An overview from THE PEW CHARITABLE TRUSTS | Oct 2013

Report 3 in the *Payday Lending in America* series

Payday Lending in America: **Policy Solutions**

Overview

About 20 years ago, a new retail financial product, the payday loan, began to spread across the United States. It allowed a customer who wanted a small amount of cash quickly to borrow money and pledge a check dated for the next payday as collateral. Twelve million people now use payday loans annually, spending an average of $520 in interest to repeatedly borrow an average of $375 in credit. In the 35 states that allow this type of lump-sum repayment loan, customers end up having to borrow again and again—paying a fee each time. That is because repaying the loan in full requires about one-third of an average borrower's paycheck, not leaving enough money to cover everyday living expenses without borrowing again.

In Colorado, lump-sum payday lending came into use in 1992. The state was an early adopter of such loans, but the situation is now different. In 2010, state lawmakers agreed that the payday loan market in Colorado had failed and acted to correct it. Legislators forged a compromise designed to make the loans more affordable while granting the state's existing nonbank lenders a new way to provide small-dollar loans to those with damaged credit histories. The new law changed the terms for payday lending from a single, lump-sum payment to a series of installment payments stretched out over six months and lowered the maximum allowable interest rates.

As a result, borrowers in Colorado now pay an average of 4 percent of their paychecks to service the loans, compared with 36 percent under a conventional lump-sum payday loan model. These loans remain costly—with fees and interest, the average annual percentage rate is 129 percent—but individual borrowers are spending 42 percent less money than they did under the old law. Payday lenders in Colorado opposed the state's move toward installment lending with affordable payments, yet after considerable storefront consolidation, credit remains widely available. The Colorado law has transformed a payday lending business with low-volume stores into one that serves more customers at each location, with borrowers spending less on loans annually.

Such a solution to the problems in today's payday loan markets—requiring loans to have affordable payments that pay down principal as well as interest—follows the path taken a century ago by the Russell Sage Foundation and an industry trade group, the American Industrial Lenders Association. They partnered to create the Uniform Small Loan Law, which was eventually adopted by a majority of states. But the protections that law provided were largely undone by the introduction of the lump-sum repayment payday loan in the early 1990s. There is growing recognition of the need to shift back to affordable lending policies for *all* small-dollar loans.

People who use payday loans are struggling financially, and they usually have trouble covering ordinary living expenses from month to month. Most are paying bank overdraft fees, most carry credit card or other debt, and almost all have credit scores that are at the lowest end of the scale. Policy discussion in recent years has focused on whether payday loan customers need more access to credit, and what rate of interest is appropriate for such loans. These are valid questions, but there is insufficient evidence to know whether consumers are better off with or without access to high-interest loans (even if the loans have affordable payments). There is, however, sufficient evidence to conclude that conventional lump-sum payday loans harm consumers compared with loans that have affordable payments. It is clear that the lump-sum payday loan has inherent structural flaws that make it unaffordable and dangerous for consumers, and that new policies to eliminate this failed product are warranted. Thus, policymakers in the 35 states that now have conventional payday lending should act urgently. They may elect to prohibit high-cost payday loans altogether (as 15 states have done), or permit them with substantial reforms.

Colorado lawmakers recognized the danger of lump-sum payday lending and made two judgments that shaped their response. First, they decided to allow payday lenders, who had been operating in their state for nearly 20 years, to continue making small loans to those with poor credit histories. This decision led lawmakers to continue allowing interest rates that significantly exceeded the state's traditional usury rate limit. Second, they resolved to transform the loans into installment products that fit more easily into consumers' budgets compared with conventional payday loans. Combined with significant safeguards that protect consumers from unscrupulous practices, this focus on affordability transformed payday lending in Colorado.

Nonetheless, the Colorado law has some considerable shortcomings: It allows interest rates that may be substantially higher than those needed to sustain profitable small-dollar lending, and its overly complicated fee structure makes comparison shopping difficult and price competition unlikely. Further, it is possible that eliminating high-cost lending entirely in Colorado would have served consumers better. But there are many important lessons in the Colorado example. The law change improved payday lending, demonstrating the viability of requiring affordable installments and comprehensive consumer safeguards.

