that borrowers have the option of only spending a small amount of each paycheck to pay back their loan

Focus group methodology

On behalf of the safe small-dollar loans research project, Hart Research Associates and Public Opinion Strategies conducted eight focus groups, with two groups per location in New York City; Chicago; Birmingham, AL; and Manchester, NH. Those groups were conducted during weekday evenings Sept. 7-19, 2011.

Additionally, the project conducted two groups in San Francisco on Nov. 16, 2011, two groups in Colorado Springs on Feb. 6, 2013, and two groups in Denver on Feb. 7, 2013. All focus groups were two hours, and all borrower quotations come from these 14 focus groups.

Colorado interview methodology

The project conducted 33 interviews with people who influenced the Colorado law or who have seen its impact firsthand. These interviews ranged in duration from 15 minutes to more than two hours. Participants included state senators, state representatives, payday lenders, advocates, religious leaders, lobbyists, credit counselors, and legislative staff who worked on the law. Unless otherwise cited, all quotes in this report about Colorado come from these interviews and focus groups. All participants were granted confidentiality. Twenty-nine consented to having the interviews recorded, and interviewers took notes in the other four. Thirty interviews were conducted in person and three by phone. All nonborrower quotes in this report come from these interviews unless otherwise noted.

Question wording

1. Introduction
    a. "Pew is a nonprofit organization doing research on small-dollar lending. We are interested in how the Colorado law is playing out."
    b. "I'm recording the interview for transcription purposes, but you will not be identified by name. Quotes from the interview may be used in a future Pew report. All participants will be identified by a title such as: Colorado government official, Colorado payday lender, Colorado payday borrower, Colorado advocate, Colorado credit counselor, and so on. Is that all right?"
    c. "Of course you may decline to answer any questions, and dozens of other people are also taking part in these interviews."
2. "Tell me a little about how you interact with payday lending, so how you see payday lending play out on a day-to-day basis in your work life?"
3. Can you describe the new law to me?"
    a. "What features of the law are important?"
    b. "How do you know?"
4. "How well is the new payday loan law working overall? "
    a. 'What tells you that?"
5. "Anything else positive about the new law, or benefits that it has had?"
6. "Anything else negative about the new law, or downsides that it has had?"
7. "As far as you can tell, is it working for both lenders and borrowers?"
    a. "Who else is impacted by the payday loan law?"
8. Ask only lenders:
    a. "Has the new law caused hardships for you? What are they?"
    b. "How about for other lenders?"
    c. "Have employees been laid off? Stores closed?"
    d. "Have you had to deny people credit under the new law who would have gotten it under the old law?"
    e. "Have more people had to borrow online, or not from storefronts, since the new law went into effect?"
9. How did the old payday loan law in Colorado work?
    a. "What were the benefits and drawbacks? What told you that?"

10. “What is the biggest difference between the old and the new law in terms of the impact they have had?”
11. “Can you think of any areas of life that have been improved because of the law?”
12. “People in other states and at the federal level are asking about how well the new payday lending law is working in Colorado. What would you tell them?”
    a. “Would you recommend other states or the federal government implement Colorado’s law?”
13. “What improvements would you like to make to the payday loan law here?”
14. “Are there any stories or anecdotes you can share to illustrate how the law is working?”
15. “Anything else you would like to share?”
16. “Can you recommend anyone else I should speak with about the payday loan law, either in person or by phone?”
    a. “Can I tell them you recommended I get in touch?”

Colorado lender location methodology

To assess how the 2010 Colorado law affected access to credit, Pew researchers plotted the payday loan stores that existed before the law change (on April 1, 2010), and after the change (on Aug. 1, 2013). The primary source of data originates from the Colorado Office of the Attorney General’s 2013 record of supervised lenders. A supervised lender is any non-depository company or individual that conducts consumer credit transactions (primarily payday loans, traditional consumer loans, second mortgages, and personal loans). As of June 2013, the list consisted of approximately 7,089 lenders that have operated or are currently operating in Colorado. The lender’s street address was the unit of analysis because the data showed that what often appeared to be a closure of a location was actually the sale of the business to another lender or a transfer between franchisees and corporate entities.

The data set was then parsed to identify payday loan storefronts based on publicly available information. The location information was paired with geographic coordinates obtained from Yahoo’s geocode services, which uses NAVTEQ geographic data. The matching was done via a third-party API application. The data were split into two categories: locations that were operating before the law change and locations operating after the change (in all, there were 433 payday lending locations in the data set). The data were transferred to a GIS application, matched to county-level 2010 census data, and analyzed.

To specifically evaluate the impact of the 2010 law change on the distance Colorado residents travel in order to take out a payday loan, the distance between licensed lending locations and population centroids was measured. The distance between these two points was calculated using the Haversine formula, which results in a “straight as the crow flies” measurement that does not take into account barriers to travel. Population information comes from the 2010 census, available at http://www.census.gov/geo/reference/centersofpop.html.

Appendix A

Loans Consume One-Third of Biweekly Income in Conventional Payday States

State	Percentage of a Borrower's Biweekly Gross Income Consumed By a Loan Payment (%)
Alabama	37
Alaska	37
California[a]	25
Colorado[b]	4
Delaware[c]	38
Florida	35
Hawaii	36
Idaho	38
Illinois[c]	36
Indiana	36
Iowa	36
Kansas	36
Kentucky	37
Louisiana[d]	34
Maine[e]	27
Michigan	36
Minnesota	32
Mississippi[f]	19
Missouri[c]	38
Nebraska	37
Nevada	37
New Mexico[c]	36
North Dakota	38
Ohio	34
Oklahoma	36
Oregon[f]	16
Rhode Island	35
South Carolina[c]	36
South Dakota	38
Tennessee	36
Texas[c]	38
Utah	37
Virginia[f]	20
Washington	36
Wisconsin[c]	39
Wyoming	34

Note:

Calculations are based on $1,192 biweekly gross income for the median payday loan borrower (paid biweekly), who earns $31,000 annually per the Federal Reserve's Survey of Consumer Finances, and borrows an average $375 payday loan. More detailed information on borrower income is included in endnote 115. A limitation of this analysis is that median payday borrower income likely varies by state, but a national figure is applied to all states because sufficient uniform state-by-state income data for borrowers are unavailable. Fees were calculated using representative terms shown on lender websites. If Advance America makes loans in the state, those terms were used. If not, Check 'n Go was used. In Oregon, where neither of these companies offers loans, ACE Cash Express was used. These companies were chosen because they are among the largest payday lenders in the United States, according to industry analyst Stephens, Inc. Although some states offer payday installment loans as well, this map includes data for lump-sum repayment loans if those are available.

a In California, payday borrowers may only borrow up to $255 at a time from a lender ($300 minus an immediate $45 fee).

b In Colorado, the minimum term is six months.

c These states allow high-interest, small-dollar installment loans from payday lenders as well as single-repayment loans. Data for single-repayment loans are included here.

d In Louisiana, lenders may not charge additional fees for loan proceeds above $350, and thus do not lend more than this amount.

e In Maine, lenders may not charge more than $25 per loan, and do not lend more than $300.

f Mississippi, Oregon, and Virginia require longer-than-average minimum loan terms, which usually results in terms covering two pay periods for a borrower, lowering the portion of each paycheck consumed by a loan.

For a summary of state payday lending law, see: http://www.pewstates.org/research/data-visualizations/state-payday-loan-regulation-and-usage-rates-85899405695.

Sources: Federal Reserve Survey of Consumer Finances, 2012. Advance America, 2013. Check 'n Go, 2013. ACE Cash Express, 2013.

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Endnotes

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5 Ibid., 19–29. The report discusses six reasons why people use payday loans they cannot afford: desperation; perception (that loans do not create ongoing debt, for example); reliance on lenders for accurate information (when lenders sell payday loans as two-week products even though borrowers end up indebted for five months, on average); focusing on the periodic finance fee, which is typically affordable (while the lump-sum repayment on the next payday is not); trust in the lender or the regulatory structure; and temptation (some describe payday loans as "too easy" in situations where they are facing constant cash shortfalls).

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9 "Frequently Asked Questions," AmeriLoan, last modified September 2013, accessed April 2013, https://mobile.ameriloan.com/?page=info_faq. Link is to an archived site with the previous repayment schedule, but terms have been updated on AmeriLoan's main FAQ page to reflect a new payment plan, https://ameriloan.com/?page=info_faq#15. Some online lenders, such as AmeriLoan, have essentially acknowledged as much, setting up loans to automatically renew rather than withdraw the full amount owed. Before recent changes to repayment terms that require the loans to be paid in full on a borrower's next payday, borrowers were automatically renewed: "Online customers are automatically renewed every pay period. Just let us know when you are ready to pay in full, and we will deduct your loan plus fees from your bank account." And "FAQ's," Payday Accelerated, accessed Sept. 20, 2013, http://paydayaccelerated.com/Questions.aspx: "Your repayment is the best part. The minimum required payment will be deducted from your bank account. You get cash when you need it most and repay when you have it! Still a little short on payday? No problem! Online customers are automatically refinanced for the first four pay periods. After that, we will debit your account the finance charge plus a $50 principle reduction per pay period until the loan is paid in full."

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20 Morris R. Neifeld, *Neifeld's Manual on Consumer Credit* (Easton: Mack Publishing Co., 1961), 336.

21 Lendol Calder, *Financing the American Dream* (Princeton, NJ: Princeton University Press, 1999), 17.

22 Neifeld, *Neifeld's Manual*, 388.

23 Donald Tyree, *The Small-Loan Industry in Texas* (Austin: Bureau of Business Research, University of Texas, 1960), 59. The author quotes an assistant attorney general of Texas.

24 Neifeld, *Neifeld's Manual*, 388.

25 Ira Cobleigh, *How and Where to Borrow Money* (New York: Avon Books, 1964), 109.

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31 Calder, *Financing the American Dream*, 118.

32 Anderson, "Experts, Ideas, and Policy Change," 271–310.

33 Neifeld, *Neifeld's Manual*, 336.

34 Charles A. Gates, "The Social Worker in the Service of the Small Loan Business," *Annals of the American Academy of Political and Social Science* 196 (1938), 223, http://www.jstor.org/stable/1021721.

35 Calder, *Financing the American Dream*.

36 Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, "Payday Loan Choices and Consequences," *Vanderbilt Law and Economics Research Paper*, no. 12-30 (2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2160947.

37 Gregory Elliehausen, "An Analysis of Consumers' Use of Payday Loans," George Washington University School of Business (2009).

38 Consumer Financial Protection Bureau, *Payday Loans and Deposit Advance Products*. This research finds most bank deposit advance customers overdraft their accounts. The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*, 33. Most traditional payday loan customers overdraw their checking accounts as well.

39 "CPI Inflation Calculator," U.S. Bureau of Labor Statistics, accessed Sept. 1, 2013, http://www.bls.gov/data/inflation_calculator.htm. Calculations performed using this inflation calculator.

40 There is no database in place in Colorado, so these data are provided by lenders to the Colorado Office of the Attorney General. State-employed examiners also compile data by reviewing lender records of individual borrowers.

41 Paul Chessin, "Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act," *Denver University Law Review* 83 (2005), 392–400, http://www.law.du.edu/images/uploads/denver-university-law-review/v83_i2_chessin.pdf.

42 Ibid.

43 Colorado Office of the Attorney General, *2009 Deferred Deposit Lenders Annual Report* (2009), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/annual_reports/2009DDLComposite.pdf.

44 The Pew Charitable Trusts, "State Payday Loan Regulation and Usage Rates," last modified July 19, 2012, http://www.pewstates.org/research/data-visualizations/state-payday-loan-regulation-and-usage-rates-85899405695.

45 DeYoung and Phillips, "Payday Loan Pricing"; and Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 through December 2008*, http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/DDLASummary2008rev.pdf: "In 2008, 96.37% of payday loans were written (contracted) at the maximum amount permitted in terms of the finance charge allowed by the law."

46 Colorado Office of the Attorney General, *2009 Small Installment Lenders Annual Report* (2009), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/annual_reports/2009SILComposite.pdf. In Colorado in 2009, 15,399 small installment loans were made to 9,047 customers.

47 The consumer advocates' coalition, Coloradans for Payday Lending Reform, was largely organized by the Bell Policy Center and Colorado Progressive Coalition.

48 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 through December 2008*.

49 Chessin, "Borrowing from Peter to Pay Paul," 423.

50 This bill was the one initially supported by the coalition known as Coloradans for Payday Lending Reform. The champion of this bill and eventually the compromise bill in the Colorado House of Representatives was Rep. Mark Ferrandino.

51 See Federal Deposit Insurance Corp., "Small Dollar Loan Pilot Program Participants," accessed June 1, 2013, http://www.fdic.gov/smalldollarloans/participants.html, for a list of banks that participated in the FDIC's small-dollar loan pilot program; and Sheila Bair, *Low-Cost Payday Loans: Opportunities and Obstacles*, (the Annie E. Casey Foundation, 2005), http://www.aecf.org/upload/publicationfiles/fes3622h334.pdf for a discussion of early low-cost small-loan providers.

52 North Carolina Office of the Commissioner of Banks, *The Consumer Finance Act: Report and Recommendations to the 2011 General Assembly* (2011), http://www.nccob.gov/Public/docs/Financial%20Institutions/Consumer%20Finance/NCCOBReport_Web.pdf. For example, North Carolina caps interest rates on small loans below 36 percent, and consumer finance companies operate in the state. But North Carolina also allows for ancillary fees that can substantially increase the loan's cost.

53 Tim Hoover, "House Passes Payday Loan Cap," *Denver Post* (Feb. 26, 2008), http://www.denverpost.com/headlines/ci_8362972; Tim Hoover, "Senators Back Cap on Payday Lending," *Denver Post* (March 26, 2008), http://www.denverpost.com/headlines/ci_8696455; and Tim Hoover, "Effort to Cap Interest on Payday Loans Dies," *Denver Post* (April 23, 2008). http://www.denverpost.com/newsheadlines/ci_9018827. A rate cap bill that Rep. Mark Ferrandino championed passed the House of Representatives in 2008 by a vote of 33–30, but a different version passed the Senate, 19–16, and the bills eventually died in committee.

54 The 2008 and 2010 bills initially capped interest rates at 36 percent but were amended to raise the cap to 45 percent annualized interest.

55 Tim Hoover, "Payday-Loan Change OK'd," *Denver Post* (May 5, 2010), http://www.denverpost.com/headlines/ci_15018282; and Peter Marcus, "New Payday Lending Measure Backed" (May 3, 2010), http://statebillnews.com/2010/05/hb10-1351-new-payday-lending-measure-backed/. The 2010 bill passed the Senate by one vote, 18-17, and the House by one vote, 33-32.

56 Interviews with people working inside and outside of government to shape the law indicated that the chief of staff to Senate Democrats at this time developed the terms and structure of Colorado's new loan.

57 Administrator of the Colorado Uniform Consumer Credit Code, *Colorado Payday Lending Demographic and Statistical Information: July 2000 through December 2011* (2012), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/annual_reports/Demo%20%26%20Stat%20Info%202000-2011.pdf. Although the revised law permits lenders to make single-payment loans, 99.9 percent of lenders choose monthly, semimonthly, or biweekly installments, or a combination of these. The number of installments varies depending on the loan contract and payment schedule.

58 Office of the Colorado Attorney General, *2012 Deferred Deposit/Payday Lenders Annual Report* (2013), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/2012%20DDL%20Composite.pdf.

59 The longest term in the Colorado examiner data from the attorney general's office is 222 days. Examiner data are on file at The Pew Charitable Trusts.

60 The Pew Charitable Trusts, *A New Equilibrium* (2011), for credit card data, http://www.pewhealth.org/uploadedFiles/PHG/Content_Level_Pages/Reports/Report_Equilibrium_web.pdf. Pew's analysis of credit union and bank installment loan data relies on *A Template for Success: The FDIC's Small-Dollar Loan Pilot Program* and the National Federation of Community Development Credit Unions' *Borrow & Save: Building Assets With a Better Small Dollar Loan*, http://cdcu.coop/wp-content/uploads/2013/03/Borrow-and-Save-Final-July-30-2013.pdf. Consumer finance company installment loan estimates are based on the statement of Thomas Durkin at the Federal Reserve Bank of Philadelphia's Small-Dollar Credit: Products, Economics, and Regulation Conference (July 12, 2013).

61 Office of the Colorado Attorney General, *2012 Deferred Deposit/Payday Lenders Annual Report* (2013), http://www.

coloradoattorneygeneral.gov/sites/default/files/uploads/2012%20DDL%20Composite.pdf; and Office of the Colorado Attorney General, *2009 Deferred Deposit/Payday Lenders Annual Report* (2010), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/annual_reports/2009DDLComposite.pdf. These comparisons can be made by reviewing state regulatory data from 2012 with the analogous data from 2009.

62 Veritec Solutions LLC, "State Links," accessed Sept. 1, 2013, https://www.veritecs.com/StateLinks.aspx. These databases are operated by Veritec Solutions, and a list of these states is posted on Veritec's website.

63 Washington State Department of Financial Institutions, *2009 Payday Lending Report* (2010), http://www.dfi.wa.gov/cs/pdf/2009-payday-lending-report.pdf; and *2012 Payday Lending Report* (2013), http://www.dfi.wa.gov/cs/pdf/2012-payday-lending-report.pdf. Washington has enacted a limit of eight loans per borrower per year; from 2009 to 2012, the number of locations dropped by 66 percent, loans made dropped by 72 percent, the number of borrowers declined by 42 percent, and the amount spent by borrowers declined by 54 percent. The number of borrowers per location in 2012 was 1,165, more than double the national average. The average loan duration increased to 26.7 days in 2012 from 19.6 days in 2009, which is likely a result of the no-cost payment plan that a borrower can request at any time. It is difficult to compare borrower outcomes in Washington and Colorado because Washington has had a much steeper drop in the number of borrowers; also, Washington's eight-loan cap is binding for the 28 percent of borrowers who reach it, while Colorado's limitations are not binding.

64 Although borrowers spent less, they did not receive less credit. The median loan amount was $400 (in nominal dollars) in 2009 and 2011.

65 Oklahoma borrowers spent $54.3 million on payday loans in 2011 and the same amount in 2009. The nominal amount of dollars advanced via payday loans in California was $3.28 billion in 2011 (at 411 percent APR) and $3.09 billion in 2009 (at 414 percent APR), indicating that consumers spent slightly more in 2011. In Florida, consumers spent $267 million on payday loans in 2011 and $236 million in 2009. All data come from state regulatory reports, and 2011 data are used because 2012 state data are unavailable for some states. The corresponding 2009–11 spending decline in Colorado was from $95.1 million to $54.6 million.

66 For example, in Oklahoma the number of borrowers increased 3.3 percent from 2009 to 2011 (from 113,576 to 117,335). In Florida, the number of borrowers is not disclosed in the state regulatory report, but the number of loans increased by 11 percent from 2009 to 2011 (from 6.2 million to 6.9 million). In California, the number of borrowers increased by 11 percent from 2009 to 2011 (from 1,567,188 to 1,738,219). The 2011 data are used because complete 2012 data are unavailable from some of these states. Colorado experienced an 11 percent decline in borrowers from 2009 to 2011.

67 Similarly, before the law change (April 1, 2008), 93 percent of the population lived within 20 miles of a payday lender. After the law change (Aug. 1, 2013), 91 percent live within 20 miles of a payday lender. The methodology section contains more details.

68 The ZIP code used in the example is 80214, covering the western edge of Denver and the immediately adjoining suburbs.

69 In Colorado, the interest and origination fee are spread evenly over the life of the loan, while the monthly maintenance fee does not take effect until the end of the second month. If the borrower pays back the loan before the end of the second month, no monthly maintenance fee is paid, meaning the loan's fees are effectively backloaded.

70 Dennis Campbell, Francisco de Asis Martinez-Jerez, and Peter Tufano, "Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures" (2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335873.

71 These figures substantially understate the impact of the law change on the bank fees that borrowers pay, because they would owe NSF fees to their bank as well as the lender, and these figures do not capture the overdraft fees that borrowers pay, which are paid only to the bank and do not show up in the lender-provided state regulatory data.

72 Advance America, Cash Advance Centers Inc., Annual Report (Period Ending 12/31/11), 5, http://quote.morningstar.com/stock-filing/Annual-Report/2011/12/31/t.aspx?t=XNYS:AEA&ft=&d=c12cd1f791e34bf03980d4825adc1730. Advance America's 2011 Annual Report (10-K) states that "regulatory changes occurring in Arizona, Colorado, and Washington caused us to close or consolidate our centers in these states in the last two years." There has been a 20 percent decline in the number of payday loan stores throughout the country since 2009. That figure is somewhat inflated by several states that have eliminated payday lending altogether since 2009, such as Arizona, which had 603 stores in 2009. Colorado's rate of consolidation during this period was much greater than the country's overall and that of states without law changes. State regulatory reports provided by Veritec Solutions LLC for 2009 and 2011 show that the number of storefronts in Oklahoma and California decreased 6.5 percent and 3 percent, respectively, while Florida experienced an increase of roughly 6.4 percent. Washington, like Colorado, made a major change to its law, imposing an eight-loan per borrower per year cap, and also saw a large decrease in the number of storefronts. Virginia made major changes to its payday loan law in 2009 and also experienced a large decline in the number of store locations. Missouri, without a law change, experienced a 19 percent decline in the number of stores, and this may have been a result of oversaturation: In 2009, Missouri had 22 stores per 100,000 residents, while Colorado had 10 stores per 100,000 residents. Colorado had also experienced an 18 percent decline in storefronts from 2007 to 2009. Nationally, there was a 5 percent drop during those years, and Colorado's may have been greater because of the extended payment plan required under its previous law change. It is also possible that factors other than changes in the law have played a role in the decline in payday lending stores in Colorado.

73 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). This paper accurately forecast Colorado's experience: "By setting a binding ceiling equal to the minimum average cost, regulators could induce more payday loans from each surviving firm. If demand is very inelastic, reducing the maximum fee may have little effect on the total number of loans taken. However, social costs are lower because the ceiling reduces the number of store locations and hence the fixed costs of providing payday loans. This exercise in microeconomic theory indicates that policy makers can rely on competition to drive profits to zero, but the surviving stores will not necessarily operate at the lowest possible cost (price). A higher rate ceiling means that each store needs to attract fewer customers to cover its fixed operating costs. Reducing the fee ceiling will lower the number of payday stores, but perhaps leave the number of payday loans relatively unaffected."

74 Veritec Solutions LLC, *Oklahoma Trends in Deferred Deposit Lending*. For example, in Oklahoma regulatory data from 2011, the average consumer spent $465.87 (8.8 loans with an average fee of $52.94 per loan), while the average Colorado borrower spent $282 in 2011. Many states permit higher fees than does Oklahoma, and lenders charge higher fees in those states. Complete 2012 data are not available from most states.

75 Office of the Colorado Attorney General, *2012 Deferred Deposit/Payday Lenders Annual Report*; and Office of the Colorado Attorney General, *2009 Deferred Deposit/Payday Lenders Annual Report*. These comparisons can be made by reviewing state regulatory data from 2012 and the analogous data from 2009.

76 In June 2013, a short stretch of West Alameda Avenue in Lakewood had four payday lenders, as did a three-mile stretch of nearby Wadsworth Boulevard. In the Denver suburb of Federal Heights, the shopping hub around Pecos Street and West 84th Avenue had four payday lenders.

77 Ernst & Young, *The Cost of Providing Payday Loans in a US Multiline Operator Environment* (2009), 23, http://www.fisca.org/content/navigationmenu/resources/formediapolicymakers/informationkit/fisca_final_09.03.09_sent_to_client.pdf; and Advance America, Cash Advance Centers Inc., Annual Report (Period Ending 12/31/11), 5. These calculations are based on a report published by Ernst & Young on behalf of Financial Service Centers of America, or FiSCA, a trade association for payday lenders, showing that the average FiSCA member store makes 3,093 loans per year. By comparison, the largest storefront lender, Advance America, made 4,087 loans per store in 2011 (10,561,000 loans made by 2,584 stores). Payday lenders are typically open daily except Sunday, or about 313 days per year. Dividing the number of loans made per year by 313 yields these figures of 10 to 13 loans per day.

78 Consumer Financial Protection Bureau, P*ayday Loans and Deposit Advance Products*, Figure 5; and Parrish and King, *Phantom Demand*.

79 Advance America, Cash Advance Centers Inc., *2011 Annual Report*. This report notes that an average customer takes out eight loans per year, implying that a store serves about 511 unique customers (based on 4,087 loans per store). 2011 state regulatory data from Florida show a similar result, with approximately 526 customers per store (1,490 locations serving just over 784,000 customers), and fewer in Oklahoma.

80 In 2009, Colorado borrowers spent $95.1 million on payday loans at 505 locations ($188,000 of revenue per location). In 2012, they spent $53.2 million on payday loans at 287 locations ($185,000 of revenue per location).

81 Burtzlaff and Groce, *Payday Loan Industry*, 15. The largest operators are those identified by Stephens Inc. as being in the Top 15 nationally by store count, and also being listed in the Colorado attorney general's report as being in the Top 10 by store count in Colorado. Seven companies make up this group.

82 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 through December 2009*.

83 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 through December 2011*.

84 The 2013 market share figure is calculated using licensee lists obtained from the Colorado Office of the Attorney General. The lists were updated Feb. 15, 2013.

85 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*, 18. Also Advance America, Cash Advance Centers Inc., "Form 10-K (Annual Report)" (2012). This report from Advance America, the largest storefront lender, provides an approximate loss rate, which is calculated 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. Advance America has made this point explicitly, stating, "97 percent of our customers pay us back." http://www.ncsl.org/portals/1/documents/fiscal/Jamie_Fulmer_PowerPoint.pdf.

86 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 through December 2011*, 15.

87 Bhutta, et al., "Payday Loan Choices and Consequences." Despite the relatively low loss rates on any individual payday loan, previous

research has found that approximately half of payday borrowers default on a loan within two years. Even with the more affordable payments in Colorado, it is unclear whether that figure will decline. It is worth remembering that payday loan borrowers after the law change look very similar to those before, meaning they likely still have deeply damaged credit histories. Bhutta, et al. found the average credit score in their payday borrower data set was a very poor 513.

88 The number of defaults per borrower per year has declined from 0.49 in 2009 to 0.34 in 2012 (30 percent). The number of defaults has also decreased in absolute terms, from 137,813 in 2009 to 81,580 in 2012. Because average borrowers now have loans out for 7½ months of the year instead of five, the number of defaults per borrower per month of credit used has declined from 0.100 in 2009 to 0.045 in 2012 (55 percent). But it is unclear if this decline is real or if it is an artifact of lenders only reporting a maximum of one default per loan, with borrowers using fewer loans. Relative to the number of loans issued, the default rate has of course increased dramatically under the new law, but this is almost inevitable now that so many fewer loans are issued, and they last more than five times as long. On each loan, borrowers have more time to default, and there is more time for a shock to occur that might result in nonpayment, such as a job loss. A similar number of defaults when borrowers are using fewer loans produces artificially inflated default-to-loan ratios. This phenomenon can be illustrated by presenting two hypothetical loan scenarios. In the first, a borrower uses one yearlong loan and defaults once at some point during the year (whether or not the borrower catches up on payments and continues to repay the debt). In the second, a borrower uses 26 two-week loans, and similarly, defaults once during the year. The first loan scenario will show a default-to-loan ratio of 100 percent, while the second will show a default-to-loan ratio of 4 percent, even though under each scenario a borrower has received credit for the same duration and defaulted the same number of times. Similarly, under the previous Colorado law, someone who borrowed the average number of times and defaulted once would have a default rate of 13 percent (1/7.84). Under the new law, someone who borrowed the average number of times and defaulted once would have a default rate of 43 percent (1/2.3).

89 Federal Deposit Insurance Corp., *Risk Management Examination Manual for Credit Card Activities* (March 2007), http://www.fdic.gov/regulations/examinations/credit_card/pdf_version/ch7.pdf. FDIC discussion of traditional underwriting.

90 The Pew Charitable Trusts, "Pew Payday Lending Methodology," modified July 2013, http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Payday_Lending_Methodology.pdf.

91 Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corp., and Office of Thrift Supervision, "Credit Card Lending: Account Management and Loss Allowance Guidance" (2003), http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030108/attachment.pdf; Office of the Comptroller of the Currency, "Comptroller Dugan Expresses Concern about Negative Amortization" (Dec. 1, 2005), http://www.occ.gov/news-issuances/news-releases/2005/nr-occ-2005-117.html; and National Credit Union Administration, "Final Rule—Part 701, Short-term, Small Amount Loans" (October 2010), http://www.ncua.gov/Legal/Documents/Regulatory%20Alerts/RA2010-13.pdf: "The loan must be amortized in such a way that allows the borrower to repay the loan in the given term. FCUs must structure the payments so that the borrower is paying a portion of the principle and interest in equal or near-equal installments on a periodic basis over the course of the loan."

92 Federal Deposit Insurance Corp., *A Template for Success: The FDIC's Small-Dollar Loan Pilot Program* (2010), http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/smalldollar.html.

93 Ibid.

94 The interest varies from prime plus 15.99 percent up to prime plus 19.99 percent, and there is a $25 annual fee. In addition, borrowers can use the line of credit to cover overdrafts on their KeyBank checking accounts at a cost of $10 per automated transfer, but there is no cost if the borrower initiates a transfer. The line of credit ranges from $250 to $1,500, with minimum monthly payments of the greater of $20 or a portion of the principal plus interest and fees. This information is based on conversations with KeyBank representatives.

95 Jeff Horwitz, "KeyBank's Small Loan Formula Avoids Payday Problems," *American Banker*, accessed July 2, 2012, http://www.americanbanker.com/issues/177_127/keybank-small-loan-formula-avoids-payday-problems-1050591-1.html.

96 North Side Community Federal Credit Union, "Other Loans," accessed Sept. 1, 2013, http://www.northsidecommunityfcu.org/other_loan_products_servic.html.

97 Pennsylvania Credit Union Association, "Credit Union Info," accessed Sept. 1, 2013, http://www.pacreditunions.com/betterchoice.html.

98 National Federation of Community Development Credit Unions, *Borrow & Save*.

99 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*, 14.

100 Ibid., 37.

101 Susanna Montezemolo, *Payday Lending Abuses and Predatory Practices*, (Center for Responsible Lending, 2013), 5, http://www.responsiblelending.org/state-of-lending/reports/10-Payday-Loans.pdf; and Marc Anthony Fusaro and Patricia J. Cirillo, *Do Payday Loans Trap Consumers in a Cycle of Debt?* (2011), 24, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1960776. This industry-sponsored paper found that even customers who receive a free first loan end up renewing or reborrowing seven times on average after the first loan.

102 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, 35; and Gregory Elliehausen, *An Analysis of Consumers' Use of Payday Loans* (2009), http://www.approvedcashadvance.com/docs/GWUAnalysis_01-2009.pdf.

103 Bhutta, et al., "Payday Loan Choices and Consequences."

104 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, 14; and The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*, 10.

105 Center for Financial Services Innovation, *2011 Underbanked Market Sizing Study* (2012), http://www.cfsinnovation.com/system/files/CFSI_2011_Underbanked_Market_Sizing_Study_November_2012.pdf. These are companies that make unsecured installment loans to borrowers, but are not banks or credit unions. Such companies frequently are members of trade associations such as the American Financial Services Association or the National Installment Lenders Association. This report estimated the consumer installment loan industry's revenue at $4.4 billion in 2011.

106 North Carolina Commissioner of Banks, *The Consumer Finance Act: Report and Recommendations to the 2011 General Assembly* (2011), http://www.nccob.org/Public/docs/Financial%20Institutions/Consumer%20Finance/NCCOBReport_Web.pdf: "They look at credit reports, but often disregard the credit score, instead looking more closely at particular lines. Underwriting places heavy emphasis on analyzing ability to repay, and closely examines income and employment."

107 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 cash flow or ability to pay the loan without having to borrow again to meet other expenses.

108 Consumer Financial Protection Bureau, *Payday Loans and Deposit Advance Products*: "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."

109 Office of the Comptroller of the Currency, "Proposed Guidance on Deposit Advance Products"; and Federal Deposit Insurance Corp., "Proposed Guidance on Deposit Advance Products."

110 Chuck Cole, presentation, California Assembly Banking and Financial Institutions Committee, Sacramento (March 4, 2013); and California Senate Bill 318 (amended April 1, 2013), http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0301-0350/sb_318_cfa_20130415_124240_sen_comm.html. California Senate Bill 318 suggested allowing lenders to charge a fee of $30 "to help offset the significant costs of underwriting."

111 Mark J. Flannery and Katherine Samolyk, "Payday Lending: Do the Costs Justify the Price?" FDIC Center for Financial Research Working Paper no. 2005/09 (2005), http://ssrn.com/abstract=771624.

112 Ernst & Young, *The Cost of Providing Payday Loans*, 23. Advance America, Cash Advance Centers Inc., Annual Report (Period Ending 12/31/11), 5. These calculations are based on a report published by Ernst & Young on behalf of FiSCA, a trade association for payday lenders, showing that the average FiSCA member store makes 3,093 loans per year. By comparison, the largest storefront lender, Advance America, made 4,087 loans per store in 2011 (10,561,000 loans made by 2,584 stores). Payday lenders are most commonly open every day except Sunday, or about 313 days per year. Dividing the number of loans made per year by 313 yields these figures of 10 to 13 loans per day. Advance America also notes that an average customer uses eight loans per year, implying a store serves about 511 unique customers. State regulatory data from Florida show a similar result, with approximately 526 customers per store (1,490 locations serving just over 784,000 customers), and fewer in Oklahoma.

113 Burtzlaff and Groce, *Payday Loan Industry*, 15.

114 Pew's benchmark is based on individual income largely because payday lenders today rely on individual income when offering a loan.

115 This figure is based on household income, not individual income, although Pew's survey data show only 33 percent of payday loan borrowers are married, and another 14 percent are living with a partner, so the differences between household and individual income may be somewhat smaller for payday borrowers than for the general population. Additionally, averaging individual income figures released by states (average monthly gross of $2,477 in Colorado, $2,426.97 in Illinois, and $2,821.98 in Washington) yields a very similar result of $30,904 annual gross individual income, or a biweekly paycheck of $1,189. Because Illinois has two different types of payday loans, the income figure for all small loan customers is used.

116 North Carolina Commissioner of Banks, *The Consumer Finance Act: Report and Recommendations to the 2011 General Assembly*, 19. While these loans generally carry much lower interest rates than payday loans, that is not because the borrowers are particularly good credit risks. Data compiled by Equifax Analytical Services for the North Carolina Commissioner of Banks revealed that the average credit score of a consumer finance customer in North Carolina was 578, and most had annual personal income between $20,000 and $40,000.

117 Proprietary data on file at The Pew Charitable Trusts.

118 Federal Reserve Board, *Survey of Consumer Finances* (2012), http://www.federalreserve.gov/econresdata/scf/scf_2010.htm; Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 through December 2011*; Washington State Department of Financial Institutions, *2011 Payday Lending Report* (2012), http://www.dfi.wa.gov/cs/pdf/2011-payday-lending-report.pdf; and Veritec Solutions LLC, *Illinois Trends Report: All Consumer Loan Products Through September 2012* (2013), http://www.idfpr.com/News/DFI/IL_Trends_Report%20since%20Inception%20through%209-30-12%20final.pdf. This figure is based on

household income, not individual income, although Pew's survey data show only 33 percent of payday loan borrowers are married, and another 14 percent are living with a partner, so the differences between household and individual income may be somewhat smaller for payday borrowers than for the general population. Additionally, averaging individual income figures released by states (average monthly gross of $2,477 in Colorado, $2,426.97 in Illinois and $2,821.98 in Washington) yields a very similar result of $30,904 annual gross individual income, or a biweekly paycheck of $1,189. Because Illinois has two types of payday loans, the income figure for all small loan customers is used.

119 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*, 14. Borrowers can afford to renew or reborrow loans, but not to repay them without borrowing again. This phenomenon explains why loss rates on these loans are only 3 percent, but three-quarters of loans are just renewals or quick reborrows of previous loans.

120 Cash America International, "Colorado Deferred Deposit Loans Rates/Fees," accessed September 2013, http://www.cashamerica.com/LoanOptions/CashAdvances/RatesandFees/Colorado.aspx. Calculation is based on the total payment amount of $788.74 divided by six months.

121 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 through December 2011*, 6.

122 This monthly income of $2,477 is the average, or mean. The $2,140 monthly income of a median borrower is lower ($25,680 annually), and if this figure were used instead of the mean, then a payment on a $500 loan would take up 6 percent of the borrower's income, and a payment on a $389 loan would take up 5 percent.

123 Office of the Comptroller of the Currency, "Proposed Guidance on Deposit Advance Products"; and Federal Deposit Insurance Corp., "Proposed Guidance on Deposit Advance Products."

124 Federal Reserve Board of Governors, "Expanded Guidance for Subprime Lending Programs" (Jan. 31, 2001), http://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010131/attachment.pdf. Bank regulators count "loan flipping" as an element of predatory lending. This guidance was jointly signed by the OCC, the Federal Reserve Board, the FDIC, and the OTS and defined "loan flipping" as "inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced" and explaining that "predatory lending" typically involves loan flipping, and/or "making unaffordable loans based on assets of the borrower rather than on the borrower's ability to repay an obligation," and/or "engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower."

125 Colorado Office of the Attorney General, *"State of Colorado v. Security Finance Corp. of Colorado,"* filed June 9, 2008, http://www.coloradoattorneygeneral.gov/sites/default/files/press_releases/2010/05/18/securityfinancecomplaint.pdf. For example, see the Colorado attorney general's complaint against Security Finance, which resulted in a settlement, alleging that "Security Finance's business model is to continually flip (refinance) loans after or as close as possible to sixty days (prior to August 2007) or four months (after August 2007) of the previous loan or refinance to maximize the number and amount of acquisition charges it earns and to prevent consumers from paying off their loans or refinances as scheduled."

126 North Carolina Commissioner of Banks, *The Consumer Finance Act: Report and Recommendations to the 2011 General Assembly*, 47.

127 Federal Reserve Board of Governors, "Expanded Guidance for Subprime Lending Programs."

128 The Pew Charitable Trusts, *A New Equilibrium*. The median fee for cash advances on credit cards is 4 percent (banks) or 2 percent (credit unions).

129 National Consumer Law Center, *The Cost of Credit: Regulation, Preemption, and Industry Abuses*, 5.6.3.3 (2005). NCLC's manual and accompanying supplement book discuss the "rule of 78s," or "sum-of-digits" method, which allows the front-loading of interest.

130 Indiana Department of Financial Institutions, "What Is the Rule of 78s?" accessed Aug. 15, 2013, http://www.in.gov/dfi/2409.htm.

131 15 USC § 1615, "Prohibition on use of 'Rule of 78's' in connection with mortgage refinancings and other consumer loans," http://www.law.cornell.edu/uscode/text/15/1615. Lawmakers sometimes prohibit the "rule of 78s" by requiring use of the "actuarial method." See, e.g., (" … the creditor shall compute the refund based on a method which is at least as favorable to the consumer as the actuarial method," where actuarial method is defined as "the method of allocating payments made on a debt between the amount financed and the finance charge pursuant to which a payment is applied first to the accumulated finance charge and any remainder is subtracted from, or any deficiency is added to, the unpaid balance of the amount financed").

132 Colorado's law also backloads one type of fee, the monthly maintenance fee. By allowing the monthly fee to apply only after the first two months of the loan term, the law actually creates an incentive for borrowers to repay their loans within the first two months (only about 33 percent of borrowers have done so to date; see Exhibit 4 of this report).

133 Office of the Colorado Attorney General, "Attorney General Announces Settlement Against EZPawn Colorado Inc. and EZMoney Colorado Inc." (April 2, 2013), https://www.coloradoattorneygeneral.gov/press/news/2013/04/02/attorney_general_announces_settlement_against_ezpawn_colorado_inc_and_ezmoney.

134 Mary C. Geesling, “Refunds of Origination/Acquisition Fees Upon Prepayment of a Payday Loan” (Aug. 12, 2011), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/Refunds%20of%20OriginationAcquisition%20Fees%20Upon%20Prepayment%20of%20a%20Payday%20Loan%20Memo.pdf.

135 Colorado Uniform Consumer Credit Code 5-3.1-105, http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/UCCC%202012.pdf: “If the loan is prepaid prior to the maturity of the loan term, the lender shall refund to the consumer a prorated portion of the annual percentage rate based upon the ratio of time left before maturity to the loan term”; And Colorado Uniform Consumer Credit Code 5-2-201: “With respect to a supervised loan or a consumer credit sale, except for a loan or sale pursuant to a revolving account, a supervised lender or seller may contract for and receive a finance charge, calculated according to the actuarial method … ”

136 Colorado Uniform Consumer Credit Code 5-3.1-108 (2), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/UCCC%202012.pdf: “Upon renewal of a deferred deposit loan, the lender may assess an additional finance charge not to exceed an annual percentage rate of forty-five percent. If the deferred deposit loan is renewed prior to the maturity date, the lender shall refund to the consumer a prorated portion of the finance charge based upon the ratio of time left before maturity to the loan term.” Note, however, that if a customer takes out a new loan after fully repaying a previous one, lenders again earn origination and maintenance fees on that loan.

137 Uriah King and Leslie Parrish, *Springing the Debt Trap*, Center for Responsible Lending (2007), 14, http://www.responsiblelending.org/payday-lending/research-analysis/springing-the-debt-trap.pdf. Original source material is state regulatory information from Florida, Michigan, Oklahoma, and Washington.

138 Community Financial Services Association of America, “CFSA Member Best Practices,” accessed September 2013, http://cfsaa.com/cfsa-member-best-practices.aspx.

139 Washington State Department of Financial Institutions, *2011 Payday Lending Report*, 7.

140 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 through December 2009*. This report notes that in the wake of the 2007 law requiring an extended payment plan after the “fourth, or subsequent, consecutive loan,” lenders found workarounds in order to avoid offering the plans. Changes implemented by lenders included “cooling-off” or “waiting” periods after the third loan (or sometimes every loan), or denying the borrower a new loan if they chose a payment plan. Thus, while measures of indebtedness fell, only 4.6 percent of all loans were converted into a payment plan compared with the 33 percent that were eligible for the plans.

141 King and Parrish, *Springing the Debt Trap*, 14. The 2007 regulatory data from these three states show fewer than 3 percent of eligible borrowers utilizing such plans.

142 Office of Consumer Credit Commissioner, *Credit Access Business Update to the House Pensions, Investments and Financial Services Committee* (2013), 5, http://www.legis.state.tx.us/tlodocs/83R/handouts/C2702013042914301/1b32f392-d511-466e-8dd4-61418a8da5e3.PDF.

143 Veritec Solutions LLC, *Illinois Trends Report: All Consumer Loan Products Through September 2012* (2013), http://www.idfpr.com/News/DFI/IL_Trends_Report%20since%20Inception%20through%209-30-12%20final.pdf. Illinois is an exception to this trend, but lawmakers there have placed substantially more constraints on lump-sum repayment loans than on payday installment loans.

144 Consumer Financial Protection Bureau, *Payday Loans and Deposit Advance Products*. Seventy-five percent of fees are paid by those using 11 or more loans per year. DeYoung and Phillips, *Payday Loan Pricing*. The authors conclude that “the profitability of payday lenders depends on repeat borrowing.”

145 Lauren E Willis, “When Nudges Fail: Slippery Defaults,” *University of Chicago Law Review*, forthcoming; Loyola-LA Legal Studies Paper no. 2012-32 (Sept. 6, 2012), http://ssrn.com/abstract=2142989.

146 King and Parrish, *Springing the Debt Trap*, 14. Note 49 of *Springing the Debt Trap* describes tactics used by lenders to avoid offering installment repayment plans under a previous Colorado law that required such plans after four consecutive payday loans.

147 Raj Chetty et al., “Active vs. Passive Decisions and Crowd-out in Retirement Savings Accounts: Evidence from Denmark,” *National Bureau of Economic Research* (November 2012). For example, the authors classify approximately 85 percent of people as “passive savers” who are heavily influenced by defaults as to whether to use a retirement savings account, but not by tax incentives to save. John Beshears et al., “The Importance of Default Options for Retirement Savings Outcomes,” *National Bureau of Economic Research* (January 2006), http://www.nber.org/papers/w12009. According to Beshears et al., “recent research has highlighted the important role that defaults play in a wide range of settings: organ donation decisions (Johnson and Goldstein 2003; Abadie and Gay 2004), car insurance plan choices (Johnson et al. 1993), car option purchases (Park, Jun, and McInnis 2000), and consent to receive e-mail marketing (Johnson, Bellman, and Lohse 2003).” The authors also find that defaults have “tremendous influence” on “savings plan participation, contributions, asset allocation, rollovers, and decumulation.”

148 Michael S. Barr, Sendhil Mullainathan, and Eldar Shafir, *Behaviorally Informed Financial Services Regulation* (New America Foundation, 2008). The authors discuss the use of “sticky” defaults to improve policy in the financial services area.

149 Anandi Mani, et al., “Poverty Impedes Cognitive Function,” Science 341, no. 976 (2013). Recent research found that people experiencing

a cash shortage, or who are primed to think about financial difficulty, perform poorly on tests, as compared with otherwise similar people (or themselves), in more financially comfortable situations. This finding suggests financial decision-making may be even more difficult in such circumstances.

150 PL$, "Texas Fee Schedule," accessed June 2013, http://www.plshome.com/loans/payday-loans. These loan data come from PL$, a large payday lender offering installment loans in Texas. Data can be found by clicking on Texas Fee Schedule and downloading the PDF of the company's loan rates in Texas. Also, "TX CSO Payday Installment Fee Schedule," ACE Cash Express, accessed June 2013, https://www.acecashexpress.com/~/media/Files/Installment/LicenseRates/TX_FeeSchedule.pdf. ACE is the second-largest payday lender by store count and requires similar payments.

151 The average household income of a payday loan borrower is $31,000, and the average payday borrower can afford a biweekly payment of $50 (or a monthly payment of $100). Additionally, averaging individual income figures released by state (average monthly gross income of $2,477 in Colorado, $2,426.97 in Illinois, and $2,821.98 in Washington) yields a similar result of $30,904 annual gross individual income, or a biweekly paycheck of $1,189. The average individual income of installment loan borrowers in an industry data set reviewed by Pew was $26,000.

152 Gregory Elliehausen and Edward C. Lawrence, "Payday Advance Credit in America: An Analysis of Customer Demand," Credit Research Center, Georgetown University (2001), http://faculty.msb.edu/prog/CRC/pdf/mono35.pdf.

153 Christopher Lewis Peterson, " 'Warning: Predatory Lender'—A Proposal for Candid Predatory Small Loan Ordinances," *Washington and Lee Law Review* 69, no. 2 (Dec. 13, 2011), http://ssrn.com/abstract=1971971.

154 According to a Pew analysis of state loan laws, 43 states and the District of Columbia set maximum interest rates for payday loans. Of the remaining seven, Texas sets maximum interest rates for pawn shop loans: http://www.occc.state.tx.us/pages/int_rates/pRate12.pdf; Nevada sets maximum interest rates for pawn shop loans: http://www.leg.state.nv.us/NRS/NRS-646.html#NRS646Sec050; and Delaware also sets maximum interest rates for pawn shop loans: http://delcode.delaware.gov/title24/c023/sc02/index.shtml. Forty-two states and the District also set maximum interest rates on consumer finance installment loans. (The eight that do not are Delaware, Idaho, Missouri, Nevada, New Mexico, South Dakota, Utah, and Wisconsin.)

155 The seven that do not set maximum allowable charges on lump-sum payday loans are Delaware, Idaho, Nevada, South Dakota, Texas, Utah, and Wisconsin. State laws are available at http://www.pewstates.org/research/data-visualizations/state-payday-loan-regulation-and-usage-rates-85899405695.

156 Rob Levy and Joshua Sledge, "A Complex Portrait: An Examination of Small-Dollar Credit Consumers," Center for Financial Services Innovation (2012), http://www.cfsinnovation.com/content/complex-portrait-examination-small-dollar-credit-consumers.

157 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*, 20–21. Pew found 37 percent of borrowers said they have been in such a difficult situation that they would have taken a payday loan "on pretty much any terms offered." Elliehausen and Lawrence, "Payday Advance Credit in America"; and Avery and Samolyk, "Payday Loans Versus Pawn Shops." The last two papers also discuss price insensitivity.

158 Office of Fair Trading, "Final decision on making a market investigation reference" (June 2013), http://www.oft.gov.uk/shared_oft/markets-work/payday-MIR.pdf.

159 Lauren Willis, "The Virtues of Price Caps," *Credit Slips* (March 14, 2013), http://www.creditslips.org/creditslips/2013/03/the-virtues-of-price-caps.html. Law professor Lauren Willis has suggested, "Given that price competition is not working, ideally a price cap would be set to what price competition would have produced—something close to an efficient lender's average cost."

160 DeYoung and Phillips, "Payday Loan Pricing." This fact can also be observed in the rates posted for various states on the websites of the largest payday lenders.

161 Ibid.

162 Based on Pew's analysis of state lending laws and markets. Many consumer finance companies are members of the American Financial Services Association.

163 Texas Office of Consumer Credit Commissioner, Texas Finance Code Chapter 342, Subchapter F Rate Chart (2012), http://www.occc.state.tx.us/pages/int_rates/Ratechart_4.pdf.

164 South Carolina State Board of Financial Institutions, Annual Report 2011-2012 (2012): 62, http://www.bofi.sc.gov/Annual%20Reports/BOFI2012AnnualReport.pdf.

165 North Carolina Office of the Commissioner of Banks, *The Consumer Finance Act: Report and Recommendations to the 2011 General Assembly*, 6. "Credit insurance (Credit life, credit accident and health, credit unemployment, and credit property insurance) may be sold with the loans. Neither the premiums charged nor any benefits to the lender count toward the limit on permitted fees."

166 Based on Pew's analysis of state lending laws. These maximum allowable loan lengths vary across states from 12 months for smaller loans to several years for larger loans.

167 Thomas Durkin, presentation, Federal Reserve Bank of Philadelphia's Small-Dollar Credit: Products, Economics, and Regulation Conference, Philadelphia (July 12, 2013).

168 National Consumer Law Center, "Stopping the Payday Loan Trap" (2010), 15, http://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/report-stopping-payday-trap.pdf. For the Federal Trade Commission's Credit Practices Rule, see 49 Fed. Reg. 7740 (March 1, 1984), codified at 16 CFR Part 444.

169 District of Columbia Official Code § 26–301, http://dccode.elaws.us/code?no=26-3&e=8: " … in the event of a need for emergency cash"; Texas Administrative Code, Rule § 83.604, http://info.sos.state.tx.us/pls/pub/readtac$ext.TacPage?sl=R&app=9&p_dir=&p_rloc=&p_tloc=&p_ploc=&pg=1&p_tac=&ti=7&pt=5&ch=83&rl=604: "This cash advance is not intended to meet long-term financial needs. This loan should only be used to meet immediate short-term cash needs"; Louisiana Office of Financial Institutions, "Deferred Presentment and Small Loans (Payday Loans) Frequently Asked Questions for Consumers," http://www.ofi.state.la.us/Payday%20Consumer%20FAQ.htm: "Payday loans are not intended to meet your long-term financial needs. The long-term use of payday loans may cause financial hardship"; and Michigan Act 244 of 2005, "Deferred Presentment Service Transactions Act," Article 3, 487.2151, Sec. 31,http://www.legislature.mi.gov/(S(g1oqis3o4gwwxezsoslhsd55))/printDocument.aspx?objectName=mcl-Act-244-of-2005&version=txt: "A deferred presentment service transaction is not intended to meet long-term financial needs."

