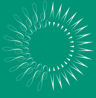
A brief from  THE PEW CHARITABLE TRUSTS | Dec 2014

# 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:

pewtrusts.org/small-loans

**Contact:** Mark Wolff, communications director **Email:** mwolff@pewtrusts.org **Phone:** 202-540-6390
**Contact:** Steven Abbott, government relations **Email:** sabbott@pewtrusts.org **Phone:** 202-540-6647

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