



Report 3 in the *Payday Lending in America* series

# Payday Lending in America: **Policy Solutions**

# The Pew Charitable Trusts

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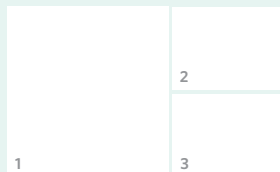
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## About the *Payday Lending in America* series

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.<sup>1</sup> 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."<sup>2</sup>



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](http://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.<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup> 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.<sup>6</sup> The payday loan, whether offered by a bank,<sup>7</sup> a storefront lender,<sup>8</sup> or an online lender,<sup>9</sup> 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.<sup>10</sup> 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.<sup>11</sup> Researchers at the Kansas City Federal Reserve found that “the profitability of payday lenders depends on repeat borrowing,”<sup>12</sup> a sharp contrast to official statements from the industry that payday loans are not meant as a long-term solution.<sup>13</sup>

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.<sup>14</sup> 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).<sup>15</sup> Twelve million people use the loans annually, spending an average of \$520 in interest to repeatedly borrow an average of \$375 in credit.<sup>16</sup>

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.<sup>17</sup> 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.”)

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## 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.<sup>18</sup> A number of consumer finance experts have written about this period.<sup>19</sup> 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."<sup>20</sup> Others describe repaying these loans as "daunting,"<sup>21</sup> explaining that repeated borrowing "almost inevitably results,"<sup>22</sup> because this structure means that the loans are "for too short a period of time, making the payments too high"<sup>23</sup> and thus will "keep the borrower in debt by encouraging renewals."<sup>24</sup> 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."<sup>25</sup> Another notes that those making these loans were "more concerned in collecting the interest than the principal."<sup>26</sup> 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.<sup>27</sup>

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.<sup>28</sup> 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.<sup>29</sup> 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.<sup>30</sup>

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.<sup>31</sup> 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.<sup>32</sup>

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."<sup>33</sup> 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."<sup>34</sup>

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.<sup>35</sup> Most payday loan borrowers have credit card debt,<sup>36</sup> many are experienced with forms of credit including mortgages and auto loans,<sup>37</sup> and most have recently experienced an overdraft on their bank accounts.<sup>38</sup> 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.<sup>39</sup> 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

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## 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.<sup>40</sup>
- 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.<sup>41</sup> The legislature authorized their exemption from the state's usury interest laws under the Colorado Deferred Deposit Loan Act, enacted in 2000.<sup>42</sup>

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.<sup>43</sup> 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),<sup>44</sup> and 96 percent of loans were made for the maximum fee permitted.<sup>45</sup>

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.<sup>46</sup>

“ 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<sup>47</sup> and many state lawmakers in Colorado agreed that conventional payday loans were harmful to consumers, and that the market was not price competitive.<sup>48</sup> 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,<sup>49</sup> with no other fees allowed.<sup>50</sup> 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,<sup>51</sup> and consumer finance companies make small installment loans to customers with poor credit in some of those states.<sup>52</sup>

The 2008 bill to repeal payday lenders' exemption from the state's interest rate cap did not pass.<sup>53</sup> In 2010, a similar bill was introduced.<sup>54</sup> 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.<sup>55</sup> (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.<sup>56</sup> 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)
<b>Maximum loan size</b>	\$500	\$500
<b>Average annual percentage rate paid</b>	319%	129%
<b>Amortization (payments reduce principal over time)</b>	No	Yes
<b>Deferred presentment loan collateral (postdated check or authorization to debit bank account)</b>	Yes	Yes
<b>Amount due on next payday (\$500 loan)</b>	\$575	\$61
<b>Cost to borrow \$500</b>		
<b>For 2 weeks</b>	\$75	≈\$10
<b>For 3 months</b>	\$450	≈\$125
<b>For 6 months</b>	\$975	\$290
<b>For 12 months</b>	\$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.<sup>57</sup>

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.<sup>58</sup> The average contracted loan term is just over six months, and the longest is just over seven months.<sup>59</sup> 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.<sup>60</sup> 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.<sup>61</sup> 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,<sup>62</sup> 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.