Although credit can be useful for consumers, this report does not determine whether or not borrowing addresses the needs of those who are chronically unable to meet expenses, or exactly what rates of interest are appropriate for small-dollar loans, and there is little research that answers these important questions. Instead, this report shows how small-dollar loans can work better for borrowers while allowing lenders to recoup costs that compensate them for the risk of providing credit to those with poor credit histories. Drawing from the Colorado example and other research, this report's findings demonstrate that small-dollar lending can fit better into a borrower's budget when loans are due in installments based on ability to repay—that is, to make required loan payments and meet other financial obligations without having to borrow again or draw from savings.

Simply adding installment payment plans to payday loans is not enough, however, because installment loans carry significant risks of their own. Small-dollar loan markets generally lack price competition, so the cost of borrowing becomes unnecessarily high in states that do not limit interest rates. Further, when the law allows installment loans to include fees and charges that are front-loaded, data indicate that lenders encourage borrowers to refinance repeatedly, a process known as loan flipping. And although automated repayment plans have certain benefits, the use of postdated checks and electronic access as loan collateral puts consumers at risk of losing control over their checking accounts and being harmed by unscrupulous lenders who abuse the system. This report provides evidence of these consumer risks and advice on how policymakers can control them.

To address the problems caused by unaffordable small-dollar loans, policymakers should prohibit payments that exceed the borrower's ability to repay. The recommendations at the end of this report include a benchmark for ensuring affordability: limiting most loan payments to 5 percent of a borrower's paycheck (individual gross income). They also promote crucial protections against harmful installment loan practices such as loan flipping and aggressive collection techniques.

Consumers want policymakers to act: By a 3-to-1 margin, payday loan borrowers support more regulation of this market. New findings in this report show that 8 in 10 borrowers favor a requirement that payments take up only a small amount of each paycheck, and 9 in 10 favor allowing borrowers to pay back loans in installments over time.

Federal regulators are beginning to respond. Recently, the Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency called on banks that offer payday loans to underwrite them to ensure that borrowers have the ability to repay them while covering other expenses.[1] The Consumer Financial Protection Bureau, which oversees both bank and nonbank lenders, released a white paper on payday loan products, concluding that "the potential consumer harm and the data gathered to date are persuasive that further attention is warranted to protect consumers" and stating its intention to "use its authorities to provide such protections."[2]

Decisive action is required from federal regulators and also from policymakers in the 35 states that permit lump-sum payday lending. Once small-dollar loans have affordable payments and safeguards in place, state lawmakers may reasonably choose to cap interest rates at or below 36 percent APR if they wish to eliminate payday loans, or above this threshold if they want small loans to be widely available to those with poor or damaged credit histories.

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.

Initial policy recommendations

Pew's research conclusively shows that payday loans are unaffordable for most borrowers. The loans require payments equal to one-third of a typical borrower's income, far exceeding most customers' ability to repay and meet other financial obligations without quickly borrowing again. Payday lenders have a unique legal power to withdraw payment directly from borrowers' checking accounts on their next payday, prompting those without enough money left for rent or other bills to return to the lenders, repay the loans, and pay an interest-only fee to quickly reborrow, resetting the due date to the next payday. This extraordinary form of loan collateral allows lenders to thrive even as they make loans to those who cannot afford them. The average borrower is in debt for nearly half the year, and the vast majority of lender revenue comes from those who borrow consecutively. Payday lenders achieve profitability only when the average borrower is in debt for months, even though the product is promoted as a short-term bridge to the next payday. These facts demonstrate a significant market failure.

Decisive action is required from the Consumer Financial Protection Bureau and other federal regulators, and from policymakers in the 35 states that now permit lump-sum payday lending. Pew recommends the following for all small-dollar consumer cash loans:

1. Limit payments to an affordable percentage of a borrower's periodic income

Research indicates that for most borrowers, payments above 5 percent of gross periodic income are unaffordable.

- **Any small-dollar cash loan should be presumed to be unaffordable, and therefore prohibited, if it requires payments of more than 5 percent of pretax income** (for example, a monthly payment should not take more than 5 percent of gross monthly income). Lenders should be able to overcome this presumption only by demonstrating that a borrower has sufficient income to make required loan payments, while meeting all other financial obligations, without having to borrow again or draw from savings.

