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ARE ALTERNATIVE FINANCIAL PRODUCTS SERVING CONSUMERS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE SMALL-DOLLAR CREDIT MARKET TO BETTER UNDERSTAND THE SPECTRUM OFALTERNATIVE FINANCIAL PRODUCTS, CONSIDER POTENTIAL CONSUMER LENDING CONCERNS, AND REVIEW THE CURRENT FEDERAL AND STATE REGULATORY LANDSCAPE

MARCH 26, 2014

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ARE ALTERNATIVE FINANCIAL PRODUCTS SERVING CONSUMERS?

WEDNESDAY, MARCH 26, 2014

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN BROWN

Chairman BROWN. The Subcommittee will come to order.

Thank you all for joining us. I thank the witnesses for being here and arriving on time. Senator Toomey, thank you for your cooperation, and Senators Heller and Warren and Senator Vitter was here a moment earlier, I believe is returning.

I want you to imagine that—we apparently are going to be called out to votes around 11, and there are four votes, so we will go as long as we can and likely dismiss, because there are four votes. If that means all of us, including Pat and I should keep our remarks within 5 minutes and ask all of you to do the same.

Imagine you are 40 years old. Imagine you are living in Mr. Rothstein's home State of Ohio. You are working at a steel mill in a union job. You are earning $60,000 a year. The plant shuts down. It could not compete. It might have been Oil Country Tubular Steel. It could not compete with illegal dumped imports from China.

You manage to find a retail job working full-time making $22,000 or $23,000 a year. Your income is a fraction of what it used to be. Your costs are about the same, and some things—perhaps food, gas, health care—are going up. You may lose your home to foreclosure. You are just trying to make ends meet, hoping you can just buy enough time until your next paycheck, with the perhaps distant hope of a better-paying job.

You applied for several credit cards. You were denied. You decide to take out a payday loan or loan against the title of your car, but the money from your loan runs out before the next pay period. Like 80 percent of consumers in the CFPB's recent study, you end up rolling over your loan. You end up, like the average borrower, rolling your loan over six or seven times, eventually paying $575 in fees that you cannot afford on a $400 loan. People are forced to turn to loans too often with triple-digit interest rates that trap

them in a cycle of debt that leaves them worse off than when they began.

The Office of the Comptroller of the Currency said in 2003, about a different subject but similar in some ways, quote, "a fundamental characteristic of predatory lending is the aggressive marketing of credit to prospective borrowers who simply cannot afford the credit on the terms being offered." The OCC was talking about mortgages in 2003.

The results of predatory lending devastated millions of American families, far too many certainly in the States represented here, especially, I think, especially Nevada and Massachusetts—or Nevada and Pennsylvania and Ohio. During the financial crisis, one mortgage lender said, "If you have a pulse, we give you a loan. If you fog the mirror, we give you a loan."

I am concerned we are now seeing this definition of predatory lending at work in small-dollar loan markets. For years, payday loans and other short-term small-dollar credit products were marketed to consumers and policy makers as a one-time stopgap to get people through a temporary emergency. Now, we are seeing these products are being used to cover basic living expenses that lenders rely on repeat lending for their profitability. Obviously, a renewal, a rollover loan, is more profitable than the initial loan, which may not be that profitable to the lender.

The cycle of a debt is a result of workers' wages stagnating over the past decade, American families' inability to accumulate enough wealth through savings over a lifetime spent working. Senator Toomey and I did a hearing on that, the bottom half of the population not being able to even close to saving any significant money for retirement. And the cycle of debt is a result of weak consumer protection, leaving consumers vulnerable to financial predators.

This is a large problem. Twelve million Americans use payday loans for years. Small-dollar lending is an $80 billion per year business. There are more payday lending stores in the United States today than there are Starbucks and McDonalds combined.

This problem is not simple. In my view, we need to raise the minimum wage. We need to extend unemployment insurance. We need to expand the Earned Income Tax Credit. All three of those rewarding work, so that people work hard, they get something and have some kind of decent standard of living. It puts money in people's pockets. It grows the economy.

We need to do more to encourage savings and wealth building. Senator Moran from Kansas and I have introduced legislation to promote prize-linked savings accounts to help consumers build assets. And we need a strong CFPB and robust consumer protections to ensure these products are affordable and sustainable. It means limits on cost requirements that consumers can repay their loan, products with longer repayment terms, and the ability to pay down principal. People who are working—and most of the people in these situations are—should have a little bit more to say for what they have—for the work they have done.