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“ 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*

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## 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,<sup>63</sup> 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

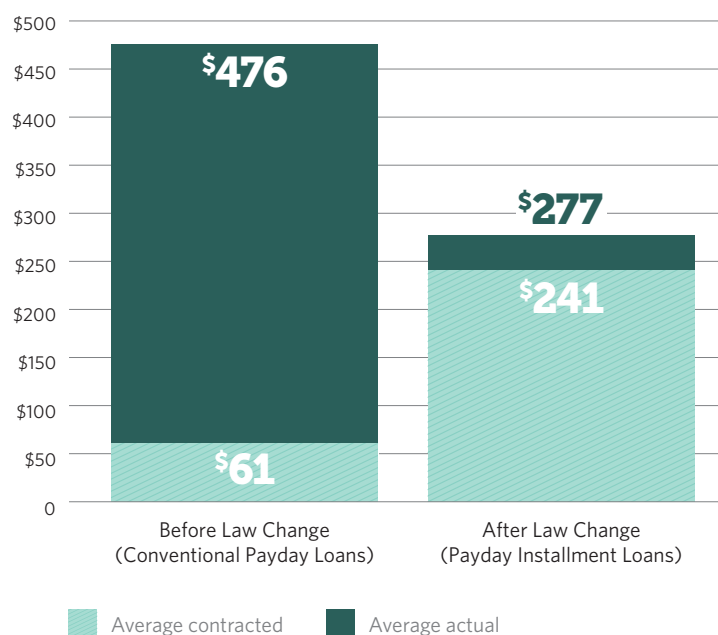
In 2012, the most recent year with data available, borrowers cumulatively spent 44 percent less than they had in 2009 under the conventional payday loan model, saving \$41.9 million.<sup>64</sup> Meanwhile, there were no similar declines in other states that published data and did not change their laws.<sup>65</sup> 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).<sup>66</sup> 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.<sup>67</sup> 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.<sup>68</sup>

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
<b>Average loan size</b>	\$368 <sup>a</sup>	\$389	6%
<b>Cost</b>			
<b>Average annual percentage rate paid</b>	319%	129%	-60% <sup>b</sup>
<b>Amount spent per borrower annually<sup>c</sup></b>	\$476 <sup>a</sup>	\$277	-42%
<b>Total spent on payday loans by borrowers</b>	\$95.1 million <sup>a</sup>	\$53.2 million	-44%
<b>Usage</b>			
<b>Loans per borrower in past year</b>	7.84 <sup>d</sup>	2.3	-71%
<b>Average loan duration</b>	18.91 days	98.90 days	423%
<b>Average days of credit used<sup>e</sup></b>	148	227	53%
<b>Percentage of loans that are renewals or taken out the same day a previous loan is paid back</b>	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

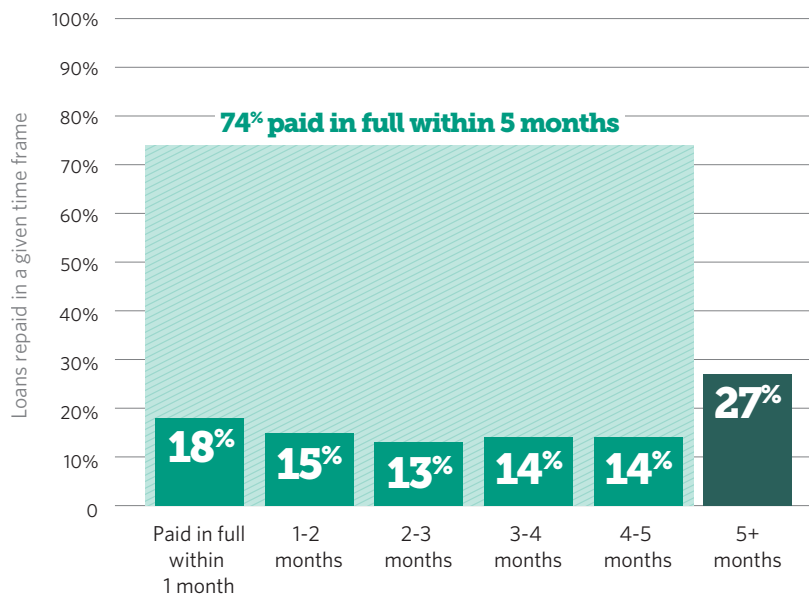
“ For us, [the problem] was really the debt cycle, the rolling over. Again, it wasn’t an emergency source of cash when people are taking out 12 loans a year, clearly. So . . . we’ve seen the number of loans go down. . . . Right there, that debt cycle and that phantom demand is gone. Now it’s real demand. 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,<sup>69</sup> 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