170 The Pew Charitable Trusts, "State Payday Loan Regulation and Usage Rates," modified July 2013. Maximum size of deferred presentment loans varies as follows: $300 (one state); $350 (two states); $500 (18 states); $550 (two states); $600 (two states); $700 (one state); $1,000 (two states); $1,500 (one state). Two states set a maximum loan size based only on consumer income.

171 John Warner National Defense Authorization Act for Fiscal Year 2007, Sec. 670 § 987, http://www.gpo.gov/fdsys/pkg/BILLS-109hr5122enr/pdf/BILLS-109hr5122enr.pdf; and Jean Ann Fox, *The Military Lending Act Five Years Later*, (Consumer Federation of America, 2012). See report for a detailed discussion of the Military Lending Act's protections and impact.

172 CashNetUSA, "How It Works," accessed July 29, 2013, http://www.cashnetusa.com/how-it-works.html. For example, one of the largest online payday lenders, CashNetUSA, makes it far more difficult for borrowers to receive funds and repay loans who do not agree to ACH payments and explicitly states, "The ACH Authorization can only be revoked after we have received payment in full of the amount owed."

173 Federal Trade Commission, "Online Payday Loans." The FTC discusses recent lawsuits against online payday lenders for alleged violations of federal laws.

174 Baptiste and Brodsky v. JP Morgan Chase Bank, filed Oct. 1, 2012. http://www.nedap.org/documents/Baptistev.ChasecomplaintFINAL.pdf. This is a complaint in a high-profile case of withdrawals by online payday lenders resulting in large bank fees for borrowers.

175 Advance America, accessed Sept. 1, 2013, http://www.advanceamerica.net. For example, in Delaware, Advance America charges 387.9 percent APR for loans that permit them to electronically debit the account, but 448.74 percent APR for loans that do not. In Wisconsin the corresponding figures are 381.62 percent APR and 439.26 percent APR.

176 Federal Deposit Insurance Corp., *A Template for Success*. In 2008, the FDIC launched a two-year pilot program to assess if financial institutions could offer affordable small loans in place of high-cost alternatives. All participating banks performed underwriting and many used credit reports to determine loan amounts and ability to pay. Even with a streamlined underwriting process, approximately three-quarters of banks offered to auto debit loan payments from the customer's account, and some offered interest rate discounts for this option. As the FDIC study noted, features of success included longer loan terms and strong underwriting criteria, as well as the ability to auto debit.

177 Caroline Glendinning and Peter A. Kemp, eds., *Cash and Care: Policy Challenges in the Welfare State* (September 2006). "The ability to collect loan repayments either through direct deduction or more certain method of direct debit would significantly reduce the costs of lending for commercial, credit providers. Credit unions and other not-for-profit lenders would also benefit from these methods of collecting payments, as they would reduce their costs and make financial sustainability more attainable."

178 Federal Trade Commission, "Online Payday Loans," accessed Sept. 1, 2013, http://www.consumer.ftc.gov/articles/0249-online-payday-loans. The FTC discusses recent lawsuits against online payday lenders for alleged violations of federal laws.

179 Baptiste and Brodsky v. JP Morgan Chase Bank. This is a complaint in a high-profile case of withdrawals by online payday lenders resulting in large bank fees for borrowers.

180 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* 35–38.

181 15 USC § 1693k and 1693e, "Compulsory use of electronic fund transfers," http://www.law.cornell.edu/uscode/text/15/1693k.

182 Jessica Silver-Greenberg, "Dimon Pledges to Change JPMorgan's Practices on Payday Loans," *The New York Times* (Feb. 26, 2013), Business Day, U.S. edition. After facing criticism for failing to protect its customers from payday lenders that aggressively used the electronic payments system to withdraw funds from JPMorgan Chase customer accounts, CEO Jamie Dimon pledged to revise the company's practices on payday loans.

183 Chris Cumming, "JPM Chase Changes Policy in Response to Payday Loan Criticism," American Banker (March 20, 2013). JPMorgan Chase

has announced its intention to charge "customers only one 'returned item fee' per month even when a lender tries to charge an account more than once." According to bank officials interviewed by Pew, as much as 30 percent of online payday lender electronic debit requests to banks are "representments," or debits that occur after an initial debit was declined for insufficient funds. By comparison, these officials indicated that banks treat representment rates of greater than 1 percent as a sign of potential malfeasance or noncompliance, and most merchants fall well under that threshold.

184 NACHA, the organization that oversees the automated clearinghouse for electronic payments, operates under bylaws voted on by member banks and other institutions. According to representatives of member banks that spoke with Pew in June 2013, NACHA is evaluating a rule change that would penalize banks that help unscrupulous lenders abuse the power to electronically debit consumer bank accounts within the NACHA network.

185 Western Sky, "Rates," accessed Sept. 2, 2013, http://www.westernsky.com/General/Rates.aspx; and Danielle Douglas, "Payday lender Western Sky Financial to stop funding loans on Sept. 3," *The Washington Post*, Business (Aug. 26, 2013). Western Sky recently announced that it would cease to fund loans.

186 CashCall, "Now Let's Talk Numbers," accessed Sept. 11, 2013, http://www.cashcall.com/Rates/CurrentRates.aspx?tab=2.

187 Maximum terms that fail to account for a borrower's income are likely to limit the size of loan available to low-income borrowers and allow unnecessarily long terms for middle-income borrowers.

188 Thomas Durkin, presentation, Federal Reserve Bank of Philadelphia's Small-Dollar Credit: Products, Economics, and Regulation Conference, Philadelphia, July 12, 2013. Consumer finance company installment loan estimates are based on the statement of Thomas Durkin, who noted that a typical consumer finance company installment loan amount is about $1,000, with a term of 12 months and an APR around 60 percent. Industry representatives and analysts have confirmed these figures in meetings with Pew. Regional Management Corp., Annual Report (Fiscal Year 2012), http://quote.morningstar.com/stock-filing/Annual-Report/2012/12/31/t.aspx?t=XNYS:RM&ft=10-K&d=fefbb7596975e37168ee08086e1ad0df. Installment lender Regional Management's annual report (10-K) indicates its average small installment loan was for $1,179 and 17 months.

189 One effective option for establishing a maximum loan length is to account for the loan's size and the borrower's income by dividing the loan's principal by the borrower's daily income (annualized income divided by 365). This resulting figure provides a reasonable maximum number of months that a loan should last. Assuming an average loan ($375) and borrower ($31,000 annual income), that will result in a loan term of 4.4 months (375/84.93). This formula works for loans smaller than this and those substantially larger, and for a wide range of incomes. Using this formula for a $500 loan and a low-income borrower ($18,000 annually) and a high-income borrower ($48,000 annually), results in loan terms of 10.1 months and 3.8 months, respectively. Of course, virtually any interest rates are possible under such a scenario, depending on the borrower's ability to pay. Slightly longer terms will be appropriate for repayments that consume less than 5 percent of a borrower's paycheck.

190 Burtzlaff and Groce, *Payday Loan Industry*, 15. Stephens Inc., in its 2011 report, estimates that borrowers do not become profitable for lenders until they have borrowed four or five times. DeYoung and Phillips, "Payday Loan Pricing." DeYoung and Phillips also conclude that "the profitability of payday lenders depends on repeat borrowing." An analysis of North Carolina data found that 73 percent of lender revenue came from borrowers using seven or more loans per year. Michael A. Stegman and Robert Faris, "Payday Lending: A Business Model that Encourages Chronic Borrowing," *Economic Development Quarterly* (2003), 22, http://ccc.unc.edu/contentitems/payday-lending-a-business-model-that-encourages-chronic-borrowing/. The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, 15.

191 Susan E. Woodward and Robert E. Hall, "Diagnosing Consumer Confusion and Sub-Optimal Shopping Effort: Theory and Mortgage-Market Evidence," *National Bureau of Economic Research* (May 2010), http://www.nber.org/papers/w16007.pdf.

THE PEW CHARITABLE TRUSTS

Appendix M

A report from THE PEW CHARITABLE TRUSTS | Oct 2014

Report 4 in the *Payday Lending in America* series

Fraud and Abuse Online: **Harmful Practices in Internet Payday Lending**

The Pew Charitable Trusts

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External reviewers

The report benefited from the insights and expertise of the following external reviewers: Mike Mokrzycki, independent survey research expert; Nathalie Martin, Frederick M. Hart chair in consumer and clinical law at the University of New Mexico; and Alan M. White, professor of law at the City University of New York. These experts have found the report's approach and methodology to be sound. Although they have reviewed the report, neither they nor their organizations necessarily endorse its findings or conclusions.

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For further information, please visit:
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The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and stimulate civic life.

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Overview

The Pew Charitable Trusts' *Payday Lending in America* report series has documented structural problems with payday loans, showing that they fail to work as advertised. They are packaged as two-week, flat-fee products but in reality have unaffordable lump-sum repayment requirements that leave borrowers in debt for an average of five months per year, causing them to spend $520 on interest for $375 in credit. This result is inherent in lump-sum repayment loans, whether from a store, website, or bank.

This fourth report in the series, *Fraud and Abuse Online*, focuses on issues that are particularly problematic in the online payday loan market, including consumer harassment, threats, dissemination of personal information, fraud, unauthorized accessing of checking accounts, and automated payments that do not reduce loan principal. Recent news coverage has detailed these problems anecdotally, but this study is the first formal analysis of online lending practices to use surveys and focus groups, consumer complaints, company filings, and information about lenders' spending on advertising and prospective borrower leads.

Many of the problems that borrowers report violate the best practices of the Online Lenders Alliance, the trade association and self-policing organization for these lenders.[1] Although the overall findings indicate widespread problems, abusive practices are not universal. Some large online lenders are the subject of very few complaints and are urging a crackdown on companies that mistreat customers. Aggressive and illegal actions are concentrated among the approximately 70 percent of lenders that are not licensed by all the states where they lend and among fraudulent debt collectors.[2]

Pew's research found that many online lending practices often have serious detrimental effects on consumers:

1. **Many online loans are designed to promote renewals and long-term indebtedness.** One in 3 online borrowers has taken out a loan that was set up to withdraw only the fee on the customer's next payday, automatically renewing the loan without reducing principal. To pay more, most of these borrowers had to make a request by phone. Other online loans increase borrowers' costs with unnecessarily long repayment periods, such as eight months to pay off a $300 loan or by including some payments in the installment schedule that do not reduce the balance.

2. **30 percent of online payday loan borrowers report being threatened by a lender or debt collector.** Threatened actions include contacting borrowers' family, friends, or employers, and arrest by the police. Online borrowers report being threatened at far higher rates than do storefront borrowers, and many of the types of threats violate federal debt collection laws.

3. **Unauthorized withdrawals, aggressive practices, and disclosure of personal information are widespread in online lending, placing borrowers' checking accounts at risk.**

    - 46 percent of online borrowers report that lenders made withdrawals that overdrew their checking accounts, twice the rate of storefront borrowers.
    - 39 percent report that their personal or financial information was sold to a third party without their knowledge.
    - 32 percent report experiencing an unauthorized withdrawal in connection with an online payday loan.
    - 22 percent report closing a bank account or having one closed by their bank in connection with an online payday loan.

4. **Nine in 10 payday loan complaints to the Better Business Bureau are made against online lenders, although online loans account for only about one-third of the market.** Most complaints deal with billing or collections issues, which include unauthorized bank debits, failure to explain or substantiate charges, failure to correct billing errors, and improper collection practices. Other reported problems include fraud, harassment, and dissemination of personal information.

5. **Online payday loans are usually more expensive than store loans.** Lump-sum loans online typically cost $25 per $100 borrowed per pay period—an approximately 650 percent annual percentage rate. Online installment loans, which are paid back over time in smaller increments, range in price from around 300 percent APR—a rate similar to those charged for store-issued payday installment loans—to more than 700 percent APR from lenders who are not licensed in all of the states where they lend. The main driver of these high costs is the frequency with which loans are not repaid: Defaults are more common in online lending than in storefront lending.

Some states have pursued action against online lenders for making loans to residents without obtaining state licenses or for other conduct that violates state laws. But state-level enforcement is often difficult, because the lenders may be incorporated in other states or offshore, or they may claim immunity based on an affiliation with Native American tribes. Intervention by federal regulators, including the Consumer Financial Protection Bureau and the Federal Trade Commission, has helped address some of the most serious concerns.[3] This intervention has not been sufficient to solve the problems that online borrowers experience. Only through strong, clear federal guidelines for the small-dollar lending market as a whole—ensuring that all loans are based on borrowers' ability to repay and safeguarding their checking accounts—can these illegal practices be eliminated.

This report documents Pew's findings regarding widespread fraud and abuse in the online lending market and examines strategies that state and federal regulators have used to address harmful and illegal practices. It also provides an overview of additional regulation, particularly at the federal level, that would protect consumers while ensuring ready and safe access to credit.

How online lending works

Online payday lenders operate under several business models. Some companies began as stores and expanded into the online market; others are online only. Like some storefront lenders, online lenders often use brand names that differ from their parent companies. These brands, known as DBAs (doing business as), enable companies to establish multiple websites, potentially increasing their ranking on a search-results page.

Storefront loans still account for the majority of the payday lending marketplace, but online lending has grown substantially since 2006. According to industry analysts, approximately one-third of payday loans originate on the Internet, and online lenders' revenue tripled from 2006 to 2013, from $1.4 billion to $4.1 billion.[4]

Online lending shares many characteristics with storefront lending, including exceptionally high prices and repayment plans that exceed many borrowers' ability to repay. Yet Internet-based lending differs from storefront lending in several key ways. (Online borrowers also differ somewhat from those who use storefront loans. For a comparison of borrower demographics, see Appendix A.)

Electronic access to checking accounts

Unlike storefront loans, which are secured by postdated checks or authorization to debit the borrowers' bank accounts, online loans primarily use electronic access to borrowers' bank accounts. Lenders deposit the loan proceeds directly into and take repayment directly from the accounts in most cases.[5] Online lenders use the Automated Clearing House (ACH) electronic payments system operated by banks to access borrowers' accounts, meaning that online lenders depend on banks to facilitate their loans in a way that storefront lenders do not.[6]

Pricing

Fees for online payday loans are generally higher than those for storefront loans, with a typical rate of $25 per $100 borrowed per pay period for lump-sum loans.[7] For an average payday loan of $375, borrowers pay a $95 fee online compared with $55 through stores.[8] In some states, lenders have both storefront and online operations, each offering loans of different amounts or with different fees or durations.[9] Many online lenders charge the same price in every state.[10] However, larger, state-licensed lenders often vary their charges depending on what is allowed under the law in each borrower's state.[11] (See Table 1.)

Table 1

Online Payday Loans Generally Cost More Than Comparable Storefront Loans

Loan prices by lender type

Loan type and location	Annual percentage rate (APR)
Storefront lump-sum national average	391
Online lump-sum national average	652

Note: APRs are based on analyst reports.

Sources: Consumer Federation of America, Stephens Inc.

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Repayment practices and repeat usage

Like storefront operations, online lenders offering lump-sum payday loans rely on repeat borrowing, especially because of the high cost of buying information from companies that collect and resell applicants' personal and financial data.[12] Those companies are known as lead generators. Repeat customers are also desirable because they default on loans at lower rates than new customers do.[13] Industry analysts estimate that, even when charging a $25 fee for each $100 borrowed per pay period, an online lender would need the customer to borrow at least three times in order to earn a profit.[14]

Most storefront lenders make what are known as lump-sum or balloon-payment loans, which are due in full on the borrower's next payday. Until recently, this type of loan was typical among online lenders as well, but many have shifted to installment structures, which are repayable over time. Some online lenders make both types of loans. One of them, LendUp, offers new borrowers only balloon-payment loans, but after a customer repays a number of them, the company will offer a lower-interest loan with a longer repayment period.[15]

Some online lenders use a hybrid repayment structure in which only the fee is automatically deducted for the first several pay periods. These fee-only payments do not reduce the amount owed. After several of these deductions, the lender amortizes the balance, taking the fee plus part of the principal until the loan is repaid in full. One lender's website describes the practice as follows: "The minimum required payment will be deducted from your bank account automatically on payday. ... Online customers are automatically refinanced for the first four pay periods."[16]

High loss rates

Online lenders do not incur the overhead required to maintain stores, which is the main driver of costs for storefront lenders.[17] Instead, online lenders' largest single cost category is losses from unpaid loans.

Cash America, a large lender with both brick-and-mortar and online lending divisions, provides an example. It filed a proposal in 2011 to spin off its online lending operation, called Enova, in a $500 million initial public offering.[18] Enova's filing offers a detailed look inside the finances of an Internet lender.[19] In 2010, Enova received $378.3 million in fee revenue from loans it made directly to borrowers and those for which it acted as a third-party guarantor. Of that, 42 percent was spent covering overhead expenses including advertising, administration, operation, and technology.[20] By comparison, the largest storefront lender spent 66 percent of revenue on overhead.[21]

Approximately 44 percent of Enova's revenue covered charge-offs—i.e., losses on loans that were not repaid.[22] This figure dwarfs the 17 percent of revenue used for charge-offs by the largest storefront lender and the 23 percent used by the largest consumer finance company.[23] (See Figure 1.) The higher losses illustrate the difficulty that online lenders face in verifying borrowers' identities, incomes, and willingness to repay. Losses are a leading reason for online lenders' failure to gain a cost advantage over stores despite their lower overhead—and for their higher prices.

Because of concerns about losses, online lenders are more selective about which applicants they approve. Some reject 80 to 85 percent of applicants, compared with roughly 20 percent among storefront lenders.[24] These rejections may also explain why online borrowers have somewhat higher incomes than storefront borrowers: Pew's survey data indicate that average household income for an online borrower is $30,000 to $40,000. One-third earn over $50,000, more than twice the share of storefront borrowers who earn that much. (See Appendix A.) These findings are consistent with previous research on online borrowers.[25]

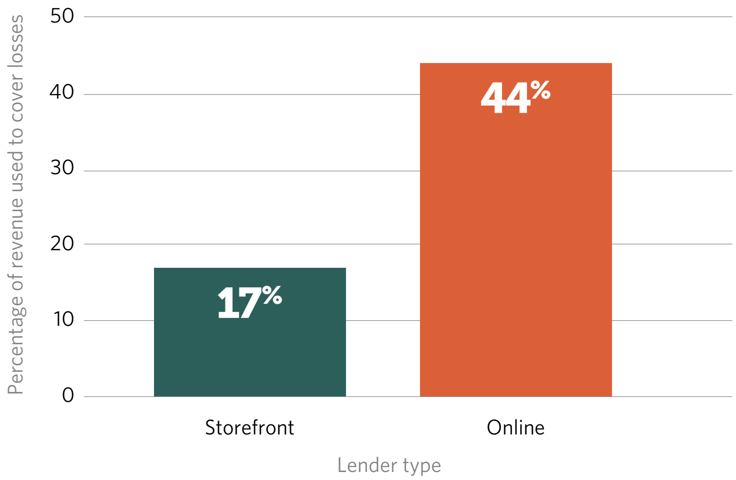
Many online lenders use sophisticated technology and advanced algorithms to predict which applicants are most likely to repay loans.[26] But even these lenders continue to charge interest rates usually in excess of 300 percent

APR,[27] suggesting that they still experience high rates of charge-offs.[28] One installment lender declined 72 percent of applicants, but defaults still reached 45 percent.[29]

Figure 1

Loan Losses Are Higher Online Than at Stores

Share of revenue diverted to charge-offs, by lender type



Note: Analysts often use Advance America, the largest storefront payday lender, as a proxy for the industry. Filings by other storefront operators indicate similar loss rates. Similarly, Enova is the largest online lender.

Sources: Advance America's 10-K filing (2011), Enova's S-1 filing (2011)

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Marketing and customer acquisition

Because online lenders do not have retail locations, they rely heavily on marketing and advertising to attract customers. Some lenders contact potential customers directly or advertise on television and radio to entice them to apply, but most rely at least in part on lead generators—companies that collect information from potential borrowers searching for loans and then sell it to lenders. Marketing and customer acquisition also represent a large cost category for online lenders.

Lead generation

Lead generators use Internet, television, and radio advertising to attract potential borrowers. Their websites collect applicants' Social Security and bank account numbers and other personal information, which they then sell to lenders. These companies match borrowers with lenders, but their policies usually include language stating that they do not accept responsibility for loan charges or terms offered by lenders.[30] Industry analysts estimate that a majority of online applicants enter their information on a lead generation site rather than a direct lender's site, and the top online ads to appear after a search for "payday loan" and related terms generally are those of lead generators.[31]

Lenders pay high fees to acquire borrower information. A first-look lead—the opportunity to be the first lender to contact a potential borrower—cost as much as $125 in 2011, but that price has since declined.[32] Lead generators typically then resell the same applicant's information to other companies after a brief initial exclusivity period for the first-look buyer.[33] Costs for second or third looks at a customer's information are significantly lower.[34]

Lists of people who have applied for payday loans through lead generators in the past are also sold by brokers.[35] Some online lenders act as both direct providers of loans and lead generators. If a company does not wish to make a loan, it may sell an applicant's information to other companies.[36]

Advertising

Pew's earlier research demonstrated that a person experiencing a cash shortfall is not necessarily shopping for the best credit option but is trying to stay solvent at a difficult time using a variety of budgeting, earning, and borrowing strategies.[37] For example, when a small number of banks offered payday loans (known as "deposit advance" loans), 15 percent of eligible customers borrowed. However, nationwide, only 4 percent of people borrow at payday loan stores, and when storefront loans are not available, few people (about 2 percent) borrow online instead.[38] (See "Payday Lending Regulation Does Not Lead to Increased Online Borrowing," Page 20.) These data suggest that convenience, a sense of trust, and highly visible advertising help increase usage.

Television and radio

Online lenders and lead generators spend hundreds of millions of dollars annually to attract customers. Data from Nielsen Co. indicate that the top five payday-loan-related advertisers spent about $277 million on television and radio from June 2012 to May 2013. The lead generator MoneyMutual (owned by Western Marketing Studios LLC) is by far the largest advertiser, spending about $211 million during that period.[39]

> The top five online payday loan advertisers spent $277 million on television and radio from June 2012 to May 2013.

TV Advertising Spurs Demand for Online Payday Loans*

"The fact that they did do television advertising is like, maybe you're somewhat reputable because I'm assuming you're in this country, and you're putting out the money to advertise nationally. ... So at least it made it seem a little bit more trustworthy." *—St. Louis online borrower*

"I think that was the only payday company that I saw that actually a celebrity was endorsing it. ... I was like, 'Okay, well, Montel does it.' " *—New York online borrower*

"I saw this thing on TV, Montel Williams. ... If he's okay with it, it's got to be okay." *—New York online borrower*

"That I could trust him, yeah. And I was surprised that it went to not just a lender, it went to a million places, all over the place. I was like, 'Does Montel know this?' " *—New York online borrower*

"I remember the commercials. ... I didn't even know those online things existed until I was in this bind. That was the first time I saw them. ... It wasn't in my universe. I hadn't even thought about it." *—New York online borrower*

* All quotes from borrowers in this report come from focus groups conducted by The Pew Charitable Trusts. MoneyMutual, for which Montel Williams is a spokesman, is by far the largest online payday loan advertiser and has spent more than $200 million a year on television and radio. Williams' name was mentioned multiple times by participants in the three groups composed exclusively of online borrowers.

Internet search ads

Online lenders also spend substantial advertising dollars on the keyword-search-linked ads that Internet users typically see on search results pages. Keywords related to payday loans typically cost $4.91 to $12.77 per click (Table 2), which is high, given the small size of the loans and that the leads are only prospective. Nevertheless, these ads form a significant portion of online lending advertising. Search activity for payday loans is highest in the months before and after Christmas, and a lead generator can spend upward of $32,000 per day on clicks from potential applicants.[40]

Table 2

Payday Loan Search Terms in the Internet Market Are Costly

Advertisers typically pay $5 to $13 per click on an online loan ad

Keyword term	Minimum	Maximum
"Payday Loan"	$4.91	$8.82
"Payday advance"	$5.39	$7.59
"Payday loans"	$7.01	$10.33
"Payday Loans"	$7.13	$9.84
"Payday loans online"	$7.33	$9.00
"Online payday loans"	$8.13	$12.77

"Payday loans" can generate more than $2 million in click fees per month.

Note: Minimum and maximum costs are point-in-time figures for Feb. 18, 2014. Costs may vary over time.

Sources: SpyFu (2014), SEMRush (2014), KeywordSpy (2014), The Pew Charitable Trusts (2014)

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Online lending practices harm borrowers

States, federal regulators, and media outlets have reported numerous instances of abuse in the online payday lending market over the past several years. These problems include threats and fraud by lenders, debt collectors, and those posing as lenders and debt collectors. Pew's research corroborates these reports and shows a broad pattern of abusive practices. The analysis found that online borrowers report problems such as threats, fraud, and dissemination of their personal information at much higher rates than do storefront payday loan borrowers. Not all lenders engage in these types of actions. Some online lenders, such as Elevate, Enova, LendUp, and Speedy Cash, are the subject of few complaints and in some cases have criticized these practices and called for raising industry standards.[41]

Obstacles to repayment

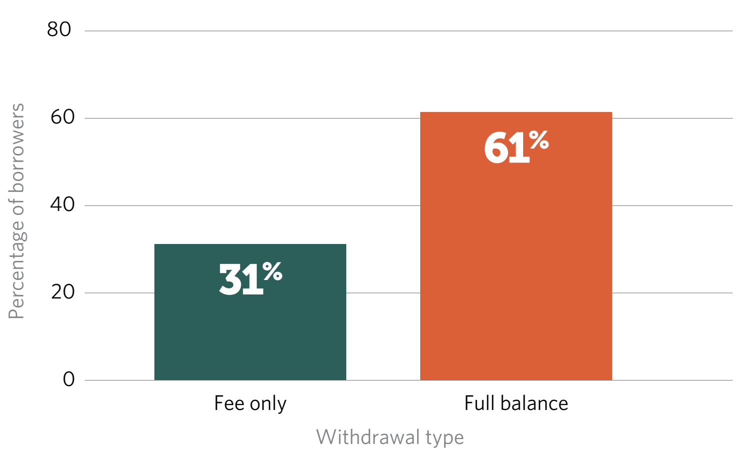
In Pew's survey, 31 percent of online borrowers report that lenders caused loans to extend automatically by withdrawing only the finance fee rather than a payment that would reduce the principal. More than half of those borrowers said that to pay more, they had to request a change by phone. If they wanted the full balance debited on the due date, they had to call their lenders two or more days in advance. (See Figure 2.)

Some websites cite a similar payment schedule on their Frequently Asked Questions or Terms and Conditions page:

- "Online customers are automatically renewed every pay period. Just let us know when you are ready to pay in full, and we will deduct your loan plus fees from your bank account."[42]
- "Customers are automatically renewed, so you do not need to request it. If your next payday comes around and you are not as caught up as you had planned, don't worry; we have it covered. We will automatically extend your due date, and only deduct the renewal fee from your checking account. Additional fees will apply, but you will be able to repay your cash advance from future paychecks."[43]

Online installment payday loans, which amortize to a zero balance, are sometimes set up to function similarly: The first several payments are interest only and do not reduce the principal owed. For example, on a $500 loan from online lender Castle Payday, operated by Red Rock Tribal Lending, the first five payments totaling $875 do not pay down any principal, and the borrower still owes the full $500 balance.[44]

Figure 2
3 in 10 Online Borrowers Had Loans Set Up to Withdraw Only the Fee
Many initial payments did not include any principal



Notes: Online borrowers were asked, "Have you ever taken out an online payday loan that was set up to ONLY withdraw the fee, or have they always been set up to withdraw the full amount?" The 77 respondents who answered "Set up to only withdraw the fee" were then asked: "And could you request online that the full amount be withdrawn, or did you need to make the request by phone?" Of this small subgroup, 39 percent could request online to have more than the interest-only fee withdrawn, while 53 percent reported that this could be done only by phone.

Source: Analysis of The Pew Charitable Trusts' survey data

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Nearly one-third of online borrowers report that lenders caused loans to extend automatically by withdrawing only the finance fee rather than a payment that would reduce the principal.

Some Loans Have Payments That Do Not Reduce Principal

"The first three payments, they'll just take the financing, the servicing, and they don't even start paying down on it."—*New York online borrower*

"When I looked at it, and they just took out the charge, and they didn't take off the principal, and I called them up and go, 'Why did you just take out $120 on $500? ... Why didn't you just take out everything?' They said, 'Well, you didn't call me.' I said, 'I called you yesterday.' " —*New York online borrower*

"[Y]ou're due on Friday. If you don't call them by Wednesday and say, 'I want to pay it off,' they'll just take the interest, and they'll keep just taking the interest until you call them and say, 'Pay it off.' Otherwise, that thing will go on forever, because every two weeks they'll just snatch whatever interest it is and never pay it off at all."—*St. Louis online borrower*

"I get paid on Thursday, so if you don't let them know by Tuesday, then Thursday they were only going to take out the interest."—*Manchester, New Hampshire, online borrower*

Threats

Online borrowers report receiving threats that they will be arrested or that their family, friends, or employers will be contacted at higher rates than do storefront borrowers. Thirty percent of online borrowers have experienced one or more of these threats. (See Figure 3.)

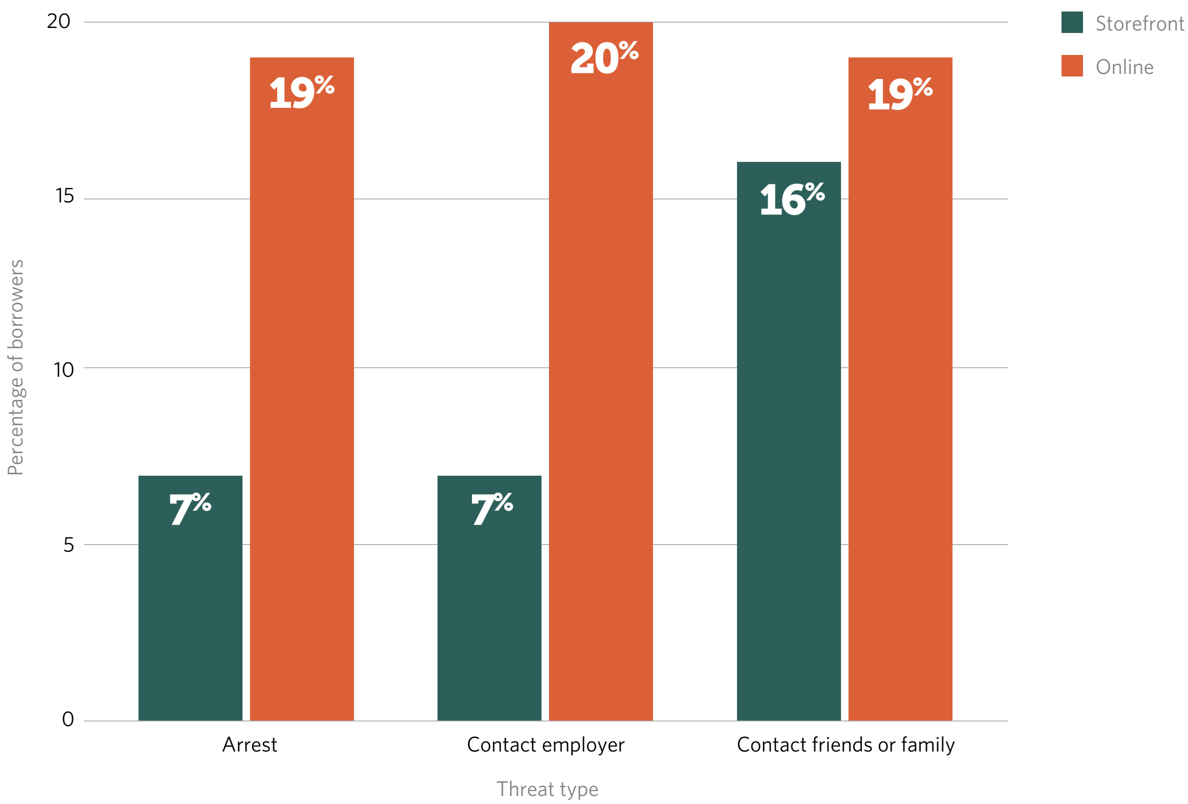
In many cases, borrowers had difficulty determining whether the contacts and threats were from lenders, debt collectors, or fraudulent entities that had purchased their information from lead generators or list brokers. The unique nature of online lending requires borrowers to submit sensitive information electronically, a process that can result in mishandling or abuse.[45]

Borrowers are often required to submit personal references when applying for payday loans (online or at stores), as well as contact information for their places of employment. In focus groups, some borrowers reported that if they failed to repay loans on time, lenders would call their references or even their employers in an effort to get the borrowers to repay. Investigations by federal regulators indicate that some payday lenders have threatened and harassed borrowers who did not repay their loans on time by visiting borrowers' workplaces and making excessive phone calls.[46] Others reported receiving threats even when they were current on or had already repaid a loan. In those instances, federal data indicate that it is likely that many of the threats came from scam artists or fraudulent third-party debt collectors.[47]

Figure 3

Threats Are More Common in Online Than Storefront Lending

30% of Internet borrowers received at least one threat



Note: Storefront borrowers were asked, "I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about: Been threatened with arrest in connection with a payday loan/Had someone threaten to contact your friends or family about your payday loan/Had someone threaten to contact your employer about your payday loan. Has this happened to you or not?"

Online borrowers were asked, "Now I'm going to read you another list of things that some people who took out online payday loans say happened to them. For each one I read, please tell me whether it has happened to you in connection with an online payday loan. How about: Been threatened with arrest in connection with an online payday loan/Had someone threaten to contact your friends or family about your online payday loan/Had someone threaten to contact your employer about your online payday loan. Has this happened to you or not (in connection with an online payday loan)?"

"Had someone threaten to contact your employer" was asked only of the 267 storefront borrowers and 165 online borrowers who answered "yes" to "Are you currently employed?"

Source: Analysis of The Pew Charitable Trusts' survey data

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In focus groups, borrowers reported receiving phone calls in which the callers threatened to have them arrested, take them to court, contact their employers, or come to their workplaces. Such practices can be illegal under the Fair Debt Collection Practices Act.[48] Some borrowers said callers stated that they were law enforcement or were calling on behalf of a government agency or law office. Although the law generally protects people from imprisonment for failure to pay a debt, some borrowers discussed their fear of being arrested and sent to jail for failure to comply with the callers' demands.[49]

30% of borrowers report being threatened in connection with an online payday loan.

Harassment and Threats

"I had the law office call me. … He tells me I have to get my attorney, and he says we will come to your job, and we'll arrest you."—*New York online borrower*

"Harassing me … probably like two years. He said he was going to call Harris County. I said, 'You can't do that.' He was like, 'Yes, I can.' "—*Houston online borrower*

"When he started calling my work, I thought I was going to lose my job."—*Manchester, New Hampshire, online borrower*

"'We're going to serve you at work day after tomorrow if this is not paid in full today.'… I said, 'Don't serve me at work,' because I'm thinking I don't want to be humiliated."—*Manchester, New Hampshire, online borrower*

"These people had me so fed up that I actually had an anxiety attack, and I went to the emergency room, because I couldn't take it no more. Saying they were going to take you to court … calling me at work saying that I took a $5,000 loan, which I would never take a $5,000 loan."—*New York online borrower*

Fraud and dissemination of personal information

Lead generators do not disclose the lenders in their networks, so borrowers learn the names of their prospective lenders only after they have entered their personal and financial information or, in some cases, only after they have received funds. After a lender buys a lead, the borrower's information remains available for sale.[50] This practice of reselling leads creates opportunities for fake debt collectors and others to buy the information and attempt to collect money using aggressive tactics. In such instances, the borrower's bank account is also at risk from those who would use the information to initiate electronic withdrawals. Critics say the sale of sensitive information also puts borrowers at risk of fraud or identity theft.[51]

Several states have issued consumer alerts associated with lead generators and warned residents not to submit personal information to companies that are not licensed by the state and to use caution when entering such information online.[52] Richard Cordray, director of the Consumer Financial Protection Bureau, observed, "The highest bidder may be a legitimate lender, but it could also be a fraudster that has enough of the consumer's sensitive financial information to make unauthorized withdrawals from their bank account."[53]

Among survey respondents, one in three online borrowers said they were contacted about a debt they did not owe, and 39 percent believed their personal or financial information was sold to a third party without their knowledge. (See Figure 4.)

Figure 4

Fraud and Dissemination of Personal Information Are Common

More than one-third of online borrowers report fraud or abuse

32% Contacted about a debt he or she did not actually owe	39% Had personal or financial information sold to a third party

Note: In the survey, online borrowers were asked, "Now I'm going to read you another list of things that some people who took out online payday loans say happened to them. For each one I read, please tell me whether it has happened to you in connection with an online payday loan. How about: Had your personal or financial information sold to a third party without your knowledge in connection with an online payday loan/Been contacted about a debt you did not actually owe in connection with an online payday loan. Has this happened to you or not?"

Source: Analysis of The Pew Charitable Trusts' survey data

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Dissemination of Personal Information

"They had all my information … my routing numbers, my banking account, my email address, my job."—*New York online borrower*

"I had to change everything. I mean, he knew everything about me."—*Manchester, New Hampshire, online borrower*

"I'm talking to the bank and he's like, 'Well, how did your information get out there? Were you really that stupid?' And I'm thinking, 'No, I don't know how it got out there,' you know. Because I didn't want to say to anybody, yeah, I'm that stupid, I needed money that bad."—*Manchester, New Hampshire, online borrower*

"He knows where I work. He says, 'I know the last four of your social.' "—*Manchester, New Hampshire online borrower*

"I want to know how they got all my information. I mean, these loan companies are supposed to have some type of security."—*New York online borrower*

Confusion about lead generators

The high price that lenders pay to acquire leads and the lack of restrictions on what companies can do with them produce an incentive for lead generators to sell applicants' private information many times. As a result, multiple lenders as well as other companies or individuals can contact a single prospective borrower.

Such practices can make it difficult for borrowers to know who is providing their loans and how to contact their lenders, particularly when the websites where they initially entered their personal information do not belong to their lenders. Lead generator sites typically disclose that they are not lenders, but many do so only in small type at the bottom of the Web pages.[54]

In focus groups, some borrowers said they were unaware that the websites were lead generator sites designed to collect and resell private information. Many borrowers reported being unsure about whom to contact if they experienced issues with their loans. They knew which websites they used to enter their personal information but not always the names or contact information of their lenders. Others were surprised to find businesses whose names they did not recognize debiting their accounts or contacting them about late payments.

Borrowers also discussed being called and emailed by numerous lenders after completing online applications or receiving additional solicitations after taking out their initial loans, sometimes causing confusion about the status of their original loans or tempting them to borrow in excess.

Confusion About Numerous Loan Offers Stemming From Lead Generation

"I'm getting texts, and I'm getting phone calls, and I'm getting emails, and I'm getting all of this stuff."—*New York online borrower*

"Next thing I know, I got phone calls at my job from two other places. 'Oh, we're depositing money in your bank account the next day.' "—*New York online borrower*

"It's very confusing … because you don't know where they're coming from. You know, I get a call and it's like, yeah, I didn't even talk, like I never even went to your website, how do you have my [information]?"—*Manchester, New Hampshire, online borrower*

"Don't give me something I didn't ask for. I mean … I'm going to take it, but don't be calling me and saying, 'Oh, you just got approved for another $300' that I don't really need. Because it's like setting me up to being more in debt than I already am."—*New York online borrower*

Bank account problems

Online lending also places consumer bank accounts at risk. Borrowers report overdrafts, unauthorized transactions, and the loss of accounts as a result of online lending practices.

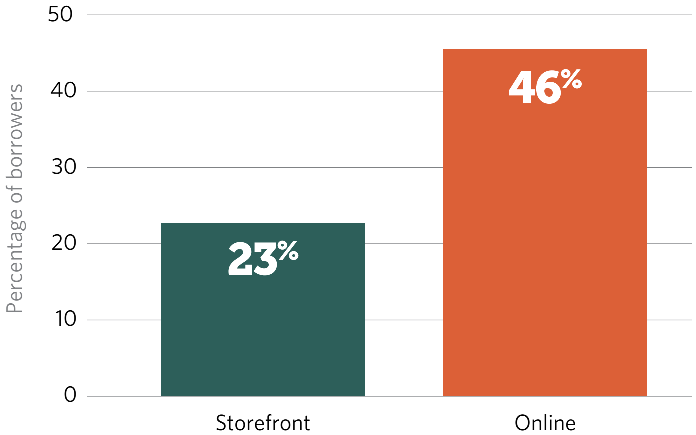
Overdrafts

Nearly half (46 percent) of online borrowers report that their bank accounts were overdrawn by payday lenders' withdrawals, twice the rate among storefront borrowers.[55] (See Figure 5.)

Figure 5

Nearly Half of Online Borrowers Report Withdrawals Causing Overdrafts

Online borrowers are twice as likely as storefront borrowers to report overdrafts



Note: Storefront borrowers were asked, "I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about: Had a payday lender attempt to make a withdrawal that overdrew your bank account. Has this happened to you or not?" Online borrowers were asked, "I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about: Had an online payday lender make a withdrawal that overdrew your bank account. Has this happened to you or not?"

Source: Analysis of The Pew Charitable Trusts' survey data

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Online Loan Payments Lead to Overdrafts and Fees

"I had to pay insufficient funds on top of that, so if a payment got returned to them, I had to pay for insufficient funds. Then they charged me $30 for a returned check, and that wasn't in the bank. I had to worry about insufficient funds for that. So they kept on hitting my account like at least 10 times in one week."—*New York online borrower*

"Direct deposit comes in. Might, if I'm lucky, zero out the checking account, but then they come back, you know, and they tap their next payment. And they all get returned. ... I had one account that closed."—*Manchester, New Hampshire, online borrower*

"I got in a situation where people were taking money out of my account without me knowing ... and they were taking money out, just kept taking extra money out. ... I didn't know nothing about it, but my bank stopped them. ... They were like, 'You're having all this money coming out, and you don't have this money in your account, so what's going on here?' ... I had to switch banks."—*New York online borrower*

Unauthorized transactions

Unauthorized withdrawals are another common problem associated with online lending. One in three borrowers reported an unauthorized withdrawal from a checking account in connection with an online payday loan.[56] (See Figure 6.) This figure is distinct from overdrafts caused by lenders' withdrawals. Online borrowers are at especially high risk of unauthorized withdrawals because their bank accounts are exposed to lenders and others who buy their information.[57]

Similarly, some online borrowers report that loan funds were deposited to their accounts unexpectedly or from unknown companies. One-fifth of borrowers received loans or other products (such as memberships or prepaid cards) they did not authorize.[58] Others described receiving loans after submitting applications but before consenting to the terms. The FTC and state regulators have taken action against some companies that withdrew money from borrowers' accounts without justification or as payment for unwanted products.[59]

Figure 6

Online Borrowers Report Unauthorized Withdrawals and Loan Originations

1 in 3 had money withdrawn without giving permission

32% Had money withdrawn from bank account without you authorizing it

20% Received a loan or product that you did not apply for or authorize

Note: Online borrowers were asked: "Now I'm going to read you another list of things that some people who took out online payday loans say happened to them. For each one I read, please tell me whether it has happened to you in connection with an online payday loan. How about: Had money withdrawn from your bank account without you authorizing it. Has this happened to you or not? How about: Received a loan or product that you did not apply for or authorize? Has this happened to you or not?" These questions were not asked of storefront borrowers, but there are few allegations of these types against storefront lenders.

Source: Analysis of The Pew Charitable Trusts' survey data

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Unwanted Loans, Undisclosed Fees

"Somebody actually supposedly enrolled me in like a payday loan insurance plan and charged me like $80 one day, which at the time put my account to the negative. So I went to the bank and they had to reimburse everything."—*Manchester, New Hampshire, online borrower*

"I applied for one, and it wasn't guaranteed I was going to get it, and they charged my account $20, and I didn't get the loan."—*New York online borrower*

"They're calling me to this day. I ended up closing my [bank] account because there's so many hidden fees."—*Houston online borrower*

"[N]ot every payday loan actually provides you with the terms enclosed with the application. The moment you submit the applications, you're already getting phone calls. So whoever intercepts you and gives you the loan, they email you the terms. And by that time, you already have the money in the bank, and you can't say, 'I don't want it,' because they're not going to take the money back."—*New York online borrower*

"We took some money out for some kind of membership. … Like a $29.95 membership fee."
—*New York online borrower*

Closed bank accounts

In Pew's survey, one-fifth of online borrowers report that banks closed their accounts or that they did so themselves because of online payday loans. One-sixth specifically reported closing accounts to prevent online lenders from withdrawing money. (See Figure 7.) By comparison, 1 in 10 storefront borrowers closed or lost a bank account for these reasons. Although some account closures occur because borrowers are unable to keep up with scheduled payments or choose not to repay loans, they also result from unauthorized withdrawals. A consumer alert from California's Department of Corporations warns borrowers, "Some lenders may deposit funds before the consumer agrees to the loan and then begin drawing funds from the consumer's account for repayment. This has led many consumers to close bank accounts to avoid more unauthorized withdrawals."[60]

Figure 7

22% of Online Borrowers Have Lost Bank Accounts Because of Online Payday Loans

12% Bank account closed by the bank because of an online payday loan

16% Consumer closed a bank account to prevent a lender from taking money

22% Had either of these happen

Note: "I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about: Had a bank account closed by your bank because of an online payday loan/Closed a bank account yourself to prevent an online payday lender from taking money out of it. Has this happened to you or not?"

Source: Analysis of The Pew Charitable Trusts' survey data

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But closing a bank account is not necessarily sufficient to prevent online lenders or others who have purchased borrower information from making withdrawals. Some lenders claim the right to access any borrower account they can identify, not just the one associated with the loan, and list some version of this practice in their terms and conditions. For example, one lender states: "If we extend credit to a consumer, we will consider the bank account information provided by the consumer as eligible for us to process payments against. In addition, as part of our information collection process, we may detect additional bank accounts under the ownership of the consumer. We will consider these additional accounts to be part of the application process and eligible for payment retrieval."[61]

Even if lenders do not use these techniques or if the borrower's bank does not allow them, closing an account still may not stop unwanted withdrawals or fees. In some instances, banks have reopened accounts closed by consumers and processed lender-initiated transactions; these are known as "zombie" accounts.[62] Borrowers who bank at institutions that allow these transactions may experience withdrawals and incur substantial insufficient-funds fees or other charges. Although some banks have announced plans to correct this problem voluntarily, consumers remain vulnerable in the absence of stronger regulatory protections against harmful repayment or collections practices.

Lost Bank Accounts

The online payday lender "is trying to charge me $790 when he was trying to withdraw money from my account, and that time I wasn't working, and I had to close my checking account. They were still charging my checking account."—*New York online borrower*

"I was told by my bank there was really no way that I can stop them from taking it out. … They closed that account, and they opened up another one."—*St. Louis online borrower*

"I actually talked to a debt-consolidating place, which I hadn't done yet, but he said, 'First off, you have to get a hold of your own, gain control of your own situation.' He says, 'Change your checking account number,' and that's what I did."—*Manchester, New Hampshire, online borrower*

"I closed off my account because they were taking out more than they should have taken out, without my permission."—*Manchester, New Hampshire, online borrower*

Customer complaints about payday lending

Pew obtained payday loan complaint data from the Better Business Bureau (BBB).[64] The BBB does not specify whether a loan was obtained at a retail store or online, but Pew was able to verify the channel for 99 percent of 4,018 complaints made against payday lenders in 2011.[65]

Although storefront payday lenders represent about two-thirds of the overall market, they accounted for just 1 in 10 complaints.[66] The vast majority—89 percent—of complaints were against online lenders, and most concerned a small group of companies operating through multiple websites.[67]

Ten parent companies received 61 percent of the complaints, and one company, AMG Services (also known as CLK Management), accounted for 33 percent. (See Table 3.)

Table 3

89% of Payday Loan Consumer Complaints Are About Online Lenders

10 lenders receiving the most complaints in 2011

Business	Percentage of total complaints
AMG Services	33
Cash America International Inc.	5
Global Payday Loan LLC	4
CMG Group LLC	3
SSM Group LLC or Summit Group LLC	3
EZ Loan Protection	3
Funds Direct	3
ACE Cash Express	2
SCS Processing LLC	2
Lenders International	1
TOTAL	61*

* Complaints add to 61 percent instead of the expected 59 percent because of rounding.

Sources: Better Business Bureau (2012), The Pew Charitable Trusts (2014)

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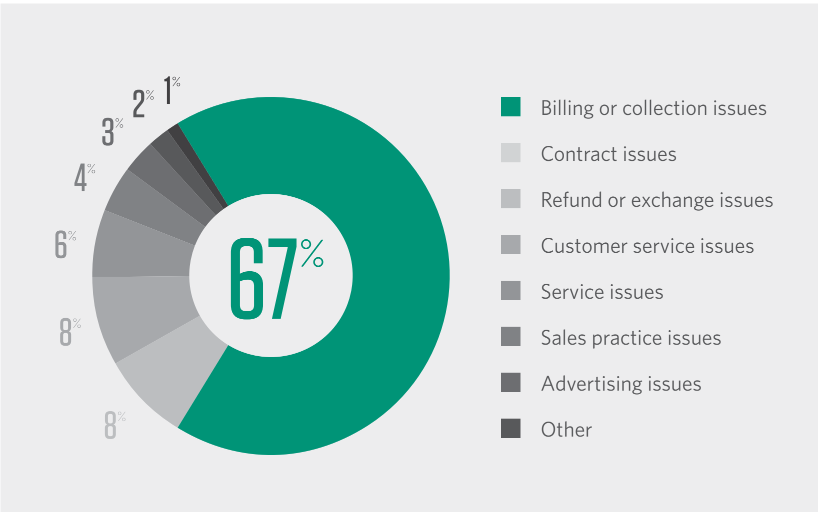
Borrowers cited “billing or collection issues” in 2 of 3 complaints against payday lenders. (See Figure 8.) Under the BBB’s reporting framework, this category includes unauthorized credit card charges or bank debits, failure to explain or substantiate charges, failure to correct billing errors, and improper collection practices.[68] These complaint data mirror the concerns that focus group and survey participants expressed about fraudulent or unexpected charges and aggressive collections behavior in the online payday loan market.

Figure 8

Billing and Collection Problems Drive Consumer Complaints About Online Payday Loans

Borrower complaints by type, 2011-13



Note: "Billing or collection issues" include failure to correct billing errors, unauthorized credit card charges or bank debits, failure to provide itemized billing as requested, failure to substantiate charges, improper collection practices, or other credit, billing, or collection issues. These results include all payday loan complaints that have a type noted. Approximately 29 percent of complaints did not have a designated type. The "other" category includes guarantee or warranty, repair, delivery, and product issues.

Sources: Better Business Bureau (2011-13)

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Proponents of storefront payday loans have argued that additional regulation would drive borrowers online. However, data indicate that rates of Internet borrowing are similar across states that have storefront lenders and those that do not. (See "Payday Lending Regulation Does Not Lead to Increased Online Borrowing," Page 20.) Consistent with this finding, the BBB data indicate that rates of payday loan complaints are also about the same in each state grouping and are similar to each state grouping's population as a percentage of the nation as a whole.[69] (See Table 4.)