Senator Toomey.

STATEMENT OF SENATOR PATRICK J. TOOMEY

Senator TOOMEY. Thank you, Mr. Chairman.

You know, I find this discussion always is a very interesting one to me. I think there is a broad acknowledgement that we have a huge segment of Americans who are what is sometimes described as underbanked. They do not have access to ordinary forms of credit, ordinary meaning that which typically higher-income, wealthier Americans have access to. And there is a vibrant, competitive market that meets the needs that they have, providing short-term credit in a variety of forms, under a variety of circumstances.

And yet we have got people in this town who want to shut off this access to credit in a number of ways, use regulators to shut down the lending industry, directly or indirectly, sometimes by forbidding banks from providing basic services to these lenders. We have got some people who think the Government should take over the business. Let us have the Government do it, because the Government is so good at everything else it does. We have got others who think that the Government should dictate prices. That is what the Government is here for, it is to set prices for goods and services, and in this case, it would be the price of credit in the form of a cap on interest rates.

There are lots of ideas that we hear, and the one idea that very seldom gets discussed is what about personal freedom? What about allowing free men and women to decide what works for them? I have got to say, there is a breathtaking underlying arrogance in the presumption by wealthy people who have never been in these circumstances that they know better than those people who make these foolish decisions and borrow this money from these institutions, an arrogance that suggests that, God forbid, we let people decide what is the most sensible thing for them to do in the circumstances that they face.

And that is the fundamental premise here, that people must not be free to decide what credit vehicle is most suitable for them among the options that are available to them. We cannot let people decide for themselves. We must preclude a whole range of choices and force them into transactions that we sitting up here approve of.

I just find that very, very disturbing. I know that view is not shared by everyone on this Committee. But, I appreciate the opportunity to have the discussion because I think we ought to hear from a wide range of opinions about this, and as for myself, Mr. Chairman, I hope that we will allow for a flexible and vibrant and dynamic marketplace that will allow people to access credit that they need in a variety of ways.

Thank you.

Chairman BROWN. Thank you, Senator Toomey.

Senator Warren.

Senator WARREN. I would like us to just get straight to the questions, so I will pass. Thank you.

Chairman BROWN. Senator Heller, would you like an opening statement?

Senator HELLER. No, Mr. Chairman.

Chairman BROWN. OK. Thank you for that. Let me introduce the panel and get started. I appreciate Senator Heller and Senator Warren's comments, or lack of comments.

[Laughter.]

Chairman BROWN. Michael Flores is President and CEO of Bretton Woods, Inc. He has over 30 years of experience in the financial industry. He has testified to this Subcommittee before.

Stephanie Klein of Enova is the Director of Consumer Lending for them, an online financial services company headquartered in Chicago. She oversees NetCredit line of Enova's installment loan products. Welcome.

Nick Bourke is with Pew Charitable Trusts. He is the Director of the Pew Charitable Trusts Safe Small-Dollar Loans Research Project, conducting research on consumer needs and perceptions, market practices, and potential regulations of payday and other small-dollar loan providers. Welcome, Mr. Bourke.

David Rothstein is familiar to this Subcommittee, also. He is the Director of Research Development and Public Affairs for the Neighborhood Housing Services of Greater Cleveland. He has published dozens of research reports, editorials, pieces of testimony on asset, housing, and consumer issues and has added greatly to the public debate on these issues.

Professor Nathalie Martin is the Frederick Hart Chair in Consumer and Clinical Law at the University of New Mexico School of Law. Her primary research focus is on small-dollar lending and public attitudes toward these products. Professor Martin, welcome.

Mr. Flores, if you would begin. Thank you.

STATEMENT OF G. MICHAEL FLORES, CHIEF EXECUTIVE OFFICER, BRETTON WOODS, INC.

Mr. FLORES. Thank you, Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee. I am grateful for the opportunity to speak with you today on the issues of consumer credit and also discuss the results of a report I recently completed on the customer and loan characteristics of online short-term loans.