# 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.

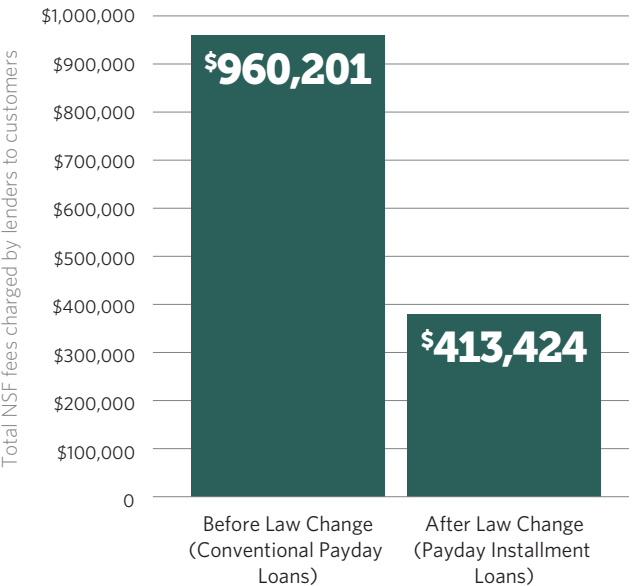
Credit counselors in Colorado emphasized that, under the previous law, they regularly made arrangements with lenders on behalf of clients that allowed them to repay loans over several months, similar to the loan term in the new law. "So we were pre-negotiating payment arrangements before it was the law," 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.<sup>70</sup> 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.<sup>71</sup>

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 <sup>a</sup>	279,570	238,014	-15%
Number of licensed locations	505	238	-53%
Borrowers per store <sup>b</sup>	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,<sup>72</sup> 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.<sup>73</sup> 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.<sup>74</sup>

“ 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.<sup>75</sup> 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.<sup>76</sup>

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,<sup>77</sup> and most of these are renewals or quick reborrows by repeat customers.<sup>78</sup> In other states, payday loan storefronts serve approximately 500 unique customers per year,<sup>79</sup> 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.<sup>80</sup> 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 <sup>a</sup>	\$2,477
Gross monthly income (median)	\$2,199 <sup>a</sup>	\$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