Table 4

States That Limit Payday Stores Do Not Have Substantially More Complaints

Consumer complaints by state regulation type, 2011-13

		Restrictive	Hybrid	Permissive
Share of U.S. population residing in each state group		**29%**	**17%**	**54%**
Share of payday loan complaints	**2011**	29%	14%	57%
	2012	30%	17%	53%
	2013	31%	16%	53%

Note: Restrictive states are those that have no payday loan storefronts. Permissive states allow single-repayment loans with APRs of 391 percent or higher. Hybrid states have payday loan storefronts but maintain more exacting requirements, such as lower limits on fees or loan usage, or longer repayment periods.

Sources: Better Business Bureau (2011-13) and U.S. Census Bureau's July 1, 2012 estimate (http://www.census.gov/popest/data/state/totals/2012). Analysis and categorization by The Pew Charitable Trusts.

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Payday Lending Regulation Does Not Lead to Increased Online Borrowing

Research demonstrates that, despite concerns that restricting access to storefront payday loans might drive consumers to less-regulated markets such as the Internet, lower storefront usage is not associated with substantially higher online borrowing. The first report in this series, *Who Borrows, Where They Borrow, and Why*, demonstrated that overall payday loan usage rates are sharply lower in states without stores and that the rate of online borrowing in those states is similar to that in states that do not restrict in-store lending. (See Table 5.) Data also show that people use loans at much higher rates when they are very aware of the loans' availability and when the lenders are convenient or trusted sources. For example, payday loan adoption rates at banks far exceed those at stores or online. (See Figure 9.)

Table 5

Method of Acquiring Payday Loans by State Law Type

Percentage of adults reporting payday loan usage in the past 5 years

	Borrow from storefront only	Borrow from online or other	Number of interviews
National	4.01%	1.48%	33,576
Permissive states	5.22%	1.37%	17,881
Hybrid states	5.06%	1.28%	5,565
Restrictive states	1.29%	1.58%	10,130

Note: Online or other represents all borrowers who have indicated online usage (including those who have borrowed both online and from a storefront), plus usage from other lenders that may include banks, credit unions, or employers, among others. Results are reported to two decimal places, but this reporting is not intended to imply such a detailed level of precision. Rather, two decimal places are used in order to avoid inaccurate calculations between groupings that could be caused by rounding. Because of sampling error, it is possible that the true level of usage in any of these groupings is slightly higher or lower. Restrictive states are those that have no payday loan storefronts. Permissive states allow single-repayment loans with APRs of 391 percent or higher. Hybrid states have payday loan storefronts, but maintain more exacting requirements, such as lower limits on fees or loan usage, or longer repayment periods. Data represent percentage of adults in each category who report having used a payday loan in the past five years. Results are based on 33,576 interviews conducted from August 2011 through December 2011.

Source: The Pew Charitable Trusts (2012)

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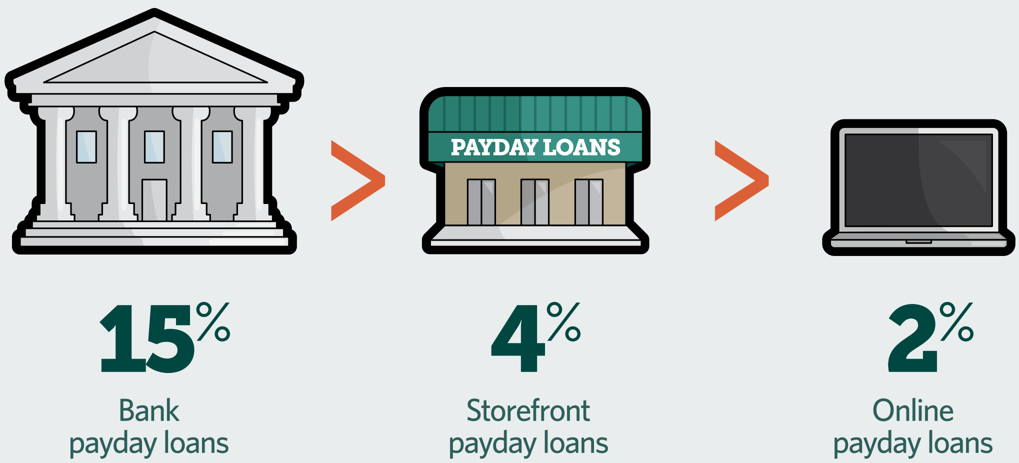
Figure 9

The More Mainstream the Lender, the More Likely People Are to Borrow

Percent of eligible customers using loans, by lender type



Note: At banks, eligible customers were those who had a checking account for at least several months, had direct deposit, had an account in good standing, and in some instances met an additional requirement.

Sources: Consumer Financial Protection Bureau (2013), The Pew Charitable Trusts (2012)

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Compliance strategies and regulatory responses

Online lenders have pursued several strategies for complying—or not—with the laws of states where their customers reside. Citing concerns about potential consumer harm or illegal activity, various states and the federal government have increased their scrutiny of online lending in recent years. However, because of legal and practical challenges, regulators have sometimes struggled to adapt to the growth of online lending.

Licensing and compliance with state law

Payday loans are primarily regulated at the state level, and generally all lenders must maintain licenses in states where they make loans.[70] Some online lenders have complied, but others have not, arguing that individual state licensing is not necessary. The four models employed by lenders are single-state license (20 percent of online lenders, per industry estimates), multistate license (30 percent), sovereign nation partnership (30 percent), and offshore incorporation (20 percent).[71]

The 'rent-a-bank' or 'rent-a-charter' model

One of the early models used by some lenders involved partnering with a national bank located in a state with permissive regulations, such as South Dakota, Utah, or Delaware.[72] The National Bank Act allows a nationally chartered bank to export the interest rate of its home state into other states, so lenders partnered with these banks in an attempt to "rent" the bank's charter and circumvent state usury laws.[73] But strict guidelines issued by the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corp. from 2000 to 2006—as well as several enforcement actions—rendered this model obsolete.[74]

Single-state license model

Online lenders using a single-state license model incorporate in a state with permissive lending laws and, as with the rent-a-bank model, attempt to circumvent rate caps in more restrictive states by effectively exporting the interest rate rules of their home states. Proponents of this model claim that "choice of law" principles (selecting one state's law to follow) justify these practices for those doing business via the Internet.[75] Regulators in some states have sent cease-and-desist letters or sought enforcement actions against online lenders using this model, arguing that the loans are illegal because the lender lacks the proper license or its practices violate state law.[76] A recent court case in New York found that states have jurisdiction over online loans made to their citizens and that lenders do not have the right to collect interest charged in violation of state limits.[77] State attorneys general from Illinois and Arkansas, among others, have also filed lawsuits against online lenders charging them with violating state usury laws.

Licensing in multiple states

Lenders using the multistate licensing model obtain separate licenses in all of the states where they do business. Some of the largest storefront lenders employ this model and offer online loans in the same states where they operate stores.[78] Depending on state law, lenders may also function as brokers and partner with third parties to fund loans or sell leads to other lenders. In some cases, lenders operate under a statute other than the one intended for payday loans. For example, in Ohio, payday lenders are licensed as credit service organizations,[79] and in Texas, they are technically credit access businesses.[80] As noted earlier, companies using this model generally are not implicated in the types of illegal practices described in this report.

Claiming Native American tribal immunity

The most recent model to emerge involves lenders claiming sovereign immunity from state or federal laws on the basis of affiliation with a Native American tribe.[81] However, it is often not clear whether the tribe is sufficiently involved in the ownership or operation of the lending business to justify such claims.[82] In many cases, a nontribal lender partners with and pays a small share of its proceeds—as little as 1 percent—to a tribe for the privilege of claiming immunity.[83] Online lenders have used these tactics to make loans that otherwise are not permitted under the state laws where borrowers reside.[84] Critics have dismissed this model as a "rent-a-tribe" arrangement driven by nontribal interests.[85]

Offshore or overseas incorporation

Lenders that incorporate offshore are a persistent concern at the state and federal levels. Like lenders that claim tribal affiliation, overseas operators sometimes assert that they are exempt from state licensing and regulatory requirements.[86] Because such lenders maintain no official presence in a state, it is often difficult for borrowers and regulators to identify or contact the lender directly. In some instances, payday lenders have allegedly claimed to be located offshore but in fact had offices in the United States.[87]

Regulatory action

In recent years, officials in several states have sought more control over online lending either by taking legal action to halt noncompliant lenders' activities or by requiring lenders to register with state regulators. These efforts have triggered disputes about the nature and scope of states' authority over online lending. For example:

State action

Regulators in Arkansas, Colorado, Illinois, Maryland, Minnesota, New York, North Carolina, Vermont, Washington, and West Virginia have been at the forefront of efforts to stop online lenders from making loans that do not comply with state law:

- In New York, Benjamin Lawsky, superintendent of financial services, brought several enforcement actions against online payday lenders in the state. In August 2013, he issued cease-and-desist orders to 35 online lenders and sent letters to 117 banks and the National Automated Clearing House Association (NACHA, the private, nonprofit regulatory body that helps oversee the electronic payments system). In the letters, he asked them to help develop safeguards to prevent abuse of the electronic payments system and to discourage noncompliant loans.[88] In April 2014, Lawsky sent cease-and-desist letters to 20 additional companies, 12 of which were allegedly using debit cards to make loans to consumers that did not comply with state law.[89]
- Arkansas's attorney general has sued numerous online payday lenders to prevent them from offering loans to or collecting payments from state residents where the loans violate the state's usury interest rate cap.[90]
- Minnesota's attorney general and commissioner of commerce have taken action against lenders who allegedly claimed tribal affiliation to evade state interest rate laws and licensure requirements.[91]
- Illinois' attorney general sued lenders whose loans allegedly did not comply with the state's interest rate limits and a lead generator that sold residents' names to those companies.[92]
- Vermont's attorney general issued letters to broadcasters and payment processors in April 2014, notifying them that showing advertisements or processing payments for prohibited loans is illegal in Vermont.[93]

Some lenders do not make loans in these or other states because of efforts by regulators or law enforcement officials.[94]

Court decisions

In some cases, online lenders claimed that they did not have to follow the laws of all the states where they lend. These companies have challenged the authority of state officials to regulate their activities, raising legal questions that courts continue to address. For example, a 2008 federal appeals court decision held that an out-of-state lender was subject to Kansas law when making loans to that state's residents via the Internet.[95] Similarly, a federal court ruled that a tribally affiliated lender could not invoke sovereign immunity to make online loans to New York residents that did not comply with state law.[96] But a California court ruled that the state's financial regulator lacked jurisdiction over a group of lenders legitimately operating as arms of Native American tribes.[97]

Federal action

"Rent-a-bank" partnerships were not widely used by online lenders because guidance from federal regulators on this model predated the rise of Internet payday lending.[98] In 2013, guidance from the Office of the Comptroller of the Currency and FDIC also emphasized that banks are responsible for third-party relationships and that payday-type loans from banks must be rigorously underwritten, further discouraging banks from acting as payday lenders.[99] Other lenders have attempted to use prepaid debit cards as a vehicle for partnering with banks to provide payday-like loans that may not comply with state laws, but banks have ceased involvement in these practices because of safety and soundness concerns from federal regulators.[100]

The Department of Justice has pursued action against banks that served as access points to the electronic bank payments system for online payday lenders engaging in allegedly fraudulent practices or making loans that violated state laws.[101] The department alleged that Four Oaks Bank played this role for a payment processor servicing more than 20 online payday lenders. A federal judge approved a settlement in April 2014 that required tight restrictions on Four Oaks' ability to do business with online lenders whose debits are returned as unauthorized more than 0.5 percent of the time.[102]

The FTC has taken a number of actions against payday lenders, focused mostly on the areas of debt collection, unauthorized withdrawals, wage garnishment, and undisclosed costs.[103] A U.S. district judge ruled in March 2014 that the FTC's jurisdiction also includes lenders claiming tribal affiliation.[104]

- In one case, the FTC took action to stop a company's debt collection practices in which employees allegedly falsely accused consumers of fraud, told consumers they worked with the government, and threatened lawsuits and arrest if debts—many of which were originally payday loans—were not repaid.[105]
- The FTC and the state of Nevada have alleged that certain online payday lenders used "unfair and deceptive collection tactics" of the sort described earlier in this report. (See Page 9.) The FTC contended that lenders "repeatedly called consumers at work using abusive and profane language" and "improperly disclosed consumers' purported debts to third parties."[106]
- In another case, callers allegedly "threatened that consumers could be arrested, prosecuted, or imprisoned for failing to pay."[107]
- In several cases, the FTC took action against companies that allegedly made unauthorized withdrawals from the checking accounts of people who had applied for online payday loans, or billed them for prepaid cards they had not purchased.[108]

The Consumer Financial Protection Bureau, which has broad authority to regulate payday lending, sued online lender CashCall in December 2013 for allegedly collecting on loans that were void in at least eight states and were made by a lender claiming tribal affiliation.[109] The CFPB also issued a civil investigative demand (subpoena) to online payday lenders claiming tribal affiliation and rejected a petition to set it aside based on the sovereignty claims.[110] And in July 2014, the bureau took enforcement action against ACE Cash Express, a payday lender with both storefront and online operations, alleging that it engaged in some of the types of illegal harassment and debt collection tactics described in this report. ACE entered into a consent order with the bureau and agreed to pay $10 million in refunds and penalties.[111]

Bank actions

Online operators depend on the ability to access a borrower's checking account directly through the use of electronic debit authorization. The Electronic Fund Transfer Act does not permit lenders to condition credit on granting access to a checking account for multipayment loans, but lenders generally make it more administratively difficult to obtain a loan via other means.[112] Borrowers who decline to grant access will receive their loan proceeds far later.[113] Therefore, consumers' banks and the Automated Clearing House system play a crucial role in enabling online payday lending.

Recently, banks have taken steps to protect accountholders, and the payments system itself, and have acted to limit their relationships with payday lenders.[114] JPMorgan Chase announced last year that it would make it easier for customers to stop unwanted or unauthorized withdrawals and close accounts, even if lenders continue to attempt to debit the accounts. It also reportedly began limiting customers' returned-item fees to one per lender in a 30-day period.[115]

NACHA's voting membership approved rule changes in August 2014 to improve the ACH system by reducing the number and costs of returned payment requests. The rule limits access by companies whose attempted withdrawals are declined at a rate over 15 percent, or 10 times that of typical companies (1.42 percent).[116] The recent Justice Department case against Four Oaks Bank identified 13 payday lenders with return rates exceeding 30 percent, meaning at least that share of attempted customer account debits were being returned unpaid.[117]

The approved amendments also lower the return rate threshold for unauthorized debits (for example, fraudulent transactions). By establishing these standards, the rule makes it harder for all merchants, including online lenders and debt collectors, to debit consumers' checking accounts in an aggressive or abusive fashion, and banks will continue to be held accountable if their merchant customers exceed allowable thresholds.[118] Although evidence suggests that some merchants will move outside the ACH system to avoid such safeguards, the NACHA rules will significantly improve the safety and fairness of the electronic payments system.[119]

In light of the evidence of widespread fraud and abuse in the online lending market, actions to protect the electronic payments system and the depositors who use it are justified. Otherwise, consumer bank accounts will remain vulnerable, and overall trust in banks and the payments system could be threatened. As NACHA explained in its proposal, the changes "are expected to improve the overall quality of the ACH Network by reducing the incidence of returned Entries and their associated costs, both financial and reputational, that such returned Entries impose on the ACH Network and its participants. These changes also are expected to increase customer satisfaction with the ACH Network by reducing the volume of transactions subject to customer dispute."[120]

Policy recommendations

Responding to the harmful practices associated with Internet payday lending will require ongoing efforts to identify and stop fraudulent or abusive practices. Regulators, banks, and industry associations such as NACHA will continue to play an important role in frustrating the efforts of bad actors. More broadly, new regulatory guidelines are required to ensure that the loan products are safer and more transparent. Pew renews its call for regulators—most urgently the Consumer Financial Protection Bureau—to enact the following core policy principles, which are designed to cover all small-dollar cash loans, including storefront payday loans, online payday loans, and similar installment loans from banks and nonbanks:

1. **Ensure that the borrower has the ability to repay the loan as structured.** Pew's research indicates that for most borrowers, monthly payments above 5 percent of gross monthly income are unaffordable. Regulators should treat frequent refinancing or high default rates as evidence of unaffordability and poor underwriting.

2. **Spread loan costs evenly over the life of the loan.** Front-loading of fees and interest creates incentives for lenders to refinance loans and extend overall indebtedness. Any fees should be paid evenly over the life of the loan. Loans should have substantially equal payments, each of which reduces the principal, amortizing smoothly to a zero balance.

3. **Guard against harmful repayment or collections practices.** Borrowers need stronger rights to protect their checking accounts against unscrupulous lenders or debt collectors, and banks should be held more accountable for honoring their customers' requests to stop payments or cancel automatic electronic withdrawals.

4. **Require concise disclosures of periodic and total costs.**

5. **Continue to set maximum allowable charges.** Research shows loan markets serving those with poor credit histories are not price competitive.

For detailed policy recommendations, see The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), pages 44-7, available at www.pewtrusts.org/small-loans.

Conclusion

The online lending marketplace shares many of the problems observed in the storefront payday lending industry, including unaffordable payments, a gap between loans' packaging and borrowers' experiences, and extremely high prices. But online borrowers report additional problems with threats, abuses, unwanted products, unauthorized withdrawals from checking accounts, and dissemination of personal information. Thirty percent of borrowers report receiving threats that they will be arrested or that their family, friends, or employers will be contacted regarding their online payday loans.

Online lending has also placed borrower checking accounts at risk: 46 percent of borrowers report experiencing overdrafts; 32 percent report unauthorized withdrawals in connection with loans; and 22 percent report losing or closing bank accounts because of online loans. These problems are far more common with online than storefront loans.

Although the Internet has the potential to bring down loan costs through a lower-overhead business model, that potential has not been realized in the deep subprime small-loan marketplace. Instead, payday loans usually cost more online than at stores, and the prices charged often violate state laws, both in states without payday loan stores and in many that have them.

The abusive practices described in this report are concentrated among the approximately 70 percent of lenders that are not licensed by all the states where they lend. Some state regulators and attorneys general have sought to enforce laws against online lenders that are not licensed in their states, but they face significant challenges to their jurisdiction and their reach.

To address these problems, federal regulators, particularly the Consumer Financial Protection Bureau, should expand their efforts to enforce relevant laws, protect consumers, and ensure the soundness of the banking and electronic payment systems. They should also undertake new efforts to establish strong, clear guidelines for the small-dollar lending market as a whole. Banks, credit unions, finance companies, online lenders, and the next generation of innovators need clear and consistent rules. Beyond merely banning harmful practices, these rules should establish the principles of responsible lending and fair play. The CFPB has a historic opportunity to create these rules and to promote the safest and most competitive small-dollar loan market possible.

Appendix A: Borrower demographics

As shown in Table A.1, people who borrow money online tend to have different demographic characteristics from those who borrow via payday loan stores. For example, online borrowers have higher incomes, averaging $30,000 to $40,000, with one-third earning more than $50,000.

Table A.1

Online and Storefront Payday Loan Borrowers Are Different

Internet borrowers earn more, have more education, and are younger than storefront borrowers

Demographic group	Percentage of storefront borrowers	Percentage of online borrowers
Homeowners	39	45
Renters	59	55
Single	38	46
Married	32	32
Separated/divorced	26	20
Widowed	3	2
Less than $15,000	24	16
$15,000 to $24,999	25	20
$25,000 to $29,999	10	8
$30,000 to $39,999	13	13
$40,000 to $49,999	8	7
$50,000 to $74,999	8	15
$75,000 to $99,999	4	9
$100,000 or more	4	10
African-American	23	26
Hispanic	14	12
White	57	49
Other race or ethnicity	5	10
Female	53	54
Male	47	46
Ages 18-34	39	43
Ages 35-49	33	38
Ages 50-64	20	16
Ages 65+	8	3
Nonparent	61	66
Parent	39	34
Less than high school	17	7
High school	40	23
Some college	30	40
College or more	12	29

Notes: The 4 percent of borrowers who have used both storefront and online payday loans are counted in both columns. The 7 percent of borrowers who have taken payday loans only from other sources, such as banks or employers, and the 1 percent who declined to state which method they used are excluded from this section. Results are based on 33,576 interviews conducted from August through December 2011, including 1,855 payday loan borrowers. For demographic data on all payday borrowers, see Page 35 of the first report in this series, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), available at pewtrusts.org/small-loans.

Source: Analysis of The Pew Charitable Trusts' survey data

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Appendix B: Methodology

Opinion research

Findings in this report are based on a survey conducted among storefront payday loan borrowers and online payday loan borrowers. The sample for this survey was compiled during eight months of screening on a nationally representative weekly survey. Borrower quotations in this report come from a series of focus groups with small-loan borrowers.

Survey methodology

Social Science Research Solutions (SSRS) omnibus survey

The Pew small-dollar loans project contracted with SSRS to conduct the first nationally representative in-depth telephone survey with payday loan borrowers about their loan usage. To identify and survey a low-incidence population such as payday loan borrowers, SSRS screened 1,000 to 2,000 adults per week on its regular omnibus survey, using random-digit dialing (RDD) methodology, from August 2011 to April 2012. The term "omnibus" refers to a survey that includes questions on a variety of topics. This survey probably minimized payday loan borrowers' denial of their usage of this product, because the omnibus survey included mostly nonfinancial questions purchased by other clients, and the payday loan questions were asked after other, less sensitive questions, giving interviewers a chance to establish a rapport with respondents.

The first phase of the research, to identify payday borrowers, asked respondents to the omnibus survey whether they had used a payday loan. If, during the months of August through mid-December, respondents answered that they had used a payday loan, they were placed in a file to be re-contacted later. Once the full-length survey was ready to field, people who had used a payday loan were then given the full-length survey and were paid an incentive of $20 to maximize participation. Because of their relative scarcity in the population, online payday loan borrowers were given an incentive of $35 for participating.

Respondents were told about the compensation only after having indicated that they had used a payday loan. Further, online payday loan borrowers who were identified during the early months of screening were sent a letter with a $5 bill informing them that they would be contacted again to take the full-length survey. The second phase of the research involved re-contacting all respondents who answered that they had used a payday loan and immediately giving the full-length survey to anyone newly identified in the weekly omnibus survey as a payday loan borrower.

Sample and interviewing

In the first phase of the survey, the Pew small-dollar loans project purchased time on SSRS' omnibus survey, EXCEL, which covers the continental United States. Analysis of the incidence of payday borrowing was conducted after 33,576 adults had been screened and answered a question about payday loan usage. An additional 16,108 adults were screened in order to find a sufficient number of storefront payday loan, online payday loan, and auto-title loan borrowers to complete a 20-minute survey about their usage and views, for 49,684 people in total to complete the research. Sampling error for those incidence estimates from the omnibus survey of borrowers is plus or minus 0.24 percentage points.

In the second phase, a total of 451 adults completed the full-length storefront payday loan survey, and 252 adults completed the full-length online payday loan survey, for a total of 703 payday borrowers. Sampling error for the full-length survey of payday borrowers is plus or minus 4.2 percentage points. Sampling error for the full-length survey of storefront payday loan borrowers is plus or minus 4.6 percentage points, and it is plus or minus 6.2 percentage points for the full-length survey of online payday loan borrowers.

EXCEL is a national weekly, dual-frame bilingual telephone survey. Each EXCEL survey consists of a minimum of 1,000 interviews, of which 300 interviews were completed with respondents on their cellphones and at least 30 were conducted in Spanish, ensuring unprecedented representation on an omnibus platform. Completed interviews are representative of the continental U.S. population of adults 18 and older. EXCEL uses a fully replicated, stratified, single-stage RDD sample of landline telephone household and randomly generated cellphones. Sample telephone numbers are computer-generated and loaded into online sample files accessed directly by the Computer-Assisted Telephone Interviewing (CATI) system. Within each sample household, a single respondent is randomly selected. Details about EXCEL and its weighting are available at: http://www.pewtrusts.org/~/media/Assets/2012/07/19/Pew_Payday_Lending_Methodology.pdf.

Question wording: Omnibus survey

Wording for omnibus survey questions is available at http://www.pewtrusts.org/~/media/Assets/2012/07/19/Pew_Payday_Lending_Methodology.pdf.

Screening phase (measuring incidence and compiling sample for callbacks):

- In the past five years, have you used payday loan or cash advance services, where you borrow money to be repaid out of your next paycheck?
- And was that physically through a store, or on the Internet?

Re-contact phase (calling back respondents who answered affirmatively and identifying additional borrowers to take the full-length survey immediately):

- In the past five years, have you or has someone in your family used an in-person payday lending store or cash advance service?

Question wording: Full-length survey of storefront and online payday loan borrowers

The data from the nationally representative, full-length survey of 451 storefront payday loan borrowers and 252 online payday loan borrowers are based on responses to the following questions, which Pew designed with assistance from SSRS and Hart Research Associates. Other questions from this survey have been published in previous reports. The sample for this telephone survey was derived from the RDD omnibus survey. All questions also included “Don’t know” and “Refused” options that were not read aloud.

Survey questions

(Online)

Have you ever taken out an online payday loan that was set up to ONLY withdraw the fee or have they always been set up to withdraw the full amount?

1 Always set up to withdraw the full amount.

2 Set up to only withdraw the fee.

3 (DO NOT READ) Both/depends.

D (DO NOT READ) Don't know.

R (DO NOT READ) Refused.

(Online)

And could you request online that the full amount be withdrawn, or did you need to make the request by phone?

1 Could request online.

2 Had to request by phone.

3 (DO NOT READ) Either/both.

D (DO NOT READ) Don't know.

R (DO NOT READ) Refused.

(Storefront)

I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about (INSERT)?

a. Been threatened with arrest in connection with a payday loan.

b. Had someone threaten to contact your friends or family about your payday loan.

c. Had a bank account closed by your bank because of a payday loan.

d. Had a payday lender attempt to make a withdrawal that overdrew your bank account.

e. Had someone threaten to contact your employer about your payday loan.

f. Closed a bank account yourself to prevent a payday lender from taking money out of it.

Has this happened to you or not?

1 Has happened.

2 Has not happened.

3 (DO NOT READ) Does not apply.

D (DO NOT READ) Don't know.

R (DO NOT READ) Refused.

(Online)

I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about (INSERT)?

a. Closed a bank account yourself to prevent an online payday lender from taking money out of it.

b. Had a bank account closed by your bank because of an online payday loan.

c. Had an online payday lender make a withdrawal that overdrew your bank account.

Has this happened to you or not?

1 Has happened.

2 Has not happened.

3 (DO NOT READ) Does not apply.

D (DO NOT READ) Don't know.

R (DO NOT READ) Refused.

(Online)

Now I'm going to read you another list of things that some people who took out online payday loans say happened to them. For each one I read, please tell me whether it has happened to you in connection with an online payday loan. How about (INSERT)?

a. Been threatened with arrest in connection with an online payday loan.

b. Had someone threaten to contact your friends or family about your online payday loan.

c. Received a loan or product that you did not apply for or authorize.

d. Had someone threaten to contact your employer about your online payday loan.

e. Had money withdrawn from your bank account without you authorizing it.

f. Had your personal or financial information sold to a third party without your knowledge.

g. Been contacted about a debt you did not actually owe.

Has this happened to you or not (in connection with an online payday loan)?

1 Has happened.

2 Has not happened.

3 (DO NOT READ) Does not apply.

D (DO NOT READ) Don't know.

R (DO NOT READ) Refused.

Focus group methodology

Hart Research Associates and Public Opinion Strategies conducted three focus groups that were exclusively composed of online payday loan borrowers. The groups met in New York City and Manchester, New Hampshire, in September 2011. In May 2014, Pew also conducted four focus groups in St. Louis and four focus groups in Houston with people who had used small-dollar loans, including several people who had used online payday loans. All participants were recruited by employees of the focus group facilities. All groups were conducted in person, lasted two hours, and included six to 12 participants.

Better Business Bureau complaint data

To determine whether complaints to the Better Business Bureau were made against online or storefront lenders, Pew classified lenders using the methods outlined below. In cases where the lender was online, Pew noted whether the company was a direct lender or a lead generator; however, despite best efforts, it is often difficult to determine whether the company has a lender's license. Payday loan lead generators are companies that obtain consumer information and loan requests to match them with one or more direct lenders operating in their networks. Some companies operate as both lenders and lead generators, meaning that if they are unable to approve consumers for loans, they will provide a match with another lender in their network. A number of companies offer loans both online and through storefront locations and are therefore classified as "both."

Online lenders have at least one of the following attributes:

- A company website stating they are a direct lender or that they will deposit cash directly into the consumer's account.
- Also included in this group are lead generators, but it is noted that they are lead generators and not lenders. Generally, a company's website will explicitly state that it is not a lender but works with lenders to provide loans.
- Also included are any companies that appear to be scams associated with online payday loans. Consumer complaint websites, as well as the BBB, note that a third-party company will charge for a payday loan application fee or other ancillary product when a consumer fills out an online payday loan application. Sometimes the money for the application fee, products, or payday loan protection will be withdrawn from the consumers' accounts without them receiving loan funds. Many of these third-party companies do not have websites and provide only phone numbers or limited contact information on the consumers' deposit account statements or through email.

Storefront locations have at least one of the following attributes:

- Have a website but offer funds in-store only and not online. The website may include the option to fill out the application online and complete the transaction in the store.
- Stores without websites and only a business name and address and/or phone number provided by BBB.

If Pew was unable to determine whether a lender had a website, we searched for the business address provided by the BBB and attempted to verify a physical location through Google Maps. In some cases, we were unable to locate either a valid website or a storefront location. Since complaints are from 2011, it is not unusual to discover that a company no longer exists, or that it is now a subsidiary of a larger parent company and operating under a different name. Thus, using the business name provided by the consumer did not always yield valid results. In addition, many business addresses refer to an office location and not a retail storefront.

If Pew was unable to determine the channel for the payday loan, we also searched online consumer complaint websites and blogs. Using these websites to find business information and complaints against lenders proved useful in determining whether the lenders operated through storefront locations or online, and also whether they were conducting business under additional names.

Endnotes

1 "OLA Best Practices," Online Lenders Alliance, accessed Feb. 25, 2014, http://www.onlinelendersalliance.org/?page=bestpractices.

2 A review of Better Business Bureau data indicates few complaints against some large companies. Further, the Federal Trade Commission has not cited some firms for engaging in the type of illegal practices documented in this report. The Online Lenders Alliance has also supported efforts to crack down on some of the worst online practices. ("OLA Applauds FTC's Action Against Fraudulent Debt Collectors," July 1, 2014, http://www.onlinelendersalliance.org/news/180304/Online-Lenders-Alliance-Applauds-FTC-Action-Against-Fraudulent-Debt-Collectors.htm and "OLA Applauds FTC Ruling Against Payday Loan Bad Actors," Aug. 1, 2013, http://www.onlinelendersalliance.org/news/134958/OLA-Applauds-FTC-Ruling-Against-Payday-Loan-Bad-Actors.htm). LendUp, on its website, also separates itself from bad actors, stating: "It's important to distinguish between reputable payday lenders and those that are looking to sell your personal information or trap you in a cycle of debt." "How do I choose a short-term lender online?" June 16, 2014, https://www.lendup.com/blog/author/Kirk%20Robinson,%20Customer%20Insights.html; John Hecht, "Online Consumer Lending Industry Review: An Industry of Growth, Innovation, and Transition," Stephens Inc., Oct. 14, 2013. Presentation on file at The Pew Charitable Trusts.

3 "U.S. District Judge Finds that FTC Can Sue Deceptive Payday Loan Business Regardless of American Indian Tribal Affiliation," Federal Trade Commission, accessed March 19, 2014, http://www.ftc.gov/news-events/press-releases/2014/03/us-district-judge-finds-ftc-can-sue-deceptive-payday-loan.

4 Dennis Telzrow and David Burtzlaff, *Payday Loan Industry*, Stephens Inc. (2007).

5 "Alternative Financial Services: Innovating to Meet Customer Needs in an Evolving Regulatory Framework," presentation by John Hecht, Stephens Inc., Feb. 27, 2014, http://cfsaa.com/Portals/0/cfsa2014_conference/Presentations/CFSA2014_THURSDAY_GeneralSession_JohnHecht_Stephens.pdf. Applicants must affirmatively consent to grant Automated Clearing House access to receive proceeds and make payments. The exception to this scenario is the rare case in which an applicant declines to grant ACH access for an online installment payday loan. These borrowers must go through a more difficult application process, wait longer to receive the loan proceeds, and initiate the repayments.

6 Telemarketing Sales Rule; Proposed Rule, 78 Fed. Reg. 41200 (July 9, 2013). Evidence suggests that lenders and other merchants sometimes rely on remotely created checks or remotely created payment orders to complete transactions outside the ACH system for the purpose of avoiding its rules designed to limit the frequency of debits on accounts with insufficient funds.

7 Consumer Federation of America, "CFA Survey of Online Payday Loan Websites" (2011), http://www.consumerfed.org/pdfs/CFAsurveyInternetPaydayLoanWebsites.pdf.

8 Advance America, Cash Advance Centers Inc., Form 10-K, fiscal year ending Dec. 31, 2011, 41; Consumer Federation of America, "CFA Survey of Online Payday Loan Websites," August 2011, http://www.consumerfed.org/pdfs/CFAsurveyInternetPaydayLoanWebsites.pdf; David Burtzlaff and Brittny Groce, *Payday Loan Industry*, Stephens Inc. (2011). The storefront figure is based on the 2011 annual (10-K) report filed by the largest storefront payday lender, Advance America. The online figure is based on the $25 per $100 rate reported by Consumer Federation of America and also by Stephens Inc.

9 Advance America, Cash Advance Centers Inc., accessed June 30, 2014, https://www.advanceamerica.net/locations/information/store-6501/OH/43207/39.8942938/-82.9954969/3296-South-High-Street/Columbus. For example, Advance America charges higher fees for online loans than in-store loans in Ohio.

10 For examples, see www.AmericanWebLoan.com and www.EZPaydayCash.com.

11 The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices," April 2014, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/StateRateLimitsFactSheetpdf.pdf. For company examples, see www.CheckIntoCash.com and www.AdvanceAmerica.net.

12 David Burtzlaff and Brittny Groce, *Payday Loan Industry.*

13 In conversations with Pew, several online lenders noted higher loss rates on customers' first loans.

14 David Burtzlaff and Brittny Groce, *Payday Loan Industry.*

15 "The LendUp Ladder," LendUp, accessed June 10, 2014, https://www.lendup.com/en/ladder.

16 Lenders advertise this practice on their websites. For examples, see http://www.mycashadvance.com/faq.aspx#6 and https://www.minutefunds.com/FAQs.html.

17 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 28, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/PewPaydayPolicySolutionsOct2013pdf.pdf.

18 "Cash America Announces the Filing of an Application for the Withdrawal of the Registration Statement of its Wholly-Owned Subsidiary Enova International Inc.," Cash America International Inc., last modified July 26, 2012, http://www.cashamerica.com/

docs/default-source/press-releases-2012/Enova_IPO_Withdrawal.pdf?sfvrsn=0; Neha Dimri, "Cash America Looking to Spin Off Online Lending Business," Reuters, April 10, 2014, http://www.reuters.com/article/2014/04/10/us-cashamerica-divestiture-idUSBREA390RW20140410. The proposal was withdrawn in 2012.

19 Enova International Inc., Form S-1, filed Sept. 15, 2011, http://www.nasdaq.com/markets/ipos/filing.ashx?filingid=7785977.

20 Enova International Inc., Form S-1, filed Sept. 15, 2011, Section 17, operating segment information, F-30. Approximately 16 percent of revenue ($59.2 million) covered marketing, and $50.2 million was spent on administration.

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22 Enova International Inc., Form S-1, filed Sept. 15, 2011, Section 17, operating segment information, F-30, http://www.nasdaq.com/markets/ipos/filing.ashx?filingid=7785977.

23 Advance America, Cash Advance Centers Inc., Form 10-K, fiscal year ending Dec. 31, 2011, http://www.sec.gov/Archives/edgar/data/1299704/000104746912002758/a2208026z10-k.htm; World Acceptance Corporation, Form 10-K, fiscal year ending Dec. 31, 2013, http://www.sec.gov/Archives/edgar/data/108385/000010838514000020/wrld-331201410xk.htm#sB457201A150DD34C2CA1B1B7E63EF27A. Figures obtained by dividing losses by revenue.

24 Paige Marta Skiba and Jeremy Tobacman, "Do Payday Loans Cause Bankruptcy?," Vanderbilt Law and Economics research paper, no. 11-13 (2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266215; Eduardo De La Torre et al. v. CashCall Inc., No. 08-cv-03174-MEJ (U.S. Dist. Ct. N.D.CA. 2014), http://sturdevantlaw.com/wp-content/uploads/2011/11/ECF-220-140730-Order-Re-MSJs.pdf; Michael Anderson and Raymond Jackson, *Perspectives on Payday Loans: The Evidence From Florida* (2010), https://www.veritecs.com/Docs/Perspectives_on_Payday_Loans_%20July_26_2010.pdf; Are Alternative Financial Products Serving Consumers?," hearings on alternative financial products before the Senate Subcommittee on Financial Institutions and Consumer Protection, Day 1, 113th Cong. (2014), statement of Stephanie Klein, director, NetCredit Consumer Lending, see video at 1:00:45: http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.LiveStream&Hearing_id=3fdcfbbe-9681-4a6d-83e5-5d1ace44289c. Among storefront payday loan applicants who meet the preliminary borrowing criteria (typically income, checking account, and references), 78.3 percent were approved by the large lender whose data were studied. As noted in a recent class action lawsuit, online installment lender CashCall Inc. allegedly rejected more than 72 percent of applications during the time frame covered by the lawsuit. Veritec data from Florida similarly indicate that 78 to 82.5 percent of payday loan applicants are approved. In her testimony, Stephanie Klein stated that NetCredit approves 15-20 percent of loan applicants. Additionally, news accounts and public documents indicate that conventional and technologically advanced online lenders reject two-thirds or more of first-time applicants. See, for example, Evgeny Morozov, "Your Social Networking Credit Score," Slate, Jan. 30, 2013, http://www.slate.com/articles/technology/future_tense/2013/01/wonga_lenddo_lendup_big_data_and_social_networking_banking.html.

25 Online Lenders Alliance, 2013 Annual Report, http://c.ymcdn.com/sites/www.onlinelendersalliance.org/resource/resmgr/2013_OLA_Annual_Report_-_FIN.pdf. This survey found that 27 percent of online borrowers have more than $50,000 in household income, and 52 percent have household income below $35,000.

26 Leena Rao, "Data Focused Underwriting and Credit Analysis Platform ZestFinance Raises $20M from Peter Thiel and Others," *TechCrunch*, July 31, 2013, http://techcrunch.com/2013/07/31/data-focused-underwriting-and-credit-analysis-platform-zestfinance-raises-20m-from-peter-thiel-and-others/; Penny Crosman, "ZestFinance Aims to Fix Underwriting for the Underbanked," *American Banker*, Nov. 19, 2012, http://www.americanbanker.com/issues/177_223/zestfinance-aims-to-fix-underwriting-for-the-underbanked-1054464-1.html.

27 National Consumer Law Center, "Big Data: A Big Disappointment for Scoring Consumer Credit Risk" (2014), http://www.nclc.org/images/pdf/pr-reports/report-big-data.pdf.

28 Enova Systems Inc., Form 10-K, fiscal year ending Dec. 31, 2013, http://www.sec.gov/Archives/edgar/data/922237/000141588914001325/ena10kdec312013.htm. Filings from Enova and public statements from Elevate Credit Inc. indicate that they are not earning supernormal returns, which would be another possible reason for charging such high prices.

29 Eduardo De La Torre et al., v. CashCall Inc., No. 08-cv-03174-MEJ, (U.S. Dist. Ct. N.D.CA. 2014), http://sturdevantlaw.com/wp-content/uploads/2011/11/ECF-220-140730-Order-Re-MSJs.pdf. For a $2,600 loan from CashCall, borrowers paid $11,000 over the 42-month term, or about $260 per month.

30 "Privacy Policy," MoneyMutual.com, last modified Aug. 21, 2013, https://moneymutual.com/privacy-policy. The policy states, "We do not endorse, nor are we responsible for the accuracy of the privacy policies and/or terms and conditions of each of the third party lenders or sellers that may advertise at the website."

31 Andrew R. Johnson, "Middlemen for Payday Lenders Under Fire," *The Wall Street Journal,* April 7, 2014, http://online.wsj.com/news/articles/SB10001424052702304819004579487983000120324; Consumer Federation of America, CFA Survey of Online Payday Loan Websites, 2011, http://www.consumerfed.org/pdfs/CFAsurveyInternetPaydayLoanWebsites.pdf. John Hecht, an analyst with investment banking firm Stephens Inc., said in *The Wall Street Journal* piece: "MoneyMutual and other lead-generation companies are an important source of business for payday lenders. In the past, as much as 75% of online payday-loan volume has been sourced from such

companies." In conversations with Pew, other industry observers suggested that the figure is closer to half. Advertisements referenced are those that first appear after searches for "payday loan" and similar terms. The Consumer Federation of America's 2011 brief also reports that "the majority of websites are lead generators and marketing sites."

32 David Burtzlaff and Brittny Groce, *Payday Loan Industry,* 15; John Hecht, Stephens Inc. (2013), investor presentation, on file with The Pew Charitable Trusts.

33 Carter Dougherty, "Data From Payday Loan Applicants Sold in Online Auctions," Bloomberg News, June 8, 2012, http://www.bloomberg.com/news/2012-06-08/data-from-payday-loan-applicants-sold-in-online-auctions.html.

34 John Hecht, Stephens Inc. (2013), investor presentation, on file with The Pew Charitable Trusts.

35 Melanie Hicken, "Big Data Knows You're Broke," CNN Money, April 29, 2014, http://money.cnn.com/2014/04/29/pf/data-brokers/index.html?iid=Lead. For example, a list of payday loan applicants can be purchased from a list broker by visiting http://www.consumerbase.com/mailing-lists/payday-loan-applicants-mailing-list.html or http://datacards.geonmedia.com/market;jsessionid=48E5C871BFCF4497650100DB75C8F279?page=research/datacard&id=201616.

36 Consumer Financial Protection Bureau, *Examination Procedures: Short-Term, Small Dollar Lending* (2012), http://files.consumerfinance.gov/f/2012/01/Short-Term-Small-Dollar-Lending-Examination-Manual.pdf; "McDaniel Seeks Compliance With Civil Investigative Demand," Arkansas Attorney General's Office, Oct. 25, 2012, http://ag.arkansas.gov/newsroom/index.php?do:newsDetail=1&news_id=601. A civil investigative demand is a subpoena issued by a government official to a company that is under investigation. The company is required to supply information, reports, or answers to questions.

37 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), 16, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/PewPaydayLendingReportpdf.pdf.

38 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why,* 23. Price variation does not account for these differences, as demonstrated by the fact that the share of adults who borrow in states where payday loans cost more than the average is not lower than in states where loans have average or lower-than-average costs.

39 The A.C. Nielsen Co., 2013. On file with The Pew Charitable Trusts. The selected payday loan advertisers represent the companies with the highest total number of ad units purchased from 2009 through 2012. The advertisers were ranked by amount spent during the 12 months from June 2012 through May 2013. The term "payday" also includes payday installment loans.

40 Findings are based on 2014 data from market research firms SpyFu, SEMRush, and KeywordSpy.

41 Ken Rees, "The Common Ground on Short-Term Lending," *American Banker*, Feb. 27, 2014, http://www.americanbanker.com/bankthink/the-common-ground-on-short-term-lending-1065913-1.html; Sasha Orloff and Jacob Rosenberg, "Yes, the Payday Loan Can Be Reinvented," *American Banker*, Feb. 21, 2013, http://www.americanbanker.com/bankthink/yes-the-payday-loan-can-be-reinvented-1056953-1.html.

42 "Frequently Asked Questions," Ameriloan, accessed April 29, 2014, https://mobile.ameriloan.com/?page=info_faq.

43 "Frequently Asked Questions," U.S. Fast Cash, accessed April 29, 2014, https://mobile.usfastcash.com/?page=info_faq.

44 "Products and Services," Epic Loan Systems, accessed March 19, 2014, http://www.epicloansystems.com/products-services.aspx. The website states, "For example, if the customer wants a ten-payment loan, where the first 3 payments are interest-only, EPIC's FlexPay system can deliver." "Castle Payday Rates," Castle Payday, accessed March 19, 2014, https://castlepayday.com/loan-rates.

45 See for example, Federal Trade Commission v. Williams, Scott, & Associates LLC et al., May 27, 2014, http://www.ftc.gov/system/files/documents/cases/160701williamsscottcmpt.pdf; "At the FTC's Request, Court Halts Collection of Allegedly Fake Payday Debts," July 1, 2014, http://www.ftc.gov/news-events/press-releases/2014/07/ftcs-request-court-halts-collection-allegedly-fake-payday-debts. An excerpt from the FTC's press release in this case follows: "Many consumers in this case were victimized twice," said Jessica Rich, director of the Federal Trade Commission's Bureau of Consumer Protection. "First when they inquired about payday loans online and their personal information was not properly safeguarded, and later, when they were harassed and intimidated by these defendants, to whom they didn't owe any money."

46 Consumer Financial Protection Bureau, *Supervisory Highlights,* Spring 2014, http://files.consumerfinance.gov/f/201405_cfpb_supervisory-highlights-spring-2014.pdf.

47 "Fake Debt Collectors," Federal Trade Commission, last modified Feb. 2012, https://www.consumer.ftc.gov/articles/0258-fake-debt-collectors; "Possible Payday Loan Collection Scam," Washington State Department of Financial Institutions, last modified Feb. 18, 2014, http://dfi.wa.gov/consumers/alerts/cash-usa.htm; "Consumer Alert: Most Common Scams of 2013 Identified," Arkansas Attorney General's Office, last modified March 12, 2014, http://arkansasag.gov/news-and-consumer-alerts/details/consumer-alert-most-common-scams-of-2013-identified.

48 For information about laws governing debt collection practices, see the Federal Trade Commission's website, http://www.consumer.ftc.gov/articles/0149-debt-collection. See also the National Consumer Law Center's website, http://www.nclc.org/issues/debt-collection.html.

49 Lea Shepard, "Creditors' Contempt," *Brigham Young University Law Review,* 1509 (2011): 104, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1928068; Jim Gallagher, "Payday Lenders Use Courts to Create Modern Debtors' Prison," *St. Louis Post-Dispatch*, Aug. 19, 2012, http://www.stltoday.com/business/local/payday-lenders-use-courts-to-create-modern-debtors-prison/article_f56ca6aa-e880-11e1-b154-0019bb30f31a.html; Jessica Silver-Greenberg, "Welcome to Debtors' Prison, 2011 Edition," *The Wall Street Journal,* March 17, 2011, http://online.wsj.com/news/articles/SB10001424052748704396504576204553811636610. In some instances, warrants have been issued or people have been jailed for "failure to appear," "theft by check," or other charges related to nonpayment of a loan.

50 List brokers and others regularly offer "aged" leads—generally meaning people who applied for payday loans more than 24 hours previously—for sale online. See, for example, http://www.linkedin.com/groups/20000-Fresh-Aged-Payday-Loan-4282879.S.162779671 and http://www.paydayloanleads.com/, accessed April 28, 2014.

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52 Washington State Department of Financial Institutions, "Consumer Alert: Lead Generators," www.dfi.wa.gov/consumers/alerts/lead-generators-cashadvanceresults.htm; "Consumer Alert: Consumers Should Be Wary of Unlicensed Payday Lenders Doing Business Online," Florida Department of Financial Services, last modified June 7, 2011, http://www.myfloridacfo.com/pressoffice/ViewConsumerAlert.asp?ID=3895; "Consumer Alert: Governor Cuomo Advises New Yorkers to Protect Against Identity Theft During Holiday Shopping Season," New York Department of Financial Services, last modified Dec. 19, 2013, http://www.dfs.ny.gov/about/press2013/pr1312191.htm.

53 Richard Cordray, Consumer Financial Protection Bureau, remarks at payday loan field hearing, (Jan. 19, 2012), www.consumerfinance.gov/speeches/remarks-by-richard-cordray-at-the-payday-loan-field-hearing-in-birmingham-al/.

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55 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans,* February 2013, 32–35, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/PewChoosingBorrowingPaydayFeb2013pdf.pdf

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59 "Payday Loan Marketers Who Allegedly Tricked Consumers Into Buying Prepaid Debit Cards Will Pay More Than $800,000 to Settle FTC Charges," Federal Trade Commission, last modified March 17, 2011, www.ftc.gov/opa/2011/03/everprivate.shtm; "Consumer Alert: USA Payday Loan," Washington State Department of Financial Institutions, last modified April 17, 2012, http://dfi.wa.gov/consumers/alerts/usa-payday-loan.htm.

60 "Internet Payday Lending Alert," California Department of Corporations, last modified Aug. 13, 2012, www.corp.ca.gov/Press/news/2012/InternetPaydayLendingAlert_8-13-12.pdf.

61 For example, this language is included at: https://www.atlasmoneyonline.com/privacy.html, accessed June 26, 2014. Cashback Advance uses the same language: https://www.cashbackadvance.com/website/privacy-policy.html, accessed June 9, 2014. ACE Cash Express uses similar language but leaves out the words "and eligible for payment retrieval," https://www.acecashexpress.com/payday-loans/texas/more-information, accessed June 9, 2014.

62 "Attack of the 'Zombie' Bank Account: Some Banks Reopen Accounts—and Impose Fees—Even After They've Been Closed," *Consumer Reports,* August 2012, http://www.consumerreports.org/cro/magazine/2012/08/attack-of-the-zombie-bank-account/index.htm.

63 Jessica Silver-Greenberg, "JPMorgan Chase is Reining In Payday Lenders," *The New York Times,* March 19, 2013, http://dealbook.nytimes.com/2013/03/19/jpmorgan-reining-in-payday-lenders/?_php=true&_type=blogs&_r=0; "Request for Comment and Request for Information," National Automated Clearing House Association, Nov. 11, 2013, https://www.nacha.org/sites/default/files/files/ACH_

Rules/2013%20RFC/ACH%20Network%20Risk%20and%20Enforcement%20Topics%20-%20Rule%20Proposal%20Description%20-%20November%2011%202013.pdf; The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 45. Refer to section "Guard against harmful repayment or collection practices."

64 The Better Business Bureau requires that all complaints be submitted in writing, either online or through standard mail. The online submission tool allows consumers to search for the business and populate the information or enter the business information on their own. (This method may explain some of the variation in business names for the same company.)

65 In total, 4,070 complaints were received, but Pew excluded 52 that originated from Canadian residents, leaving 4,018 complaints. The BBB does not take complaints against companies incorporated outside the U.S. or Canada (for these companies, it encourages consumers to contact the International Consumer Protection and Enforcement Network), so this data set probably underrepresents complaints against online payday lenders. Although the BBB collects a variety of information on payday loan complaints, it does not specify the channel through which the loan was obtained—at a storefront or online. In most cases, however, it does provide the consumer's city and state, as well as the company's name and address. Using this information, Pew was able to verify the channel for 99 percent of complaints made against payday lenders. Pew undertook this categorization before receiving the 2012 and 2013 data.

66 John Hecht, Stephens Inc. (2014). Stephens Inc. estimates that stores account for two-thirds of loan volume.

67 Details on how businesses were classified is included in the methodology section of the report.

68 "Nature of Complaint," Better Business Bureau, accessed June 30, 2014, https://www.bbb.org/consumer-complaints/file-a-complaint/nature-of-complaint/.