I worked in banking consulting for well over 30 years, and in the past 15 years, I have conducted research on short-term credit, including overdrafts and payday loans, and in the last 6 or 7 years, I have studied prepaid cards, as well. I am also on the faculty of the Pacific Coast Banking School of the University of Washington, where I teach a retail banking course.

Based on my most recent research, which was commissioned by the Online Lenders Alliance, and analysis of other studies, the need for short-term low-dollar products is real and the demand is growing. I just noticed an article in the *Washington Post.* A Brookings Institution study says that now one-third of all households are living paycheck to paycheck, so the income is creeping up higher into the middle class for the need for short-term credit.

The Center for Financial Services Innovation estimates the annual demand for unsecured short-term credit to be about $61 billion, of which $8.5 billion was of overdrafts, $4.5 billion of deposit advance products, which probably now will tend toward overdrafts, Internet payday loans of $18.5 billion, and storefront payday loans of $30 billion. The intent of this study was to build a first of its kind analysis. This is the largest data analysis commissioned by the industry to look at what data was available, both from the specialty credit bureaus as well as the lenders. We also wanted to comment on the strengths and weaknesses of the data that was out

there, establish a baseline from which future annual updates can be based, to try to provide an initial understanding of customer demographics and loan usage patterns, and, of course, compare this data to other research, such as Pew and CFPB in order to add information to this discussion.

We analyzed over 60 million application records from the three specialty credit bureaus. That included nine million loan records over a 4-year period beginning in 2009. Because of certain constraints, and I will be happy to talk about that later, within the credit bureau data, we added an additional 1.6 million customer records from three lenders around the country.

The key findings, for the most part, track closely with Pew and CFPB. Of course, there are a few exceptions. In general, the median age of the customer is 39, annual median income of $30,000, and they are generally paid on a bi-weekly basis. The average loan amount is about $400, but, I think, most interestingly, is that average loan amount has increased from 2009, about $380, to over $530 in 2013.

The average annual number of loans range from two to four, with 30 percent of customers having only one loan. This is where we differ a little bit from the other studies, and part of it is due to methodology and part of it is due to the data that was available.

Annual days indebted range from 70 to 106 days, which compares to Pew's analysis of 144 days and CFPB's analysis of the storefront loans of 199 days.

Finally, loan performance from the credit bureaus indicate 71 percent of the loans were paid as needed, and 89 percent had no charge-off flags.

I believe the growth in loan amount as well as the intensity of usage characteristics has led to a trend of the industry moving from the 2-week product to an installment product. The installment product, I believe, will provide more flexibility for the consumer and will lead to less cost for the consumer. That said, I still think there is a viable need for the 2-week product and that it fits within the continuum of credit services needs in that the 2-week product is going to be less expensive than an overdraft, and an overdraft is going to be less expensive than returning a check insufficient.

Innovative companies, many of them operating exclusively on the Internet, are trying to develop innovative products to drive down cost. In my discussions with these companies, they say the real innovation is limited because of the patchwork of State laws that are out there. I believe Federal law is needed to establish consistent rules and regulations to allow these companies to innovate and drive down costs.

I notice an interesting quote from the Office of the Comptroller of the Currency in 2011. I will paraphrase, but it is that in the 21st century, the Internet and the advent of technological innovations has accentuated the seamless—the geographic seamlessness of financial services products. So, we have let the genie out of the bottle. People can go on the Internet, see what products are available, but they are constrained by State regulations in terms of what products they can get.

I believe H.R. 1566 is probably the best vehicle currently available and enjoys close to 50–50 bipartisan cosponsorship to allow customers access to credit on a national basis.

Thank you for your time, and I look forward to answering your questions.

Chairman BROWN. Thank you very much, Mr. Flores. Thank you for staying within the 5 minutes, too. I appreciate that.

Ms. Klein.

STATEMENT OF STEPHANIE KLEIN, DIRECTOR, NETCREDIT CONSUMER LENDING, ENOVA INTERNATIONAL

Ms. KLEIN. Good morning, Members. Thank you, Chairman Brown, for inviting me here today. Again, I am Stephanie Klein. I am a Director of Consumer Lending at Enova. We are a global leader in online financial services, headquartered in Chicago. I am really grateful for the opportunity to share some of our experience with you today.