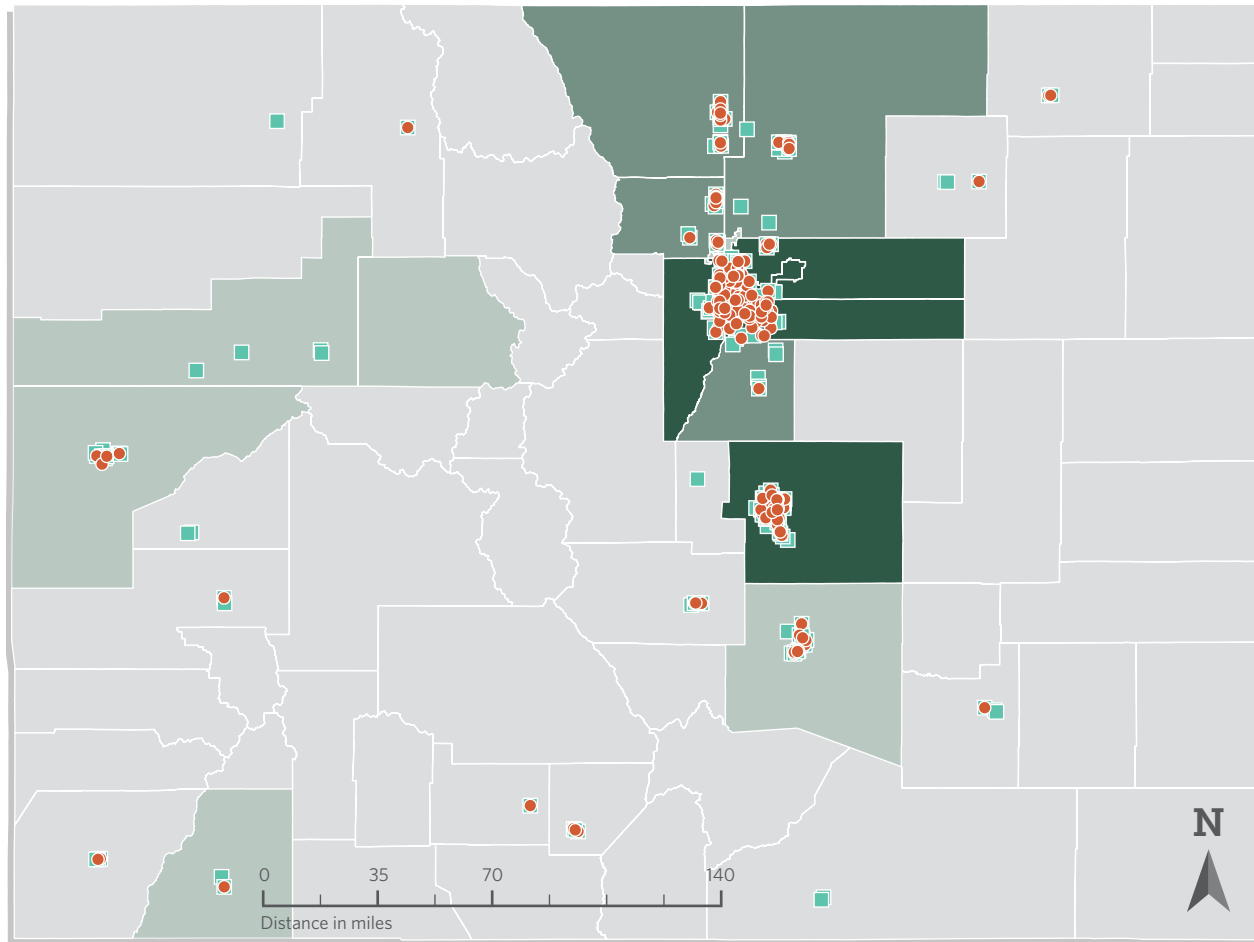
Since the new law went into effect, larger operators have increased their market share in the state. Before the change, seven of the largest operators<sup>81</sup> owned 59 percent of Colorado stores.<sup>82</sup> By the end of 2011, their market share was 69 percent,<sup>83</sup> and more recent data indicate that figure has risen to 73 percent.<sup>84</sup>

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



### 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,<sup>85</sup> 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.<sup>86</sup> The other 90 percent of loans were paid in full or were being paid as agreed.<sup>87</sup> Data from the attorney general’s office indicate that the number of annual defaults per borrower declined 30 percent under the new law.<sup>88</sup>

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.<sup>89</sup> 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