69 Nine in 10 complaints are against online lenders, but seven of the 10 states with the most complaints also have stores. This finding would be unlikely if rates of online borrowing were far higher in states without stores. The 10 states with the most complaints, in order, are Texas, California, New York, Florida, Pennsylvania, Illinois, North Carolina, Ohio, Michigan, and Missouri.

70 "DFI Issues Cease And Desist Order Against an Internet Payday Lender for Violating State and Federal Collection Laws," Washington State Department of Financial Institutions, last modified Oct. 18, 2010, http://www.dfi.wa.gov/consumers/news/2010/unlicensed-internet-lenders.htm. This news release from the Washington State Department of Financial Institutions highlights one example of how states enforce licensing laws. Other states have followed similar measures to ensure that online lenders are state-licensed entities and subject to the same laws as storefront lenders. As discussed elsewhere in this report, however, some courts have ruled that under certain circumstances, such as when the lender may validly claim tribal sovereign immunity, states do not have authority over online lenders.

71 John Hecht, Stephens Inc. (2013), investor presentation, on file with The Pew Charitable Trusts.

72 5 Del. C. §978, 5 Del. C. §2227 et seq., 5 Del. C. §2744, and §2202. The Delaware law, which took effect in January 2013, capped the number of payday loans to five per borrower per 12 months and changed the maximum payday loan size from $500 to $1,000. Many online lenders have moved to installment loans to remain viable.

73 12 U.S.C. § 38: US Code—Section 38: The National Bank Act; The Pew Charitable Trusts, *Policy Solutions,* endnote 154; The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices." According to the National Bank Act, 43 states and the District of Columbia set maximum rates for payday loans, and of the seven states that do not set rates on consumer installment loans, three have established maximum rates for pawn loans.

74 Sheila Bair, "Low-Cost Payday Loans: Opportunities and Obstacles," the Annie Casey Foundation (2005), http://www.cfsinnovation.com/sites/default/files/imported/managed_documents/low-cost_payday_loans_opportunities_and_obstacles.pdf; Michael Stegman, "Payday Lending," *The Journal of Economic Perspectives* 21 (2007): doi:10.1257 /jep.21.1.169; "Guidelines for Payday Lending," Federal Deposit Insurance Corp., last modified Feb. 25, 2005, http://www.fdic.gov/news/news/financial/2005/fil1405a.html; OCC advisory letter, Office of the Comptroller of the Currency, last modified Nov. 27, 2000, http://www.occ.gov/static/news-issuances/memos-advisory-letters/2000/advisory-letter-2000-10.pdf.

75 Quik Payday Inc. v. Stork, 549 F. 3d 1302 (10th Cir. 2008); Consumer Federation of America, *Internet Payday Lending* (2004), 9 and 22, http://www.consumerfed.org/pdfs/Internet_Payday_Lending113004.PDF.

76 For example, see http://www.mass.gov/ocabr/banking-and-finance/laws-and-regulations/enforcement-actions/2013-dob-enforcement-actions/westernsky04042013.html or http://www.idfpr.com/DFI/CCD/Discipline/13CC499503MNEServicesCDOrder.pdf. (See Page 23 for more detail.)

77 Otoe-Missouria Tribe of Indians v. New York State Department of Financial Services, U.S. Dist., LEXIS 144656, 2013 WL 5460185 (S.D.N.Y. 2013).

78 Advance America operates under a variety of names and works with various affiliates online and in stores. See www.purposefinancialservices.com/assets/uploads/documents/Ohio_VS_AA_CK_Cashing_AA0062OH-CC_1.11.12.pdf and www.advanceamerica.net/assets/uploads/documents/privacy-policies/mississippi.pdf. Cash America International also operates under different names and affiliates with companies in the U.S. and other countries. In 2006, it acquired CashNetUSA, its online lending entity.

See www.cashamerica.com/Files/NewsReleases/2006/06_0918%20CashNetUSA%20Purch.pdf. CashNetUSA's advertisements state that the company has served more than 1.5 million customers.

79 For example, CashNetUSA operates as a credit services organization in Ohio, http://www.cashnetusa.com/fee-schedule-ohio.html.

80 For example, ACE Cash Express operates as a credit access business in Texas, https://www.acecashexpress.com/~/media/Files/Products/Shared/Internet/License/TX_License.pdf.

81 Adam Mayle, "Usury on the Reservation: Regulation of Tribal-Affiliated Payday Lenders," *Review of Banking & Financial Law"* 31 (2012): 1053, http://www.bu.edu/law/central/jd/organizations/journals/banking/archives/documents/volume31/UsuryOnTheReservation.pdf. Historically, an arm that is created and overseen by a tribe is considered to have sovereign immunity.

82 Nathalie Martin and Joshua Schwartz, "The Alliance Between Payday Lenders and Tribes: Are Both Tribal Sovereignty and Consumer Protection at Risk?" *69 Washington & Lee Law Review* 69 (2012): 751 http://scholarlycommons.law.wlu.edu/wlulr/vol69/iss2/9/; Baillie v. Processing Solutions LLC et al., No. RG 07-327031 (Calif. Sup. Ct.), 2011, https://www.documentcloud.org/documents/250961-modoc-tribe-share-of-payday-lending-business.html#document/p13/a33656.

83 State of Colorado v. Cash Advance et al., No. 05CV1143, slip op. at 10 (Denver Dist. Ct. 2012).

84 Nathalie Martin and Joshua Schwartz, "The Alliance Between Payday Lenders and Tribes."

85 Michael Hudson and David Heath, "Fights Over Tribal Payday Lenders Show Challenges of Financial Reform," Center for Public Integrity, Feb. 7, 2011, http://www.publicintegrity.org/2011/02/07/2151/fights-over-tribal-payday-lenders-show-challenges-financial-reform.

86 Kevin Wack and Joe Adler, "Cheat Sheet: Online Lenders' Legal Minefield," *American Banker*, Oct. 1, 2013, http://www.americanbanker.com/issues/178_190/cheat-sheet-online-lenders-legal-minefield-1062524-1.html?zkPrintable=1&nopagination=1.

87 Commonwealth of Pennsylvania Department of Banking and Securities Bureau of Compliance and Licensing v. Carey Vaughn Brown, No. 130009 (ENF-C&D) (2013); State of Arkansas v. Chris Kamberis et al., No. 60CV-14-2198 (Ark. Cir. Ct. 2014). According to the Pennsylvania Banking Department, Brown and his affiliated companies conducted operations from Chattanooga and Rossville in Tennessee and Carson City, Silver Springs, and Las Vegas in Nevada. However, they had post office boxes, mailing addresses, and service providers located in Grenada, Bermuda, the British West Indies, and Canada.

88 New York Department of Financial Services, letter to financial institutions regarding illegal online payday loans offered and sold to New York customers, last modified Aug. 6, 2013, http://www.dfs.ny.gov/about/press2013/pr130806-link1.pdf.

89 "Cuomo Administration Takes Action to Halt Illegal, Online Payday Lending Through Debit Card Networks," New York Governor's Office, April 30, 2014, https://www.governor.ny.gov/press/04302014-online-payday-lending.

90 "McDaniel Files Suit Against Online Payday Lender," Arkansas Attorney General's Office, Sept. 14, 2011, http://ag.arkansas.gov/newsroom/index.php?do:newsDetail=1&news_id=460; "McDaniel Obtains Court Orders To Bar Online Payday Lenders," Arkansas Attorney General's Office, May 4, 2011, http://www.ag.state.ar.us/newsroom/index.php?do:newsDetail=1&news_id=418; "McDaniel Files Suit Against Online Payday Lenders," Arkansas Attorney General's Office, June 9, 2014, http://arkansasag.gov/news-and-consumer-alerts/details/mcdaniel-files-suit-against-online-payday-lenders.

91 State of Minnesota v. CashCall Inc. et al., No. 27-CV-13-12740 (MN Dist. Ct. 2013).

92 "Madigan Cracks Down on Unlicensed, Predatory Payday Lenders," Office of the Illinois Attorney General, last modified April 8, 2014, http://illinoisattorneygeneral.gov/pressroom/2014_04/20140408.html.

93 "Attorney General Announces $1,000,000 Crackdown on Illegal Lending," Vermont Office of the Attorney General, last modified April 23, 2014, http://ago.vermont.gov/focus/news/attorney-general-announces-$1000000-crackdown-on-illegal-lending.php; Justin E. Kolber, assistant attorney general, letter to Jim Condon, April 2014; Justin E. Kolber, assistant attorney general, letter to Marsha Jones, April 2014, http://ago.vermont.gov/assets/files/Consumer/Illegal_Lending/Letter%20to%20TPPPA%20April%202014.pdf.

94 "Court Order Restricts Online Payday Lender," Arkansas Office of the Attorney General, last modified Aug. 21, 2012, http://ag.arkansas.gov/newsroom/index.php?do:newsDetail=1&news_id=579. For example, before it stopped operating, Western Sky Loans stated that it did not make loans to residents of California, Colorado, Maryland, Missouri, South Dakota, or West Virginia. Cash Fairy's website states that it does not make loans to residents of Arkansas, Montana, or West Virginia. Lendgreen's website states that it does not make loans to residents of 20 states or the District of Columbia. State attorneys general have in many cases reached agreements with specific online payday lenders not to make loans to residents of their states.

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96 Otoe-Missouria Tribe of Indians v. New York State Department of Financial Services, U.S. Dist., LEXIS 144656, 2013 WL 5460185 (S.D.N.Y. 2013). The court stated "The undisputed facts demonstrate that the activity the State seeks to regulate is taking place in New York, off of the Tribes' lands. Having identified no 'express federal law' prohibiting the State's regulation of payday loans made to New York residents in New York, the Tribes are subject to the State's non-discriminatory anti-usury laws."

97 The People of the State of California v. Miami Nation Enterprises et al., No. B242644 (Cal. App. 2d 2014).

98 Dollar Financial Corp., Form 10-K, fiscal year ending June 30, 2008, https://www.sec.gov/Archives/edgar/data/1271625/000089322008002500/w66715e10vk.htm. For example, DFC Global partnered with First Bank of Delaware in 2006 to offer CustomCash, an installment loan. The bank reviewed and funded the loans, and DFC earned a fee for servicing them. After the FDIC's 2006 guidelines on partnerships between banks and payday lenders, the bank stopped offering the loans through third-party retailers in Pennsylvania in April 2007 and instead offered them only through its own branches and online. DFC has continued to offer the CustomCash loan in other U.S. locations.

99 "Attorney General Cuomo Announces Distribution Of $5.2 Million Settlement In 'Rent-a-Bank' Payday Lending Scheme," New York State Office of the Attorney General, last modified Nov. 17, 2009, http://www.ag.ny.gov/press-release/attorney-general-cuomo-announces-distribution-52-million-settlement-rent-bank-payday. There have been occasional instances of banks facilitating payday loans that do not comply with state law despite the clear guidance from federal regulators. For example, payday lenders Telecash and CRA Services partnered with County Bank in Delaware to avoid New York's civil usury rate cap of 16 percent, but pursuant to action from the New York attorney general in 2009, the lenders agreed to pay $5.2 million in restitution in addition to other penalties and costs.

100 "Agreement By and Between Urban Trust Bank, Lake Mary, Florida, and the Comptroller of the Currency," Office of the Comptroller of the Currency, last modified July 25, 2012, http://www.occ.gov/static/enforcement-actions/ea2012-190.pdf; "Urban Trust Bank Streamlines Prepaid Card Features," Urban Trust Bank, last modified Jan. 13, 2013, http://www.urbantrustbank.com/custom/fi/urbantrustbank/fb/disclosure/InsightJanuary2013PressRelease.pdf.

101 Jessica Silver-Greenberg, "Justice Department Inquiry Takes Aim at Banks' Business With Payday Lenders," *The New York Times*, Jan. 26, 2014, http://dealbook.nytimes.com/2014/01/26/justice-dept-inquiry-takes-aim-at-banks-business-with-payday-lenders/.

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103 "Payday Lending," Federal Trade Commission, accessed July 18, 2014, http://www.ftc.gov/news-events/media-resources/consumer-finance/payday-lending; "FTC Puts Texas-based Operation Permanently Out of the Debt Collection Business After It Allegedly Used Deception, Insults, and False Threats against Consumers," Federal Trade Commission, modified May 29, 2014, http://www.ftc.gov/news-events/press-releases/2014/05/ftc-puts-texas-based-operation-permanently-out-debt-collection?utm_source=govdelivery. A summary of press releases summarizing major actions is available from the FTC.

104 "U.S. District Judge Finds that FTC Can Sue Deceptive Payday Loan Business Regardless of American Indian Tribal Affiliation," Federal Trade Commission, last modified March 19, 2014, http://www.ftc.gov/news-events/press-releases/2014/03/us-district-judge-finds-ftc-can-sue-deceptive-payday-loan.

105 Federal Trade Commission v. Federal Check Processing Inc., No. 1:14-cv-00122-WMS (W.D.N.Y. 2014), https://docs.google.com/gview?url=http://docs.justia.com/cases/federal/district-courts/new-york/nywdce/1:2014cv00122/97424/43/0.pdf?1395849487&chrome=true.

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111 Consumer Financial Protection Bureau, consent order in the matter of ACE Cash Express, file No. 2014-CFPB-0008, July 10, 2014, http://files.consumerfinance.gov/f/201407_cfpb_consent-order_ace-cash-express.pdf.

112 "Frequently Asked Questions," CashNetUSA, accessed July 18, 2014, https://www.cashnetusa.com/faq.html. For an example, see the following response from CashNetUSA 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."

113 "Loan Application," Check 'n Go, accessed May 14, 2014, https://myaccount.checkngo.com/pdlapplication.aspx?afscampaignid=1. Select "state of residence," and select "Mail Paper Check or Cashier's Check." Response: "You have elected to pay your loan funds via paper check. Selecting this option may extend the length of time it takes us to process your application by 7-10 business days. To proceed: 1. Please call us to complete your loan application. 2. We will send you a paper application that you will need to complete and send back to us. 3. We will then send you a contract agreement within 2 business days of processing your application. 4. Return the signed contract agreement along with a paper check for the amount of your first installment payment. 5. Upon receipt of the signed contract agreement and the paper check, your loan funds will be sent to you in the form of a check. The entire process may take 7-10 business days to complete. Please contact us at 1-800-723-7022 to complete your application."

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117 United States of America v. Four Oaks Fincorp Inc. et al., No. 5:14-cv-00014 (E.D. N.C. 2014), http://www.manatt.com/uploadedFiles/Content/4_News_and_Events/Newsletters/BankingLaw@manatt/7-U.S.-v-Four-Oaks-Fincorp.pdf. The 13 payday lenders identified had return rates between 31.42 percent and 70.02 percent.

118 "ACH Network Risk and Enforcement Topics," NACHA.

119 Telemarketing Sales Rule, 78 Fed. Reg. 131 (July 9, 2013). In a recent notice of proposed rulemaking, the FTC stated: "Fraudulent telemarketers and unscrupulous payment processors prefer, however, to use remotely created payment orders to evade the ACH Network and exploit the weaknesses inherent in the check clearing system." The notice includes discussion of remotely created checks, which, according to the FTC, "are more susceptible to fraud than paper checks" and remotely created payment orders, which the FTC describes as being "at least as susceptible to fraud as remotely created checks."

120 "Request for Comment and Request for Information," NACHA, Nov. 11, 2013, https://www.nacha.org/sites/default/files/files/ACH_Rules/2013%20RFC/ACH%20Network%20Risk%20and%20Enforcement%20Topics%20-%20Rule%20Proposal%20Description%20-%20November%2011%202013.pdf.

THE PEW CHARITABLE TRUSTS

Appendix N

A report from THE PEW CHARITABLE TRUSTS | March 2015



Auto Title Loans

Market practices and borrowers' experiences

The Pew Charitable Trusts

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External reviewers

The report benefited from the insights and expertise of the following external reviewers: Mike Mokrzycki, independent survey research expert; Katherine Samolyk, economist (former official with the Federal Deposit Insurance Corp. and the Consumer Financial Protection Bureau); Jeremy Tobacman, assistant professor of business economics and public policy, Wharton School of the University of Pennsylvania; Alan White, professor of law, City University of New York; and Lauren Willis, professor of law and Rains senior research fellow, Loyola Law School, Los Angeles. These experts have found the report's approach and methodology to be sound. Although they have reviewed the report, neither they nor their organizations necessarily endorse its findings or conclusions.

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For further information, please visit:

pewtrusts.org/small-loans

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The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and invigorate civic life.

Contents

Overview

More than 2 million people, approximately 1 percent of American adults, use high-interest automobile title loans annually, borrowing against their cars.[1] A lender, after inspecting a car brought in by a prospective borrower, makes a loan based on a portion of the vehicle's value and keeps the title as collateral while the customer continues using the car.[2] The borrower usually must repay the principal plus a fee in a single balloon payment, typically after one month, and the lender has the right to repossess the car if the loan is not repaid.[3]

Over 8,000 title loan stores operate in the 25 states where this type of loan is available.[4] States have differing limits on loan sizes, fees, and durations, resulting in large cross-state variation in the loans' costs for borrowers.[5] Title loans are less widely used than payday loans and are usually made for larger amounts, but the two products are similar in structure, cost, and business model. The typical customer for both is a low-income worker who is struggling to make ends meet.[6] These parallels are underscored by the fact that about half of title loan branches also offer payday loans.[7]

Most title loans are structured as balloon-payment, also known as lump-sum payment, loans, as described above; some states also allow or require title loans to be repayable in installments.[8] When the loan comes due, borrowers who cannot afford to repay can renew it for a fee. As with payday loans, payments exceed most title loan borrowers' ability to repay—so the large majority of loans in this market are renewals, rather than new extensions of credit.[9]

One key reason title loans are so expensive is that, as in the payday loan market, borrowers do not primarily shop based on price, and so lenders do not lower prices to attract customers.[10] Instead, lenders tend to compete most on location, convenience, and customer service. In states that limit the fees lenders can charge for payday loans, lenders operate fewer stores—with each serving more customers—and credit remains widely available.[11] Similar access to title loans could be maintained at prices substantially lower than those in the market today.[12]

The research base on title loans is far smaller than that on similar subprime small-dollar credit products, such as payday loans.[13] To begin filling this gap, The Pew Charitable Trusts conducted the first nationally representative telephone survey of borrowers, a series of focus groups, and an examination of state regulatory data and company filings to illuminate practices, experiences, and problems in the title loan market. (See Appendix C.) Unless otherwise noted, information about market trends and legal requirements is based on Pew's analysis of lenders' practices, market trends, and applicable laws. The analysis found that:

1. Title loan customers spend approximately $3 billion annually, or about $1,200 each, in fees for loans that average $1,000.[14] The annual interest rates for title loans are typically 300 percent annual percentage rate (APR), but lenders charge less in states that require lower rates.[15]
2. The average lump-sum title loan payment consumes 50 percent of an average borrower's gross monthly income, far more than most borrowers can afford.[16] By comparison, a typical payday loan payment takes 36 percent of the borrower's paycheck.[17]
3. Between 6 and 11 percent of title loan customers have a car repossessed annually. One-third of all title loan borrowers do not have another working vehicle in their households.
4. Only one-quarter of borrowers use title loans for an unexpected expense; half report using them to pay regular bills. More than 9 in 10 title loans are taken out for personal reasons; just 3 percent are for a business the borrower owns or operates.
5. Title loan borrowers overwhelmingly favor regulation mandating that they be allowed to repay the loans in affordable installments.

This report details these findings, and shows that the title loan market has many similarities with the payday loan market as well as several important differences, such as larger loan sizes and the risk to borrowers of losing a vehicle. Overall, the research demonstrates that the title loan market suffers from the same fundamental problems as the payday loan market, including unaffordable balloon payments, unrealistically short repayment periods, and unnecessarily high prices.

Pew urges state and federal policymakers to address these problems. They may elect to prohibit high-cost loans altogether (as some states have done), or issue new, more uniform regulations that would fundamentally reform the market for payday and title loans by:

- Ensuring that the borrower has the ability to repay the loan as structured.
- Spreading costs evenly over the life of the loan.
- Guarding against harmful repayment and collections practices.
- Requiring concise disclosures.
- Setting maximum allowable charges.

In particular, as the federal regulator for the auto title loan market, the Consumer Financial Protection Bureau should act urgently to alleviate the harms identified in this research. Although the bureau lacks the authority to regulate interest rates, it has the power to codify important structural reforms into federal law.

How auto title lending works

Auto title loans are high-interest cash loans for which borrowers post their car title as collateral. Some states set limits on sizes, fees, and durations of title loans or provide consumer protections regarding borrowers' rights in the event of default.[18] Though some credit unions offer title loans, most such loans originate from specially licensed title loan stores. More than 8,000 of these stores operate in 25 states nationwide.[19] Twenty-five states and the District of Columbia do not have title loan stores, because they either explicitly prohibit lending against a car title or cap APRs on these loans no higher than 36 percent, a rate at which auto title lenders generally do not operate.

Loan terms and conditions

To get a title loan, an applicant drives his or her car to a store and provides the lender with the title to the car as collateral.[20] In most cases, potential borrowers must own a car free and clear in order to qualify for a title loan, meaning that they do not owe money under a conventional auto loan.[21] The loan amount offered is a fraction of the value of the car as assessed by the lender. The borrower leaves with the loan proceeds in 15 to 45 minutes (or just a few minutes for renewals) and retains use of the car while the loan is outstanding.[22]

If the loan becomes past due, the lender has a right to repossess the car.[23] The borrower then has a chance to redeem the car by repaying the loan principal, interest, and any additional fees.[24] Otherwise, the lender may sell the car to recover the amount owed. Depending on state law, if more is owed on the loan than the sale yields, the lender may pursue the borrower for additional payments, known as a deficiency balance.[25] Conversely, if the car sale yields more than is owed for the loan, some states require the lender to return the surplus value to the borrower.[26]

Cost

Title loans average $1,000, though they range from less than $100 to more than $10,000 depending on the value of the car and lenders' and borrowers' preferences.[27] State laws also influence loan sizes, either through direct limits or caps on the interest rates that lenders are permitted to charge on loans of different amounts.[28]

Nationally, the most common APR charged on the typical one-month title loan is 300 percent, or 25 percent for each month that the loan is outstanding, but rates vary somewhat on a state-by-state basis, primarily because of differing regulations.[29] The average borrower spends an estimated $1,200 in fees annually for a $1,000 loan.[30] (See Table 1.) Each year, this comes to approximately $3 billion across the more than 2 million American adults who use these loans.[31] (Lenders typically describe interest charges as fees, and they usually do not charge both interest and fees.)

Table 1

On Average, Annual Fees Paid for a Title Loan Are More Than the Principal

Loans typically carry an APR of 300%

Average loan size	**$1,000**
Average fees paid per customer per year	**$1,200**
Typical annual percentage rate charged	**300%**

Sources: TMX Finance, 2011, 2012; Center for Responsible Lending, 2013; and state regulatory data, 2011, 2012, 2013

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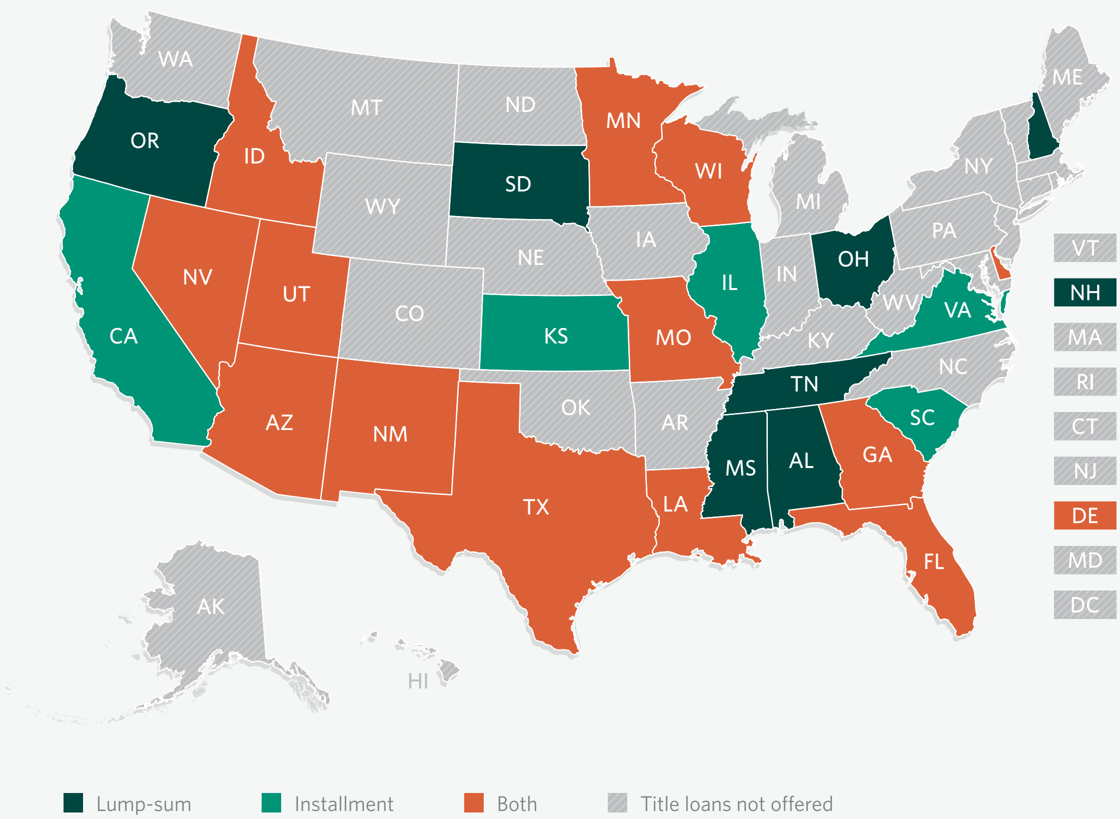
Loan duration

The most common term for a title loan is 30 days. Depending on state law, however, loans can last as little as two weeks or more than a year.[32] In most states that allow title lending (see Map 1), borrowers cannot already owe money on their cars. For this reason, a borrower can obtain only one title loan per vehicle at a time. Because the borrower's car is provided as collateral, many title lenders do not require an applicant to prove income.[33] Loan-to-value ratios vary greatly in the industry but average about one-quarter of the vehicle's retail value.[34]

Map 1

Auto Title Lenders Operate in 25 States

Types of title loans offered, by state



Notes: Lump-sum loans require a balloon payment, typically after one month; installment loans are repaid in smaller payments over time. All title loan states, except for Arizona, Georgia, and New Hampshire, also have payday lending. In some states, not indicated here, consumer installment lenders offer underwritten loans collateralized by a car title.

Sources: Pew's analysis of states' lending statutes and existing lender practices

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Comparisons with the payday lending business model

Title lending is often compared with pawn lending, but on close inspection, the title loan business model more closely resembles that of payday lending.[35] Both payday and title lending allow people with damaged credit histories to borrow relatively small amounts of money at high interest rates, primarily from stores that serve a small number of customers at each location and compete primarily on location, speed, and customer service, rather than price. The nation's largest title lender spends about 66 percent of its revenue on overhead and just 18 percent on losses, similar to the largest payday lender.[36] The average store serves only about 300 unique title loan customers a year (about one unique customer each business day); by comparison, the average payday loan store serves about 500 individuals annually.[37] Both businesses cover their considerable overhead by charging high prices to these small numbers of customers. Therefore, like storefront payday lenders, title loans are expensive primarily because of the cost to operate stores, rather than because of the risk of losing the loan principal or because they earn unusually high profits.

> Title lenders spend more than three times as much on overhead as on losses.

Payday loans are far more widely used than title loans: Payday loan stores operate in 36 states, while title loan stores operate in 25. About 5 percent of American adults use payday loans annually, but only about 1 percent—slightly more than 2 million people—borrow from title lenders.[38]

One important difference between these products is that title loans are larger than payday loans on average ($1,000 vs. $375). This is one reason that the estimated $1,200 spent annually by an average title loan borrower on fees is more than twice the $520 spent a year by an average payday loan borrower.[39]

The title loan market is also slightly more concentrated than the payday loan market.[40] The largest firm, TMX Finance, operates more than 1,650 stores, or roughly one-fifth of all locations.[41] Many other lenders offer title loans as a secondary product along with payday or pawn loans.[42]

Other similarities between title and payday loans are the characteristics, financial circumstances, and experiences of their borrowers. These topics are discussed in depth in the following pages, and findings are based on survey and focus group research except where otherwise noted. Like the payday loan market, the title loan market suffers from fundamental problems, including unaffordable payments, unrealistically short repayment periods, and unnecessarily high prices.

Who are title loan borrowers?

Most title loan borrowers experience persistent financial distress

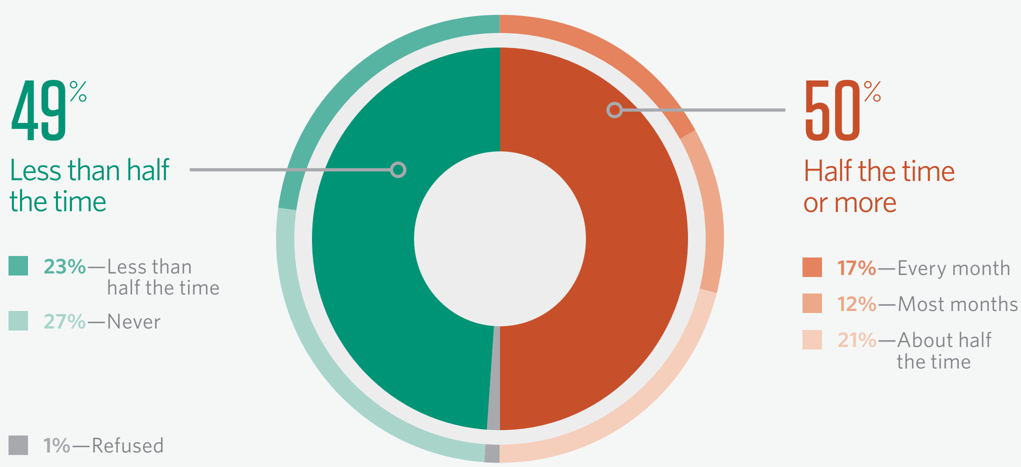
Pew conducted the first nationally representative telephone survey of title loan borrowers about their experiences with the loans. Unless otherwise noted, all findings about borrowers' views and experiences come from this new research. (See Appendix C for details of the methodology.) Pew's survey data and other available research indicate that title loan borrowers are generally demographically similar to payday loan borrowers and have comparable incomes (gross annual median income of just under $30,000, or a little less than $2,500 a month).[43] (See Appendix A for a table of borrowers' demographics.)

People who use auto title and payday loans are also similar in their reasons for doing so and in their borrowing patterns.[44] Approximately half of survey respondents report having trouble paying their bills at least half the time. (See Figure 1.)

Figure 1

50% of Borrowers Have Trouble Meeting Expenses at Least Half of the Time

3 in 10 struggle to make ends meet most months



Note: Respondents were asked, "How often, if ever, do you have trouble meeting your regular monthly bills and expenses?" Results are based on 313 interviews. Data do not add to 100% due to rounding.

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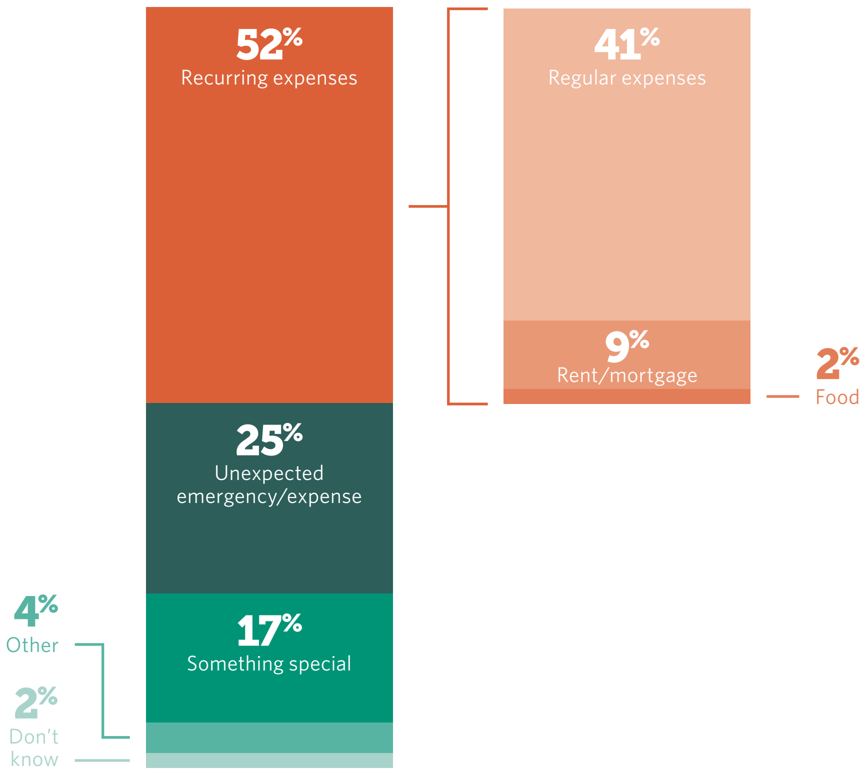
Just over half of borrowers use title loans to cover regular expenses, such as rent or utilities; only about 1 in 4 first used a loan for an unexpected expense.[45] (See Figure 2.) Nearly all borrowers—94 percent—report using the loans exclusively for personal or family expenses, not business expenses. This finding is consistent with a previous survey of title loan customers from three states, which found that very few borrowers used the loans for a business purpose.[46]

Unlike payday borrowers, title loan customers are not required to have a bank account. However, three-quarters report that they do.[47] Although title and payday loans are sometimes advertised as a way to avoid checking account overdrafts, half of title loan borrowers who have checking accounts have overdrawn their accounts in the past year, comparable to the figure for payday loan borrowers.[48] (See Figure 3.)

Figure 2

Half of Borrowers Use Title Loans to Cover Regular Bills

Only 1 in 4 use them for unexpected expenses



Note: Respondents were asked, "Thinking back now to (that first/the) time you took out an auto title loan, what specifically did you need the money for? To pay rent or a mortgage; to pay for food and groceries; to pay a regular expense, such as utilities, car payment, credit card bill, or prescription drugs; to pay an unexpected expense, such as a car repair or emergency medical expense; to pay for something special, such as a vacation, entertainment, or gifts? (Do not read) Other (specify)." Results are based on 313 interviews.

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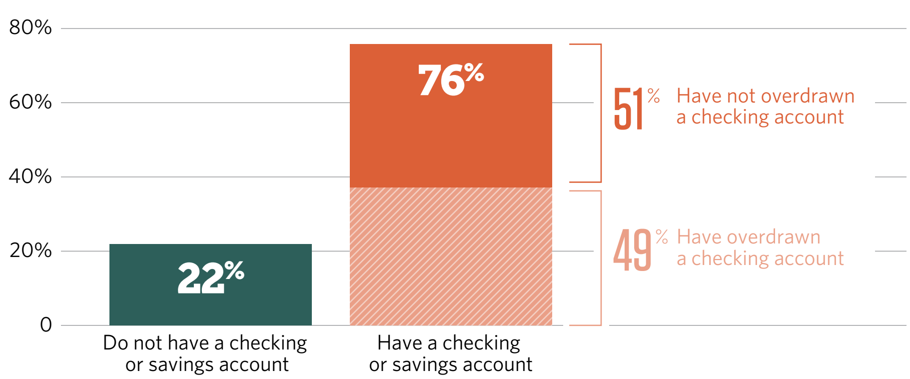
94% of borrowers report using title loans exclusively for personal or family expenses, not business expenses.

Figure 3

Most Title Loan Borrowers Have Checking Accounts

Half of those have been overdrawn in the past year



Notes: Borrowers were asked, "Have you used ... in the past year?" Results are based on 313 interviews. Of those, 239 had a checking account and were asked "Overdrafting on your checking account." Each item was asked separately. Some data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

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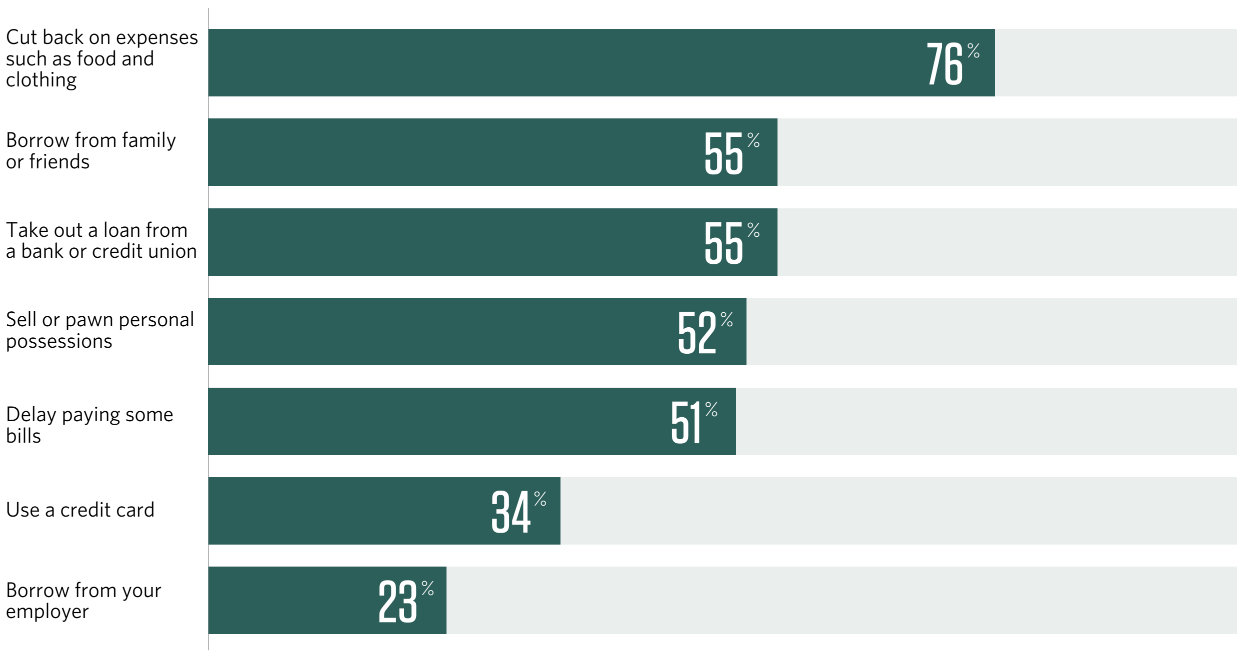
Most borrowers have alternatives to title loans

Like payday borrowers, most people report having other options if title loans were unavailable, including 3 in 4 who say they would cut back on basic expenses. Most also say they could borrow from family and friends, sell or pawn possessions, delay paying some bills, or take a loan from a bank or credit union. (See Figure 4.)

Figure 4
Alternatives to Title Loans
3 in 4 report they would cut back if they could not borrow



Note: Respondents were asked, “For each, tell me whether you would use this option if you were short on cash and short-term loans no longer existed. How about … ” Results are based on 313 interviews.

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Most borrowers rely on lender information and word of mouth

Seven in 10 title loan borrowers report that they rely on lenders to provide accurate information about the loans. (See Figure 5.) Similarly, they say that they do little independent research and do not compare prices or terms among lenders. Most attribute this to the urgency of getting a loan quickly to pay bills. This is consistent with previous research showing that, when choosing a small loan, subprime borrowers focus on how quickly they can get the funds, how much they can borrow, and whether they are certain to be approved.[49]

Pew’s earlier research found that for most small loan customers, price is not the primary consideration.[50] In focus groups, title loan borrowers echoed this sentiment, explaining that they chose their lender based on location, advertisements, and recommendations from friends or family, rather than comparison shopping for cost or negotiating a lower price.[51]

How Borrowers Chose a Title Lender

"I went because that was where my friend had gone."—*St. Louis title loan borrower*

"It was close to home for me."—*St. Louis title loan borrower*

"They advertise on TV, and it was just because that was the one that was there."—*Houston title loan borrower*

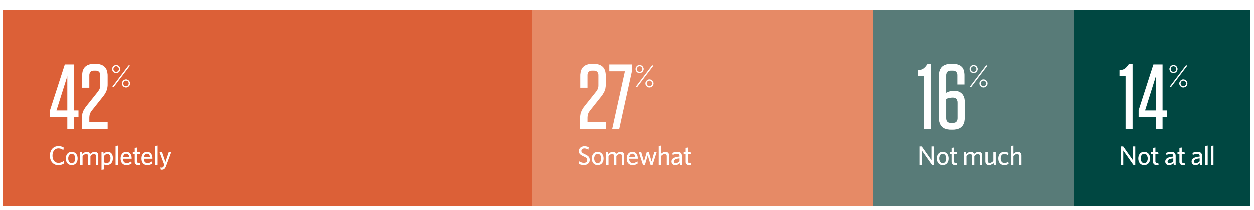
"There's one right there, so let's go because we need this money now. We don't have time to shop, and it's an impulse."—*St. Louis title loan borrower*

Note: All quotes from borrowers in this report come from five focus groups conducted by The Pew Charitable Trusts with title loan borrowers. One group was conducted in Birmingham, Alabama, two were conducted in Houston, and two were conducted in St. Louis.

Figure 5

7 in 10 Borrowers Rely on Lenders for Accurate Information

Few do independent research or comparison shop based on price



Note: Respondents were asked, "How much do you rely on auto title lenders to give you accurate information—completely, somewhat, not much, or not at all?" Results are based on 313 interviews. Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

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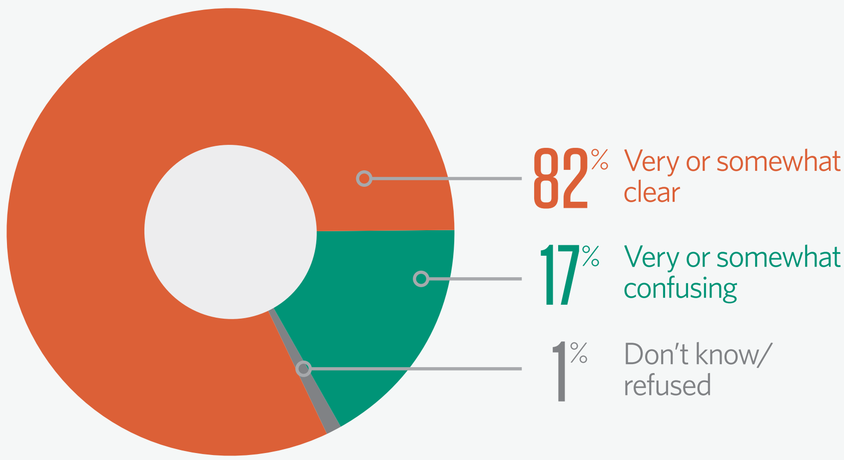
Borrowers say terms are clear

Four in 5 borrowers report that the terms of a title loan are very or somewhat clear, suggesting that most believe they know what is required to repay their debts. (See Figure 6.) As with lump-sum payday loans, the cost to the borrower for the stated term (typically one month) is quite transparent, but the loan's real cost over many months is far higher.[52] This finding raises questions about why people choose unaffordable loans if they think the terms are clear. Twenty-two percent of title loan borrowers report that they have been in such difficult financial situations that they would accept a title loan on any terms offered. (See Appendix C.)

Figure 6

4 in 5 Borrowers Say Loan Terms Are Clear

Most report knowing the amount of the monthly fee



Note: Respondents were asked, "When you took out (that first/the) auto title loan, would you say the terms and conditions of the loan were very clear, somewhat clear, somewhat confusing, or very confusing?" Results are based on 313 interviews.

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Borrowers Rely on Title Lenders for Information

"They tell you you're going to have this paid in a month, and you're thinking, okay." —*Birmingham, Alabama, title loan borrower*

"I rely on their expertise … and depending on the circumstances, I may not know what questions I should ask you."—*Houston title loan borrower*

"You're going to pay exactly what they tell you to do, to pay. If they told me all I had to do was $100, I would give them their $100, and I know I'm done and … I would have to pay that $100 until forever."—*Birmingham, Alabama, title loan borrower*

Borrowers' experiences

Title loans often exceed customers' ability to repay

The average $1,000 title loan with a typical $250 fee requires a lump-sum payment of $1,250 after 30 days, far more than most borrowers can afford. (See Table 2.) This payment represents approximately 50 percent of an average borrower's gross monthly income ($2,500). While payday loan borrowers report that they can afford a median of $100 a month, that figure is $200 for title loan borrowers.[53] As with payday loans, this disparity between what title loan customers can afford and what is required to retire the debt leads them to repeatedly renew their loans.

> An average title loan repayment consumes about half of an average borrower's gross monthly income.

Table 2

2 in 3 Borrowers Cannot Afford Payments of More Than $250 a Month

Few can pay the $1,250 needed to retire a typical lump-sum title loan

Amount	Percentage
$100 or less	36
$101-250	31
$251-500	18
$501 or more	9
Don't know/refused	6

Note: Respondents were asked in an open-ended question, "How much can you afford to pay each month toward an auto title loan and still be able to pay your other bills and expenses?" Results are based on 313 interviews.

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Most title loans are renewals

State regulatory data demonstrate the centrality of renewals to the title loan business model. In Tennessee, approximately 84 percent of all title loans are renewals.[54] In Texas, the figure is at least 63 percent.[55] These data are based on a strict definition of renewals—extensions for a fee; they do not include loans that are repaid and then quickly re-borrowed in less than a month.

Testimony from the head of one of the largest title lenders confirms that, under the stated terms, lump-sum title loan payments do not fit in borrowers' budgets: "Without the ability to renew the Customer Loans, customers will be required to pay the Customer Loans in full within the next 30 days creating a hardship. … Many customers will likely be unable to repay the [Customer] Loans within the next 30 days."[56] Further testimony suggests that the title lending business model is based on this expectation of renewals driven by the inability to repay: "[Our] expected return is due to the fact that the Customer Loans are typically renewed at the end of each month and thereby generate significant additional interest payments. … The average thirty (30) day loan is typically renewed approximately eight (8) times."[57]

These findings mirror those from research on the payday loan market. Three independent analyses found that between 76 and 86 percent of payday lenders' revenue comes from renewals or quick re-borrows.[58]

Even for the minority of title loans that use installments rather than lump sums, payments frequently exceed what typical borrowers say they can afford. For example, in Illinois, an average installment title loan has a monthly payment of about $227; in Virginia, the average is $242, and in Texas, $341.[59]

Payments Exceed Borrowers' Ability to Repay

"[S]ome people are in desperate need of money, and there is just nothing else they can do about it. I think that there are a lot of people that giving them this loan that they can't afford is going to put them in a deeper hole because they're just not going to be able to get out of it." *—Houston title loan borrower*

"It's based on an assumption that things are going to get better, and then if they don't then you're stuck."*—Houston title loan borrower*

"The majority of the time, it's not in the budget. ... You're just getting it to get that fix, to get what you need paid right then and there. Then I'll come back and worry about that later." *—Houston title loan borrower*

"It was huge payments that just were out of reach, but I ended up having to borrow to make those payments."*—St. Louis title loan borrower*

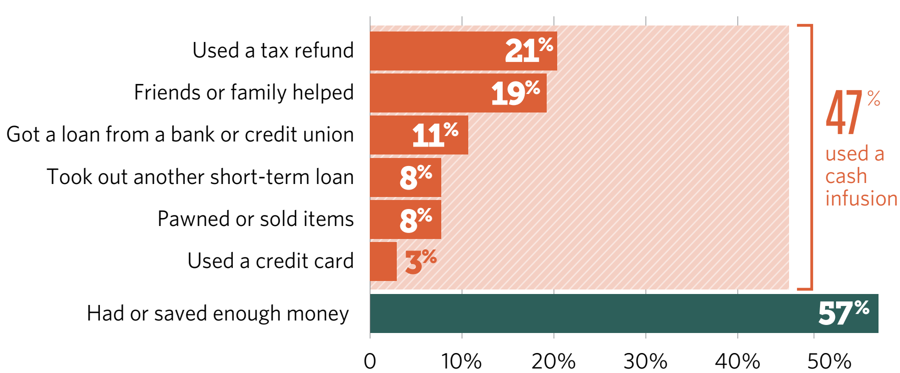
How people repay title loans

To repay a title loan, 47 percent report using a cash infusion, such as a tax refund. (See Figure 7.) Strategies that people employ to repay loans mirror those that some borrowers use to repay payday loans: borrowing from family or friends, getting a longer-term loan from a bank or credit union, or pawning or selling personal belongings. Most borrowers report that they could use at least one of these options instead of taking a title loan, and nearly half eventually resorted to one or more in order to repay a loan.

Figure 7

47% Report Using a Cash Infusion to Repay a Title Loan

Borrowers paid off loans with tax refunds, help from family or friends, or bank loans



Note: Borrowers were asked, "Please tell me whether you have or have not used each of the following methods to pay back an auto title loan. How about ...?" Figures add to more than 100 percent because some people have used multiple methods to repay title loans. Each item was asked separately. Results are based on 313 interviews.

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How Borrowers Repaid Title Loans

"They wanted to take my car just for one payment, and I thought that was so very, very unfair. So what I had to do, I had to go to my credit union to borrow the money to pay them back." *—Birmingham, Alabama, title loan borrower*

"I borrowed to pay it off because I didn't want to lose my car."*—St. Louis title loan borrower*

"I finally just had to go and borrow money off of a credit card and pay it off."*—St. Louis title loan borrower*

"I went ahead and had to borrow from my parents to cover it."*—St. Louis title loan borrower*

"Sometimes you want to go to [a lender] before you ask family because you have pride. And then realize that you need the family's help anyway, so you have to call them to get you out of the situation."*—Houston title loan borrower*

"All the fees, extra charges, late fees, and then trying to come pick it up and charging me for the demand power of trying to pick it up when it was locked in the garage. It was about roughly $8,000 that my grandmother had to pay."*—St. Louis title loan borrower*

Repossession

One in 9 borrowers reports having a car repossessed by a title lender. (See Appendix B.) This figure is in line with data from state regulators, which indicate that typically 6 to 11 percent of borrowers have a car repossessed in a given year.[60] Some 15 to 25 percent of repossessed vehicles are returned to borrowers who pay their overdue loan balances plus fees,[61] and the rest are sold. So approximately 5 to 9 percent of borrowers, or 120,000 to 220,000 people, lose their cars in a given year.[62]

These are not small failure rates for a consumer credit product. Yet while the data suggest that repossession is a serious issue in the title loan market, it affects only a small minority of borrowers. In focus groups, some reported that fear of repossession motivated them to keep up with payments. Others cited it as the reason they asked family or friends for help, or borrowed from another source, even if they had previously rejected those options in favor of a title loan.