This 5 percent affordability threshold, which is based on survey research and analysis of market data, is a benchmark that policymakers can use to identify small-dollar loans that pose the most risk of harm or unaffordability. It generally will result in installment loans that have terms of months, rather than weeks, but the loan duration can be self-adjusting depending on the income of the borrower. It is also flexible enough to accommodate various policy choices regarding maximum loan size, duration, or finance charge. Normal supervision can assess compliance, so this recommendation does not necessitate a database. Borrowers will remain responsible for deciding how many loans to take and how often to use them.

For calculation purposes, required payments would include principal, interest, and any fees. To discourage loan splitting or other methods of frustrating this policy, payments from all loans by a given lender should be considered together. Examiners should treat frequent refinancing or "re-aging" of loans as evidence of unaffordability and poor underwriting.

2. Spread costs evenly over the life of the loan

It is important to prevent front-loading of fees and interest on installment loans. Experience shows that front-loading practices make the early months of the loan disproportionately more profitable for lenders than the later months, creating incentives for them to maximize profit by encouraging borrowers to refinance loans before they are fully paid off (a process known as loan "flipping" or "churning").

- **If fees other than interest are permitted, require them to be earned evenly over the life of the loan.** Any fees, including origination fees, that lenders fully earn at the outset of the loan create a risk of loan flipping. Therefore, fees should be refundable to the borrower on a pro-rata basis in the event of early repayment.
- **Require all payments to be substantially equal and amortize smoothly to a zero balance by the end of the loan's term.**
- **Prohibit accounting methods that disproportionately accrue interest charges during the loan's early months.** Such front-loading schemes, often known as the "rule of 78s" or "sum of digits" methods, encourage loan flipping, because a lender earns far more interest income at the outset of the loan than in later months.

3. Guard against harmful repayment or collection practices

Payday and deposit advance lenders have direct access to borrowers' bank accounts for collecting loan repayment. Lenders use this access to ensure that they are paid ahead of other creditors, an advantage that allows them to make loans without having to assess the borrower's ability to repay the debt while also meeting other obligations. Although this arrangement shields the lender from certain risks and may facilitate lending to those with poor or damaged credit, it comes at the cost of making consumers vulnerable to aggressive or unscrupulous practices. High rates of bounced checks or declined electronic payments are indicators of such practices. Borrowers lose control over their income and are unable to pay landlords or other creditors first.

- **Treat deferred presentments as a dangerous form of loan collateral that should be prohibited or strictly constrained.** Deferred presentment or deferred deposit loans require borrowers to give the lender the right to withdraw payment from the borrower's bank account. This requirement is fulfilled through a personal check that is postdated to the borrower's next payday or through a non-revocable electronic debit authorization. Because of the inherent dangers, state laws generally authorize deferred presentments only for loans that are understood to serve short-term, urgent liquidity needs. Of the states that have deferred deposit loans, a majority set the maximum term at six months or less, and a majority set the maximum loan amount at $500 or less.

  Policymakers may reasonably choose to prohibit deferred presentments if they do not want payday lenders to operate. If allowed, deferred presentments should never apply for more than six months or for loans of more than $500.
- **Prevent unscrupulous lenders from abusing the electronic payments system, and make it easier for consumers to cancel electronic payment plans.** Some installment lenders establish automatic repayment plans using electronic payment networks. Although this mechanism can help lower the cost of small-dollar loans and make loan management more convenient, evidence shows that it also exposes consumers and their checking accounts to significant risk. Regulators should establish a balance between lender and borrower interests, especially in cases—such as online lending markets—where there is evidence of aggressive lending or collections behavior. Pew recommends making it easier for consumers to stop automatic withdrawals, placing limits on the number of NSF fees that borrowers may pay, and closing the electronic payments system to merchants that abuse it (as evidenced by repeated attempts to withdraw funds from borrower accounts, excessive use of NSF fees, or other aggressive behavior). These goals may be accomplished through regulatory action and stronger oversight of the electronic payments system by the banks that operate it.
- **Monitor and respond to signs of excessively long loan terms.** Some high-interest installment payday lenders set excessively long loan terms, with only a small portion of each payment reducing the loan's balance. Therefore, policymakers should consider establishing maximum loan terms. These should take into account a

borrower's financial capability, measured by income or ability to repay, as well as the size of the loan principal. Colorado demonstrates that for average payday borrowers, six months is long enough to repay $500, and in consumer finance installment loan markets, approximately one year is usually sufficient to repay $1,000.