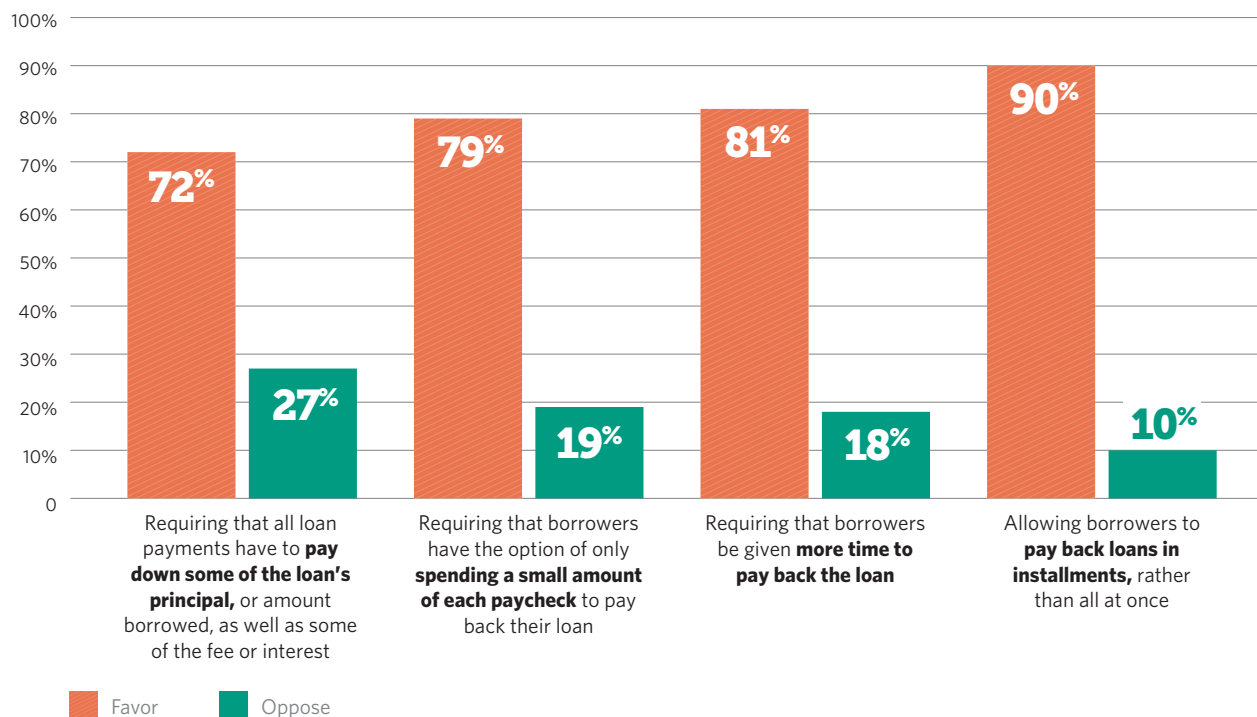
### Overwhelming borrower preference for affordable installment loans

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.<sup>90</sup> 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

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## 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

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## 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.<sup>91</sup>

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.”<sup>92</sup> (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.<sup>93</sup>

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.<sup>94</sup> 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.”<sup>95</sup>

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.<sup>96</sup> Credit unions in Pennsylvania offer loans with a 90-day repayment term,<sup>97</sup> and loans promoted by the National Federation of Community Development Credit Unions have repayment terms of three months to a year.<sup>98</sup>

## Section 3: Ensuring affordability

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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<sup>99</sup> (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.<sup>100</sup>

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.<sup>101</sup> 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.<sup>102</sup> Typical payday loan applicants have poor credit scores in the low 500s,<sup>103</sup> 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.<sup>104</sup> 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.

## 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,<sup>105</sup> perform underwriting to determine what payments are affordable based on an analysis of the borrower's income and expenses.<sup>106</sup> 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.<sup>107</sup> 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).<sup>108</sup>

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

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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.

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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."<sup>109</sup> 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.