If a borrower's vehicle is repossessed and sold and yields more in a sale than the borrower owes, many states require lenders to return the surplus value to the borrower. Research indicates that such surpluses are rare, which may seem surprising because loan-to-value ratios average only one-quarter of the vehicle's retail value.[63] One reason surplus values are uncommon is that lenders typically charge high repossession and storage fees to borrowers in default that increase the amount owed and consume car sale revenue in excess of the original debt.[64]

Lenders charge repossession-related fees to avoid losses on defaulted loans and to earn additional revenue. But because few loans end in repossession, these fees are not a core part of the title loan business model.[65]

Borrowers Experience Repossession

"I'm paying … interest, and my principal hasn't come down a bit. I lost a car like that. … We paid on it for almost a year. Then it dawned on me, and I finally said, 'You know, this is ridiculous; just take this stupid car.' "—*St. Louis title loan borrower*

"They took my truck … a $2,000 truck, and I borrowed $400. … I tried calling them for a few weeks, and she just kept saying, 'Read your contract.' "—*Houston title loan borrower*

"When I came to tell them that I couldn't pay, he took my keys and put it on the board and told me, 'Miss, the car is ours.' "—*Birmingham, Alabama, title loan borrower*

"Well, I made like two payments, and then I realized that if I didn't pay it off in full that the loan just kept renewing itself every month. … There was no way I was going to pay that much money back. So I just had to cut my losses. … I was like, 'No, y'all can have this car.' "—*St. Louis title loan borrower*

"We paid probably in total about $1,500 when we got done, and they still ended up taking it." —*St. Louis title loan borrower*

"I've been called [as a police officer] by a customer [having a car repossessed] who is not understanding what they were getting themselves into and thinking a police officer could help. I've gotten calls from the company themselves and the customers."—*St. Louis title loan borrower*

The consequences of repossession likely vary depending on each borrower's situation. Thirty-five percent of respondents report having no more than one working vehicle in their household; the rest have two or more.[66] (See Appendix B.) Nearly all report using a car to complete essential tasks such as traveling to work, school, and medical appointments and to buy food and other household goods. (See Appendix B.) Of those who drive to school or work, half said they would get a ride, carpool, or use another car in the household if their car were repossessed. (See Table 3.) Thirty-one percent would take public transit, walk, or bike, and 15 percent said they could not get to school or work.[67] For this last group in particular, the consequences of losing their car could be dire.

Table 3

Most Borrowers Have Other Ways to Commute to Work If a Car Were Repossessed

15% report that they would not be able to get to school or work

Ways to Commute	Percentage
Would get a ride, carpool, or use another car in the household	50
Would take public transit	18
Would walk or bike	13
Could not get to work or school	15

Note: Borrowers were asked, "If your car were repossessed, how would you get to school or work?" Results are based on 313 interviews. Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

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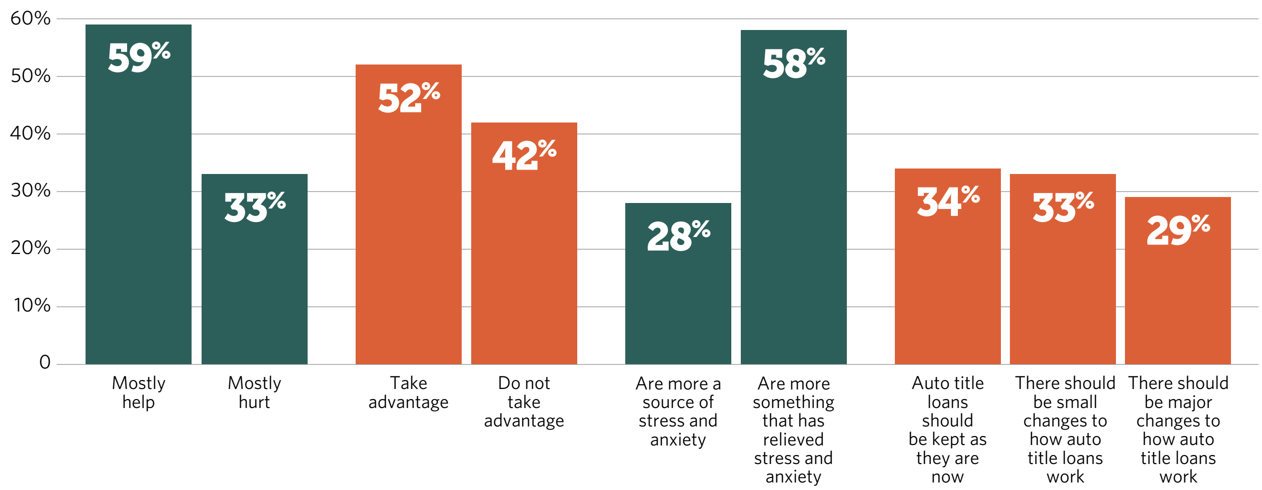
Borrowers' opinions

Borrowers see title loans as providing help and temporary relief at a difficult time, but half feel that the loans take advantage of them. (See Figure 8.) A greater number say the loans help more than they hurt, but an even larger majority favors changes to how title loans work. The conflicted sentiments of title loan borrowers are similar to those expressed by payday loan borrowers.[68] Customers appreciate having credit available to them but feel that the terms are unfair and that the loans do not serve them well. Borrowers are split as to whether they would be likely to take a title loan again if they were in a financial bind. (See Figure 9.)

Figure 8

Borrowers Express Conflicting Feelings About Title Loans

Customers say the loans help and provide relief but take advantage and should be changed



Note: Borrowers were asked: "Overall, do you think that auto title loans mostly help borrowers like you or mostly hurt borrowers like you?" "What do you think, do auto title loans take advantage of borrowers or not?" "Have auto title loans been more a source of stress and anxiety for you and your family or more something that has relieved stress and anxiety?" "Which of the following best describes your view?" Each question was asked separately. Results are based on 313 interviews. Data do not add to 100% because "Don't know," "Refused," and "Both" were omitted from this chart.

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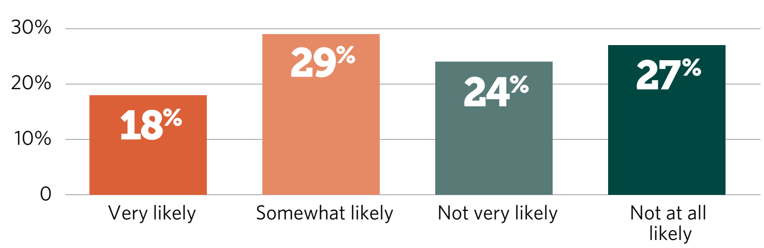
Figure 9

Just Under Half of Borrowers Say They Are Likely to Use Title Loans Again

51% would not borrow in the future



Note: Borrowers were asked, "If you find yourself in a financial bind again, how likely is it that you would take out an auto title loan?" Results are based on 313 interviews. Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

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Borrowers want policymakers to act

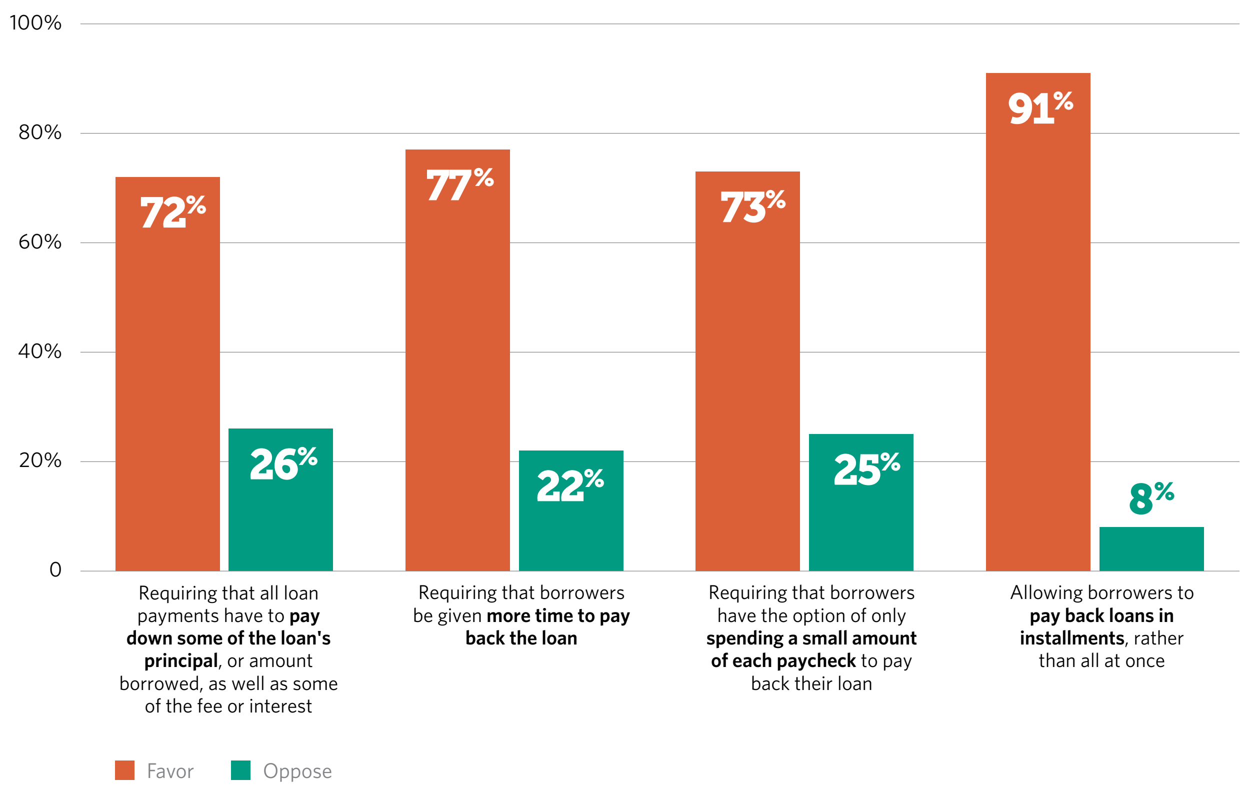
Sixty-six percent of title loan borrowers believe the industry should be more regulated. (See Appendix B.) Specifically, they favor new requirements ensuring that title loans are repayable in affordable, amortizing—or principal-reducing—installments. (See Figure 10.) This structure would allow them to make predictable and realistic payments that reduce their loan balance and provide a clear pathway out of debt. This change is particularly needed in the title loan market because the average loan size ($1,000) is much larger than that of an average payday loan, and the costs associated with nonpayment are higher, because the vehicle can be repossessed.

66% of title loan borrowers believe the industry should be more regulated.

Figure 10

Borrowers Overwhelmingly Support Requiring Affordable Installment Payments

Most title loan customers want more regulation



Note: Borrowers were asked, "Now I'm going to read you some ideas for how title loans could be changed or modified. After I read each idea, tell me whether this sounds like something you would favor or oppose. How about …? Do you favor or oppose this?" Each item was asked separately. Results are based on 313 interviews. Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

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Solutions for the title loan market

Many states do not allow high-interest title lending today. Pew recommends that they continue to prohibit this practice. Studies have found mixed results as to whether greater access to high-interest credit benefits or harms consumers overall.[69] Pew's data show that many people who use these types of loans are coping with long-term financial problems, including persistent difficulty covering regular expenses. More access to credit will not solve these imbalances. In other words, the evidence does not support an expansion of title lending.[70]

Instead, there is strong evidence to support eliminating or reforming high-cost title loans. In states that allow title lending today, regulation is urgently needed to prohibit this harmful form of credit or substantially change it to make the market safer and more transparent. Pew's proposed solutions are neither an endorsement of high-interest credit nor a promotion of credit as a means to cope with persistent cash shortfalls. Rather, they are intended to help policymakers address the harms of title loans where they currently exist, while allowing for the evolution of more beneficial and affordable products.

Because of the collateral required, the title loan market presents unique risks to borrowers, and it is important to provide safeguards that reduce the share of loans that end in vehicle repossession. The consequences of losing a car after defaulting on a title loan can be severe, especially for the 1 in 3 borrowers who do not have another vehicle in their household. However, as in the payday loan market, the more pervasive problems in the title loan market are unaffordable payments, unrealistically short repayment periods, and unnecessarily high prices. Regulators can take concrete steps to address these issues and reduce the resulting harm to borrowers.

Improve affordability

Pew's extensive analysis of payday loan products—as well as other research on the effects of regulatory changes, particularly Colorado's payday loan reform, which replaced balloon payments with more affordable installments—has important implications for the title loan market.[71] Because of the similarities between auto title and payday loans, the options for improving affordability are also comparable.

One key element of improving affordability is identifying what constitutes a reasonable payment for a given borrower. To do this, lenders should be required to assess applicants' ability to repay based on their income and expenses. Pew's previous research identified a benchmark for determining when small-dollar loans are unaffordable for most consumers: the 5 percent affordability threshold.[72]

Data from payday and installment loan markets indicate that monthly payments equal to more than 5 percent of a borrower's monthly gross income would exceed a typical customer's ability to repay.[73] Policymakers should presume that any loans with monthly payments larger than 5 percent of the borrower's gross monthly income are unaffordable, unless thorough underwriting has demonstrated that the borrower can afford them while meeting all other financial obligations and without needing to re-borrow to make ends meet.[74] Pew developed this threshold based primarily on four data sources:

- The share of a borrower's paycheck that is spent on fees to renew or re-borrow a payday loan without reducing the principal.
- The amount that borrowers report they can afford to pay compared with their self-reported income.
- The share of a Colorado borrower's paycheck that is spent on loan payments under the state's successful regulatory reforms.

- The share of a borrower's paycheck that is spent on payments for an underwritten, unsecured loan from a traditional consumer finance company.[75]

This threshold refers only to the size of a borrower's payment, not to the loan price. (See Table 4.) It works for loans of any size and for customers at all income levels. Though originally identified for the payday loan market, this threshold would also improve affordability in the title loan market. Moreover, adopting this policy for title loans would allow policymakers to treat all small-dollar loans consistently, whether secured by a postdated check, electronic debit authorization, car title, or borrower's signature.[76]

Table 4

The 5% Threshold Results in Installment Payments That Are Affordable for Most Borrowers and Profitable for Lenders

Payments are based on borrowers' income

Annual income	Monthly income	Monthly installment payment (at 5% of monthly income)
$18,000	$1,500	$75
$24,000	$2,000	$100
$30,000	$2,500	$125
$36,000	$3,000	$150
$48,000	$4,000	$200
$60,000	$5,000	$250

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Establishing Affordability Without Documented Income

Payday lenders require borrowers to have a documented income, but some title lenders do not.* Policymakers may wish to preserve the availability of title loan credit for people who are paid in cash or have difficulty documenting income. If applicants do not have paperwork to demonstrate their income but have collateral in the form of a vehicle, states can allow lenders to calculate payments based on a low level of assumed income, such as the state or federal minimum wage for a full-time employee. The payments resulting from this assumption are small enough that in most cases lenders will choose to document income if possible.

* Todd J. Zywicki, "Consumer Use and Government Regulation of Title Pledge Lending," George Mason University School of Law Mercatus Center (2010), 13, accessed Sept. 16, 2014, http://www.law.gmu.edu/assets/files/publications/working_papers/1012ConsumerUseandGovernmentRegulation.pdf; and Consumer Federation of America and Center for Responsible Lending, "Driven to Disaster" (2013), 10, accessed Aug. 22, 2014, http://www.responsiblelending.org/other-consumer-loans/car-title-loans/research-analysis/CRL-Car-Title-Report-FINAL.pdf.

Curtail unnecessarily long loan durations

With effective reforms, including strong ability-to-repay standards, lump-sum loans will be scarce and installment loans with affordable payments will become the norm. But even after this transition occurs, some lenders may attempt to increase revenue by designing loans with unnecessarily long repayment terms.

Already in the online installment payday loan market, some lenders have used excessive durations to increase the amount paid by borrowers. Under this strategy, monthly fees paid over unnecessarily long periods drive up the cost of the loan. For example, a $300 loan that is structured to last eight months at a cost of $1,198.75 in fees requires the borrower to pay a total of $1,498.75.[77] Similarly, one auto title lender offers 16-month loans of $500 that cost $1,111 for total repayment of $1,611 and of $1,500 with a cost of $2,862 and a $4,362 total repayment.[78]

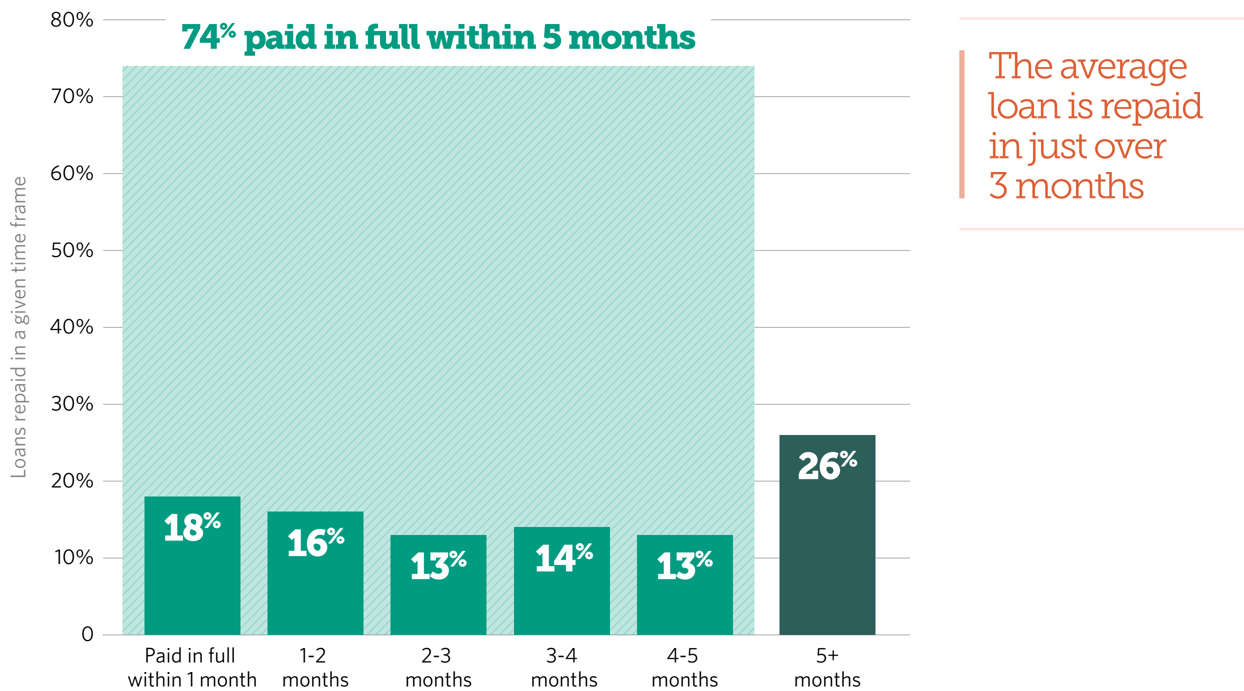
Prepayment

However, evidence also suggests that borrowers pay off high-cost loans early when they can afford to do so.[79] In Colorado, where a 2010 legislative reform required payday loans to be repayable in no less than six months, three-quarters of all loans are repaid by the end of the fifth month. (See Figure 11.) Because the Colorado law prohibits front-loading of fees and interest, borrowers who repay early are not subject to prepayment penalties or other charges related to refinancing.[80]

Figure 11

Most Colorado Payday Installment Loans Are Paid Off Early

Affordability requirement lets borrowers choose when to repay



Source: Colorado Office of the Attorney General, 2014

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If regulators require loans to have affordable payments, some lenders might attempt to impose unnecessarily long repayment terms. It is unclear how substantial the problem would be, given that borrowers could pay loans off early. Nevertheless, policymakers should implement safeguards to reduce this risk.

Most importantly, policymakers should ensure that borrowers can repay loans early without incurring penalties. In addition, borrowers who prepay should receive a pro rata refund of any fees paid to originate the loan. Though origination fees may be reasonable in some circumstances, these fees encourage lenders to steer borrowers to refinance in the subprime, small-dollar lending market, so requiring prorated reimbursement is necessary to protect consumers.[81]

Fixed maximum loan terms

Policymakers may also wish to set maximum allowable loan durations. One approach is to set fixed maximum loan terms. Most states where payday or title lenders operate already have maximum loan terms, which lawmakers could adapt to installment loan markets.[82] As Colorado's installment payday market demonstrates, even at high interest rates, six months is generally long enough for a borrower to repay a $500 loan. In other installment loan markets, one year is usually long enough to repay $1,000.[83]

However, there are drawbacks to imposing fixed maximum loan terms. The feasibility of a given loan term depends on the borrower's financial wherewithal and the principal value of the loan, among other factors, and fixed terms do not account for these variables. For example, using the 5 percent affordability threshold and a six-month term, someone earning $60,000 annually ($5,000 monthly) who borrows $500 would repay $250 a month, or $1,500 total (an unnecessarily high cost of $1,000). This borrower could afford to repay the loan faster, resulting in a much lower cost of borrowing.

Conversely, six months would not be long enough for a low-income borrower to repay the same $500 loan. Someone earning $18,000 annually ($1,500 monthly) could afford to pay only $75 a month. Over six months, that amount would total $450, not even enough to repay the loan principal. This borrower would need a longer term.

Flexible maximum loan durations

Another approach is to establish a flexible loan-term rule. Under this system, the maximum allowable duration scales according to each borrower's income, the size of the installment payment, and the principal amount borrowed. One method for determining maximum loan duration (in months) is to divide the loan's principal by the borrower's average daily income.

The formula shown in Table 5 would prevent the problems associated with excessive loan lengths while avoiding the limitations of fixed maximum terms by structuring each loan according to what the borrower can afford. It adjusts to reflect different circumstances, is easy to calculate, and produces reasonable loan terms that are viable for borrowers and lenders. For loans with monthly installments roughly equal to 5 percent of borrowers' monthly gross income, the formula results in maximum durations of approximately one month for each day of income borrowed.

Table 5

A Formula for Preventing Excessive Durations for Installment Loans

Maximum loan terms should be calculated based on income and principal

$$\text{Maximum loan duration (months)} = \frac{\text{Amount borrowed}}{\text{Borrower's average daily income}} \times \frac{5\%}{p}$$

where p is the loan's payment-to-income ratio (monthly payment due divided by the borrower's gross monthly income). This allows the duration to scale with payment sizes larger or smaller than 5% of gross monthly income (see discussion of 5% affordability threshold above).

Examples: The following examples show formula results for loans with monthly payments equal to 5% of borrowers' gross monthly income.

Borrower income	Monthly payment at 5% of monthly income	Maximum loan duration (in months)		
		$300 loan	$500 loan	$1,000 loan
$18,000 a year $1,500 a month, $49 a day	$75	6.1	10.1	20.3
$30,000 a year $2,500 a month, $82 a day	$125	3.7	6.1	12.2
$48,000 a year $4,000 a month, $132 a day	$200	2.3	3.8	7.6

Notes: Examples shown above assume that other policy safeguards have also been implemented, including ability-to-repay standards that reduce periodic payments to an affordable amount and minimization of prepayment penalties or fees associated with refinancing. The formula includes a modifier (5 percent divided by p) to normalize loan durations while allowing for periodic payments that are larger or smaller than the recommended affordability standard (the 5 percent payment-to-income threshold). This modifier results in longer maximum terms for loans with relatively small periodic payments, and shorter maximum terms for loans with relatively large periodic payments.

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Collateral limits

Another strategy for guarding against unnecessarily long loan durations is to limit lenders' ability to collateralize loans. For example, policymakers could prohibit lenders from taking postdated checks, Automated Clearing House electronic payment authorization, or car titles for longer than a specified period of time. This restriction would create a disincentive for lenders to artificially inflate loan durations because doing so would expose them to more risk and potentially higher loss rates. The allowable time could be set according to the same strategies described for maximum loan terms above: fixed at six months per $500 borrowed, or set according to the formula shown in Table 5.

Increase loan-market efficiency by establishing reasonable price limits

In markets for small-dollar credit such as payday and title loans, competitive forces do not drive costs down. Instead, as an industry analyst notes, "Consumers of payday loans are not price sensitive (or sufficiently price sensitive to drive competition) but choose lenders on speed and convenience." [84] To gain customers, lenders compete by adding more locations instead of lowering prices.[85] This practice increases overhead costs and makes the business model highly inefficient with each store serving relatively few customers. Because lenders do not compete primarily on price, consumers pay excessive rates: typically 200 to 300 percent APR for title loans, often reaching the ceilings in states that have them.[86]

Economic theory suggests that when market prices exceed costs, prices should decline because businesses can charge less to attract customers as long as they remain profitable. Economists Katherine Samolyk, Robert Avery, and Mark Flannery have analyzed why this mechanism does not occur in payday loan markets and have identified a solution.[87] In particular, they cite price limits that are high enough for lenders to be profitable but low enough to force consolidation and increase efficiency as a way to potentially reduce interest charges without substantially decreasing consumers' access to credit:

> By setting a binding ceiling equal to the minimum average cost, regulators could induce more payday loans from each surviving firm. If demand is very inelastic, reducing the maximum fee may have little effect on the total number of loans taken. However, social costs are lower because the ceiling reduces the number of store locations and hence the fixed costs of providing payday loans. … A higher rate ceiling means that each store needs to attract fewer customers to cover its fixed operating costs. Reducing the fee ceiling will lower the number of payday stores, but perhaps leave the number of payday loans relatively unaffected.[88]

This prediction has proved accurate in describing the impact of payday loan reforms. Pew's research found that in states with price limitations, loans are available and cost less. (See Table 6.) In these states, payday lenders operate more efficiently, with fewer stores that each serve more customers.[89] For example, following reforms in Colorado and Washington state (which also enacted a payday loan law that resulted in below-average costs), stores now serve an average of more than 1,000 distinct customers annually, far more than before their laws changed.[90] The title loan market would likely see similar results from price limitations,[91] because, like payday loans:

1. Title loans are small loans made through retail stores to people with badly damaged credit histories.
2. The business model is based on serving a small number of repeat customers at each store and attracting new customers by opening more locations rather than lowering prices.
3. Most revenue is used to cover overhead, with less than a fifth spent on covering losses.
4. Serving more customers at each store has relatively little effect on fixed costs.

As noted earlier, title and payday lenders spend more than three times as much on overhead as they do to cover losses. The largest title lender has 4.2 employees per store, compared with 2.5 employees per store at the largest payday lender.[92] Additionally, title loan stores tend to serve fewer customers than payday loan stores.[93]

Table 6

Lower Price Limits Drive Consolidation

Payday loans cost more when states fail to limit interest rates

	Average cost to borrow $300 for 5 months	Median stores per 100,000 residents
Lower-than-average rate cap	$281	3.0
Average rate cap	$435	7.2
Higher-than-average rate cap	$528	14.9
No rate cap	$604	12.9

Note: Among states that provide information on how many borrowers and stores they have, those with below-average prices tend to have more borrowers per store.

Source: The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (2014)

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When asked in Pew's focus groups whether they would be willing to have many stores close if it meant lower prices at the remaining locations, title loan borrowers were eager to make that trade-off. Based on what occurred in states that required lower prices for payday loans, this process would involve four steps:

1. Policymakers enact reforms requiring lower but viable prices and affordable payments.
2. Lower prices provide insufficient revenue to support all existing stores, so lenders consolidate operations into fewer locations and in some cases diversify their product offerings to include payday or other small loans as well as title loans.
3. The pool of borrowers utilizes the remaining stores.[94]
4. Each remaining store's revenue net of losses remains roughly unchanged because of its large increase in borrowers served.

No state has yet enacted this policy in the title loan market. To project what a more efficient title loan market would look like in this type of scenario, Pew modeled a typical store's revenue and losses with an increased customer count. To maintain current revenue net of losses, a title loan store that diversified to offer both title loans and payday loans would serve approximately 1,600 customers annually, of whom 800 would be title loan borrowers and 800 payday loan borrowers. (See Table 7.) This figure is somewhat higher than the number of customers served by an average payday loan store in Washington and Colorado today, after their reforms.

Table 7

Fewer Stores and Lower Prices Mean a More Efficient Title Loan Market

Reducing costs for lenders and borrowers protects access to credit and profitability: estimated outcomes following reforms

	Current (title loans only)	Projected—more efficient (diversified to offer additional products, e.g., payday loans)		
	Title loan customers	Title loan customers	Payday loan customers	Totals per store
Borrowers per store	300	800	800	1,600
Revenue per borrower per year	$1,200	$460	$211	$335.50
Revenue per store	$360,000	$368,000	$168,800	$536,800
Losses	$64,800	$172,800	$68,000	$240,800
Revenue net of losses	$295,200	$195,200	$100,800	$296,000

Notes: The estimate above illustrates how lenders may consolidate operations and diversify product offerings if policymakers implement Pew's proposed reforms (including requiring affordable payments, amortization, and reasonable limits on loan duration and pricing). It assumes that title lenders would serve more customers per store and introduce additional products, such as payday loans—as companies have done in some states that require lower title loan fees. Current data are rounded estimates based on available state regulatory and company data. This projection maintains lenders' revenue net of losses by assuming that loan size and loan losses remain the same on a per-borrower basis for title loans. The "more efficient" payday loans use Colorado's aggregate lender-reported 2013 data on loan size ($393), fees paid ($211), and losses per customer ($85); see also The Pew Charitable Trusts, "Trial, Error, and Success in Colorado's Payday Lending Reforms" (2014), available at http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2014/12/trial-error-and-success-in-colorados-payday-lending-reforms. Revenue per store is a sum of losses and revenue net of losses. The store's revenue consists of the fees paid per borrower multiplied by its customer count.

Sources: State regulatory data from Mississippi, Tennessee, Texas, and Virginia, as well as filings from TMX Finance; and Colorado Office of the Attorney General, 2014

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Lower Prices Are Possible at Banks and Credit Unions

Title loans could cost less than projected in the analysis for traditional title loan stores if they were offered by providers that cover overhead expenses by selling many products to a large number of customers, such as banks and credit unions. Depository institutions would also benefit as lenders by making loans to existing customers who have other accounts with them. Some credit unions already serve members who have damaged credit by offering installment loans that are secured by car titles and have interest rates below 25 percent APR.[*] Depository institutions are better positioned to offer lower-cost title loans than are stores that sell only a small variety of financial products to a limited population.[†]

* Examples include Family Federal Credit Union, Silver State Schools Credit Union, FedChoice Federal Credit Union, Texas Dow Employees Credit Union, St. Louis Community Credit Union, and University Credit Union.

† Depository institutions also benefit from having a lower cost of funds than nonbank providers.

Diversifying revenue

If a store offered only title loans in the example in Table 7, it would need approximately 1,200 customers annually to maintain its revenue net of losses at these lower prices.[95] In states that require lower charges for title loans, some diversification is already happening: Stores are making up for revenue lost due to lower prices by offering a wider range of financial services, such as check-cashing, bill-pay services, prepaid cards, tax preparation, or pawn loans.

Compared with operators that sell multiple products, stores that offer only title loans tend to have more title loan revenue and serve more title loan borrowers at each location, as might be expected, because they must in order to cover all of their operating expenses with just that one product.[96] For example, in Virginia, which has unusually high title loan revenue per store, lenders can be viable while selling only title loans, and just 28 percent of title loan branches offer payday loans.[97] In Oregon, where state law limits the size of title loan fees, all title lenders also offer payday loans.[98]

Similarly, following Colorado's 2010 payday loan reform, large businesses that offered check-cashing as well as payday loans fared far better, closing only a sixth of stores, compared with more than half among those that did not.[99]

Recommendations lead to lower-cost loans with affordable payments

Policymakers seeking to allow title lending, protect consumers from needless costs, and facilitate industry profitability will need a package of reforms that improves market efficiency by requiring affordable payments, competitive costs, and reasonable loan durations. Table 7 demonstrated how a typical store might operate in this market, and Table 8 shows the cost, payment structure, and duration of a $1,000 title loan for an average borrower, based on the recommendations outlined here.

Table 8

Building a More Affordable Title Loan

Payment and duration limitations improve efficiency, protect borrowers

	Current	Projected (more efficient)
Average loan size	$1,000	$1,000
Fees paid per borrower per year	$1,200	$460
Loan payment as share of gross monthly income	50%	5%
Amount due in 1 month	$1,250	$122
Average stated loan duration	30 days	1 year

Notes: Duration is the time needed for an average borrower earning $30,000 a year to repay a $1,000 loan using no more than 5 percent of monthly income for each monthly payment. The APR that would result from this sample loan is 76 percent. Note that this is not a recommended APR standard; rather, it shows the APR that would result from a given sample loan under policies that use cost limitations to replicate a price-competitive market. The monthly payment is the principal plus the fee divided by 12 months ($1,000 + $460 = $1,460/12 = $121.67).

Sources: State regulatory data from Mississippi, Tennessee, Texas, and Virginia, as well as filings from TMX Finance

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The loan depicted in Table 8 has an APR of 76 percent,[100] which should not be understood as a recommended price for a title loan. Rather, it is the APR that would result from the projected scenario in which cost limits are used to replicate a price-competitive market, and a maximum loan duration is set according to the formula described in Table 5. These policies would result in relatively lower APRs for larger loans and lower-income borrowers and relatively higher ones for smaller loans and higher-income borrowers. It is possible that efficient nonbank lenders could profitably offer title loans at lower prices to subprime customers.

Pew's policy recommendations for all small-dollar loans

As this analysis has shown, the title loan market shares many similarities with the payday loan market. The typical borrower for both products is a low-income worker who routinely struggles to pay ordinary living expenses and who usually renews or re-borrows the loan to make ends meet. And the same fundamental problems afflict both markets—unaffordable balloon payments, unrealistically short repayment periods, and unnecessarily high prices. Therefore, Pew renews its call to policymakers to enact policies to cover all small-dollar cash loans, including storefront payday loans, online payday loans, title loans, and consumer installment loans from banks and nonbanks.

State policymakers may choose to eliminate high-cost auto title and payday loans altogether or to fundamentally reform them to be safer and more affordable. The Consumer Financial Protection Bureau does not have the authority to regulate interest rates, but it can and should require small-dollar loans to have manageable installment payments and establish certain important safeguards. Pew's small-dollar loan policy recommendations can reduce the cost of title loans and improve the affordability of payments while maintaining consumer access to credit:[101]

1. **Ensure that the borrower has the ability to repay the loan as structured.** Policymakers should require all small-dollar loans to have payments that borrowers can afford. Lenders should be required to determine applicants' ability to repay based on their income and expenses. However, policymakers wishing to allow for a streamlined underwriting process may choose to treat loans with monthly payments of less than 5 percent of the borrower's monthly gross income as meeting a "proxy" ability to repay test (Pew's research indicates that for most borrowers, monthly payments above 5 percent of their gross monthly income are unaffordable). Without exception, all loans should be required to have affordable payments determined according to an ability-to-repay test or "proxy" ability-to-repay standard. Additionally, regulators should treat frequent refinancing or high default rates as evidence of unaffordability and poor underwriting.
2. **Spread loan costs evenly over the life of the loan.** If loans are required to have affordable installment payments, front-loading of fees and interest creates incentives for lenders to refinance loans and extend overall indebtedness. Any fees should be incurred evenly over the life of the loan. Loans should have substantially equal payments, each of which reduces the principal, amortizing smoothly to a zero balance.
3. **Guard against harmful repayment or collections practices.** Policymakers should ensure that lenders do not use excessively long repayment periods to increase revenue. Generally, six months is long enough to repay a $500 loan, and one year is long enough to repay $1,000. Pew has proposed a flexible formula to scale these typical repayment periods for borrowers with different incomes and for loans of varying sizes. Policymakers should also ensure that vehicle repossession is only a last resort for lenders, rather than a way to earn additional revenue.
4. **Require concise, accurate disclosures of periodic and total costs.**
5. **States should continue to set maximum allowable charges.** Research shows that loan markets serving those with poor credit histories are not price competitive.

Based on this report's findings, the first, third, and fifth policy recommendations are most important for the title loan market. For more details on these policy recommendations and the research base behind them, see The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 44–47, http://www.pewtrusts.org/small-loans.

Conclusion

The auto title loan market is plagued by the same major problems found in the payday loan market: unnecessarily high prices and unaffordable payments that lead to extended indebtedness. But title loan borrowers face the additional risk of losing an asset—a car—which, for some, is their primary form of transportation. On average, the larger loan sizes in the title loan market also lead borrowers to spend more than double the amount payday loan borrowers do annually.

The first nationally representative survey of title loan borrowers found that they hold mixed views of the loans, seeing them as taking advantage but also providing relief. Two-thirds of borrowers favor more regulation of this market, especially a requirement that loans be repayable in affordable installments. Colorado employed this regulatory strategy in the payday loan market with great success while also requiring lower prices. But no state has done so in the title loan market, where stores serve even fewer customers than in the payday loan market.

Title loans carry substantial risk for those who use them, so those states that do not have high-interest title lending should continue to prohibit it. In the states where title loans currently exist, lawmakers can ensure safer, less costly, and readily available subprime credit by making title and other small-dollar loans repayable in affordable installments, with reasonable limits on cost and duration. Such reform can drive industry consolidation, leading to more efficient title loan stores that would serve larger numbers of customers at each and could viably charge lower prices. The Consumer Financial Protection Bureau and state policymakers can achieve these outcomes by implementing Pew's policy recommendations.

Appendix A: Borrowers' demographics

Table A.1

Borrowers' Demographics

Demographic group	Percentage of title loan borrowers
Homeowners	50
Renters	50
Single	37
Married	46
Separated or divorced	14
Widowed	2
Income less than $15,000	20
$15,000 to $24,999	22
$25,000 to $29,999	12
$30,000 to $39,999	11
$40,000 to $49,999	7
$50,000 to $74,999	13
$75,000 to $99,999	8
$100,000 or more	4
African-American	14
Hispanic	12
White	65
Other race or ethnicity	7
Female	43
Male	57
Ages 18-34	34
Ages 35-49	34
Ages 50-64	21
Ages 65 or older	10
Employed	63
Self-employed	13
Employed by others	50
Student	6
Homemaker	4
Retired	9
Unemployed	11
Disabled	8
Less than high school	20
High school	36
Some college	27
College or more	16

Note: Results are based on 313 interviews. Some data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

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Appendix B: Additional findings from Pew's survey

Tables B.1–B.7

Additional Findings

"I'm going to read you several things that some people have told us happened to them. For each one I read, please tell me whether it has happened to you. How about ... Has this happened to you or not?"	Has happened (%)	Has not happened (%)
Had a car repossessed by an auto title lender	11	89
Had an auto title lender threaten to repossess your car	19	80
Had someone threaten to contact your employer about your auto title loan	10	89
Had someone threaten to contact your friends or family about your auto title loan	12	87

Note: Each item was asked separately. Results are based on 313 interviews. Some data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

"Do you use your car to...?"	
Travel to school or work	80 (%)
Travel to medical appointments	95
Travel to buy food and other household goods	98

Note: Each item was asked separately. Results are based on 313 interviews.

(Among those who are currently employed) "Are you self-employed or a small business owner, or not?"	
Yes, self-employed	20 (%)
No, not self-employed	77
Both, self-employed and work for someone else	3

Note: Results are based on 196 employed respondents.

"Thinking back now to (that first/the) time you took out an auto title loan, what specifically did you need the money for?" "And was that primarily a personal or family expense, or was that primarily for a business that you own or operate?"	
Personal or family expense	94 (%)
For a business I own or operate	3
Both (not read aloud)	2

Note: Results are based on 313 interviews. Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

"Have you used a ... in the past year?"	Yes	No
Credit card	45 (%)	53 (%)
Prepaid card	35	64

Note: Each item was asked separately. Results are based on 313 interviews. Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

"Thinking of all the members of your household who are currently living at home, if you added up how many working cars or trucks all of them own or lease, how many would that be?"	
No car	3 (%)
1	32
2	39
3	16
4 or more	10

Note: Results are based on 313 interviews.

"Which of these statements comes closer to your point of view?"	
Auto title loans should be more regulated	66 (%)
Auto title loans should not be more regulated	31

Note: Results are based on 313 interviews. Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

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Appendix C: Methodology

Opinion research

Findings in this report are based in part on a survey conducted among 313 title loan borrowers. The sample for this survey was compiled over the course of eight months of screening on a nationally representative weekly survey. Borrowers' quotations in this report come from a series of focus groups with title loan borrowers.

Survey methodology

Social Science Research Solutions omnibus survey

The Pew small-dollar loans project contracted with Social Science Research Solutions (SSRS) to conduct the first nationally representative, in-depth telephone survey with title loan borrowers about their loan usage. To identify and survey a low-incidence population such as these borrowers, SSRS screened 1,000 to 2,000 adults a week on its regular omnibus survey, using random-digit dialing methodology, from August 2011 to April 2012. The term "omnibus" refers to a survey that includes questions on a variety of topics. This omnibus survey probably minimized title loan borrowers' denial of their usage of this product, because the survey included mostly nonfinancial questions purchased by other clients, and the title loan questions were asked after other, less sensitive questions, giving interviewers a chance to establish a rapport with respondents.

The omnibus survey asked respondents whether they had used a title loan. If, during the months of August through mid-December, respondents answered that they had used a title loan, they were placed in a file to be re-contacted later. In order to maximize participation once the full-length survey was ready to field, people who had used a title loan were then given the full-length survey and paid an incentive of $20 for participating, as were those who had been identified initially. Respondents were told about the compensation only after having indicated that they had used a title loan.

Sample and interviews

Pew purchased time on SSRS' omnibus survey, EXCEL, that covers the continental United States. A total of 49,684 people were screened and asked about title loan usage.

A total of 313 adults completed the full-length title loan survey. Sampling error for the full-length survey of title loan borrowers is plus or minus 6.4 percentage points, including the design effect.

EXCEL is a national weekly, dual-frame bilingual telephone survey. Each EXCEL survey consists of a minimum of 1,000 interviews, of which 300 were completed with respondents on their cellphones and at least 30 were conducted in Spanish, ensuring unprecedented representation on an omnibus platform. Completes are representative of the continental U.S. population of adults 18 and older. EXCEL uses a fully replicated, stratified, single-stage, random-digit dialing sample of landline telephone households, and randomly generated cellphones. Sample telephone numbers are computer-generated and loaded into online sample files accessed directly by the Computer-Assisted Telephone Interviewing system. Within each sample household, a single respondent is randomly selected. The sampling and overall methodologies for the title loan and payday loan surveys were the same. Details about EXCEL and its weighting are available at http://www.pewtrusts.org/~/media/Assets/2012/07/19/Pew_Payday_Lending_Methodology.pdf.

Question wording: Omnibus survey

Wording for omnibus survey questions is available at http://www.pewtrusts.org/~/media/Assets/2012/07/19/Pew_Payday_Lending_Methodology.pdf.

Screening phase (measuring incidence and compiling sample for callbacks):

- In the past five years, have you taken out an auto title loan, where you borrow money against your car title to be repaid in a short period of time?

Re-contact phase (calling back respondents who answered affirmatively, and identifying additional borrowers to take the full-length survey immediately):

- I'm going to read a few things that some people have used in the past five years. Please tell me (have you/have you or has anyone in your family) used any of them:

An auto title loan, where you borrow money against your car title to be repaid in a short period of time?

Question wording: Full-length survey of title loan borrowers

Full wording for questions from the nationally representative, full-length survey of 313 title loan borrowers was included in the main report. Wording follows for the question whose full wording was not contained in the text of the main report. Pew designed questions with assistance from SSRS and Hart Research Associates, except those for demographics, which are based on standard questions asked by SSRS. The sample for this telephone survey was derived from the random-digit dialing omnibus survey. All questions also included "Don't know" and "Refused" options that were not read aloud.

Have you ever felt you were in such a difficult situation that you would take an auto title loan on pretty much any terms offered or have you never felt that way?

1. Yes, have felt that way.
2. No, have not felt that way.

Focus group methodology

Hart Research Associates and Public Opinion Strategies conducted a focus group that was exclusively composed of title loan borrowers in Birmingham, Alabama, in September 2011. In May 2014, Pew also conducted four focus groups composed exclusively of title loan borrowers: two in St. Louis and two in Houston. All participants were recruited by employees of the focus group facilities. All groups were conducted in person, lasted two hours, and included eight to 11 participants. Several other focus groups of small-loan borrowers included one or more title loan borrowers as well.

Endnotes

1 The estimate of 1 percent of American adults using title loans each year is calculated three ways, drawing on data available from state regulatory reports and industry filings:

- The share of adults who use title loans in states that allow them (an average of 1.6 percent, based on the three states that report the number of individual borrowers: Illinois, Texas, and Virginia, which represent approximately 40 percent of the national market by store count) multiplied by the adult population of those states (148 million), yielding 2.4 million.
- The number of title loan stores (8,138, see endnote 4) multiplied by the number of borrowers per store (300, based on industry filings and state regulatory data) (estimate of 2.4 million).
- TMX Finance's customer count (470,000), divided by its share of stores (13.4 percent at the end of 2012), divided by the ratio of its borrowers per store (454) to the average number of borrowers per store (300), yields a similar 2.3 million borrowers.

Federal Deposit Insurance Corporation, *2013 FDIC National Survey of Unbanked and Underbanked Households* (2014), 47, accessed Oct. 29, 2014, https://www.fdic.gov/householdsurvey/2013report.pdf; and U.S. Census Bureau, "Annual Estimates of the Resident Population for Selected Age Groups by Sex for the United States, States, Counties, and Puerto Rico Commonwealth and Municipios: April 1, 2010, to July 1, 2013," 2013 Population Estimates, accessed Jan. 12, 2015, http://factfinder.census.gov. There are approximately 243 million adults in the United States, according to the U.S. Census Bureau's 2013 estimate.

2 ACE Cash Express, "Frequently Asked Questions," 2014, accessed Aug. 29, 2014, https://www.acecashexpress.com/title-loans/faq; and Todd J. Zywicki, "Consumer Use and Government Regulation of Title Pledge Lending," George Mason University School of Law Mercatus Center (2010), 13, accessed Sept. 16, 2014, http://www.law.gmu.edu/assets/files/publications/working_papers/1012ConsumerUseandGovernmentRegulation.pdf. Motorcycles can also be used to secure a title loan in many states.

3 Zywicki, "Consumer Use"; and Jim Hawkins, "Credit on Wheels: The Law and Business of Auto-Title Lending," *Washington and Lee Law Review* 69, no. 2 (2012), accessed Aug. 25, 2014, http://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=4272&context=wlulr.

4 Center for Responsible Lending, *Car-Title Lending* (2013), 16, accessed Aug. 25, 2014, http://www.responsiblelending.org/state-of-lending/reports/7-Car-Title-Loans.pdf. The Center for Responsible Lending's report focused on the 21 states that have a significant presence of high-interest title lending. Additionally, Florida, Minnesota, Ohio, and Oregon have a limited presence of high-interest title lending.

5 Ibid.

6 Pew has published an extensive collection of research about payday lending. See http://www.pewtrusts.org/small-loans.

7 Virginia Bureau of Financial Institutions, *Motor Vehicle Title Lenders* (2014), accessed Aug. 27, 2014, https://www.scc.virginia.gov/bfi/reg_inst/title.pdf; Virginia Bureau of Financial Institutions, *Payday Lender Licensees* (2014), accessed Aug. 27, 2014, https://www.scc.virginia.gov/bfi/reg_inst/pay.pdf; and Commisioner of Financial Institutions, "Report of the Commissioner of Financial Institutions, State of Utah" accessed Sept. 8, 2014, http://www.dfi.utah.gov/PDFiles/Annual.PDF. In Virginia, 29 firms make title loans across 470 branches. Seven of those firms are also registered as payday lenders, and 130 of the branches also offer payday loans (28 percent). By comparison, 22 firms make payday loans at 228 branches. In Utah, 47 percent of firms offering title loans also offer payday loans. Texas has 2,254 single-payment title loan locations, accounting for one-quarter of the national market by store count. State regulatory data indicate that about half of these locations report making payday loans as well. Licensee lists from Oregon show that all 43 stores offering title loans in Oregon also offer payday loans.

8 New Mexico Regulation and Licensing Department, Financial Institutions Division, *Annual Report Regarding Installment Loan Products With APR Greater Than 175%* (2013), accessed Aug. 11, 2014, http://www.rld.state.nm.us/uploads/files/FID%202013%20HB337%20Reports.pdf; Texas Office of Consumer Credit Commissioner, *Credit Access Business (CAB) Annual Reporting* (2013), accessed Aug. 22, 2014, http://www.occc.state.tx.us/pages/publications/consolidated_reports/CAB/2013%20CAB%20Annual%20CAB%20Report%20by%20MSA%204-30-2014.pdf; and 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. This affidavit noted that 83 percent of TMX Finance's portfolio was lump-sum loans. As shown in Map 1, most states do not require loans to be repayable in installments. Even in states such as Texas and New Mexico, which allow both types of loans, 85 percent and 87 percent of loans made are due in a lump sum, respectively.

9 For ability to repay, see The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), accessed Aug. 25, 2014, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/PewChoosingBorrowingPaydayFeb2013pdf.pdf. For market renewals, see Robinson, "Affidavit of John Robinson," 7; Tennessee Department of Financial Institutions, "2012 Report on the Title Pledge Industry," accessed Sept. 16, 2014, http://www.tennessee.gov/tdfi/compliance/tpl/TDFI%202012%20Report%20Title%20Pledge%20Industry.pdf; and Tennessee Department of Financial Institutions,

2014 Report on the Title Pledge Industry (2014), accessed Jan. 14, 2015, http://www.tennessee.gov/tdfi/compliance/tpl/Title%20Pledge%20Report%202014.pdf. Robinson's affidavit noted eight renewals on average.

10 The Pew Charitable Trusts, "The Post Office and Financial Services" (paper presented at the Financial Services and the Post Office Conference, Washingon, D.C., 2014). Veritec Solutions LLC, *Competition Commission Payday Lending Market Investigation* (2013), 10–11, accessed Sept. 10, 2014, https://assets.digital.cabinet-office.gov.uk/media/5329df75e5274a2268000357/130310_veritec_solutions_response_to_is.pdf. "On a sector level, prices are broadly similar because customers are not price sensitive." "[I]mpediments to shopping around occur because consumers are likely to go ahead with the first lender that approves the individual for a loan rather than seek approval from several firms before choosing the best offer. This behaviour is caused by consumers' limited ability to access cheaper mainstream finance, and their desire to have the sums delivered to them swiftly."

11 The Pew Charitable Trusts, *How State Rate Limits Affect Payday Loan Prices* (2014), accessed Jan. 28, 2015, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/StateRateLimitsFactSheetpdf.pdf.

12 Robert B. Avery and Katherine A. Samolyk, "Payday Loans Versus Pawn Shops: The Effects of Loan Fee Limits on Household Use" (2011), accessed Sept. 3, 2014, http://web.law.columbia.edu/sites/default/files/microsites/transactional-studies/files/10PDL_averysamolykpayday.20110909_0.pdf. The Avery and Samolyk paper explains this process: In states which allow higher prices, lenders compete away excess profits by opening more stores, probably because they do not expect to gain more customers by lowering prices. The high prices seen in the title loan market, combined with relatively low loss rates and little evidence of supernormal profits, indicate that the same phenomenon is occurring.

13 Consumer Federation of America and Center for Responsible Lending, "Driven to Disaster" (2013), accessed Aug. 22, 2014, http://www.responsiblelending.org/other-consumer-loans/car-title-loans/research-analysis/CRL-Car-Title-Report-FINAL.pdf; Hawkins, "Credit on Wheels"; Kathryn Fritzdixon, Jim Hawkins, and Paige Marta Skiba, "Dude, Where's My Car Title?: The Law, Behavior, and Economics of Title Lending Markets" (2013), accessed Aug. 25, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2224247; Nathalie Martin and Ozymandias Adams, "Grand Theft Auto Loans: Repossession and Demographic Realities in Title Lending," *Missouri Law Review* 77 (2012), accessed http://law.missouri.edu/lawreview/files/2013/01/Martin.pdf; and Zywicki, "Consumer Use."