4. Require concise disclosures that reflect both periodic and total costs

Research shows that small-dollar loan borrowers focus on the periodic cost of borrowing but often struggle to evaluate overall cost, making it difficult to compare other loan options or to decide whether to borrow, adjust budgets, or take other actions. All loan offers should clearly disclose:

- The periodic payment due.
- The total amount to be repaid over the life of the loan.
- The total finance charges over the life of the loan.
- The effective annual percentage rate, or APR, of the loan.

These four numbers should be displayed clearly, and with equal weight, to encourage borrowers to consider both periodic and long-term costs. To facilitate comparison shopping, all loan costs should be stated as interest, or interest plus a standard fee. If a fee is permitted in addition to interest, it should be included in the calculation of finance charges and APR, based on the loan's stated term. As with other consumer financial products such as credit cards, regulators should require simple, standardized disclosures showing maximum allowable charges at the time of application as well.

5. Continue to set maximum allowable charges on loans for those with poor credit

Research shows that lenders generally do not compete on price in these markets serving those with poor credit, which is why almost every state has laws that set maximum allowable rates on small-dollar loans. Without regulations, prices reach levels that are highly disproportional to lender cost, or far higher than necessary to ensure access to credit. Colorado's payday loan law shows it is possible to ensure widespread access to loans of $500 or less for people with poor credit histories, at prices far lower than those charged for conventional payday loans. It is also possible that such credit could be available at rates lower than the average APR of 129 percent in Colorado. In states that have permitted higher interest rates than this, storefronts have proliferated, with no obvious additional benefit to consumers.

States may reasonably choose to set maximum annualized interest rates of 36 percent or less if they do not want payday lenders to operate. States may also reasonably choose to allow interest rates higher than 36 percent if they do want payday lenders to operate. But even when regulations require all loans to have affordable repayment structures, there is insufficient research to know whether consumers will fare best with or without access to high-interest installment loans. Thus Pew does not recommend law changes in the 15 states that do not have payday lending, because such a change may not benefit consumers. In the 35 states that have conventional lump-sum payday lending, lawmakers should require loans to have affordable payments and then set maximum annualized interest rates according to whether they want payday lenders to operate.

These recommendations are intended to apply to all consumer cash loans of several thousand dollars or less, regardless of provider type (bank, nonbank) or product type (payday loan, installment loan, cash advance), exclusive of loans secured through pledge or deposit of property. They are based on findings documented in Pew's Payday Lending in America *series, available at: www.pewtrusts.org/small-loans.*

Borrowers want regulators to act

A nationally representative survey conducted by Pew shows that, by a 3-to-1 margin, payday loan borrowers want more regulation of this market. Eight in 10 favor a requirement that payments take up only a small amount of each paycheck, and 9 in 10 favor allowing borrowers to pay back loans in installments over time.

The limited benefits of access to credit

In circumstances where people are using credit to pay other debts and obligations, it is unclear whether promoting more access to credit is, on net, beneficial as a way to manage expenses or harmful as another burden for people who are already struggling financially. What is clear, however, is that a loan that is used to make ends meet creates danger if it requires payments that exceed a borrower's ability to repay. Payday loans, which typically require one-third of a borrower's biweekly income, *greatly exceed* most borrowers' ability to repay. That is why there is a need for immediate policy change to eliminate unaffordable small-dollar loan payments.

These recommendations are not an endorsement of high-cost credit or a promotion of credit as a means to address persistent cash shortfalls. Instead, they are intended to help policymakers address the problem of unaffordable small-dollar loans in the 35 states that have lump-sum payday lending, while allowing for the evolution of more beneficial and affordable products among the nation's banks and other lenders. That is why, in addition to providing a benchmark for identifying potentially harmful or unaffordable loans, policymakers should define rules for safe and transparent installment lending, collections, disclosures, and pricing.

THE PEW CHARITABLE TRUSTS