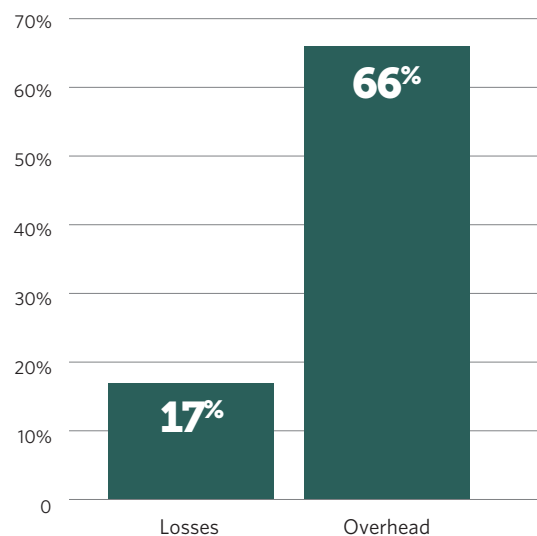
For conventional payday lenders, the transition to proper underwriting will be difficult. Their business model avoids almost entirely this cost of ensuring ability to repay, relying instead on a loan structure that gives the lender the right to collect the loan in full directly from the borrower's checking account on his or her next payday. The transition to underwriting would add complexity and cost to a payday lender's business model,<sup>110</sup> which is already characterized by high overhead costs.<sup>111</sup> (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.<sup>112</sup> Less detailed information is available for online lenders, but costs include expensive customer acquisition through lead generators,<sup>113</sup> 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.<sup>114</sup>

- **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<sup>115</sup> 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.<sup>116</sup> For 76 percent of installment loans in this sample, monthly payments equaled 5 percent or less of borrowers' monthly income.<sup>117</sup> 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<sup>118</sup> gross biweekly income.<sup>119</sup> 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.<sup>120</sup> The average monthly income of a Colorado payday loan borrower is \$2,477 (\$29,724 annually), according to state regulatory data.<sup>121</sup> 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.<sup>122</sup>

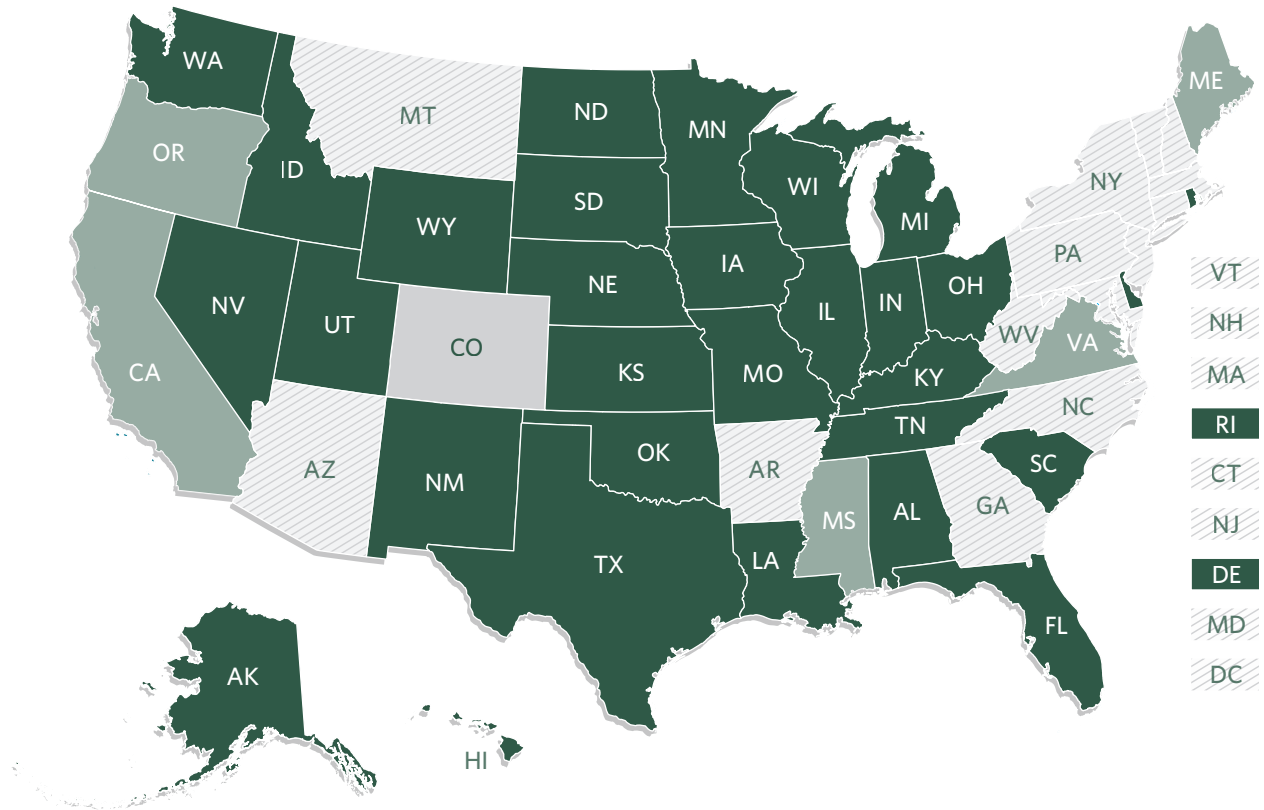
These findings suggest that any loan requiring payments of more than 5 percent of the borrower's paycheck should be treated as unaffordable, unless thorough underwriting demonstrates otherwise.