14 Hawkins, "Credit on Wheels"; and TMX Finance, Form 10-K, fiscal year ending Dec. 31, 2012, http://www.secinfo.com/d11MXs.xXad.htm#1stPage. This $1,000 loan size is Pew's estimate based on state regulatory data where available (California, Idaho, Illinois, New Mexico, Oregon, Tennessee, Texas, and Virginia), industry filings by TMX Finance and EZ Corp., and an average loan size of $1,000 reported by TJD Financial Services to Jim Hawkins in "Credit on Wheels." Pew's estimate of $1,200 in fees paid annually is based on revenue and number of customers using data from TMX Finance ($656,755,000 in revenue in 2012 and 470,000 customers, or $1,400 each) and state regulatory data from Texas ($866 per customer using lump-sum title loans and $1,196 per customer using installment title loans). Fees paid annually are probably much higher in a state such as California that has larger title loans, and probably much lower in a state such as Oregon that has smaller title loans. The distribution of loan sizes and amounts spent vary far more in the title loan market than in the payday loan market, owing to wide variation in state laws and the fact that title lenders are generally willing to lend more because the loans are collateralized by vehicles. The amount spent per customer on a given title loan may exceed this figure because title loans are often kept out over more than one calendar year, including renewals. It is not possible from the available data to calculate an average number of months of the year that the median borrower has a title loan outstanding, but the loans' sizes, costs, and amounts spent per borrower imply that it is about five to six months of the year.

15 Average annual percentage rates in states that publish data are: Idaho, 310 percent; Illinois, 212 percent; New Mexico, 270 percent for lump-sum, 314 percent for installment; Oregon, 149 percent; Tennessee, approximately 264 percent; Texas, 306 percent for lump-sum, 223 percent for installment; Virginia, 216 percent. Annual percentage rate is the cost of borrowing for one year. Therefore a loan with an APR of 300 percent (25 percent a month), will carry the same APR regardless of how long it is outstanding, though a borrower's costs increase proportionately with each month that it remains unpaid. Interest on title loans, like payday loans, does not compound. An average is unavailable in Tennessee, but a majority of loans are made at the legal maximum rate of 22 percent a month, or 264 percent APR.

16 This calculation is based on a typical title loan of $1,000 plus a typical fee of $250, divided by the average gross monthly income of a title loan borrower, which is about $2,500.

17 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 18, accessed Aug. 25, 2014, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/PewPaydayPolicySolutionsOct2013pdf.pdf.

18 Center for Responsible Lending, *Car-Title Lending*.

19 Ibid., 16. The Center for Responsible Lending's report focused on states that have a significant presence of high-interest title lending. Additionally, Florida, Minnesota, Ohio, and Oregon have at least a limited presence of high-interest title lending.

20 Many lenders require a spare key as well.

21 Martin and Adams, "Grand Theft Auto Loans."

22 Robinson, "Affidavit of John Robinson," 3; and LoanMax Title Loans, "How Does a Title Loan Work?" 2015, accessed Jan. 8, 2015, https://www.loanmaxtitleloans.net/HowItWorks. "And within 20 minutes of your arrival, you'll be leaving with your vehicle AND the cash you need!"

23 Zywicki, "Consumer Use"; and Martin and Adams, "Grand Theft Auto Loans."

24 Ibid.

25 Hawkins, "Credit on Wheels," 552 and 586.

26 Ibid., 586 and 595–98.

27 Ibid.

28 California Department of Business Oversight, *Annual Report, Operation of Finance Companies Licensed Under the California Finance Lenders Law* (2013), accessed Sept. 12, 2014, http://www.dbo.ca.gov/Licensees/Finance_Lenders/pdf/CFL2012ARC.pdf; and Oregon Department of Consumer and Business Services, *Oregon Licensed Consumer Finance Companies: 2013 Payday and Title Loans* (2014), accessed Nov. 10, 2014, http://www.cbs.state.or.us/dfcs/cf/annual_reports/2013.pdf. For example, because Oregon and California exempt loans of certain sizes from their standard interest rate limits, almost all title loans in Oregon are made for $300 or less, but in California most are for $2,500 or more. Average size title loans for states that release data are: California, $3,659; Idaho, $892; Illinois, $893, New Mexico, $1,020 (lump-sum) and $831 (installment); Oregon, $241; Tennessee, $868; Texas, $1,240 (lump-sum) and $1,142 (installment); and Virginia, $1,160.

29 For example, *Tenn. Code Ann. § 45-15-111; Va. Code Ann. § 6.2-2216.* Average annual percentage rates in states that publish data are: Idaho, 310 percent; Illinois, 212 percent; New Mexico, 270 percent for lump-sum, 314 percent for installment; Oregon, 149 percent; Tennessee, approximately 264 percent; Texas, 306 percent for lump-sum, 223 percent for installment; Virginia, 216 percent. Annual percentage rate is the cost of borrowing for one year. Therefore, a loan with an APR of 300 percent (25 percent a month), will carry the same APR regardless of how long it is outstanding, though a borrower's costs increase proportionately with each month that it remains unpaid. Interest on title loans, like payday loans, does not compound.

30 Robinson, "Affidavit of John Robinson," 13. This figure is an average, based on the number of title loan customers in the market and the revenue reported by lenders to state regulators and in company filings. Robinson testified that an average title loan at his company is renewed eight times, for a total indebtedness of nine months per loan, although in most cases these loans will cover parts of two calendar years, which explains why borrowers' annual spending on a title loan is likely lower than their overall spending.

31 Consumer Federation of America and Center for Responsible Lending, "Driven to Disaster." This paper estimates that title loan borrowers spend $3.6 billion annually. Pew calculates this figure differently, based on the number of stores and revenue per store but arrives at a similar conclusion as to the overall amount spent annually on title loans.

32 Veritec Solutions LLC, *Illinois Trends Report: All Consumer Loan Products Through September 2012* (2013), 25, accessed Sept. 16, 2014, http://www.idfpr.com/News/DFI/IL_Trends_Report%20since%20Inception%20through%209-30-12%20final.pdf. Title loans can have stated durations of just a few weeks, while in Illinois, the average stated term is longer than a year because state law requires longer repayment periods.

33 Consumer Federation of America and Center for Responsible Lending, "Driven to Disaster."

34 Ibid.; and Hawkins, "Credit on Wheels."

35 Some states regulate title loans with their pawn loan statutes, but title loans and pawn loans have little in common. Pawn loans average $80, less than a 10th the size of the average title loan. Pawned items remain with the lender while the loan is outstanding, and many are forfeited. Neither is the case in the title loan market. For more on pawn loans, see Susan Carter, Marieke Bos, and Paige Marta Skiba, *The Pawn Industry and Its Customers: The United States and Europe* (2012), accessed Oct. 21, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2149575.

36 TMX Finance, Form 10-K, fiscal year ending Dec. 31, 2011, http://www.secinfo.com/d11MXs.xXad.htm, 21; TMX Finance, Form 10-K, fiscal year ending Dec. 31, 2012, 19–20; and Advance America, Form 10-K, fiscal year ending 2011, http://www.advanceamerica.net.

37 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 18. This estimate of title loan borrowers per store is based on state regulatory data from Mississippi, Tennessee, Texas, and Virginia, as well as filings from TMX Finance.

38 See endnote 1.

39 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), 9, accessed Aug. 25, 2014, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/PewPaydayLendingReportpdf.pdf.

40 Tennessee Department of Financial Institutions, *2014 Report on the Title Pledge Industry*, 6. This Tennessee report notes that the 10 largest operators in the state account for 63 percent of all stores and 77 percent of all loans. Nationally, the largest lender operates about 20 percent of all title loan stores (using the figure in the subsequent endnote and dividing it by the estimated total number of stores in the

market). Two other large title loan operators are LoanMax and Community Loans of America. In the payday loan market, according to Stephens Inc., the largest company, Advance America, operated approximately 13 percent of payday loan stores at the end of 2012.

41 TMX Finance, "Store Locations," accessed Jan. 20, 2015, http://www.tmxcareers.com/store-locations. Noting that TMX Finance operates more than 1,650 stores across three brands.

42 For example, https://www.acecashexpress.com/locations/texas/fort-worth/1355 or http://www.speedycash.com/store-services/find-a-store/alabama/birmingham/palisades-and-green-springs-highway.

43 See also Martin and Adams, "Grand Theft Auto Loans," 76; Gregory Elliehausen, "An Assessment of Consumers' Use of High-Rate Credit Products" (2011), accessed Sept. 16, 2014, http://web.law.columbia.edu/sites/default/files/microsites/transactional-studies/files/12PDL_Elliehausen.High_rate_credit_products_2011-07.pdf; and Veritec Solutions, *Illinois Trends Report*, 25. Pew's survey data indicate the median annual income falls at the high end of the $25,000 to $30,000 range. For calculation purposes in this report, median annual income of $30,000 is used.

44 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*; and The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*. More than half of payday loan borrowers report having trouble paying regular bills at least half the time, and one-quarter report having difficulty paying bills every month. Seven in 10 report using their loans to cover regular living expenses such as rent, mortgage, credit card bills, or utilities.

45 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, 14. These figures are somewhat different than the 69 percent of payday loan borrowers who reported first using a loan for a regular expense, and the 16 percent who reported first using a loan for an unexpected one.

46 Fritzdixon et al., "Dude, Where's My Car Title?" 1,036.

47 Ibid., 1,035. On this question there is a substantial difference from the survey results obtained by Fritzdixon et al. They found that 57 percent had used a checking account in the past year.

48 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*, 32–33.

49 Center for Financial Services Innovation, *A Complex Portrait: An Examination of Small-Dollar Credit Consumers* (2012).

50 The Pew Charitable Trusts, "The Post Office and Financial Services" (paper presented at the Financial Services and the Post Office Conference, Washingon, D.C., 2014).

51 See also Sendhil Mullainathan and Eldar Shafir, *Scarcity: Why Having Too Little Means So Much* (New York: Henry Holt, 2013). This phenomenon, in which low-income borrowers struggling to manage finances do not focus on loan prices—and instead focus on speed, certainty, and customer service—is a form of "tunneling," coined by Mullainathan and Shafir.

52 Marianne Bertrand and Adair Morse, "Information Disclosure, Cognitive Biases, and Payday Borrowing" (2009), accessed Sept. 26, 2014, http://bfi.uchicago.edu/RePEc/bfi/wpaper/BFI_2009-007.pdf; and Texas Office of Consumer Credit Commissioner, "Disclosure: Auto Title Loan - Single Payment" (2012), accessed Sept. 26, 2014, http://www.occc.state.tx.us/pages/industry/CAB/Fillable%20Auto%20Title%20Single%20Pay%20Disclsoure%20(Dec%2012).pdf. Efforts to "de-bias" customers by telling them that they are likely to re-borrow loans many times have been largely unsuccessful in reducing loan usage. The disclosures tested in the Bertrand and Morse paper are required in Texas.

53 This research does not delve into why that is the case, but one possible reason is that title loan borrowers typically own their vehicles free and clear, meaning they do not have a monthly car payment.

54 Tennessee Department of Financial Institutions, "2014 Report on the Title Pledge Industry," 6–7. The Tennessee report breaks out the number of times that each loan is renewed. This report indicates that 233,424 new title loans were made in the year studied, and Pew's renewal analysis calculates that there were 1,184,071 renewals (a loan that was renewed five times is counted as one new loan and five renewals).

55 Texas Office of Consumer Credit Commissioner, *Credit Access Business (CAB) Annual Reporting*. This report states that there were 795,686 title loan refinances (renewals) in 2013, compared with 472,944 new loans. Loans that were repaid and quickly re-borrowed are counted as new loans in this report.

56 Robinson, "Affidavit of John Robinson, " 11.

57 Ibid., 13.

58 Consumer Financial Protection Bureau, *CFPB Data Point: Payday Lending* (2014), accessed Sept. 16, 2014, http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.; Center for Responsible Lending, *Phantom Demand: Short-Term Due Date Generates Need for Repeat Payday Loans, Accounting for 76% of Total Volume* (2009), accessed Sept. 16, 2014, http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf; and Alex Kaufman, *Payday Lending Regulation* (2013), accessed Sept. 16, 2014, http://www.federalreserve.gov/pubs/feds/2013/201362/201362pap.pdf. The *CFPB Data Point* report found that 80 percent of payday

loans are taken out within two weeks of a previous loan's due date, similar to the 76 percent found by the Center for Responsible Lending (based on Oklahoma's data) and the 86 percent within 30 days found by Kaufman.

59 These figures are calculated from state regulatory data, based on average loan size, fees paid, and duration of installment title loans in each state. The average APRs are 212 percent in Illinois, 223 percent in Texas, and 216 percent in Virginia.

60 This estimate is based on state regulatory data from 2011 to 2014 from Idaho, Tennessee, Texas, and Virginia. Data from previous years from Illinois and Montana are also in line with these figures. Hawkins, "Credit on Wheels." Overall, these figures are slightly higher than those reported by Hawkins because they use data from different states, according to what was available at the time of the analysis. These figures exclude the unusual title loan markets of California and Oregon; both states' repossession rates are outliers. In California, there were 13,089 repossessions in 2013 and 91,505 loans, constituting a repossession rate of 14.3 percent. Oregon typically has very few repossessions; it had five in 2013 and none in 2012.

61 Virginia State Corporation Commission, *The 2013 Annual Report of the Bureau of Financial Instiutions* (2013), accessed Sept. 16, 2014, https://www.scc.virginia.gov/bfi/annual/ar04-13.pdf; and Idaho Department of Finance, *2013 Annual Report* (2014), accessed Sept. 16, 2014.

62 These calculations are based on an estimate of 2.4 million title loan borrowers, 5 to 9 percent of whom have their vehicles repossessed and sold.

63 Consumer Federation of America and Center for Responsible Lending, "Driven to Disaster," 10; and Hawkins, "Credit on Wheels," 551.

64 Hawkins, "Credit on Wheels," 551; and California Department of Business Oversight, *Annual Report*. Of the 7,371 collateral sales in California in 2013, only 920 resulted in a surplus balance. Hawkins also notes that in Tennessee in 2008, lenders returned just $251,047 in surpluses to borrowers.

65 Tennessee Department of Financial Institutions, "2012 Report on the Title Pledge Industry," 9; and Hawkins, "Credit on Wheels," 551–52. "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." In Tennessee, lenders report spending 3.5 percent of revenue on repossession expenses.

66 Because these questions ask about a borrower's current situation, these survey results may not represent people's situations at the times they most recently used title loans. It is likely that the 3 percent of borrowers who had no vehicle at the time of the survey had one at the time they last used a title loan.

67 Fritzdixon et al., "Dude, Where's My Car Title?" 1,038. The Fritzdixon et al. survey also found that 15 percent of title loan borrowers reported they could not find another way to school or work.

68 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans*, 39–46.

69 John Caskey, *Payday Lending: New Research and the Big Question* (2010), accessed Sept. 15, 2014, https://www.philadelphiafed.org/research-and-data/publications/working-papers/2010/wp10-32.pdf.

70 Alan M. White, "Credit and Human Welfare: Lessons From Microcredit in Developing Nations," *Washington and Lee Law Review* 69, no. 2 (2012), accessed Sept. 16, 2014, http://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=4283&context=wlulr. White has framed this very fundamental question about borrowers' welfare as the key one to answer in evaluating what public policy toward high-interest, small-dollar credit should be. This question is difficult to address for this market, as well as the payday lending market, but is much easier to resolve if the scope is limited to what features of small-dollar loans lead to better or worse outcomes.

71 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 7–21.

72 Ibid., 29–32.

73 Ibid.

74 Ibid.

75 Ibid.

76 Policymakers could use this threshold in tandem with loan costs or durations as a tool for identifying potentially harmful loans or to establish standards for quickly determining a borrower's ability to repay.

77 "Castle Payday Rates," Castle Payday, accessed March 19, 2014, https://castlepayday.com/loan-rates.

78 Speedy Cash, "Arizona Online Installment Title Loans Rates & Terms," accessed Sept. 3, 2014, http://www.speedycash.com/rates-and-terms/arizona. Other examples of high-cost title installment loans include Texas Title Loans' six-month, $500 loan with a finance charge of $795.51, http://txtitleloans.net/licensing-and-fees, and a 24-month loan from TitleMax of Missouri for $713.50 with a finance charge of $1,950.48 (contract on file at Pew).

79 Marianne Bertrand and Adair Morse, "What Do High-Interest Borrowers Do with Their Tax Rebate?" (2009), accessed Nov. 21, 2014, http://faculty.haas.berkeley.edu/morse/research/papers/bertrandMorse_Stimulus.pdf.

80 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 33–35. For example, Colorado law requires lenders to refund origination fees on a pro rata basis in the event of early repayment, which minimizes incentives for lenders to engage in high-frequency refinancing, or "loan flipping."

81 Ibid.

82 Ibid., 41.

83 Ibid., 42.

84 Veritec Solutions LLC, *Competition Commission Payday Lending Market Investigation* (2013), 10–11, accessed Sept. 10, 2014, https://assets.digital.cabinet-office.gov.uk/media/5329df75e5274a2268000357/130310_veritec_solutions_response_to_is.pdf. "On a sector level, prices are broadly similar because customers are not price sensitive." "[I]mpediments to shopping around occur because consumers are likely to go ahead with the first lender that approves the individual for a loan rather than seek approval from several firms before choosing the best offer. This behaviour is caused by consumers' limited ability to access cheaper mainstream finance, and their desire to have the sums delivered to them swiftly."

85 Even if a small number of customers seek out lower prices, a collective action problem exists in that lenders would have to expect that many prospective borrowers would do this in order to justify lowering prices.

86 In states that publish data, average annual percentage rates are: Idaho, 310 percent; Illinois, 212 percent; New Mexico, 270 percent for lump-sum, 314 percent for installment; Oregon, 146 percent; Tennessee, approximately 264 percent; Texas, 306 percent for lump-sum, 223 percent for installment; Virginia, 216 percent. Illinois, Oregon, Tennessee, and Virginia limit maximum allowable charges, and the interest rates listed here are close to the price ceilings for average-sized loans in those states.

87 Robert B. Avery and Katherine A. Samolyk, "Payday Loans Versus Pawn Shops"; and Mark J. Flannery and Katherine A. Samolyk, "Scale Economies at Payday Loan Stores" (2007), accessed Sept. 4, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2360233.

88 Flannery and Samolyk, "Scale Economies at Payday Loan Stores," 23.

89 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*; and The Pew Charitable Trusts, *How State Rate Limits Affect Payday Loan Prices.*

90 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 17–18 and endnote 63. Like Colorado, Washington state also has below-average APRs for payday loans because of state law. In 2013, Washington averaged 1,333 unique payday loan borrowers per store. Neither state actually required lower dollar charges per loan, but instead added provisions requiring that borrowers be allowed more time to repay without commensurately higher charges.

91 Several efficiency gains not discussed in detail in this paper are also likely to result from a transition from lump-sum payments to installment payments. Small-loan stores are rarely busy, but they can experience "peak-load" problems—high volume during some hours on days when customers are paid, such as Fridays, or the 15th or last of the month. Installment payments made electronically can reduce the need for staff to receive payments from customers coming into the store every 30 days to renew or repay loans. To the extent that defaults decline with more affordable payments and lower prices, as they have in Colorado's payday loan market, lenders' losses and collections expenditures may drop as well.

92 Advance America LLC, Form 10-K, 2011; and TMX Finance, Form 10-K, Dec. 31, 2012. As of each of their most recent Annual (10-K) Report filings, Advance America had 2,541 stores and 6,465 employees at the end of 2011, and TMX Finance had 1,035 stores and 4,335 employees at the end of 2012.

93 This estimate is based on state regulatory data from Mississippi, Tennessee, Texas, and Virginia, as well as filings from TMX Finance. The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions,* 18. Pew's report details the estimate of 500 payday borrowers per store.

94 Ibid., 17–18 and endnote 63.

95 For a lender to be similarly efficient and charge similar prices without expanding its customer base to include payday loan borrowers, it would need approximately 1,200 title loan customers. It could also probably serve fewer title loan customers if it offered other alternative financial services, such as check-cashing, bill payments, prepaid cards, or pawn loans.

	Current	More efficient
Borrowers per store	300	1,200
Fees paid per borrower per year	$1,200	$462
Revenue per store	$360,000	$554,400
Losses	$64,800	$259,200
Revenue net of losses	$295,200	$295,200

96 TMX Finance, Form 10-K, Dec. 31, 2012; and ProPublica, "Projected Financial Summary, Fiscal Year Ending 2013," http://www.propublica.org/documents/item/1236355-tmx-ratings-agency-presentation-2013.html. TMX Finance's 2012 10-K Annual Report notes that it served 470,000 customers at 1,035 stores, or 454 borrowers per store. State regulatory data from Mississippi, Tennessee, Texas, and Virginia indicate that average title loan stores serve far fewer customers per store. Although TMX Finance's store count represents about one-fifth of the market, it likely has a larger share of the market by customer count and revenue. Its projected revenue for 2014 was $1.05 billion, approximately one-third of the overall revenue in the market.

97 Virginia Bureau of Financial Institutions, *Motor Vehicle Title Lenders*; Virginia Bureau of Financial Institutions, *Payday Lender Licensees*; and Commisioner of Financial Institutions, "Report of the Commissioner of Financial Institutions, State of Utah." In Virginia, 29 firms make title loans across 470 branches (as of Sept. 8, 2014). Seven of those firms are also registered as payday lenders, and 130 of the branches also offer payday loans (28 percent). By comparison, 22 firms make payday loans at 228 branches. In Utah, 47 percent of firms offering title loans also offer payday loans. Texas has 2,254 single-payment title loan locations, accounting for one-quarter of the national market by store count. State regulatory data indicate that about half of these locations report making payday loans as well. Licensee lists from Oregon show that all 43 stores offering title loans in Oregon also offer payday loans.

98 Licensee lists from Oregon on file at The Pew Charitable Trusts. State data indicate that 43 stores offer title loans in Oregon and that in 2012, they made loans with a total nominal value of $11.5 million and an average finance charge of $13 per $100 borrowed (the maximum allowed).

99 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 19.

100 Other examples of a $1,000 loan under Pew's policy recommendations: For a borrower earning $18,000 a year, the maximum monthly payment a lender could charge would be $75. This loan would have a 52 percent APR and a loan duration of just over 20 months. For a borrower earning $42,000, the maximum monthly payment would be $175. This loan would have a 116 percent APR and a loan duration of just under nine months.

101 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*. Pew's research has demonstrated, through a case study of Colorado's 2010 payday loan reforms, that these types of policies can lead to better outcomes for consumers while preserving widespread access to credit.

THE PEW CHARITABLE TRUSTS

Appendix O

A fact sheet from THE PEW CHARITABLE TRUSTS | April 2014

How State Rate Limits Affect Payday Loan Prices

Storefront payday loans are available in 36 states. Borrowers in some of them pay twice as much for the same loans that comparable customers get in other states. Pew's research indicates that a state's limit on interest rates is the key factor driving loan pricing. The four largest payday lenders in the United States charge similar prices within a given state, with rates set at or near the maximum allowed by law. But in states with higher or no interest rate limits, the same companies charge comparable borrowers far more for essentially the same small-loan product. (See Figure 1.)

Figure 1

Payday Loans Cost More Where Laws Allow Higher Rates

Fee limits and prices in 3 states

	Cost to borrow $300 per two-week pay period				
	Max. allowed by state law	Payday Lender A	Payday Lender B	Payday Lender C	Payday Lender D
Florida	$35	$35	$35	$33	$35
Alabama	$52.50	$52.50	$52.50	$52.50	$52.50
Texas	no limit	$61	$91	$61	$67

Sources: Websites of four largest lenders and state payday loan laws

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Borrowers in states with no rate caps—Idaho, South Dakota, Texas, and Wisconsin—pay the highest prices in the country, more than double those paid by residents of several states with interest rate limits, such as Colorado, Maine, Minnesota, and Oregon.

Competition does not explain lower prices

States with high or no rate limits tend to have the most payday loan stores per capita.[1] (See Figure 2.) But in states with lower rate limits, payday credit is not significantly constrained; instead, fewer stores simply serve more customers each.[2] For example, in the three years after Colorado lowered permissible interest rates for payday loans, half of stores closed; but each remaining store served 80 percent more customers. Borrowers' access to credit in the state was virtually unchanged.[3] In the 15 states that prohibit payday lending or interest rates higher than 36 percent, there are no payday lending stores.[4]

Figure 2

Payday Loans Cost More When States Fail to Limit Interest Rates

Lender pricing for comparable loans, by state price limit

Average cost to borrow $300 for 5 months*	Median stores per 100,000 residents	State	Max. charge allowed on a $300 loan per 2-week pay period	Average cost to borrow $300 per 2-week pay period*	Average cost to borrow $300 for 5 months*	Average annual percentage rate charged	Notes
Lower than average rate cap							
$281	3.0	Colorado	$16	$16	$172	*129*	*There is little or no price variation within each state. All competitors in a given state charge at or near the maximum allowable price. However, individual companies charge significantly different prices across state lines. Many companies charge double in one state what they charge in another.*
		Oregon	$18	$18	$177	156	
		Maine	$25	$25	$250	217	
		Minnesota	$29	$29	$288	252	
		Rhode Island	$30	$30	$300	261	
		Wyoming	$30	$30	$300	261	
		Mississippi†	$33	$33	$330	287	
		Florida	$35	$35	$345	304	
		Virginia	$37	$37	$370	*305*	
Average rate cap							
$435	7.2	Iowa	$39	$39	$390	339	
		Michigan	$42	$42	$425	369	
		Indiana	$44	$44	$440	382	
		California‡	$45	$45	$450	*411*	
		Kansas	$45	$45	$450	391	
		Oklahoma	$45	$45	$450	391	
		South Carolina	$45	$45	$450	391	
		Washington§	$45	$45	$360	*192*	
		Illinois	$47	$47	$465	*330*	
		New Mexico	$47	$47	$470	*337*	
Higher than average rate cap							
$528	14.9	Alaska	$50	$50	$500	435	
		Tennessee**	$53	$49	$490	426	
		Alabama	$53	$53	$525	461	
		Hawaii	$53	$53	$529	461	
		Nebraska	$53	$53	$530	461	
		Kentucky	$54	$54	$536	469	
		Louisiana**	$55	$47	$467	435	
		North Dakota	$61	$61	$610	530	
		Missouri	$225	$56	$563	*455*	

Continued on next page

Average cost to borrow $300 for 5 months*	Median stores per 100,000 residents	State	Max. charge allowed on a $300 loan per 2-week pay period	Average cost to borrow $300 per 2-week pay period*	Average cost to borrow $300 for 5 months*	Average annual percentage rate charged	Notes
No rate cap							
$604	12.9	Nevada	no limit	$60	$596	521	*There is some price variation within each state. Lenders generally charge more than they do in states with rate limits.*
		Utah	no limit	$63	$627	*474*	
		Delaware§	no limit	$63	$315	*517*	
		South Dakota	no limit	$66	$660	574	
		Wisconsin	no limit	$66	$660	574	
		Idaho	no limit	$67	$668	582	
		Texas	no limit	$70	$701	*454*	
Disputed							
		Ohio**	legal dispute	$68	$680	591	

Notes on data: Italics indicate that regulatory data are used. If a state published no regulatory data in the past three years, the average advertised cost of a payday loan from the four largest payday lenders is used. Alaska had no regulatory data, and none of the four largest payday lenders operated storefronts. Therefore, data from other payday lenders were used. In Colorado and Washington, effective APRs are much lower than advertised APRs. In Colorado, loan costs are backloaded—that is, fees are placed more at the end of the loan term instead of the beginning—and most loans are repaid early. Washington offers a no-cost payment plan at any time, and therefore it has an average loan term of 26.7 days. To calculate stores per 100,000 residents, the most recent published state regulatory data are used. If that information is unavailable for a state, data published by Stephens Inc. are used.

* Average payday borrowers have a loan out for five months of the year (based on industry filings). Average cost to borrow is based on the four largest national payday lenders.

† In Mississippi, effective interest rates are often higher than those advertised for loans above $250, because of "loan splitting," a practice in which some lenders attempt to earn more revenue per two-week period by offering two small loans instead of one larger one.

‡ In California, only $255 can be borrowed, not $300.

§ Delaware assumes only five loans are used, and Washington assumes eight loans, because of caps on the number of loans in those states. Delaware also has payday installment loans, which cost about $350 to borrow $300 for five months.

** Louisiana and Tennessee have some slight price variation that may stem from legal interpretations of allowable fees. Ohio has large price variation based on a legal dispute about allowable prices and licensing.

Sources: U.S. Census Bureau's American Community Survey 2011 and 2012; websites of four largest lenders, 2014; state payday loan laws, available at http://www.pewstates.org/research/data-visualizations/state-payday-loan-regulation-and-usage-rates-85899405695

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Policy recommendations

Policymakers in states with conventional payday lending can reduce the harm caused by unaffordable payments and noncompetitive prices by implementing Pew's policy recommendations:

- Limit payments to an affordable percentage of a borrower's periodic income. Pew's research indicates that monthly payments above 5 percent of gross monthly income are unaffordable.
- Spread costs evenly over the life of the loan.
- Guard against harmful repayment or collection practices.
- 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. In states that have permitted higher interest rates than Colorado's, storefronts have proliferated, with no obvious additional benefit to consumers.

Endnotes

1 States with more firms operating, a standard measure of competition, do not see lower prices. For example, 42 firms operate in the lowest-interest state with payday loan stores, Colorado, but loans cost far more in states such as Kansas, Nebraska, and Florida, which have more firms operating.

2 This tendency is detailed in 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.

3 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), http://www.pewstates.org/research/reports/payday-lending-in-america-policy-solutions-85899513326.

4 These jurisdictions are Arizona, Arkansas, Connecticut, District of Columbia, Georgia, Maryland, Massachusetts, Montana, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Vermont, and West Virginia.

For further information, please visit:

pewtrusts.org/small-loans

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A brief from THE PEW CHARITABLE TRUSTS | Dec 2014

Trial, Error, and Success in Colorado's Payday Lending Reforms

Overview

Payday loans typically carry annual percentage rates of 300 to 500 percent and are due in a lump sum, or balloon payment, on the borrower's next payday, usually about two weeks later. These loans are advertised as quick fixes for unexpected expenses, but repaying them consumes more than a third of an average borrower's paycheck, leading to repeated borrowing for an average of five months of the year. Some states have recognized that these loans are harmful and have enacted laws to protect consumers, with varying degrees of success.

In Colorado, a 2007 law that attempted to reform the payday lending industry failed to achieve policymakers' goals of reducing harm to payday borrowers while preserving access to small-dollar credit. The law preserved lump-sum lending, allowing lenders to make four consecutive balloon-payment loans but then requiring them to offer borrowers an installment plan. This approach inadvertently preserved a business model in which lenders' and borrowers' interests were not aligned: Profitability still relied on income from loans that greatly exceeded most borrowers' ability to repay without re-borrowing. As a result, according to regulators, many lenders moved to protect their profits by deterring or preventing borrowers from using an installment plan. Short-term, balloon-payment loans thus continued to dominate the market, and the law failed to protect consumers as intended, with outcomes for borrowers changing only slightly.

Colorado lawmakers learned from that experience and enacted new legislation in 2010 requiring all loans to be repayable over time at lower rates.[1] Data released by the Colorado Attorney General's Office in December 2014 indicate that this law led to more affordable loan payments, fewer defaults, and lower prices for payday loans; increased efficiency at payday lending stores; and ensured that credit remained widely available.[2] (See Table 1.)

As the federal Consumer Financial Protection Bureau and policymakers in other states take action in response to the harm caused by payday lending, they can learn the following from Colorado's experience:

1. Allowing lenders to make several lump-sum loans before being required to offer affordable installment payments did not align their profitability with borrowers' ability to repay and therefore resulted in minimal changes to the market.
2. Requiring affordable installments for all loans successfully aligned lenders' profitability with borrowers' ability to repay and led to a viable business model for lenders while delivering better outcomes for consumers, with virtually no reduction in access to credit.

Table 1

Payday Lending in Colorado Did Not Change Substantially Until Lump-Sum Loans Were Eliminated in 2010

State payday lending market, pre- and post-reform, 2006, 2009, and 2013

	Before 2007 reform	After 2007 reform	After 2010 reform
	Lump-sum loans only	4 lump-sum loans before repayment plan	Installment loans only
Borrowers' total spending on loan fees	$105.7 million	$95.1 million	$54.8 million
Share of loans taken out the same day as a previous loan was repaid	64.5%	61.2%	36.7%
Share of biweekly income consumed per loan payment	34%	38%	4%
Market efficiency (borrowers per store)	438	554	1,102

Notes: "Before 2007 reform" refers to 2006 data, "after 2007 reform" refers to 2009 data, and "after 2010 reform" refers to 2013 data. The 2007 law structure remained in place until enactment of the 2010 law, which replaced the lump-sum loan with one that is repayable over at least six months.

Sources: Colorado Office of the Attorney General, 2007, 2010, and 2014; Administrator of the Colorado Uniform Consumer Credit Code, 2007, 2010, and 2014

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Conventional payday lending relies on repeated borrowing

The typical payday loan is a lump-sum, or balloon-payment, loan that is due in full on the borrower's next payday. Because storefront payday lenders have high fixed costs and relatively few customers at each location, they cannot make a profit unless customers renew or re-borrow repeatedly. For consumers, the key driver of repeat borrowing is financial distress caused by unaffordable balloon payments (i.e., balances that must be paid in full on the due date, usually triggering borrowers to take out another loan). National data show that 67 percent of borrowers use seven or more loans per year, accounting for 90 percent of lenders' revenue, and most of those loans occur in rapid succession as customers borrow to help cover shortfalls created by previous balloon payments.[3] State data show similar outcomes.[4] In other words, lenders cannot make balloon-payment loans profitably if borrowers are limited to low-frequency use.

> "The interests of the business and the interests of the individual were moving in opposite directions [under the 2007 law]. We wanted one that bent those curves back a little bit by saying the businesses do better when the person actually has a route out of debt as opposed to a route deeper in debt."
>
> Mark Ferrandino, *speaker of the Colorado House of Representatives*

2007 reform fails

Before 2007, Colorado borrowers faced the same problems with payday loans that consumers in 35 other states are experiencing today: A balloon payment, typically due two weeks after the loan was made, consumed more than one-third of an average borrower's paycheck. As a result, people could not afford basic expenses without borrowing again, so they renewed or quickly re-borrowed the loans, remaining in debt for an average of more than five months of the year and spending more on fees than they originally received in credit.

In 2007, Colorado lawmakers sought to help borrowers by requiring lenders to offer a no-cost installment plan for repayment to anyone who took out at least a fourth consecutive balloon-payment loan,[5] with "consecutive" defined as within five calendar days of repaying a previous loan. Lenders responded by establishing practices to prevent customers from using installment plans:

> "The payment plan law resulted in significant changes to the policies and procedures of most payday lenders in Colorado. The majority of payday lenders have implemented new operating policies. These include 'cooling-off' or 'waiting' periods after a third consecutive payday loan or after every payday loan. These policies restrict a consumer from reaching the required four consecutive loans trigger before a payment plan must be offered."[6]

At least half of all lenders employed this technique or other practices to discourage use of installment plans or prevent borrowers from becoming eligible for them.[7] As a result, only 4.6 percent of loans were converted to installment plans under the 2007 law.[8] Borrowers used almost as many loans after the reform as they did before and spent nearly as much on fees.[9] The number of loans taken out the same day that a previous loan was repaid also declined only slightly, indicating consumers' continued inability to both repay and cover expenses without borrowing again.[10] (See Table 2.)

In 2007, Colorado lawmakers attempted to retain the lump-sum loan but provide an installment plan as an "off-ramp" for those who could not afford the balloon payments and used four or more loans. The law's crucial flaw was not recognizing that the business model of balloon-payment loans relies on repeated borrowing, with heavy usage the rule and not the exception.

The legislation did not align lenders' success with borrowers' ability to repay, and this dissonance explains its failure. By attempting to preserve the balloon-payment loan while requiring lenders to provide an option that would offer a pathway out of debt, Colorado's 2007 law put payday stores' revenue under immense pressure, which in turn led to widespread circumvention by lenders. If borrowers used the installment plans, lenders' revenue would plummet and the business model would fail. If lenders prevented use of the installment plans, borrowers would struggle to retire their debt.

Table 2

Requiring Installment Plans Upon a 4th Lump-Sum Loan Had a Limited Impact on Borrowing

Outcomes for payday loans before and after the 2007 law

	Before 2007 reform	After 2007 reform	Change
	Lump-sum loans only	4 lump-sum loans before repayment plan	
Total annual number of loans	1,801,134	1,565,481	-13%
Total spending on loans	$105.7 million	$95.1 million	-10%
Payday lending stores	661	505	-24%
Share of loans that were renewals or same-day loans	64.5%	61.2%	-5%
Loans per borrower	9.38	7.84	-16%

Notes: The "cooling-off" periods introduced by lenders as a result of the 2007 reform may have led borrowers to obtain loans from other lenders while their initial lender would not serve them. Colorado did not have a centralized database that recorded borrowers' usage across lenders, as some states do. So to the extent that consumers used multiple lenders, they would appear as multiple borrowers in the data. For example, a person who used 12 loans per year from one lender before the law change might now alternate between two lenders, taking out three loans in a row from each to avoid the new cooling-off periods and still use a total of 12 loans. This person would look like two borrowers using six loans each, instead of one using 12. To the extent this happened, the apparent decline in loans per borrower may be overstated.
The reform took effect on July 1, 2007. Data from before the reform are results from 2006, and data from after the reform are from 2009. In inflation-adjusted terms, $105.7 million in 2006 dollars is equivalent to $112.5 million in 2009 dollars.

Sources: Colorado Office of the Attorney General, 2007 and 2010; Administrator of the Colorado Uniform Consumer Credit Code,, 2007 and 2010

2010 reform succeeds

Colorado lawmakers were determined to solve the payday loan problems plaguing their state even after the failure of the 2007 effort. They also wanted to preserve access to small-dollar loans and give lenders a chance to stay in business while reducing harm to consumers. Their solution was a reform, enacted in 2010, that required all payday loans to be repayable over at least six months, reduced total permissible fees, and disallowed front-loading of charges. This structure meant that lenders had to earn their revenue evenly over time without recourse to lump-sum renewal fees.

The 2010 payday loan law enables borrowers to repay loans in installments that consume an average of 4 percent of their biweekly income, rather than the 38 percent they would need to make a balloon payment.[11] All payments reduce principal, so that no debt remains on the loan's end date. Borrowers are permitted to prepay loans without penalty at any time, and 74 percent of loans are repaid before the sixth month.[12] The average loan is repaid after just over three months. The average annualized interest rate is 115 percent—still high, but the lowest rate of any state where payday loan stores operate.[13] (See Table 3.)

Table 3

Loan Payments Became Affordable Under the 2010 Law

Comparative outcomes for payday loans in Colorado, 2009 and 2013

	Before 2010 reform	After 2010 reform
	4 lump-sum loans before repayment plan	Installment loans only
Maximum loan size	$500	$500
Average loan duration (including loans repaid early)	18.91 days	98.62 days
Average annual percentage rate	319%	115%
Share of a borrower's biweekly income taken up by the next loan payment	38%	4%
Cost to borrow $500 for 2 weeks	$75	~ $10
Cost to borrow $500 for 6 months	$975	$290
Amortization (payments reduce principal over time)	No	Yes

Note: "Before 2010 reform" refers to 2009 data, and "after 2010 reform" refers to 2013 data.

Sources: Colorado Office of the Attorney General, 2010 and 2014

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It is noteworthy that 18 percent of loans are repaid in full in the first month.[14] This proportion is similar to the share of conventional payday loan customers in other states who do not follow the typical pattern of repeated borrowing and instead use only one or two balloon-payment loans per year. Under Colorado's 2010 law, this minority that can afford to repay loans quickly continues to do so, regardless of the loan structure, which indicates that these borrowers have not been adversely affected from the loss of lump-sum loans. Meanwhile, most consumers have taken advantage of the longer repayment term.

Effect on borrowers

Since enactment of the reforms, Colorado's borrowers spend 42 percent less annually on payday loans but receive more days of credit. And requiring more affordable payments has had other positive effects as well: a 23 percent decline in defaults per borrower and a 48 percent decrease in lender-charged bounced-check fees. Before the law, 61 percent of loans were taken out the same day that another one was paid back, largely because borrowers could not afford to repay loans and still cover basic expenses. That figure has declined by 40 percent. (See Table 4.)

Table 4

Renewals and Negative Effects Declined Under the 2010 Colorado Reform

Comparative outcomes for payday loans, 2009 and 2013

	Before 2010 reform	After 2010 reform	Change
	4 lump-sum loans before repayment plan	Installment loans only	
Average loan size	$368	$393	7%
Total dollars spent	$95.1 million	$54.8 million	-42%
Defaults per borrower	0.493	0.379	-23%
Lender-charged bounced-check fees	$960,201	$497,611	-48%
Share of loans that were renewals or taken out the same day	61.2%	36.7%	-40%

Notes: In inflation-adjusted terms, $368.09 in 2009 dollars is equivalent to $399.69 in 2013 dollars, $95.1 million in 2009 dollars is equivalent to $103.3 million in 2013 dollars, and $960,201 in 2009 dollars is equivalent to $1,042,643 in 2013 dollars. "Before 2010 reform" refers to 2009 data. The post-2010 figures on share of loans that were renewals or taken out the same day are taken from the most recent examiners' report, which covers calendar year 2012; other data from "after 2010 reform" refer to 2013 data.

Sources: Colorado Office of the Attorney General, 2010 and 2014; Bureau of Labor Statistics, 2014

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Effect on the market

In the years since Colorado's 2010 reforms, payday loan businesses have become more efficient and have served more customers at lower prices. The law's transparent pricing, realistic loan durations, and lower price limits have produced a market in which lenders succeed if borrowers repay loans as scheduled. Lenders are no longer dependent on renewals and repeated borrowing to operate profitable businesses.

> Colorado's [2010] law is better for borrowers and viable for lenders."
>
> *Colorado Attorney General John Suthers and former Governor Bill Ritter, McClatchy-Tribune News Service op-ed, April 22, 2014*

The average payday loan store in Colorado served only 554 unique borrowers per year in 2009 (fewer than two per day) but now serves 1,102 per year. During this period of consolidation, half of payday loan stores closed, but those that remain are more efficient. (See Table 5.) Further, the incomes and demographics of these stores' customers did not change substantially after the law passed, indicating that the reforms did not price low-income borrowers out of the market and that payday loan credit remains widely available to Coloradans with damaged credit histories.[15]

Table 5

Payday Lending Stores Are More Efficient Under Colorado's 2010 Reform

Comparative outcomes for payday loans, 2009 and 2013

	Before 2010 reform	After 2010 reform	Change
	4 lump-sum loans before repayment plan	Installment loans only	
Number of stores	505	235	-53%
Number of borrowers	279,570	259,000	-7%
Borrowers per store	554	1,102	99%
Loan revenue per store	$188,292	$233,027	24%
Borrowers' average annual income	$29,496	$31,668	7%
Borrowers' median annual income	$26,388	$27,024	2%

Notes: In inflation-adjusted terms, $29,496 in 2009 dollars is equivalent to $32,029 in 2013 dollars, and $26,388 in 2009 dollars is equivalent to $28,654 in 2013 dollars, indicating that, after the law changed, borrowers do not earn higher incomes. The post-2010 figures on borrowers' incomes are taken from the most recent examiners' report, which covers calendar year 2012; "after 2010 reform" refers to 2013 data. "Before 2010 reform" refers to 2009 data. The increase in loan revenue per store should not be understood to imply an increase in profitability. The figure of 235 stores is based on licensees reported by Colorado regulators as of Dec. 31, 2013. The regulators' report of 2013 activity published a figure of 260 store locations. The difference is due primarily to the exclusion in this analysis of corporate offices located outside Colorado that are registered with the state but do not make loans.

Sources: Colorado Office of the Attorney General, 2010 and 2014; Administrator of the Colorado Uniform Consumer Credit Code, 2010 and 2014

Key takeaways

Colorado lawmakers' 2007 effort to reform the payday lending industry did not achieve their goal of reducing harm to borrowers while preserving access to small-dollar credit. The successful 2010 reform addressed the flaws in the 2007 law by entirely replacing balloon payments with affordable installment payments. The Colorado experience can help the Consumer Financial Protection Bureau and other policymakers avoid the pitfalls associated with trying to preserve balloon-payment loans by considering the following:

1. Allowing lenders to make several lump-sum loans before being required to offer affordable installment payments did not align their profitability with borrowers' ability to repay and therefore resulted in minimal changes to the market.
2. Requiring affordable installments for all loans successfully aligned lenders' profitability with borrowers' ability to repay and led to a viable business model for lenders while delivering better outcomes for consumers, with virtually no reduction in access to credit.

In the coming months, federal policymakers should use their historic opportunity to eliminate the problems caused by lump-sum payments by requiring all loans to have affordable installment payments. The lessons from Colorado show that this approach benefits borrowers and is feasible for lenders.

Endnotes

1 Administrator of the Colorado Uniform Consumer Credit Code, *Colorado Payday Lending Demographic and Statistical Information: July 2000 Through December 2011* (2012), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/Demo%20%26%20Stat%20Info%202000-2011_0.pdf. The 2010 law requires a six-month minimum loan term. Virtually all loan contracts—99.9 percent—are scheduled to be repaid in regular installments. The number of installments varies depending on the loan contract and payment schedule.

2 Colorado Office of the Attorney General, *2009 Deferred Deposit Lenders Annual Report* (2010), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/annual_reports/2009DDLComposite.pdf; and Colorado Office of the Attorney General, 2013 Deferred Deposit Lenders Annual Report (2014), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/2013%20DDL%20Composite%20FINAL_0.pdf.

3 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.

4 Veritec Solutions LLC, "Florida Trends in Deferred Presentment" (2010); Veritec Solutions LLC, "Oklahoma Trends in Deferred Deposit Lending" (2011), http://www.ok.gov/okdocc/documents/2011_10_OK%20Trends_Final_Draft.pdf.

5 Colorado Uniform Consumer Credit Code 5-3.1-108(5), C.R.S.

6 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 Through December 2008* (2010), 14, https://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/DDLASummary2008rev.pdf.

7 Colorado Office of the Attorney General, *2009 Deferred Deposit Lenders Annual Report*.

8 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 Through December 2009* (2010), 14, http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/DDLASummary2009corr_0.pdf. Other states, such as Florida, Michigan, and Oklahoma, that have allowed lenders to make lump-sum loans and required them to offer installment plans in limited circumstances have seen an even smaller share of loans converted to installment plans. In Washington, where borrowers may request a no-cost installment plan at any time, 10 to 13 percent of loans have been converted.

9 Colorado Office of the Attorney General, *2006 Deferred Deposit Lenders Annual Report* (2007); and Colorado Office of the Attorney General, *2009 Deferred Deposit Lenders Annual Report*.

10 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 Through December 2009*; and Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 Through December 2006* (2007), http://www.thebell.org/PUBS/other/2007/CUCCCpaydaystats.pdf.

11 Colorado Uniform Consumer Credit Code 5-3.1-101 et seq.

12 Colorado Office of the Attorney General, *2013 Deferred Deposit Lenders Annual Report*.

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

14 Colorado Office of the Attorney General, *2013 Deferred Deposit Lenders Annual Report*.

15 Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 Through December 2009*; and Administrator of the Colorado Uniform Consumer Credit Code, *Payday Lending Demographic and Statistical Information: July 2000 Through December 2012* (2014), http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/Colorado%20Payday%20Lending%202012.pdf; and The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 20, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/PewPaydayPolicySolutionsOct2013pdf.pdf.

For further information, please visit:

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The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and invigorate civic life.

Appendix Q

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

<table>
<tr><th></th><th>Short-term loans
Loan duration of 45 days or less</th><th colspan="2">Longer-term loans
Loan duration of more than 45 days; all-in annual percentage rate (APR) of more than 36%; preferred repayment position*</th></tr>
<tr><td rowspan="2">Ability to repay (ATR)</td><td>1 Short-term ATR</td><td colspan="2">3 Longer-term ATR</td></tr>
<tr><td>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</td><td colspan="2">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</td></tr>
<tr><td rowspan="2">Alternative requirements</td><td>2 Short-term alternative</td><td>4 Longer-term alternative: NCUA-type loans‡</td><td>5 Longer-term alternative: 5% payment-to-income ratio§</td></tr>
<tr><td>• $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</td><td>• 28% interest + $20 fee
• Loan amounts of $200 to $1,000
• Six-month maximum loan duration
• Maximum of two loans per six-month period</td><td>• Monthly payment cannot exceed 5% of gross monthly income
• Six-month maximum loan duration
• Maximum of two loans per 12-month period</td></tr>
</table>

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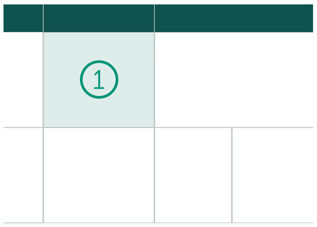
1 Section 1. Short-term ability-to-repay loans



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.

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

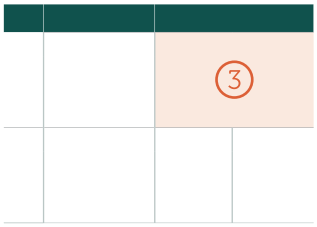
Note: Costs are based on a fee of 20 percent per pay period (521% APR). Loan prices are frequently higher in states without price limits and from lenders operating online without state licenses, and are frequently lower in states with price limits.

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

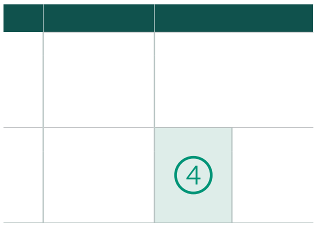
Issuer	Principal borrowed	Loan duration	Monthly payment	Finance charges
Speedy Cash	$500	18 months	$90.35	$1,126.30
Advance America	$500	6 months	$306.97	$1,341.84
Castle Payday	$500	11 months	$291.25	$2,703.75
CashCall	$2,525	47 months	$294.46	$11,314.62

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

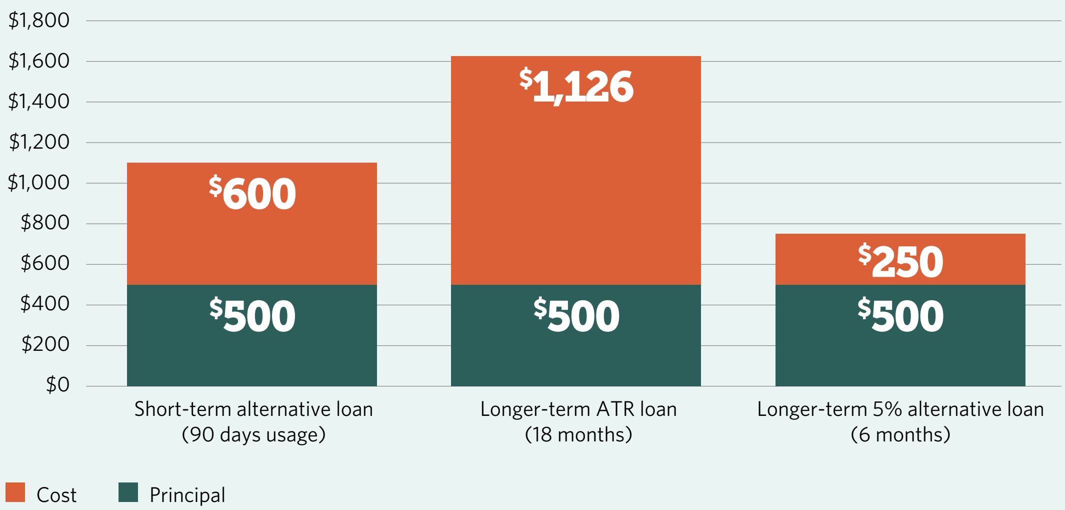
Recommendations:

- 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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The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and invigorate civic life.

Appendix R

A chartbook from THE PEW CHARITABLE TRUSTS | July 2015

CFPB Proposal for Payday and Other Small Loans

A Survey of Americans

The Pew Charitable Trusts

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This chartbook benefited tremendously from the insights and expertise of outside survey expert Cliff Zukin, professor of public policy and political science at the Edward J. Bloustein School of Planning and Public Policy at Rutgers, the state university of New Jersey.

Acknowledgments

The authors would also like to thank Pew staff members Steven Abbott, Claudia Deane, Jennifer V. Doctors, Carol Hutchinson, Bernard Ohanian, and Rica Santos for providing valuable feedback on the chartbook; Dan Benderly and Kristin Centrella for design support; Thad Vinson for project management and digital support; and our other current and former colleagues who made this work possible.

Overview

Payday loans typically carry annual percentage rates of 300 to 500 percent and are due in a lump sum, or balloon payment, on the borrower's next payday, usually about two weeks later. These loans are advertised as quick fixes for unexpected expenses, but repaying them consumes more than a third of an average borrower's paycheck, leading to repeated borrowing for an average of about half the year. Approximately 12 million Americans use payday loans annually, spending an average of $520 in fees to repeatedly borrow $375.[1]

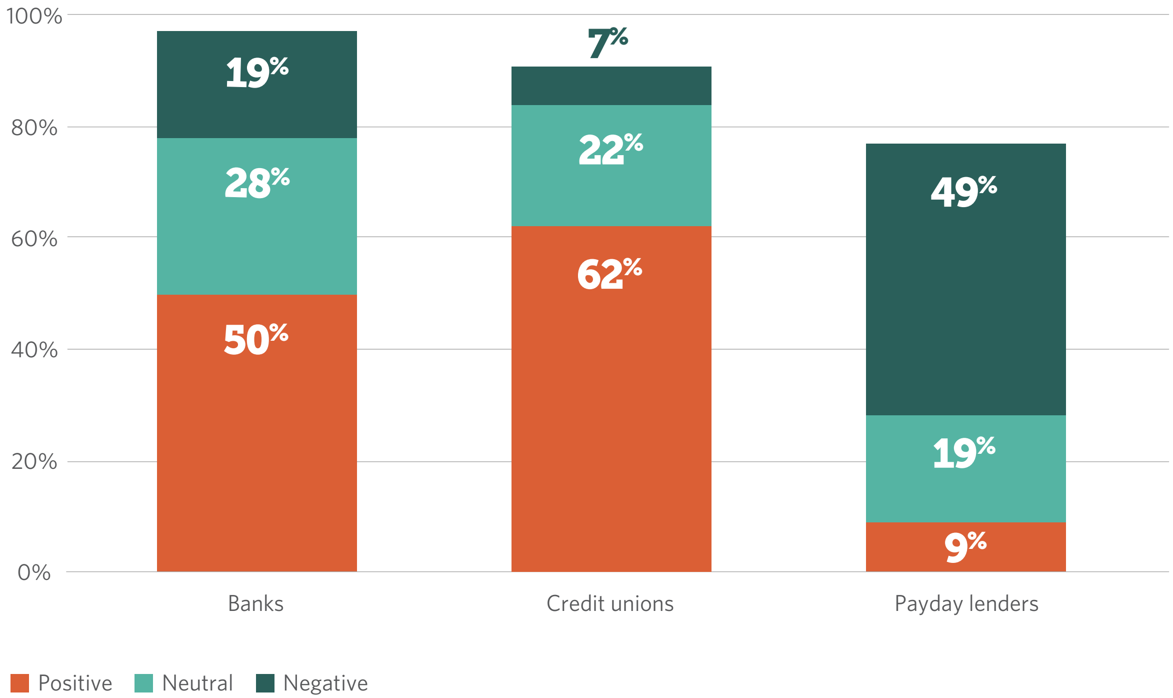
In March 2015, the Consumer Financial Protection Bureau (CFPB), the federal agency with authority over payday loans, proposed a framework for regulating these and similar loans.[2] The Pew Charitable Trusts then conducted polling in May to gauge Americans' views on payday lending, the key elements of the CFPB proposal, and the types of loans that would be likely to result from it. The survey found that:

- 75 percent of respondents believe that payday loans should be more regulated; similarly, in a 2013 Pew survey, 72 percent of payday loan borrowers said they wanted more regulation. (See Figure 2.)
- By large margins, the public favors each of the major components of the CFPB framework, including requiring loans to be repayable in affordable installments. (See Figure 3.)
- Respondents overwhelmingly see as unfair the prices charged for loans currently offered by payday lenders, some of which probably would still be available under the proposed CFPB framework. (See Figure 5.)
- By a ratio of more than 5-to-1, respondents favor allowing banks to offer small loans at lower prices than those charged by payday lenders. (See Figure 3.)
- Respondents believe the types of small loans that would probably be offered by banks have fair prices, even though the rates are higher than those for mainstream credit, such as credit cards. (See Figures 5 and 6.)

Figure 1

Only 1 in 10 Americans View Payday Lenders Positively

Attitudes toward financial institutions, by type



Note: Respondents were read the following statement: "I'm going to read you the names of some types of financial institutions. For each, please just tell me if your opinion of that institution is very positive, somewhat positive, neutral, somewhat negative, or very negative." Results are based on 1,018 interviews. Data do not add to 100 percent because "don't know" and "refused" were omitted from this chart.

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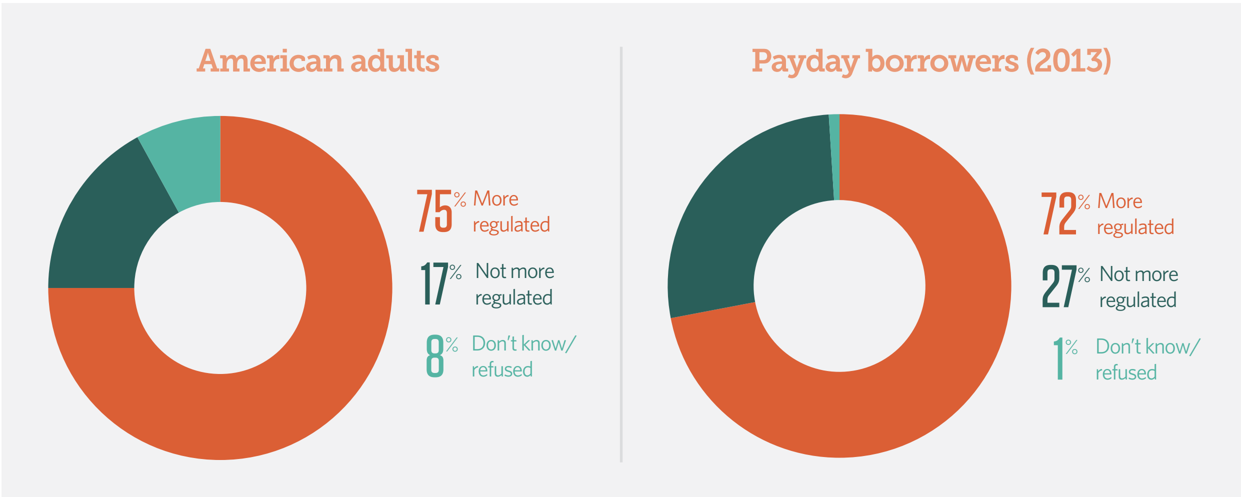
Negative views of payday lenders outnumber positive ones by a 5-1 ratio.

Figure 2

3 in 4 Americans Want Payday Loans to Be More Regulated

This finding reflects similar opinions expressed by payday borrowers



Note: Respondents were read the following statement: "Now I'd like to ask you some questions about payday lending. Payday lenders are companies that generally operate through storefronts or the Internet. They make small loans, often at high interest rates, that are usually due back on the borrower's next payday." Then they were asked: "Which of these statements comes closer to your point of view? 1) Payday loans should be more regulated; 2) Payday loans should not be more regulated." Results are based on 1,018 interviews.

Source: Survey results for payday loan borrowers were published in a previous report by The Pew Charitable Trusts: *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), http://www.pewtrusts.org/~/media/Assets/2013/02/20/Pew_Choosing_Borrowing_Payday_Feb2013-(1).pdf.

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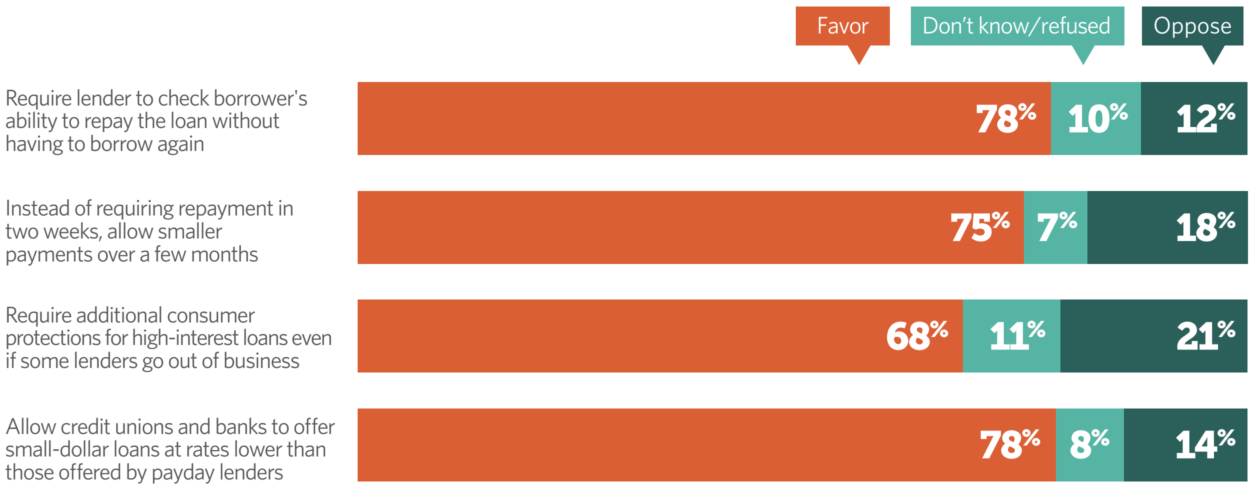
Figure 3

Americans Overwhelmingly Support the CFPB Proposal's Key Elements

Respondents favor new payday loan guidelines by at least a 3-1 ratio



Note: Respondents were read the following statement: "There is a government agency that regulates payday lending called the Consumer Financial Protection Bureau, or CFPB. The CFPB has proposed some new regulations for payday lending. I'd like to get your opinion on some of these ideas. Please tell me if you favor or oppose each. a) For some loans, payday lenders would legally have the responsibility to make sure that customers could afford to repay the loan without having to borrow again to do so; b) Repaying a payday loan generally takes up about one-third of the borrower's next paycheck, and the loan is due back in two weeks. Instead of requiring repayment in two weeks, the proposal would allow borrowers to make smaller payments spread over a few months; c) If loans with interest rates above 36 percent required stricter consumer protection rules, some payday lenders would probably go out of business, while others would continue to operate. Would you favor or oppose requiring additional consumer protections for high-interest loans?; d) Some bank customers have low credit scores and can't get credit cards. This proposal would allow credit unions and banks to offer them loans at rates lower than those offered by payday lenders." Results are based on 1,018 interviews.

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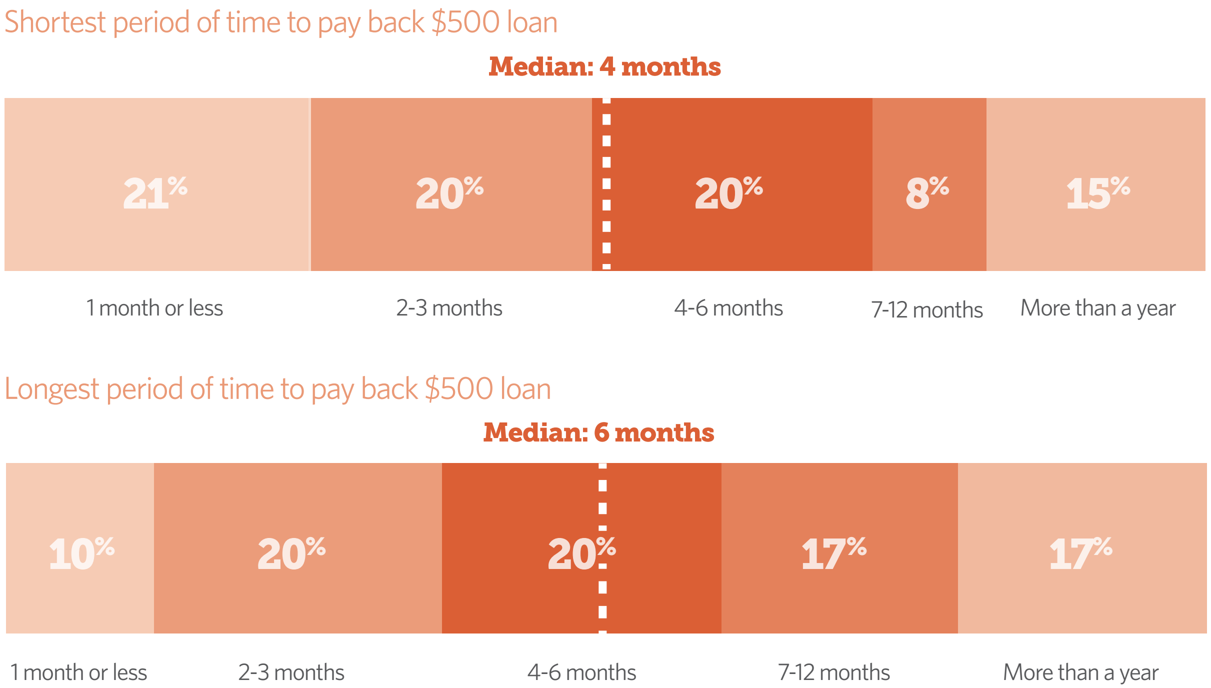
Figure 4

4 to 6 Months Is Considered a Reasonable Length for a $500 Loan

Most respondents say one month is too short, more than a year is too long



Note: Half of respondents (518) were asked: "If a person who is living paycheck to paycheck gets a $500 loan, what is the shortest amount of time that seems reasonable to require that person to pay it back?" The other 500 were asked: "If a person who is living paycheck to paycheck gets a $500 loan, what is the longest amount of time that seems reasonable for that loan to go on?" Data do not add to 100 percent because "don't know" and "refused" were omitted from this chart. This question was open-ended, with no response options read.

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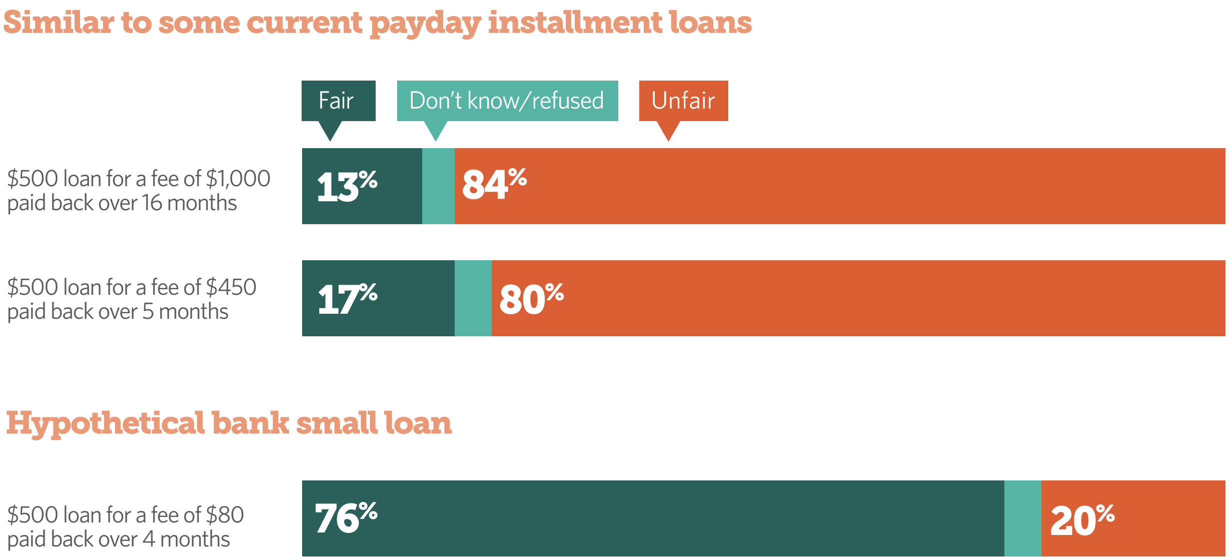
Some lenders make $500 loans that are due in full after two weeks, while others stretch repayment over more than a year. The CFPB proposal would allow lenders to continue offering some two-week loans and would not limit the length of other loans.

Figure 5

Americans View Current Payday Installment Loan Charges as Unfair

But 3 in 4 say an $80 fee is fair for a $500 loan paid back over 4 months



Note: Respondents were read the following statement: "Here are some examples of small loans that might be available to people who have low credit scores. For each, please tell me whether you think the terms seem fair or unfair. a) $500 for a fee of $1,000 paid back over 16 months, so a person who borrows $500 will pay back $1,500; b) $500 for a fee of $450 paid back over 5 months, so a person who borrows $500 will pay back $950; c) $500 for a fee of $80 paid back over 4 months, so a person who borrows $500 will pay back $580." Results are based on 1,018 interviews. The annual percentage rates (APRs) for these loans, which were not read to respondents, are 207 percent for Loan A, 313 percent for Loan B, and 75 percent for Loan C. The order in which these questions were read was randomized in the survey.

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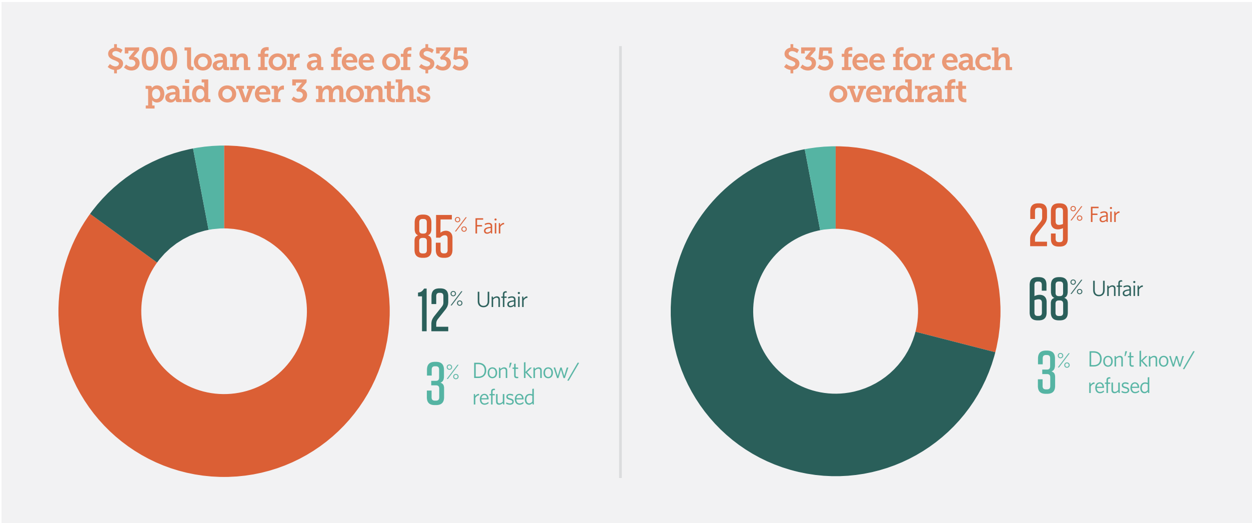
By overwhelming margins, Americans view payday loan prices as unfair. In contrast, they consider the approximate prices that banks would probably charge for such loans to be fair. Figure 5 shows respondents' opinions about two high-cost payday installment loans that would probably continue to exist under the CFPB's proposal and a lower-cost, small installment loan that banks might offer.

Figure 6

More Than 8 in 10 Say a $35 Fee for a Three-Month, $300 Loan Would Be Fair

But two-thirds consider checking account overdraft fees to be unfair



Note: Respondents were asked: "If banks and credit unions offered a three-month, $300 loan for a fee of $35, do you think that loan would be fair or unfair?" and "Today, banks typically charge a fee of around $35 for each overdraft. Do you think that's fair or unfair?" Results are based on 1,018 interviews.

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Americans consider checking account overdraft fees to be unfair, but they view a similar fee for a three-month, $300 loan as fair. The CFPB is considering new policies for regulating overdraft practices and small-dollar loans.

Methodology

On behalf of The Pew Charitable Trusts, Social Science Research Solutions (SSRS) conducted a nationally representative random-digit-dialing (RDD) telephone survey of 1,018 adults. Interviews were conducted May 27-31, 2015. The margin of error including the design effect is plus or minus 3.7 percent. SSRS conducted 512 interviews via cellphone and 36 in Spanish. A more detailed methodology is available at http://ssrs.com/wp-content/uploads/2014/02/SSRS_Omnibus_Methodology_115.pdf.

Endnotes

1 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), 8, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/PewPaydayLendingReportpdf.pdf.

2 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. For a summary of the proposal, analysis, and recommendations, see http://www.pewtrusts.org/~/media/Assets/2015/07/CFPB-Primer_ARTFINAL.pdf.

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Appendix S

A brief from THE PEW CHARITABLE TRUSTS | Aug 2016

Stocksy

From Payday to Small Installment Loans

Risks, opportunities, and policy proposals for successful markets

Overview

All of the largest payday lenders now offer installment loans, which are repayable over time and secured by access to the borrower's checking account, in addition to conventional payday loans that are due in a single lump sum.[1] This shift toward installment lending has been geographically widespread, with payday or auto title lenders issuing such loans or lines of credit in 26 of the 39 states where they operate.[2]

Research by The Pew Charitable Trusts and others has shown that the conventional payday loan model is unaffordable for most borrowers, leads to repeat borrowing, and promotes indebtedness that is far longer than advertised.[3] To address these problems, the Consumer Financial Protection Bureau (CFPB) in June 2016 proposed a rule for regulating the payday and auto title loan market by requiring most small loans to be repayable in installments. In Colorado, a structure requiring that loans be payable over time—combined with lower price limits—was shown to reduce harm to consumers compared with lump-sum loans, after that state passed legislation in 2010 requiring all payday loans to become six-month installment loans.[4]

Further, national survey data show that 79 percent of payday borrowers prefer a model similar to Colorado's, in which loans are due in installments that take only a small share of each paycheck.[5] Seventy-five percent of the public also supports such a requirement.[6]

To get ahead of the CFPB's regulation and avoid state-level consumer protections, and in response to these consumer preferences, the trend toward payday installment lending is accelerating.[7] However, as it exists today, Four practices particularly threaten the integrity of the subprime small-dollar loan market: unaffordable payments, front-loaded charges, excessive durations, and noncompetitive prices.

in the absence of sensible regulatory safeguards, this installment lending, as well as that in the traditional subprime installment loan market that has existed for a century, can be harmful.[8]

This brief describes practices that are unique to the payday installment loan market and others that exist primarily in the traditional subprime installment loan market, focusing on four that threaten the integrity of subprime small-dollar loan markets: unaffordable payments, front-loaded charges that add costs for borrowers who repay early or refinance, excessive durations, and unnecessarily high prices.[9]

Federal and state policymakers should act now to establish policies that benefit consumers and encourage responsible and transparent lending. Pew's research shows that regulators can address harmful practices by containing payment sizes, requiring that all charges be spread evenly over the term of the loan, restricting most loan terms to six months, enacting price limits that are sustainable for borrowers and lenders that operate efficiently, and providing a clear regulatory path for lower-cost providers, such as banks and credit unions, to issue small loans.

The CFPB can implement many of these protections. However, it does not have the authority to limit interest rates, so although lump-sum lending will be largely curtailed after the bureau's rule takes effect, high-cost installment loans will probably continue to be issued unless states act to regulate them. As the transition toward longer-term lending continues, policymakers should address problems wherever payday installment loans and subprime installment loans exist.

Why lenders are moving away from lump-sum products

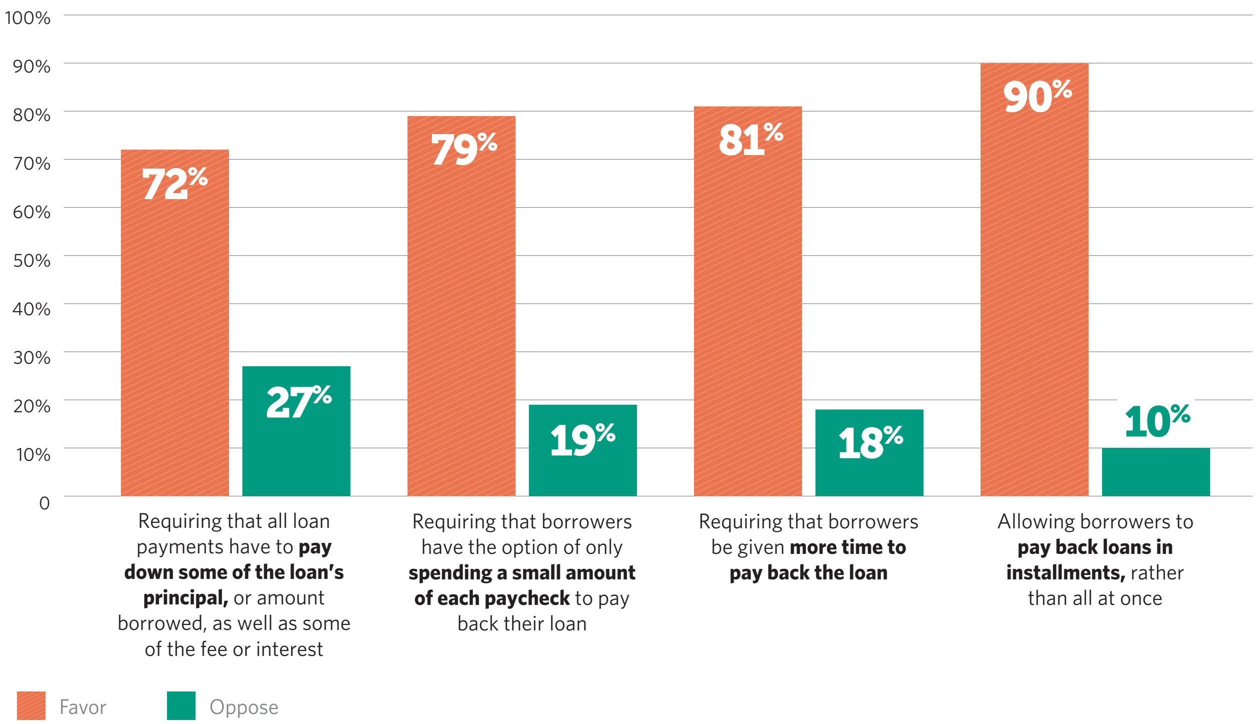
The trend among payday and auto title lenders toward offering installment loans is being driven by three factors: consumer preference, regulatory pressure, and lenders' effort to avoid consumer protections put in place for lump-sum payment loans.

Consumer preference

Pew's research shows that, compared with the conventional lump-sum model, payday loan customers overwhelmingly support requiring an installment payment structure that gives them more time to repay loans in smaller amounts that fit into their budgets. One lender explained, "I learned in Colorado that our consumers like the affordability," and noted the industry's probable shift in that direction.[10] The head of the primary trade association for online lenders said her members have mostly changed their products from two-week lump-sum loans to installment loans in response to consumer demand.[11] (See Figure 1.)

Figure 1

Overwhelming Borrower Support for Requiring Installment Payment Structure



Note: Data represent percentage of payday borrowers who gave the listed answer. Results are based on 703 interviews conducted from December 2011 through April 2012. Respondents were asked: "Now I'm going to read you some ideas for how payday loans could be changed or modified. After I read each idea, tell me whether this sounds like something you would favor or oppose. How about ...? Do you favor or oppose this?" Data do not add to 100% because "Don't know" and "Refused" were omitted from this chart.

Source: The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (October 2013), http://www.pewtrusts.org/en/research-and-analysis/reports/2013/10/29/payday-lending-in-america-policy-solutions

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Regulation

In 2013, federal banking regulators issued guidance strongly discouraging banks from issuing lump-sum "deposit advance loans," which mimic the structure of conventional payday loans.[12] The CFPB's proposed rule for payday and similar loans emphasizes the need for affordable monthly payments, and if finalized, the bureau's rule would expedite the transition toward installment loan structures.[13]

In response, payday lenders have supported bills in several states, including Arizona, Indiana, Mississippi, and Tennessee, to allow the types of high-cost installment loans and lines of credit that would be permitted under the CFPB's proposal.[14] Industry consultants have also observed that the CFPB's pending rule encourages a shift to installment lending. One noted that "many of today's payday consumers can likely handle an installment loan, at yields that emulate a payday loan," and encouraged the industry to lobby to change state laws to facilitate "high-yield" installment products.[15]

Consumer protections

Some lenders have switched to installment loans to avoid consumer protection laws.[16] For example, after a Delaware law took effect in 2013 and restricted to five the number of short-term consumer loans that payday lenders in that state may make to a given borrower in any 12-month period,[17] companies began offering installment loans of more than two months alongside conventional two-week payday loans. This allowed them to avoid triggering the new limit because the law defined "short term" as less than 60 days.[18] In another case, the Military Lending Act of 2007 limited interest rates on loans to military service members of 91 days or less, so lenders began making loans of 92 days or more in order to charge higher rates.[19] Lenders have used similar tactics in Wisconsin, Illinois, and New Mexico.[20]

High-Cost Installment Loans Could Proliferate Under CFPB Rule

Payday and auto title lenders are already issuing high-cost installment loans or lines of credit in 26 of the 39 states where they operate. The CFPB issued a proposed rule in June 2016. Once it is finalized and lump-sum lending is more restricted, lenders will probably accelerate their efforts to expand high-cost installment loans to other states, and they are likely to do that in two ways. First, they will probably attempt to modify laws in the states that do not yet allow installment lending. Until now, lenders have had little incentive to advocate for such change because they could issue lump-sum payday and auto title loans, but as that market becomes more restricted, they will be motivated to try to increase the number of states that permit high-cost installment lending.

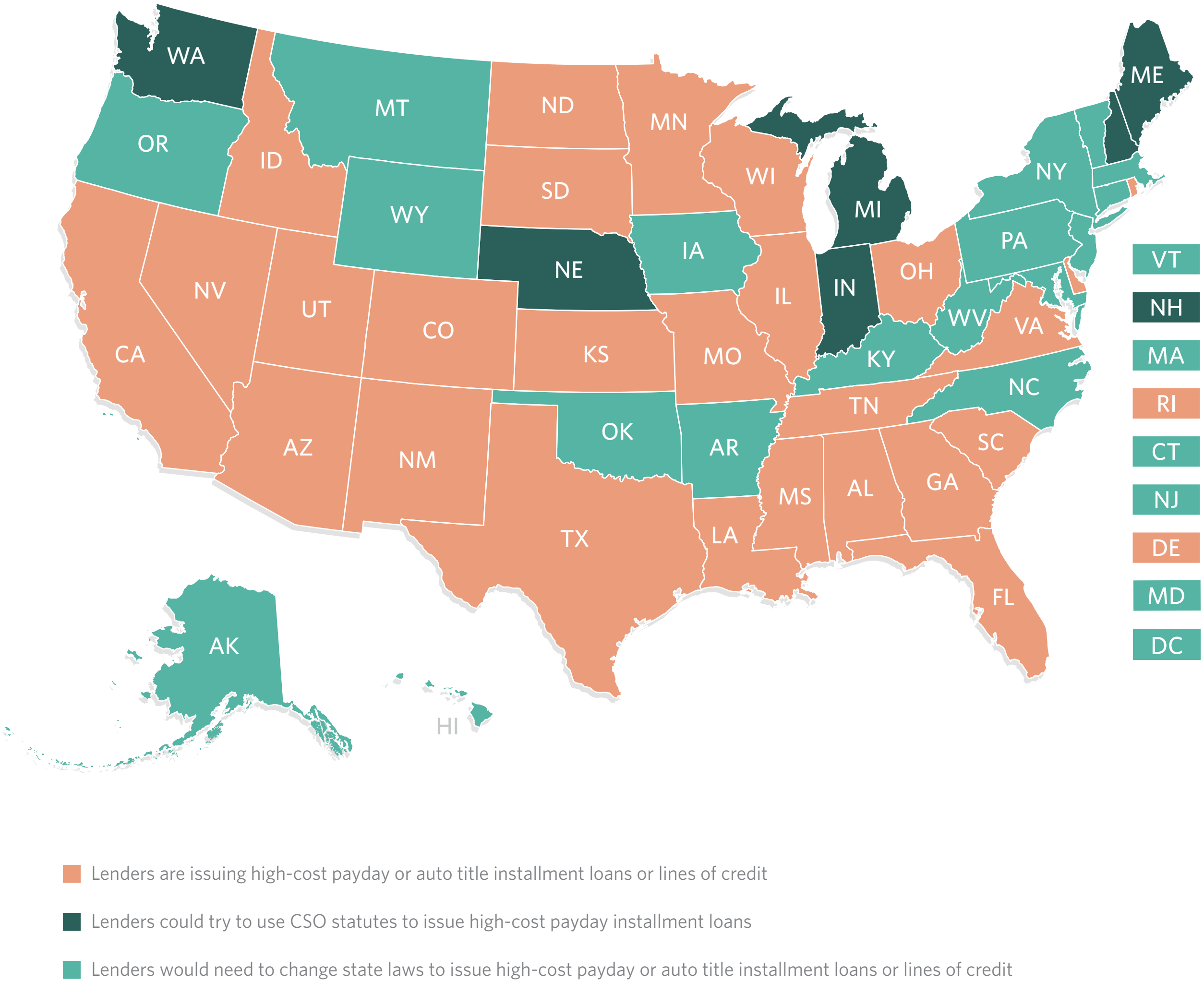
Secondly, they may try to take advantage of credit services organization (CSO) statutes, which allow the brokering of loans, in states that have such laws.[*] Payday and auto title lenders in Ohio and Texas already act as brokers under such laws, meaning that they charge large fees to borrowers to arrange loans and guarantee those loans for other lenders. Functionally, this brokering is an evasion of low interest rate limits because the fees charged are in addition to the interest paid to the third-party lender and significantly increase borrowers' costs.[†] Some of the states where payday and auto title lenders operate but do not issue installment loans or lines of credit also have CSO statutes that lenders may try to use to circumvent consumer protections. In total, at least 32 of the 39 states where payday and auto title lenders operate could be vulnerable to high-cost payday or auto title installment loans. Table 1 shows the types of payday installment loans being issued under Ohio's CSO statute.

* National Consumer Law Center, *Installment Loans: Will States Protect Borrowers From a New Wave of Predatory Lending?* (July 2015), 41-42, http:// www.nclc.org/images/pdf/pr-reports/report-installment-loans.pdf.

† Mark Huffman, "Consumer Group Charges Loophole Allows Continued Payday Lending in Ohio," *Consumer Affairs*, Nov. 11, 2015, https://www.consumeraffairs.com/news/consumer-group-charges-loophole-allows-continued-payday-lending-in-ohio-111115.html.

Figure 2

At Least 32 States Could Be Vulnerable to High-Cost Installment Lending



Notes: Several states have regulatory interpretations that prevent payday lenders from using these CSO statutes, but those could be altered without a law change. Some states only allow payday installment loans of amounts above a set threshold, such as Alabama ($2,000), California ($2,500 for both payday and auto title installment), North Dakota ($1,000), and South Carolina ($600).

Sources: Pew's analysis of existing market practices and state laws; The Pew Charitable Trusts, *Auto Title Loans: Market Practices and Borrowers' Experiences* (2015)

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Table 1

Payday Lenders Use Ohio's Credit Services Organization Statute to Issue High-Cost Installment Loans

New loans are larger, longer-term

Loan amount	Biweekly payment	Duration in weeks	Total due	APR
$500	$85	26	$1,105	360%
$1,000	$132	52	$3,432	328%
$2,000	$258.29	34	$4,390.93	275%

Notes: In 2008, Ohio changed its law to impose a 28 percent interest rate limit on payday loans under the state's Short-Term Loan Act. However, payday lenders took advantage of the state's CSO law to make lump-sum and longer-term loans that have rates far in excess of that limit, and auto title lenders used the same approach to begin making high-cost loans in Ohio for the first time. Costs and features shown are for the $500 and $1,000 loans offered by Cash America (Cashland) stores. Costs and features for the $2,000 loan are from Rise Credit.

Sources: Cash America and Rise Credit

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How regulators can address the 4 key problems with installment loans

Unaffordable payments

Most installment payday loans have payments that exceed what typical borrowers can afford. Unaffordable payments can lead to the same types of problems that exist in the conventional lump-sum loan market: frequent re-borrowing, overdrafts, and the need for a cash infusion to retire debt.

Payday installment loan payments are usually much more than the 5 percent of income that borrowers can afford. And because lenders have access to borrowers' checking accounts, either electronically or with postdated checks, they can collect the installments regardless of the borrowers' ability to afford the payments. Similarly, in the auto title loan market, lenders' ability to repossess borrowers' vehicles can pressure customers to make loan payments they cannot afford, which in turn can leave consumers without enough money to meet their basic needs.

Table 2 shows how payday installment loan payments in several states consume between 7 percent and 12 percent of the average borrower's gross monthly income (of just under $2,600) and compares that with loan payments in Colorado, where strong regulations require both smaller payments and lower prices.[21]

Table 2

Payments Usually Exceed What Average Borrowers Can Afford

Installment model does not guarantee affordability

Lender (state)	Loan amount	Total cost	Loan duration	Monthly payment
ACE Cash Express (TX)	$600	$586	Four months	$297
CashNetUSA (NM)	$600	$952	Seven months	$222
Advance America (WI)	$500	$595	Five months	$219
Plain Green Loans (multiple states)	$500	$578	Six months	$180
Speedy Cash (IL)	$500	$542	Six months	$174
Colorado	$500	$290	Six months	$130

Notes: No specific company is listed for Colorado because the state requires all payday loans of the same size to have the same structure, and all major lenders charge the same interest and fees. Some lenders list biweekly payments rather than monthly ones. For these cases, the durations and payments are shown here in months (e.g., eight biweekly payments approximate a four-month term).

Sources: Colorado Office of the Attorney General; websites of listed companies

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To solve the problem of unaffordable payments, policymakers should require loans to be repayable in small installments that are affordable for most borrowers. Research shows that in order to fit the budgets of typical payday loan borrowers, payments must not exceed 5 percent of monthly income.

Another solution that has been proposed is to require lenders to conduct underwriting to assess the borrowers' ability to repay. However, without clear product safety standards, such as limiting loan payments to 5 percent of a borrower's paycheck, this approach carries risk. It can add substantially to the price of loans by imposing new costs on lenders. And because lenders have access to borrowers' checking accounts or car titles and can collect even if borrowers lack the ability to repay, it provides lenders with little incentive to ensure that payments are truly affordable.

Problem 1

Unaffordable Payments

Summary and proposed solution

Problem: Large monthly payments often exceed borrowers' ability to repay, creating a risk of frequent refinancing or inability to pay other bills.

Some installment loans have payments of several hundred dollars a month, which is more than most borrowers can afford. Because lenders have access to borrowers' checking accounts or car titles, borrowers often make loan payments even though they are left unable to pay other bills or cover basic expenses. As a result, borrowers frequently refinance, repay loans and then quickly re-borrow, or struggle to pay for necessities.

Solution: Establish clear ability-to-repay standards, limiting loan payments to an affordable percentage of a borrower's periodic income.

For most borrowers, monthly payments above 5 percent of gross monthly income are unaffordable. Treat loans that require larger payments as potentially dangerous and subject them to stronger ability-to-repay standards. Examiners should also treat frequent refinancing or high default rates as evidence that loan payments are unaffordable.

Notes: In the banking system, regulatory examiners watch for signs of default masking, that is, refinancing loans when borrowers are unable to afford payments, in order to avoid having to treat the loan as delinquent or defaulted. See, e.g., "Federal Financial Institutions Examination Council's Uniform Retail Credit Classification and Account Management Policy," 65 Fed. Reg. 36903 (June 12, 2000). "A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies."

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Front-loaded charges

It is customary in consumer credit markets for lenders to assess an upfront fee to process an application or originate a loan. But in subprime consumer finance installment loan markets, large upfront origination fees often harm consumers by significantly increasing the cost of the loan at the time it is issued, effectively penalizing borrowers who repay early. These fees increase revenue and provide a substantial incentive for lenders to encourage refinancing in order to earn an additional origination fee. Small-loan borrowers are particularly susceptible to offers to refinance because, like many low- and moderate-income households, their income is often volatile and they have little or no savings.[22]

This misalignment of incentives has led to widespread repeated refinancing, or "loan flipping," in the traditional subprime small installment loan market, with refinances accounting for about three-quarters of loan volume for one of the largest lenders.[23] One company's CEO explained on an earnings call with investors that its customer service representatives receive a bonus based on how many of their customers refinance "because encouraging renewals is a very important part of our business."[24]

To solve this problem, finance charges, such as fees and interest, should be spread evenly over the life of the loan, rather than front-loaded. This protects borrowers against incurring large fees at the outset of the loan and aligns lenders' and borrowers' interests by ensuring profitability and affordability without discouraging early payment or providing an incentive to lenders to steer their customers toward refinancing.

When Colorado reformed its payday loan statute in 2010, it allowed an origination fee but required lenders to provide pro rata refunds whenever borrowers prepay. This was critical to the success of the state's reform because lenders did not have an incentive to steer borrowers to refinance loans.[25]

Problem 2

Front-Loaded Fees That Lead to Refinancing

Summary and proposed solution

Problem: Front-loaded fees create an incentive for lenders to encourage refinancing—sometimes called "loan flipping."

Origination fees or other upfront charges add significant cost to a first installment loan, and the borrower pays those costs again each time the loan is refinanced. As a result, lenders earn higher profits if they encourage borrowers to refinance these loans before they are paid off, while borrowers pay higher effective interest rates than they initially agreed to.

Solution: The simplest approach is to allow only interest charges or monthly fees on the loan, with no other fees.

If other fees are permitted, require that they be spread evenly over the life of the loan (origination or other prepaid fees should be pro rata refundable in the event of early repayment). Also, require that all payments be substantially equal, and reduce the balance to zero by the end of the loan's term. Finally, borrowers must be able to prepay loans without penalty at any time.

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Excessive durations

Some high-interest installment loans have unreasonably long terms, with only a small portion of each payment reducing the loan's balance. Excessive loan lengths can double or triple borrowers' costs,[26] and very long loan durations also pose risk to borrowers with volatile incomes. In lower-income months, they may struggle to afford loan payments but have little choice because lenders have access to their checking accounts or car titles. Pew's research has found that even at high interest rates, six months is generally long enough to repay a $500 loan, and one year is typically sufficient for a $1,000 loan.[27] Similarly, the public considers very short terms (less than a month) or very long terms (more than a year) to be unreasonable for a $500 loan.[28]

Discouraging excessive loan terms will become important as longer-term installment loans become the norm. The final CFPB rule for payday and similar loans will need to include clear guidelines for appropriate loan durations. States that modify their existing payday or installment loan statutes should also put policies in place that discourage excessive lengths. The CFPB's proposed guidelines for certain longer-term alternative loans require terms between 45 days and six months.[29] This range is consistent with Pew's findings about the time borrowers need to repay loans affordably, with public opinion about reasonable durations for a $500 loan, and with the small-dollar loan programs established by the Federal Deposit Insurance Corp., National Credit Union Administration, and National Federation of Community Development Credit Unions, which give borrowers several months to repay.[30]

Problem 3

Excessive Durations

Summary and proposed solution

Problem: Unreasonably long repayment terms extend indebtedness and drive up the cost of borrowing.

Speedy Cash offers a $500 auto title installment loan in Arizona with 18 monthly payments of $90.35, for a total repayment of about $1,626. In Illinois, an average auto title loan is for $893, lasts more than a year, and carries $2,030 in fees for a total repayment of $2,923.

Online lender CashCall issues loans of $2,525 with 47 payments of $294.46, requiring a borrower to pay back $13,839.62. Online lender Castle Payday offers eight-month loans that have 16 payments ranging from $67.50 to $105, so that a borrower who receives $300 will pay back $1,498.75.

Solution: Require loans to have reasonable repayment terms.

Colorado's payday loan reform has demonstrated that even at high interest rates, six months is generally long enough to pay back $500. Alternatively, states can prevent the use of unnecessarily long durations by capping loan costs (fees and interest) at half of principal. This limit generates enough revenue for lenders to earn a profit while removing their incentive to set up loans with excessive lengths.

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Unnecessarily high prices

Prices in the payday and auto title loan markets are higher than is needed to ensure the availability of credit and the profitability of lenders. But research shows that borrowers are in financial distress and are primarily focused on how much they can borrow, how quickly they can receive the funds, and how certain they are to be approved, so lenders compete on location, customer service, and speed and do not lower prices to gain customers.[31] As a result, prices remain far higher than is necessary for lenders to be profitable and to ensure the widespread availability of credit for consumers.[32] Therefore, rate limits are necessary to reduce prices and promote safe payday and auto title loans. Forty-six states and the District of Columbia set price limits on at least one type of small-dollar loan.[33]

Policymakers can employ two strategies to encourage reasonably priced credit. The first is to cap fees and interest rates. When states have enacted limits that fall below current payday loan prices but somewhat above traditional usury rate thresholds, lenders have stayed in business and continued to be profitable and credit has remained readily available. Policymakers can restrict interest rates and fees at or slightly below the level seen in Colorado, where an average $389 payday installment loan is repaid in three months and carries an APR of 121 percent—the lowest of any state—for a total cost of $116 in fees.[34]

Regardless of the CFPB's final rule, however, state policymakers may reasonably choose to prohibit payday and auto title loans in their states. An effective way to do this is by limiting finance charges to 36 percent APR (inclusive of all fees), which has historically applied to loans of larger sizes and is a price point at which these lenders will not operate.

The second strategy to drive down loan prices is to enable lower-cost providers of small loans. Banks and credit unions have large competitive advantages over payday and auto title lenders because they are diversified businesses that cover their overhead by selling other products, could lend to their own customers rather than paying to attract new ones, have customers who make regular deposits in their checking accounts, and have a low cost of funds.[35] As a result, these financial institutions could profitably make small loans at double-digit APRs, for prices that are six to eight times lower than those offered by payday lenders. However, to offer these loans sustainably, banks' fee-inclusive rates would generally need to be somewhat higher than 36 percent APR.[36]

Banks and credit unions would also need to use simple, clear, streamlined underwriting standards to issue small loans profitably, such as a limit on monthly loan payments of 5 percent of monthly income and on loan terms of six months as the CFPB proposed in its March 2015 framework.[37] Underwriting that requires staff time or extensive documentation would discourage banks from issuing small loans, because it would cost more in overhead than they could earn in revenue and make them vulnerable to increased regulatory scrutiny.

In addition, banks could take steps to screen out very poor credit risks by ensuring that applicants make regular deposits, have an account in good standing, are not using overdraft services excessively, and are not delinquent on other loans inside the bank or credit union. Pew estimates that with streamlined standards such as these, banks could profitably offer a $400, three-month loan for about $50 to 60, or half what Colorado's payday installment loans cost today.

Problem 4

Noncompetitive Prices

Summary and proposed solution

Problem: Payday and auto title loan prices are far higher than is necessary to ensure widely available credit.

Forty-six states and the District of Columbia set price limits on at least one type of small-dollar loan, but they vary widely. Colorado's payday loans average 121 percent APR, far lower than the average APR of 391 percent in other states. Lenders operate without any rate limits in eight states, and their prices usually exceed 450 percent APR.

Payday loans are typically priced at the highest allowable interest rate in each state because consumers in distress do not focus on price, and therefore small-dollar lenders do not compete on that metric.

Conventional payday and auto title loan stores are inefficient, serving an average of only 500 and 300 unique customers a year, respectively, and both spend two-thirds of their revenue on overhead. However, experience shows that under price limits such as Colorado's, efficient lenders remain profitable and provide widespread access to credit at much lower prices.

Solution: Enact research-based price limits and enable lower-cost providers to enter the small-dollar loan market.

When Colorado cut its permissible rates for small-dollar lenders by almost two-thirds, credit continued to be widely available.

The CFPB and other federal regulators should permit banks and credit unions to offer small installment loans at viable prices, which are sustainable for both financial institutions and consumers using simple, highly automated underwriting. Banks could profitably issue small loans at prices six to eight times lower than those charged by payday lenders, saving low- and moderate-income borrowers billions of dollars annually.

Alternatively, state lawmakers who wish to eliminate payday lending and other small credit can follow the lead of 15 states that have prohibited payday lending by setting rate caps at 36 percent APR or below (inclusive of fees) or banned it using another method. Pew recommends that states that do not allow high-interest lending continue to prohibit it.

Note: Lawmakers in Florida, Oregon, Rhode Island, and Washington have also enacted law changes that resulted in lower prices, with credit remaining widely available in their states.

Sources: The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (April 2014), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/stateratelimitsfactsheetpdf.pdf; The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (October 2013), 39–40, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/PewPaydayPolicySolutionsOct2013pdf.pdf; The Pew Charitable Trusts, "Trial, Error, and Success in Colorado's Payday Lending Reforms" (December 2014), http://www.pewtrusts.org/~/media/assets/2014/12/pew_co_payday_law_comparison_dec2014.pdf; Nick Bourke, "Regulators Should Let Banks Get Back to Small-Dollar Loans," *American Banker*, Sept. 16, 2015, http://www.americanbanker.com/bankthink/regulators-should-let-banks-get-back-to-small-dollar-loans-1076693-1.html

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Conclusion

The payday loan market is quickly moving away from lump-sum lending and toward installment loans. The shift is driven in part by consumer preference and regulatory pressure, but in some instances lenders have used installment loan models to evade consumer protections that cover only shorter-term loans.

The CFPB's proposed small-dollar loan rule will almost certainly accelerate this transition, but if it is going to benefit consumers, it must also be structured to ensure reasonable terms, affordability, and lower prices. To prevent new harm to borrowers, federal and state policymakers should take additional steps to resolve the four major problems with the small installment loan market: unaffordable payments, front-loaded charges that often lead to high rates of loan refinancing, excessive durations, and noncompetitive pricing. These issues can be solved by requiring that payments be affordable as determined by the borrower's income, mandating that all charges be spread evenly over the term of the loan, limiting terms for small-dollar loans to six months in most cases, enacting price limits that are sustainable for borrowers and lenders that operate efficiently, and allowing lower-cost providers such as banks and credit unions to issue small loans sustainably.

Methodology

To conduct this research, Pew reviewed the payday, auto title, pawn, and installment loan and credit services organization statutes of every state as well as the websites of selected payday and auto title lenders. Pew contacted state regulators and lenders in any state where it was unclear whether payday installment loans, auto title installment loans, or similar lines of credit were being issued.