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



**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
<b>Conventional lump-sum loan repayment</b>		
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 <sup>a</sup>	36%	\$431
8 loans maximum per year <sup>a</sup>	36%	\$431
Cooling-off period between loans <sup>a</sup>	36%	\$431
<b>Installment loan repayment</b>		
30-day minimum <sup>a</sup> (2 installments)	18%	\$216
6-month minimum (Colorado)	4%	\$47
10% of biweekly income	10%	\$119
<b>5 percent affordability threshold</b>	<b>5%</b>	<b>\$60</b>

### 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

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A 5 percent affordability threshold establishes a benchmark for identifying potentially unaffordable loans as they emerge in the market.

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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.<sup>123</sup> 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

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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.<sup>124</sup>

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.<sup>125</sup> 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.<sup>126</sup>

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.<sup>127</sup>

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,<sup>128</sup> 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.<sup>129</sup> 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.<sup>130</sup> Lawmakers sometimes address this problem by requiring lenders to use the standard actuarial method.<sup>131</sup> 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.<sup>132</sup> 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.<sup>133</sup> But after the Colorado attorney general's office ruled that the origination fee was indeed refundable on a pro-rata basis,<sup>134</sup> 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.<sup>135</sup> 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.<sup>136</sup>

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<sup>137</sup>—even though the payday industry’s trade associations call for participating lenders to offer an installment option to customers who continually reborrow.<sup>138</sup> 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.<sup>139</sup> 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.<sup>140</sup>

Data published in state reports from Florida, Michigan, and Oklahoma show even fewer borrowers taking advantage of such payment options.<sup>141</sup> In Texas, where payday lenders are permitted to make both installment and payday loans, the conventional lump-sum repayment predominates.<sup>142</sup> Consequently, customers repeatedly borrow.<sup>143</sup>

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.<sup>144</sup> 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.<sup>145</sup> Payday lenders have resisted efforts to promote installment loans to repeat borrowers in states that have attempted to allow both models to coexist.<sup>146</sup>

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.<sup>147</sup> The loan structure as presented is an especially “sticky default” from which few borrowers stray.<sup>148</sup> 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<sup>149</sup> (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.

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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.

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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),<sup>150</sup> far more than an average payday borrower can afford.<sup>151</sup>

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.<sup>152</sup> 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.<sup>153</sup> 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.<sup>154</sup> Even in the 35 states that allow high-interest, lump-sum payday loans, 28 limit the permissible charges.<sup>155</sup> 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.<sup>156</sup> Further, demand for payday loans is not sensitive to price.<sup>157</sup> 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."<sup>158</sup> In such circumstances, setting maximum allowable rates can ensure that borrower costs resemble those in a marketplace with price competition.<sup>159</sup>

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.<sup>160</sup> 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.<sup>161</sup> 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).<sup>162</sup> 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,<sup>163</sup> and in South Carolina from 43 to 130 percent.<sup>164</sup> 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.<sup>165</sup> To ensure that consumer installment loans do not extend indefinitely, some states impose a maximum loan term in addition to a rate cap.<sup>166</sup> 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.<sup>167</sup>

## 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.<sup>168</sup> 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.<sup>169</sup> 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.<sup>170</sup> 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."<sup>171</sup>

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,<sup>172</sup> unscrupulous lenders have not honored borrowers' requests to cancel them,<sup>173</sup> and there can be lag time between the request and when it takes effect,<sup>174</sup> 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.<sup>175</sup> 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."<sup>176</sup> 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.<sup>177</sup>

Yet there is evidence that unscrupulous lenders<sup>178</sup> can abuse the privilege of electronically debiting checking accounts, leading to excessive withdrawals<sup>179</sup> and to borrowers incurring fees or struggling to pay other bills.<sup>180</sup>

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.<sup>181</sup> 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.<sup>182</sup> 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.<sup>183</sup> 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.<sup>184</sup>

## 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.<sup>185</sup> 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.<sup>186</sup>

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.<sup>187</sup> 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.<sup>188</sup> 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.<sup>189</sup>

## 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.<sup>190</sup>



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.<sup>191</sup>

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](http://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](http://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](http://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 <sup>a</sup>	25
Colorado <sup>b</sup>	4
Delaware <sup>c</sup>	38
Florida	35
Hawaii	36
Idaho	38
Illinois <sup>c</sup>	36
Indiana	36
Iowa	36
Kansas	36
Kentucky	37
Louisiana <sup>d</sup>	34
Maine <sup>e</sup>	27
Michigan	36
Minnesota	32
Mississippi <sup>f</sup>	19
Missouri <sup>c</sup>	38
Nebraska	37
Nevada	37
New Mexico <sup>c</sup>	36
North Dakota	38
Ohio	34
Oklahoma	36
Oregon <sup>f</sup>	16
Rhode Island	35
South Carolina <sup>c</sup>	36
South Dakota	38
Tennessee	36
Texas <sup>c</sup>	38
Utah	37
Virginia <sup>f</sup>	20
Washington	36
Wisconsin <sup>c</sup>	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>.

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## Endnotes

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- 9 "Frequently Asked Questions," AmeriLoan, last modified September 2013, accessed April 2013, [https://mobile.ameriloan.com/?page=info\\_faq](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](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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  - 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.
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  - 25 Ira Cobleigh, *How and Where to Borrow Money* (New York: Avon Books, 1964), 109.
  - 26 Gerald W. Gibbs, *The Complete Guide to Credit and Loans* (New York: Playboy Paperbacks, 1982), 65.
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  - 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](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](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](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](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](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/small-dollar-loans/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](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](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](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](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](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](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](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://cdc.ucoop/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](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](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](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, *Payday 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](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](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](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.ncuca.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](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](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](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](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](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](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/NCCOBRReport\\_Web.pdf](http://www.nccob.org/Public/docs/Financial%20Institutions/Consumer%20Finance/NCCOBRReport_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](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](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%2009-30-12%20final.pdf](http://www.idfpr.com/News/DFI/IL_Trends_Report%20since%20Inception%20through%2009-30-12%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](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](https://www.coloradoattorneygeneral.gov/press/news/2013/04/02/attorney_general_announces_settlement_against_ezpawn_colorado_inc_and_ezmoney).

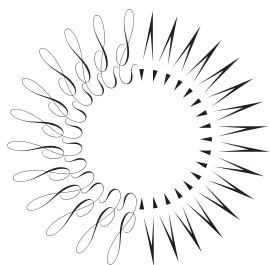
- 134 Mary C. Geesling, "Refunds of Origination/Acquisition Fees Upon Prepayment of a Payday Loan" (Aug. 12, 2011), <http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/uccc/Refunds%20of%20OriginationAcquisition%20Fees%20Upon%20Prepayment%20of%20a%20Payday%20Loan%20Memo.pdf>.
- 135 Colorado 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, "CFSAA 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](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](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.occ.state.tx.us/pages/int\\_rates/pRate12.pdf](http://www.occ.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.offt.gov.uk/shared\\_offt/markets-work/payday-MIR.pdf](http://www.offt.gov.uk/shared_offt/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.occ.state.tx.us/pages/int\\_rates/Ratechart\\_4.pdf](http://www.occ.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](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](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](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=febb7596975e37168ee08086e1ad0df>. 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>.



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