Endnotes

1 High-interest installment loans and lines of credit are issued by storefront payday lenders and state-licensed online payday lenders in 19 states: Alabama, California, Colorado, Delaware, Idaho, Illinois, Kansas, Missouri, New Mexico, North Dakota, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, and Wisconsin. High-interest auto title installment loans are issued in 17 states, and lenders were allowed to start offering them in Mississippi as of July 1, 2016. In total, multipayment payday or auto title loans are available in 26 of the 39 states where payday and auto title lenders operate.

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For more information, please visit:

pewtrusts.org/small-loans

Detailed policy recommendations are available in Pew's report Payday Lending in America: Policy Solutions*, available at http://www.pewtrusts.org/paydaypolicysolutions.*

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The Pew Charitable Trusts is driven by the power of knowledge to solve today's most challenging problems. Pew applies a rigorous, analytical approach to improve public policy, inform the public, and invigorate civic life.

Appendix T

AMERICAN BANKER

Colorado's Payday Loan Reforms Offer Blueprint for CFPB

By Nick Bourke
February 4, 2015

The Consumer Financial Protection Bureau can learn a lot from the Centennial State.

The agency is currently in the process of developing new regulations for payday lenders. It would be well served to model its proposed rules after Colorado's. The meaningful reforms that state's lawmakers implemented in 2010 have dramatically improved outcomes for payday loan borrowers while still maintaining consumers' access to credit.

More than four years later, payday loan borrowers in Colorado are spending 42% less in fees, defaulting less frequently and paying lenders half as much in penalties for bounced checks as before the reforms took effect, according to an analysis of Colorado regulatory data. These consumers still have ready access to small-dollar loans. Installment payments average less than $50 biweekly, roughly one-ninth the size of payments required by lenders in other states.

The CFPB has a historic opportunity to fix the small-dollar loan market by emulating Colorado's example. That would entail requiring that all payday and similar loans have payments that are much smaller and more affordable than is currently the case.

It would also mean enacting protections against deceptive practices like loan flipping, in which lenders encourage borrowers to refinance their loans in order to generate new origination fees or to mask a potential default for those who are struggling to make a payment. As former CFPB Deputy Director Raj Date recently noted, uniform regulations that eliminate deceptive practices in the small-dollar loan market are the key to enabling newer, better products.

Borrowers are eager for regulators to act, according to a nationally representative survey of 703 payday loan customers conducted by The Pew Charitable Trusts in 2012. Payday loan borrowers overwhelmingly favor new regulations. Eight in ten support requirements that loans be repayable over time in installments that consume only a small amount of every paycheck. Most borrowers cannot afford to put more than 5% of their pretax paycheck toward each loan payment without having to borrow again to make ends meet, according to Pew's calculations based on data from surveys and market research.

The CFPB can adopt Colorado's affordable-payments model without copying its exact legal code. The agency could require payday lenders to adhere to specific loan durations depending on the amount borrowed. It could also mandate that lenders determine that each borrower has the ability to repay before extending credit or explicitly require affordable loan payments, such as limiting periodic payments to no more than 5% of the borrower's periodic pretax income.

These measures have been unnecessary in the 14 states, along with the District of Columbia, that have upheld traditional usury interest rate caps. Interest rate limits continue to be an important policy tool for improving small-loan markets. But that is not an option for the CFPB, which does not have the legal authority to regulate interest rates.

Meanwhile, balloon-payment payday loans in 35 states continue to harm borrowers. Only Colorado has figured out how to make payday loans available in a relatively safe and transparent fashion.

Colorado also has provided lessons on how not to implement payday loan reform. The state's 2007 attempt to overhaul the payday lending industry failed. That effort allowed lenders to continue making conventional, balloon-payment loans, but required them to offer an installment plan after making four consecutive loans.

As a recent report from The Pew Charitable Trusts shows, this approach did not work. Balloon-payment loans continued to dominate the market, and outcomes for borrowers changed only slightly. The policy's failure can be largely attributed to its attempt to treat the symptom — repeat borrowing — without addressing the disease. The real problem was an unaffordable balloon payment that consumed more than a third of the next paycheck of a borrower who was already in financial distress.

When Colorado legislators tried again in 2010, they tackled the core problem of affordability. In addition to the reduced costs of payday loans and the decline in defaults and bounced check fees, the state experienced a 40% decrease in same-day loan renewals. These are demonstrably better results for the people who take out payday loans — which helps explain why the Colorado borrowers that Pew interviewed are satisfied.

Colorado lawmakers achieved these results by imposing principles that ought to be obvious but have been forgotten in every other payday loan market. In sum, all loan payments should be tailored to fit into borrowers' budgets and lenders should not be able to boost profits or mask defaults through loan flipping.

That is exactly the right model for federal regulators to follow.

Nick Bourke is director of the small-dollar loans project at The Pew Charitable Trusts. Follow him on Twitter@nibosays.

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Appendix U

AMERICAN BANKER.

Regulators Should Let Banks Get Back to Small-Dollar Loans

By Nick Bourke
September 16, 2015

The payday loan market is past due for reform. Implemented correctly, new regulatory standards will help payday loan borrowers by making these loans safer and more affordable, as well as pave the way for better, lower-cost installment loans from banks.

Consumers are eager for this change. Surveys show that most borrowers who have turned to payday lenders want reforms that will result in smaller payments and lower prices. They overwhelmingly favor stronger regulation of the market. Similarly, more than 70% of all Americans favor stronger regulation of the payday loan market and support allowing banks to offer lower-cost small loans.

The Consumer Financial Protection Bureau took an important step toward achieving these goals in March with a proposal that would address the affordability of payday loans. With a few crucial adjustments to make it more difficult for lenders to issue financially dangerous loans and easier for them to issue safe ones, the CFPB's comprehensive and well-balanced plan should lead to smaller, more manageable payments with better outcomes for consumers.

The bad news is that high interest rate loans will continue to exist, since the CFPB lacks authority to limit interest rates. Payday loans with annual percentage rates of an average 400% would likely persist under a section of the proposal that requires verification of income and expenses but does not limit loan durations or payment sizes. So, for example, a $500 payday installment loan with $1,300 in fees would continue to be on the market, just as it is today.

The good news is that safer, more affordable options could thrive under rules outlined under the longer-term alternative section of the CFPB proposal. As currently devised, this alternative would require less underwriting and documentation if the lender agrees to limit loan durations to six months and cap monthly payments at an affordable 5% of monthly income, or $125 for the average borrower who earns about $30,000 per year. Payments above that amount are unaffordable for most borrowers. These two crucial safeguards would lead to much lower-cost and affordable credit than loans that merely verify income and some expenses.

This option would end the regulatory uncertainty about acceptable loan structures, underwriting, and pricing that has prevented banks from offering small installment loans. Such clarity would also enable banks to leverage their competitive advantages over payday lenders. They already have branch networks in place to sell many financial products, while storefront lenders spend two-thirds of their revenue on overhead. Banks already serve the vast majority of payday loan borrowers, because a checking account and income are required to obtain a payday loan. By contrast, customer acquisition and charge-offs are major cost drivers for online payday lenders. Banks also have a lower cost of funds and have the ability to take installment loan payments as soon as deposits arrive.

The option for small installment loans with payments limited to 5% of a borrower's income is the only one in the CFPB's framework that will enable banks to offer credit that provides borrowers with enormous cost savings. Despite these lower prices, banks' cost advantages would enable them to make a profit — if they are allowed to use the low-cost, streamlined underwriting requirements that the CFPB has initially proposed.

Such loans could also strengthen banks' reputation, since this credit would be viewed favorably by the general public, according to a recent Pew Charitable Trusts survey. Respondents overwhelmingly saw the prices that payday lenders currently charge as unfair. But 76% viewed a $500, four-month loan with a fee of $80 as fair. An even larger majority (85%) saw a $300, three-month loan with a fee of $35 as fair. These hypothetical bank loans have somewhat high APRs, but they still cost borrowers about *six times less* than similar installment loans from payday lenders.

Making such loans would enable banks to serve customers who do not qualify for prime products without imposing costly overdraft penalty fees, which are a primary source of bank credit for these same customers today. Small loans could also enhance access to the banking system by encouraging migration away from online payday loans and excessive use of overdraft, both of which put customers at risk of losing their checking accounts.

Although safe, small installment loans from banks would lead to better outcomes for consumers than payday loans, several challenges must be resolved before they can become standard products. If bank regulators such as the Office of the Comptroller of the Currency require extensive underwriting, rather than the simplified process in the CFPB's proposal and the National Credit Union Administration's “Payday Alternative Loan” guidelines, it will be difficult for banks to issue these loans.

Similarly, the CFPB should make its rules as streamlined as possible. For example, it should not put a limit on the number of safe, 5% payment installment loans that lenders can offer annually. For their part, banks would need to show a commitment to offering small-installment credit to customers who have low balances and credit scores.

If these hurdles can be overcome, payday loan customers would be served by the banks where they already have checking accounts — and would save billions of dollars annually.

Nick Bourke is director of the small-dollar loans project at The Pew Charitable Trusts.

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Appendix V

Credit Union Times

Why Credit Unions Should Watch the Payday Loan Market

By Nick Bourke December 04, 2015

In the next few months, the CFPB will propose new payday loan rules that build on the bureau's initial framework. Those rules will provide a much-needed response to many of the deficiencies in the payday loan market, which will benefit the consumers who currently use these loans. But the CFPB also should ensure the new rules help credit unions provide better small loan alternatives.

More than 100 million payday loans are issued annually, typically at rates between 300% and 500% APR. This is a large market that credit unions could serve better than payday lenders do, and at far lower cost to borrowers. Today, credit unions do help members facing financial hardship through programs that encourage saving and increase financial literacy. But when these individuals and families are struggling to make ends meet, they often look for immediate financial assistance. So payday lenders step in with an offer that some folks can't refuse: A loan averaging $375 with an appealing fixed fee, usually provided in less time than it takes to have a pizza delivered.

Payday loans often turn into months-long ordeals that cost consumers more in fees than they receive in credit. But on the front end, speed and ready access to credit are major selling points of payday loans. Seven in 10 customers report focusing primarily on speed or convenience, as opposed to cost, when choosing where to borrow. So, to entice members to use lower-cost, more reasonably structured installment options, credit unions will need to issue small loans much more quickly.

Federal regulators have an important role to play in making that possible. First, regulators should continue to support the NCUA's Payday Alternative Loan program. These loans cost six to seven times less than a payday loan. With maximum charges of 28% annualized interest and a $20 application fee, effective APRs range from 35% to 148% depending on a loan's size and duration. While these rates are high, the small principal amount results in low costs for the member. For example, a three-month, $300 loan with an APR of 69% would cost only $35. In a recent survey, 85% of Americans said the terms of such a loan were fair.

The program's efficacy is reflected in a surprisingly low charge-off rate of just 2%, which is partially attributable to the fact that borrowers are already credit union members who make regular deposits to their checking accounts and typically repay via electronic debit. Yet the PAL program has tight revenue constraints, which is one reason that few of these loans are issued. About one in 7 federal credit unions currently participates in the PAL program, and they issued approximately 170,000 loans in 2014 – just a sliver of the overall market with far less than 1% of the volume of payday loans issued that year.

That's why regulators should support new ways for credit unions to make affordable small loans quickly and efficiently, which the CFPB is now considering. Its proposed regulatory framework supports both the NCUA PAL program and a new type of loan that has affordable payments (5% or less of the borrower's monthly income) and reasonable durations (no longer than six months). These are the two safest types of loans outlined in the CFPB's framework given their clear and conservative safeguards.

In our conversations with credit union executives nationwide, they have stressed the need for the kind of alternatives the CFPB is considering in order to minimize regulatory burden and allow origination of better loans at a fair price. Unlike other loans described in the CFPB's proposal, which would require extensive documentation and underwriting, the simplified origination process of the two loan programs would enable credit unions to issue these safe and affordable loans quickly, with far less compliance burden.

Consumers who borrow from regulated depository institutions where they already hold accounts would save significant sums of money and reduce their risk of becoming unbanked. In Pew's study of online borrowers, 22% reported closing or losing a checking account in association with an online payday loan.

If the CFPB formalizes these options, credit unions would be able to greatly expand their small loan offerings.

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A fact sheet from THE PEW CHARITABLE TRUSTS | Jan 2016

Payday Loan Facts and the CFPB's Impact

Overview

Twelve million Americans take out payday loans each year, spending more than $7 billion on loan fees. The data below provide facts on the market and borrower usage, plus a brief review of the Consumer Financial Protection Bureau (CFPB) proposed framework to regulate payday and auto title loans.

Most borrowers pay more in fees than they originally received in credit

- The average payday loan borrower is in debt for five months of the year, spending an average of $520 in fees to repeatedly borrow $375. The average fee at a storefront loan business is $55 per two weeks.
- Payday loans are usually due in two weeks and are tied to the borrower's pay cycle. Payday lenders have direct access to a borrower's checking account on payday, electronically or with a postdated check. This ensures that the payday lender can collect from the borrower's income before other lenders or bills are paid.
- A borrower must have a checking account and income to get a payday loan. Average borrowers earn about $30,000 per year, and 58 percent have trouble meeting their monthly expenses.
- Although payday loans are advertised as being helpful for unexpected or emergency expenses, 7 in 10 borrowers use them for regular, recurring expenses such as rent and utilities.
- Auto title loans are similar to payday loans, except that the average loan is $1,000 and is secured by a borrower's car title. Roughly 2.5 million Americans spend $3 billion on auto title loan fees each year.
- Payday loans are available in 36 states, with annual percentage rates averaging 391 percent. The other states effectively prohibit these loans by capping rates at a low level or enforcing other laws.

Payday loans are unaffordable for most borrowers

- The average payday loan requires a lump-sum repayment of $430 on the next payday, consuming 36 percent of an average borrower's gross paycheck. However, research shows that most borrowers can afford no more than 5 percent while still covering basic expenses.
- As a result, most borrowers renew or reborrow the loans. This explains why the CFPB found that 80 percent of payday loans are taken out within two weeks of repayment of a previous payday loan.
- The payday lending business relies on extended indebtedness: three-quarters of payday loans go to those who take out 11 or more of the loans annually.
- The payday loan market is not price competitive. Most lenders charge the maximum rate allowed under state law. States without rate limits have the highest prices.

Colorado's payday loan reform improved affordability, lowered prices, and kept credit available

- In 2010, Colorado law replaced conventional two-week payday loans with six-month installment payday loans at interest rates almost two-thirds lower.
- Access to credit remains widely available in Colorado. Although half of the payday loan stores closed, the other half now serve twice as many customers at each location, and 91 percent of residents still live within 20 miles of a store.
- Average borrowers now pay 4 percent of their next paycheck toward the loan instead of 38 percent.
- Borrowers save money by repaying the loans early, and 75 percent do so.
- Borrowers save more than $40 million annually on the loans.

CFPB's proposal will help, but it needs to be strengthened

- 75 percent of all Americans favor more regulation of payday loans, and there is strong public support for the CFPB's proposal to allow loans to be repaid in affordable installments.
- Borrowers overwhelmingly want reform, with 8 in 10 favoring requirements that payments take up only a small amount of each paycheck and that borrowers be given more time to repay their loans.
- The CFPB's proposal will set a new national minimum safety standard. But high-interest payday and auto title loans will continue to exist where permitted by state law.
    - The most dangerous loans under the CFPB framework would be those with no limits on cost, duration, size, payment size, or access to a customer's account if the lender verifies the applicant's income and a few expenses. These loans could go on for more than a year at 400 percent interest.
    - The safest loans would be those that follow national credit union guidelines or that limit payments to 5 percent of income, and loan duration to six months. These rules would provide a pathway for banks and credit unions to offer customers lower-cost installment loans.
- Pew's analysis of the initial proposal recommends a stronger ability-to-repay standard in the CFPB rule and clearer guidelines to prevent unreasonable loan durations, unaffordable payments, and lender abuse of checking account access.
- Pew supports the CFPB's clear standards that enable lower-cost loans with affordable payments at 5 percent of a borrower's monthly income and a reasonable term of up to six months.

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Appendix X

THE PEW CHARITABLE TRUSTS

The Pew Charitable Trusts / **Research & Analysis** / How the CFPB Small Loans Rules Would Work

ANALYSIS

How the CFPB Small Loans Rules Would Work

Payday loan reform: An evaluation, Part 1

March 16, 2016

Small-Dollar Loans

By Nick Bourke

The CFPB's rules should protect borrowers and foster access to better forms of small credit with affordable payments.

In spring or summer of 2016, the Consumer Financial Protection Bureau (CFPB) will publish an official notice of proposed rule-making to establish federal regulations for payday and similar loans for the first time since these products emerged in the early 1990s. In a framework published in March 2015, the bureau made clear that high-cost payday and auto title lending will continue but with new safeguards intended to protect against harmful practices that are pervasive in today's market. The bureau will most likely finalize the rules nine to 12 months later.

How the CFPB finalizes its rules will determine whether small-dollar lending will transform into a safe and reliable financial market. The rules will probably prevent some harmful loans from being issued, but to ensure that the millions of loans that are made are affordable and have fair and reasonable terms and conditions, the CFPB will have to set clear, measurable, and enforceable guidelines.

The CFPB framework lets lenders choose how to comply

According to the CFPB's framework, the new rules will apply to all "covered loans" from any lender. Covered loans include certain short-term loans of 45 days or less and longer-term loans of more than 45 days that (1) have an "all-in" annual percentage rate (APR)—a rate that includes the cost of all fees and insurance—of more than 36 percent and (2) are effectively secured by the borrower's checking account or vehicle title. When making a covered loan, lenders will be required to choose from two options:

- **"Ability to repay" underwriting process.** Lenders must document the borrowers' income and certain expenses and make a "reasonable determination" that the loan payments will fit within their means, but the CFPB will not impose limits on the cost, size, or duration of loans; payment amounts; or the length of time lenders have access to borrowers' checking accounts or car titles. In other words, lenders will be able to set any loan terms they wish as long as they complete the required documentation process and determine that the borrower can afford the required payments. Regulatory examiners will be responsible for monitoring lenders for signs of unreasonable lending practices, but unless the bureau outlines clear metrics for identifying violations, those reviews may not produce meaningful enforcement or deliver significant protection for consumers.

- **"Alternative requirements."** Instead of dictating an underwriting process, this option features more objective guidelines for ensuring that loans are structured to meet general ability-to-repay standards. The alternative requirements include restricting borrowers to three consecutive short-term lump-sum loans and a maximum of six per year, and for loans lasting longer than 45 days, defining affordable payments as no more than 5 percent of the borrower's monthly income and reasonable loan durations as six months or less. These options, as well as other parts of the initial framework, may change as the CFPB finalizes its rules.

High-cost loans will remain widely available

The CFPB does not have the authority to ban high-cost credit or to regulate interest rates. Instead, its framework sets conditions lenders must satisfy when making these loans in order to prevent some applicants from getting loans that could be harmful. Although the bureau wisely made borrowers' ability to repay the central theme of its framework, it has not yet established sufficiently clear, objective, and enforceable guidelines describing the quality of loans that people actually receive.

If finalized according to the framework, the bureau's rules would give high-cost lenders unusually strong leverage in the form of direct access to customers' checking accounts or vehicle titles, which would allow them to collect payments and generate profits even when loans are unaffordable for borrowers. The ability to take money directly from checking accounts or repossess a vehicle means high-cost lenders would tend to get paid regardless of the customers' financial circumstances or priorities. This, in turn, would insulate lenders from the damaging effects of unaffordable loans, such as defaults and losses, while borrowers would bear the brunt and would often be left unable to pay other bills or purchase food or other necessities.

This structure would also make it difficult for the CFPB and other regulators to identify when a lender is engaging in unfair or aggressive underwriting practices because lenders' balance sheets appear healthy, while customers would suffer the consequences of unaffordable payments, hardships that would be largely undetectable by regulators. Industry analysts have credibly forecast that most payday loan borrowers would pass through the ability-to-repay underwriting process and receive a loan, meaning millions of Americans would be subject to excessive prices and potentially harmful loan terms even under the CFPB rules.

For these reasons, Pew supports the CFPB's "alternative requirements" for loans lasting longer than 45 days as outlined in the March 2015 proposal, which because of their objective standards for affordable monthly payments and reasonable durations, represent the safest and clearest part of the framework. If finalized in the rules, these guidelines would not only provide greater protection to customers seeking credit in the existing small-loan marketplace, they would also enable lower-cost lenders such as banks and credit unions to make new types of installment loans at prices far below those of payday lenders.

In short, the CFPB must strengthen its proposed ability-to-repay standards as well as preserve and improve its alternative requirements for longer-term loans.

Key questions to ask when the CFPB publishes its payday loan rules

The CFPB's rules should protect borrowers and foster access to better forms of small credit with affordable payments. To be successful, the bureau must ensure that the answers to the following questions are yes:

1. Do the rules stop the most harmful payday loan practices and establish clear guidelines for new, lower-cost products to enter the market?

2. Do the “ability to repay” underwriting standards screen out prospective borrowers who cannot afford more debt and provide clear protections for those who do receive credit? Do they include clear and easy-to-enforce guidelines for affordable payments and reasonable durations? Do they help ensure that after making their payments, borrowers will still have enough money each month to cover child care, transportation, medical care, and other necessities?

3. Do the “longer-term alternative” guidelines support lower-cost bank and credit union options? Do they go beyond simply accommodating the handful of small loan alternative programs that exist today and provide clear rules on affordable payments and reasonable durations to encourage the introduction of new types of small installment loans that have the potential to help millions of Americans?

Pew will continue to evaluate the rules as they develop.

Next: How the CFPB Framework Could Affect the Small Loan Marketplace

Nick Bourke directs the small-dollar loans project at The Pew Charitable Trusts.

Appendix Y

THE PEW CHARITABLE TRUSTS

ANALYSIS

How the CFPB Framework Could Affect the Small-Loan Marketplace

Payday loan reform: An evaluation, Part 2

March 29, 2016

Small-Dollar Loans, Consumer Finance

By Nick Bourke

The Consumer Financial Protection Bureau (CFPB) is preparing the first federal regulations for payday and similar loans. This is propelling a shift in the market away from the conventional payday loan model, which has led to serious harm because the loans must be paid off after two weeks in a single payment that consumes about one-third of the typical borrower's next paycheck. Instead, small-loan lenders are increasingly using installment loan models in which borrowers settle over a period of months. Although longer-term loans generally work better for borrowers, they can be harmful without additional regulatory protections. Whether borrowers would fare better under these new types of longer-term loans would depend on the strength and clarity of the CFPB's pending rules.

The market will continue to shift toward installment lending

Today, payday and auto title lenders operate in 39 states; in 25 of them, lenders already issue installment loans or lines of credit that would pass the CFPB's proposed ability-to-repay rules even though many have annual percentage rates exceeding 300 percent and include unaffordable loan terms. These loans lack the safeguards that well-structured installment loans should have, including affordable loan payments and limits on cost and duration.

The CFPB's rules would not prevent the spread of all potentially harmful loans because the bureau lacks the power to regulate interest rates. In fact, the agency's March 2015 outline of its proposed payday loan rules provided a clear pathway for lenders to continue making high-cost loans where allowed by state law. Further, high-cost payday and auto title installment lending is likely to expand beyond the 25 states where it exists today as lenders continue to push the limits of state laws or seek to amend state laws in their favor. However, this probability raises important questions: What will these longer-term loans look like, and how will the CFPB ensure the safety and fairness of these loans for the millions of people who will use them? The answers will depend on whether the CFPB stamps out common harmful practices; provides a strong regulatory framework on which state lawmakers can build; and sets clear, simple rules to encourage traditional financial institutions to provide new loans that are safer and less expensive.

Best-case scenario

In the best-case scenario, the CFPB would improve its regulatory approach in two ways. First, it would strengthen its proposed "ability-to-repay" underwriting requirements to prevent harmful practices, such as issuing borrowers loans that last too long or charging large origination fees that make reborrowing expensive and dangerous. Second, it would finalize clear and sensible guidelines describing the "longer-term alternative" option, which features a streamlined underwriting process for lenders but also includes more stringent rules governing the safety of the loans. Clear guidelines for payment size, duration, and other loan terms would improve the overall transparency and safety of loans while reducing origination and regulatory compliance costs for lenders. This could enable lenders—especially banks and credit unions—to enter the market with new small installment loan products that cost less and work better for borrowers.

Clear rules would also give state lawmakers a tangible framework on which to build. The CFPB lacks authority to regulate pricing or dictate loan terms and will give lenders options for how to comply with federal rules. Yet state lawmakers do have the power to regulate pricing and require lenders to follow exacting standards. The CFPB could help by including an option in its federal rule that clearly defines a safe loan and provides a model for state legislation.

The bureau's March 2015 regulatory proposal included such an option, based in part on Colorado's successful 2010 payday loan reform, which would require loans to have affordable payments of no more than 5 percent of the borrower's paycheck and reasonable durations of six months or less. That option was the strongest part of its initial proposal, and the CFPB should finalize it, or something very similar, in its final payday loan rules.

Worst-case scenario

In the worst-case scenario, the CFPB would make none of these improvements. High-cost payday and auto title installment loans would continue to spread without essential protections to guard against excessive durations and unaffordable payments, and better loan options would not emerge. State lawmakers would have no model to standardize around, and lower-cost providers such as banks and credit unions would be discouraged from entering the market due to regulatory costs and uncertainties. Millions of Americans could continue to be harmed by unsafe loan products without having access to better alternatives.

The table below summarizes these scenarios.

Potential Outcomes of the CFPB's Rules for Payday and Similar Small Loans

Good regulation should strengthen consumer protections and lower costs

Do regulations enable better credit?

Do regulations protect against harmful credit?	**No** Weak or ambiguous regulations discourage banks and credit unions from offering small loans.	**Yes** Clear regulations make it easy for banks and credit unions to offer lower-cost small loans.
No Weak or ambiguous underwriting standards allow lenders to offer loans with extreme durations, unaffordable payments, and excessive prices.	**Worst-case scenario** Credit remains harmful, and safe lower-cost alternatives do not emerge. There are no clear guidelines for state lawmakers to build on, and banks and credit unions stay out of the market due to ambiguous regulatory requirements.	Harmful loans remain widely available, but new safe and lower-cost alternatives also emerge.
Yes Strong safeguards improve credit from payday and auto title lenders.	Credit is safer but still very expensive, and lower-cost alternatives do not emerge.	**Best-case scenario** Credit is safer, and new lower-cost alternatives emerge. State lawmakers have a strong model to build upon. Banks and credit unions have clear guidelines for developing new loans.

Note: These probable scenarios for the small-loan market under the CFPB's payday and auto title loan rules are based on data from states that have enacted payday loan reforms, interviews with bank and credit union executives and other stakeholders, public statements and product information released by lenders, and recent market developments.

Source: The Pew Charitable Trusts, "Understanding the CFPB Proposal for Payday and Other Small Loans" (July 2015), http://www.pewtrusts.org/-/media/assets/2015/07/cfpb-primer_artfinal.pdf

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If the CFPB's regulations were sufficiently clear and rigorous, they could directly stop many of the worst harms in these markets, help enable banks and credit unions to introduce new types of lower-cost small loans, and give state legislators a standard model on which to improve consumer protections in their states.

Next: How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-Cost Small Loans

Nick Bourke directs the small-dollar loans project at The Pew Charitable Trusts.

Appendix Z

THE PEW CHARITABLE TRUSTS

ANALYSIS

How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-Cost Small Loans

Payday loan reform: An evaluation, Part 3

April 05, 2016

Small-Dollar Loans

By Nick Bourke

Most people who use payday and similar loans live paycheck to paycheck, have damaged credit profiles, and frequently have trouble paying their monthly bills. They also tend to have volatile income that fluctuates by more than 25 percent from month to month (think of those who earn hourly wages at jobs with unpredictable schedules). This helps explain why 7 in 10 borrowers say they use payday loans mainly for recurring expenses such as rent, mortgage, and utilities. Borrowing cannot solve fundamental problems, including low wages or poor financial planning, but affordable, fairly structured small installment loans can help bridge gaps in the budgets of these vulnerable consumers. Banks and credit unions could play a large role in ensuring access to such safe small credit, but only if regulators provide guidelines that are clear and simple.

Thanks to the Consumer Financial Protection Bureau (CFPB), conventional payday loans are on the decline. In response, lenders have begun to shift toward offering longer-term installment payday loans, which are safer but often also needlessly expensive. Because the bureau cannot regulate interest rates or eliminate all high-cost small loans, these new products will probably remain widely available even after the CFPB completes its regulations. What is unclear is whether traditional financial institutions will enter this market and offer better types of small installment credit options under the CFPB rules. Currently, banks generally do not provide small loans to financially fragile customers (with the unfortunate multibillion-dollar exception of fee-based overdraft), and only 1 in 7 federal credit unions offers a payday alternative loan: In 2014, such institutions made only 170,000 such loans, compared with more than 100 million payday loans.

If new and better forms of small credit are to emerge from banks and credit unions, it is up to federal regulators to break the logjam, starting with the CFPB. Many traditional financial institutions, including some very large ones, have expressed interest in serving this market, but only if they can confidently operate within clear regulatory guidelines. Decisiveness and clarity from the CFPB and other regulators are essential. Firm rules about acceptable loan structures, underwriting, and pricing would ensure that new products are safe for borrowers (unlike deposit advance loans, for instance, which were simply lump-sum payday loans offered by a handful of banks until regulators stopped the practice in 2013). Clear rules for a new type of small installment loan would help banks and credit unions avoid regulatory violations and automate the loan origination process, which would keep prices down.

Encouraging banks and credit unions to offer small credit options makes sense because they are federally regulated entities that can make such loans at prices that are at least six times lower than payday loans, which will probably continue to exist in the years ahead. Traditional financial institutions have significant competitive advantages over payday lenders, including large existing branch networks, diversified product lines, existing relationships with borrowers, and the lowest cost of funds in the industry. By contrast, nonbank lenders incur substantial costs that they must cover from revenue on a narrow line of products. Storefront payday lenders spend two-thirds of their revenue on overhead, and customer acquisition and defaults are major cost drivers for online lenders.

Payday loan borrowers are worthy candidates for loans from traditional financial institutions because they are already bank or credit union customers. (To get payday loans, consumers must have checking accounts.) Yet millions of them go outside their financial institutions to access small amounts of credit, spending roughly $9 billion on payday loans and $3 billion on auto title loans each year. The availability of lower-cost credit from traditional financial institutions could save these consumers more than $10 billion annually, help them to improve their credit scores, and give them access to safer, more affordable products. These loans would also provide an alternative to costly overdrafts: Unlike a $35 fee for an overdraft, a $35 fee for a $300 installment loan looks like a fair deal to most Americans.

The CFPB is not the only regulator in the small loan market, but it is the most important, and it must act boldly to set clear federal standards. If the CFPB leads the way, other federal agencies that regulate the safety and soundness of financial institutions (known as “prudential” regulators) can also help by permitting banks and credit unions to issue responsible, lower-cost small installment loans according to the CFPB’s guidelines. These agencies include the Office of the Comptroller of the Currency (OCC), Federal Reserve Board of Governors, Federal Deposit Insurance Corp. (FDIC), and National Credit Union Administration (NCUA).

Two main factors will determine whether the CFPB’s final rules make lower-cost bank and credit union lending feasible. The rules should include:

1. A clear regulation that traditional financial institutions could rely on when structuring new and better types of small-loan programs. For example, the CFPB’s March 2015 proposed framework included a “longer-term alternative” option that, if enacted, would require loans to have affordable monthly payments

of no more than 5 percent of customers' monthly income and reasonable durations of no more than six months. In a national survey, 76 percent of Americans said a loan made under this framework would be fair, compared with only 17 percent who said a commonly available payday loan is fair. Respondents also considered this type of alternative bank loan to be much more fair than typical checking account overdraft fees. The CFPB should finalize that option, or something very similar, in its published rules.

2. Specific guidance from prudential banking regulators (the OCC, FDIC, Federal Reserve Board, and NCUA) to allow for fast and low-cost origination of safe small-dollar loans in compliance with the CFPB's rule at prices that are fair to borrowers and lenders. (See table below.)

Under these conditions, Pew estimates that banks and credit unions could sustainably offer alternative loans to millions of their customers who use payday loans, potentially saving borrowers billions of dollars a year.

Banks and Credit Unions Could Offer Affordable Small-Installment Loans, Given Proper Regulatory Guidance

Estimate of viable credit products with payments of no more than 5% of borrower income

	$500 loan	$400 loan	$300 loan
Loan term	5 months	4 months	3 months
Monthly payment	$120	$116	$112
Total cost	$100	$64	$36
Average cost of this credit using payday loans today	$750	$480	$270

Source: "Understanding the CFPB Proposal for Payday and Other Small Loans," The Pew Charitable Trusts (July 2015), http://www.pewtrusts.org/~/media/assets/2015/07/cfpb-primer_artfinal.pdf

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Appendix AA

THE PEW CHARITABLE TRUSTS

ANALYSIS

How the CFPB Proposal Would Regulate Payday and Other Small Loans

A summary of the draft rule

September 07, 2016

Small-Dollar Loans

By Nick Bourke

In June, the Consumer Financial Protection Bureau (CFPB) released a proposed rule to regulate payday, auto title, and some high-cost installment loans. The proposal applies to “covered loans” from any lender, including payday, auto title, online, and nonbank installment lenders as well as banks and credit unions, but not to overdraft services, pawn loans, business loans, and other types of credit. Covered loans are defined as:

- Loans lasting 45 days or less.
- Loans lasting longer than 45 days if they have an all-inclusive annual percentage rate (APR)—which includes annual, application, and other fees, as well as the cost of ancillary products such as credit insurance—above 36 percent and the lender obtains access to a borrower’s checking account or vehicle title (collectively described as a “leveraged payment mechanism”) within 72 hours of disbursing the loan funds. The all-inclusive APR is not a rate limit, which the CFPB

does not have authority to set; rather, it defines the loans that are covered by the regulation.

Before issuing covered loans, lenders would be required to use a CFPB-defined process to assess each borrower's ability to repay (ATR) or they could choose to comply with additional standards, known as conditional exemptions, and then use their own method of determining ATR. As summarized in Table 1, requirements would vary depending on whether the loan was short-term (no more than 45 days) or longer-term.

Table 1

Permissible Loans Under CFPB's Proposed Small-Dollar Lending Rule

Draft regulations by loan type

	Conventional payday loans (45 days or less)	High-cost installment loans (more than 45 days; all-in APR >36%; leveraged payment mechanism [account access or vehicle title])		
Ability to repay (ATR)	1 Short-term ATR Similar requirements as longer-term ATR • Lender must assess applicant's finances to determine ATR • Verify income, pull credit report, estimate expenses • Review borrowing history using real-time database • Make "reasonable determination" of affordability	3 Longer-term ATR • Lender must assess applicant's finances to determine ATR using an analysis similar to the process for short-term ATR loans • No firm limits on loan size, payment amount, cost, duration, default rate, or length of access to account or vehicle title		
		Longer-term alternatives		
Alternative requirements (conditional exemptions)	2 Short-term alternative • $500 maximum • Maximum of 3 consecutive loans per borrower, each smaller than previous loan (e.g., $450>$300>$150) • Maximum of 6 loans or 90 days in debt per borrower per 12 months • 30-day waiting period before moving to longer-term ATR loans • No holding of car titles	4 NCUA*-type loans • 28% interest + $20 fee • Loan amounts of $200-1,000 • 6 months maximum duration • Maximum of 3 loans per borrower per 6 months	5a Portfolio default rate • 36% interest + $50 fee • Lender forfeits origination fees if portfolio default rate exceeds 5% • 24 months maximum duration • Maximum of 2 loans per borrower per 6 months	5b 5% payment option, possible addition† • Monthly payment limited to 5% of monthly income • 6 months maximum duration

* National Credit Union Administration.

† The 5 percent payment option was included in the CFPB's March 2015 outline for the rule. The June 2016 Notice of Proposed Rulemaking did not include this option, but the CFPB has requested comments about whether to include it in the final rule.

Note: The rule applies to any "covered loan" as summarized in the column headings above. See Section 1041.3 of the CFPB proposal for a complete definition.

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Click on the image above to expand.

For more information on the CFPB's allowable loans as outlined in Table 1, see the bureau's small loan rule. For details on the 5% payment option, see 81 Fed. Reg. 48040.

Short- and longer-term ATR loans

The CFPB's defined ability-to-repay assessment—also called a "full-payment test"—would require the lender to verify applicants':

- Debt obligations through credit reports.
- Income and estimated monthly expenses, including accounting for expected volatility.
- Borrowing history as recorded in a specialty payday loan database to be set up by one or more third-party firms. (Lenders would also have to report their lending activity to the database system in real time.)

Using this information, lenders would have to make a "reasonable determination" that their customers would have the ability to repay their loans according to the terms.

This section of the rule places no limits on loan size, payment amount, cost, term, origination fees, default rate, or how long lenders could retain access to borrowers' checking accounts or vehicle titles.

Refinancing loans would be permissible only if several conditions were met. For more information, see sections 1041.5 and 1041.9 of the CFPB proposal.

Alternative requirements for short-term loans

The proposal provides one alternative in which lenders issuing conventional payday loans of up to $500 would be exempt from conducting the full-payment test. (See Table 1, Section 1.) To limit potential consumer harm associated with unaffordable loan payments, the draft rule specifies that if the borrower took a second loan within 30 days, it must be at least one-third smaller than the initial loan, and a third consecutive loan must be two-thirds smaller than the initial loan. For example, if the first loan is for $450, the second would be for no more than $300, and the third would be for no more than $150.

Lenders would not be able to issue:

- Another short-term alternative loan to a borrower who had three consecutive loans within the past 30 days.
- Another short-term alternative loan to a borrower who had used these loans six times or for 90 days in the previous 12 months.
- A longer-term ATR loan to any borrower who had used a short-term loan within 30 days.

For more information see Section 1041.7 of the CFPB proposal.

Alternative requirements for longer-term loans

The draft rule includes two exemptions to the ATR assessment for loans of more than 45 days' duration, and the CFPB is soliciting comments on whether to include an additional conditional exemption in the final rule.

Lenders could, without conducting a full-payment test, issue:

- A given borrower up to three loans in a six-month period that had interest rates of no more than 28 percent, application fees of no more than $20, principal balances between $200 and $1,000, and terms between 46 days and six months each. (See Table 1, Section 4.)

This provision would accommodate loans made under the National Credit Union Administration's Payday Alternative Loan program (NCUA PAL), which was created in 2010 and generated about 170,000 loans in 2014, the most recent year for which this figure is available. For more information, see Section 1041.11 of the CFPB proposal.

- Loans under the portfolio default rate option, which have interest rates of no more than 36 percent, origination fees of $50 with higher fees allowed if they were commensurate with the cost of making the loan, and durations between 46 days and 24 months. (See Table 1, Section 5a.) If more than 5 percent of these loans defaulted in a year, a lender would have to return all origination fees paid by all borrowers that year for this type of loan.

In addition, the CFPB is requesting comments on a third potential longer-term conditional exemption: the 5 percent payment option, or "5 percent payment-to-income ratio." This alternative would require monthly loan payments to be no more than 5 percent of a borrower's gross monthly income, with a repayment term longer than 45 days but no more than six months. (See Table 1, Section 5b.)

The CFPB proposed the 5 percent payment option in its 2015 initial framework as a potential "burden-reduction measure" for lenders and a means to ensure consumer access to small-dollar credit. In its most recent proposal, the CFPB states that it "broadly solicits comments on the advisability of such an approach" and asks whether any lenders would choose to offer loans under the 5 percent payment option but not under the core ATR requirements. For more information, see 81 FR 48039.

Additional components

If a lender attempted to withdraw payment from a customer's checking account and two consecutive attempts were returned unpaid, the lender would have to obtain a new authorization from the customer before debiting the account again. A lender would also have to notify the borrower three days before attempting to debit the account; this requirement would apply only to short-term and ATR loans.

The proposed rule strongly encourages installment loans with terms longer than 45 days. The small-dollar loan market already is shifting away from single-payment loans and toward installment loans and lines of credit, so the proposal would probably accelerate that change.

Comments on the proposal are due Oct. 7, 2016.

Pew conducted an analysis of the proposed rule and its impact, which is posted at http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/the-cfpbs-proposed-payday-loan-regulations-would-leave-consumers-vulnerable.

Appendix AB

THE PEW CHARITABLE TRUSTS

ANALYSIS

The CFPB's Proposed Payday Loan Regulations Would Leave Consumers Vulnerable

An analysis of the draft rule

September 07, 2016

Small-Dollar Loans

By Nick Bourke

Proposed regulations from the Consumer Financial Protection Bureau (CFPB) would protect consumers from conventional, lump-sum payday loans, which Pew's research has shown usually have unaffordable payments that trigger reborrowing. The pending rule strongly encourages payday and auto title lenders to give borrowers more time to repay loans in smaller installments, rather than large lump-sum payments. Yet even as the proposal would accelerate the shift toward installment lending that is already under way in this market, it fails to provide standards for affordable payments or reasonable loan lengths that are sufficiently clear to ensure the safety of this credit for consumers.

The rule would require lenders to follow a specific process for evaluating a borrower's financial condition, but it would probably leave consumers vulnerable to harmful terms and discourage banks and credit unions from entering this market and offering lower-cost alternatives. Because the draft rule focuses on the process of issuing a loan rather than on establishing product safety standards, payday installment loans with annual percentage rates (APRs) of 400 percent will probably remain common in the marketplace, but lower-cost offerings from mainstream lenders are unlikely to become widely available.

Click here for Pew's summary of the proposed rule.

High-cost installment loans will be common under the proposal

In June, the CFPB released a proposed rule to regulate payday, vehicle title, and certain high-cost installment loans. As described in Pew's summary of the bureau's proposal, for all covered loans the lender is required to use a specific process for assessing the borrower's ability to repay (ATR) or may choose its own method for assessing the borrower's ATR in exchange for meeting certain standards, known as conditional exemptions.

The proposal places limits on conventional payday loans, which are due in full after two weeks, that will make these products far less prevalent and, instead, strongly encourages lenders to issue multipayment loans with terms longer than 45 days. Giving consumers more time to repay in installments is a positive step, but dangerous loans with APRs of 400 percent and higher are likely to be commonplace under this proposal.

The payday and auto title loan markets have already shifted in this direction: In 26 of the 39 states where payday and auto title lenders operate today, they issue loans or lines of credit that would qualify. This model of lending is likely to spread to other states as payday and title lenders adopt new business practices, begin lending under new statutes, or work to change relevant state laws.

Most loans issued under the proposed rule would probably be this type of harmful high-cost installment credit, offered mainly by payday and auto title lenders following the “longer-term ability-to-repay” section of the rule (Section 3 in the table), with typical APRs of 300 percent or higher. Most borrowers are likely to pass the ability-to-repay (also called full payment) test for loans lasting more than 45 days, especially because lenders are permitted to estimate, rather than verify, applicants’ living expenses. The longer-term ATR section includes no limits on loan or payment size, cost, duration, rate of default, or how long a lender may keep access to a borrower’s checking account or car title.

Research suggests that some borrowers would struggle to afford the payments on the longer-term ATR loans. Industry analysts have estimated that 60 to 80 percent of current payday loan borrowers would qualify for a payment of at least $200 a month, even though average borrowers report being able to afford only $100. When borrowers qualify only for payments of less than even $100, lenders would still be able to issue them high-cost loans by substantially stretching the repayment period. For example, payments on a $500 loan could last 18 months and accrue $1,126 in fees.

Vendors are already developing or marketing products to help payday lenders comply with the CFPB’s proposed ability-to-repay rule and enable widespread high-cost installment lending from payday and auto title lenders that are willing to dedicate staff time and take on regulatory risk in exchange for the right to charge rates that far exceed those of mainstream creditors.

Among the options in the proposal, the longer-term ability-to-repay section (See Table 1, Section 3.) would almost certainly be the one most commonly used by payday and auto title lenders, and those loans would be by far the most expensive made under the proposed rule.

Table 1

Under the CFPB's Proposed Rule, High-Cost, Potentially Harmful Loans Could Remain Common

Examples of small-dollar loans that would be available

	Conventional payday loans (45 days or less)	High-cost installment loans (more than 45 days; all-in APR >36%; leveraged payment mechanism [account access or vehicle title])		
Ability to repay (ATR)	① Short-term ATR • Little to no lending here.	③ Longer-term ATR • **Costs and duration:** typical $500 loan cost; $500-$1,000 in fees; 6-month term. • **Primary lenders:** payday and auto title. • **Availability:** high, at stores and online.		
Alternative requirements (conditional exemptions)	② Short-term alternative	Longer-term alternatives ④ NCUA*-type loans	⑤a Portfolio default rate	⑤b 5% payment option, possible addition†
	• **Costs and duration:** typical $500 loan cost; $250-$350 in fees; 3 months of the year. • **Primary lender:** payday. • **Availability:** medium. Some payday lenders will probably offer these loans, but they will make up a small share of loan volume.	• **Costs and duration:** typical $500 loan cost; $45-$50 in fees; 4-month term. • **Primary lender:** credit unions. • **Availability:** somewhat low, primarily at low-volume loan programs from a minority of credit unions.	• **Costs and duration:** typical $500 loan cost; $38-$88 in fees, 4-month term (lender forfeits $50 origination fee if default rate exceeds 5%). • **Primary lender:** community banks. • **Availability:** somewhat low, on an ad hoc basis from community banks to known customers.	• **Costs and duration:** Typical $500 loan cost; ~$80-$100 in fees, 4-month term. • **Primary lenders:** banks and some credit unions. • **Availability:** high (if included in final rule).

* National Credit Union Administration.

† The CFPB is soliciting comments about whether to include this provision in the final rule (see 81 Fed. Reg. 48040).

Note: The rule applies to any "covered loan" as summarized in the column headings above. See Section 1041.3 of the CFPB proposal for a complete definition.

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For more information on the CFPB's allowable loans as outlined in Table 1, see the bureau's small loan rule. For details on the 5% payment option, see 81 Fed. Reg. 48040.

Underwriting-only approach fails to address harms of high-cost installment lending

Ensuring that small-dollar loan payments are affordable is essential to protecting consumers, and lenders and regulators can determine appropriate payments in a variety of ways. All lenders underwrite loans to manage risk, but unlike mainstream creditors, payday and auto title lenders have access to borrowers' checking accounts and car titles to improve their ability to collect on loans. This extraordinary power over financially fragile consumers makes these high-cost loans inherently dangerous. Pew's research has shown that it can lead to the inability to cover basic living expenses without borrowing again and to significant additional costs, such as repeated overdrafts, lost vehicles, and closed checking accounts. As a result, clear safeguards are necessary to protect consumers: An underwriting-only approach to regulation, such as the CFPB has proposed, is insufficient.

The primary shortcoming of the proposed ability-to-repay test is that it lets aggressive lenders set large payments and excessive durations even as they maintain long-term access to vulnerable borrowers' checking accounts or vehicle titles. The longer-term ability-to-repay provision (Section 3 in the table) places no limits on loan principal, payment size, cost, term, or origination or other fees and sets no standards for acceptable default rates or for how long lenders may access borrowers' accounts or vehicle titles. Without such safeguards, the regulation will neither sufficiently curb harmful loans nor promote competition from lower-cost, mainstream lenders.

3 of the 4 Proposed Alternatives Are Unlikely to Make Better Credit Widely Available

Under the proposed regulation's alternative requirements, or conditional exemptions, lenders would be able to use their own methods for assessing borrowers' ability to repay in exchange for following rules about loan structure, cost, or frequency of usage that are intended to limit potential harms to consumers. These more specific consumer protection standards mean that, in general, loans issued according to these sections will pose less risk to consumers than the longer-term ability-to-repay loans that will probably be widely available. Each conditional exemption takes a different approach to protecting consumers, and the portfolio default rate option and the short-term alternative both entail some risk of consumer harm:

- **Short-term alternative loans (Table 1, Section 2)** are conventional payday loans of up to $500 but with a limitation of six loans and 90 days indebtedness per year, and a requirement that each subsequent loan be successively smaller. These loans will tend to have unaffordable payments and excessive prices, but the proposed standards for loan usage, principal reduction, loan size, and term will limit consumer harm.
- **NCUA-type loans (Table 1, Section 4)**, which are modeled on the National Credit Union Administration's Payday Alternative Loan program, would have low costs and reasonable terms. But the overall benefit to consumers would be modest because availability is likely to be low and limited mostly to credit unions. NCUA loans do not generate signficant revenue, which means that most lenders would not be likely to offer them. Credit unions issued just 170,000, according to data available for 2014, compared with roughly 100 million payday loans.
- **The portfolio default rate option (Table 1, Section 5a)** would pose significant risks to consumers and the marketplace. The "safe harbor" provision for this option, which allows lenders to charge a $50 origination fee, would harm consumers by front-loading loan costs and effectively penalizing borrowers who repay early or refinance. At the same time, the low default rate threshold and severe penalty for breaching it would strongly encourage aggressive loan collection techniques because lenders would have to forfeit a large share of revenue if they did not collect on at least 95 percent of loans. Together, the high origination fee and default threshold penalty would risk re-creating one of the fundamental problems the CFPB has identified in this market: "Too many short-term and longer-term loans are made based on a lender's ability to collect and not on a borrower's ability to repay."

In addition, the volume of lending under the portfolio default rate option is likely to be low, with some ad hoc lending from community banks to known customers.

- **The alternative most likely to produce lower-cost credit at adequate scale is the 5 percent payment option (Table 1, Section 5b).** The CFPB is soliciting comments on whether to include in the final rule the 5 percent payment option, which it introduced in its 2015 outline. This loan structure would require lenders to follow standards designed to make loans better match borrowers' ability to repay by limiting the size of monthly payments and restricting terms to six months. Banks and some credit unions were planning to use the 5 percent structure to issue lower-cost loans at scale, but it will not be possible unless the option is in the final rule.

Clear product safety standards would better protect consumers and encourage lower-cost alternatives

The 5 percent payment option's clear standards would protect consumers and enable mainstream lenders to use automated underwriting and origination techniques that reduce costs. Because every payday loan borrower is required to have a checking account and verifiable income, banks and credit unions are well positioned to take a large portion of the market from high-cost lenders, saving millions of consumers billions of dollars annually.

However, without the 5 percent option, these providers will generally be unable to offer consumer-friendly small loans at scale, leaving the market dominated by high-cost payday and auto title lenders. Payday lenders have expressed a willingness to conduct extensive paperwork and take on legal risk associated with ambiguous regulatory rules, as long as they can charge customers 300 percent APR or more. But banks generally would not be willing or able to do so. Better, lower-cost small loans will only emerge with clear, strong regulatory guidelines; for example:

- Under the 5 percent payment option, a $400 three-month bank loan would cost $50 to $60 in total fees.
- But under the CFPB's draft rule, payday lenders would remain in control of this market and charge fees of $300 to $450 for the same $400 in credit.

Recommendations

Once finalized, the CFPB's rule will help hasten the shift away from unaffordable lump-sum loans and toward installment lending that is already under way in the payday and auto title loan markets. As constructed, the primary benefit the proposal would offer borrowers is more time to repay high-cost, risky loans, but it would not provide them with adequate protections against excessive durations, unaffordable payments, and prices that are far higher than needed to make credit profitably available.

Pew recommends that the CFPB take firmer steps to prevent covered loans from becoming dangerous or abusive, particularly by limiting how long lenders can retain access to a borrower's checking account and subjecting lenders with high default rates to greater levels of scrutiny. And the final rule must set clear product safety standards, including the 5 percent payment option to protect consumers from the harms associated with high-cost payday and auto title installment loans and enable banks and credit unions to provide safer, lower-cost small-dollar credit.

The CFPB is accepting comments on the rule until Oct. 7.

Take action now ›

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