Senators, I am here to tell you about the exciting new credit solutions we have been developing, what we have learned, who we are serving, and how we can help underserved consumers have equal access to quality credit. We believe we can change the dynamics in the industry and provide a pathway toward upward mobility that will benefit millions of hardworking Americans who have been left behind by the traditional banks.

At Enova, since our launch in 2004, we have been using advanced technology and analytics to create innovative products that meet consumers' evolving credit needs. I oversee NetCredit. NetCredit is one of Enova's newest installment lending products for U.S. consumers. With NetCredit, customers can borrow $1 to $10,000 and pay back over time in fully amortizing installments over 6 to 48 months. Payment amounts are typically just 6 to 8 percent of gross paycheck, and we actually derived this ratio through rigorous testing of customer behavior.

But just recently, we also released a new tool where customers can actually vary their payment amount online, and in real time, they can see the impact on the duration of the loan as well as the total cost of borrowing as they customize their payment. And interestingly, since we released this new tool, we have seen that customers, on average, are self-selecting that same 6 to 8 percentage of gross paycheck that we had calculated and targeted historically. So, I think this is a true testament to the power of the advanced analytics capabilities that we have developed over the past decade at Enova.

Our customer demographic does present a unique challenge when it comes to pricing. While NetCredit customers typically have moderate incomes, usually ranging from about $40,000 to $60,000, and they always also have an active bank account, they have very low credit scores. Compared to the average U.S. FICO score of 689, 90 percent of NetCredit customers score below 650, and the vast majority are actually below 600. So, we are really serving a very high-risk borrower who traditional banks are not willing or able to serve.

Our answer to this challenge is a unique risk-based pricing algorithm. By leveraging multiple data sources and evaluating literally

hundreds of variables, we have been able to successfully distinguish high-risk borrowers from lower-risk borrowers and price accordingly. As a result of this innovation, NetCredit's average interest rates are 50 percent lower than other leading online lenders, and almost 75 percent lower than a typical payday loan product.

Furthermore, because we use the simple daily interest method, customers can save money by making early payments when they have extra funds. There are no fees to our loans, simple interest only, no origination, application fees, nothing up front. So, I think this is a benefit, and, in fact, one-third of our customers take advantage of this benefit and do choose to pay back their loans early.

Over the past 2 years, we have been working hard to foster relationships with the major credit bureaus. We have dedicated significant resources to this effort and we are very excited to help customers start building credit with these products. This is a unique benefit that cannot be offered with 2-week products, but is possible with longer-term installment loans.

Now that I have told you a little bit about what we are innovating and some of the benefits we can offer our customers, let me tell you about the significant challenges we face due to the current regulatory landscape.

It is our belief that current State laws do not adequately serve consumers. Instead of working toward innovative solutions that can be scaled across 50 States, we are forced to develop new products for individual States within the constraints of antiquated consumer credit statutes that were never drafted with current technologies or Internet lending in mind. In many cases, instead of allowing customers a choice of quality credit products, the State law actually forces customers into the single-payment loan as their only option.

Our mission at Enova is to create high-quality innovative products that can not only serve an immediate credit need, but can also help customers achieve a better financial future. We have proactively shared our experience with groups like the Center for Financial Services Innovation and the CFPB's Project Catalyst in order to promote discussion on how we can design policies that help working families throughout the country achieve equal access to credit. We envision uniform Federal standards that enable innovation to meet the needs of today's increasingly mobile, tech-savvy consumers. I encourage all of you to support legislation to modernize our laws for the benefit of the 68 million Americans in this country who do not currently have sufficient access to credit.

Thank you, Chairman Brown, thank you, Committee Members, for allowing me to be here and share this testimony and I look forward to any questions.

Chairman BROWN. Thank you, Ms. Klein.

Mr. Bourke.

STATEMENT OF NICK BOURKE, DIRECTOR, SAFE SMALL-DOLLAR LOANS RESEARCH PROJECT, THE PEW CHARITABLE TRUSTS

Mr. BOURKE. Thank you, Chairman Brown and Ranking Member Toomey, Members of the Committee. My name is Nick Bourke. I am with the Pew Charitable Trusts. We are a large 501(c)(3) nonprofit organization. A big part of our mission is to generate good

quality research that helps inform good public policy, and I would like to focus today on the research that we have been conducting over the past 3½ years about payday and small-dollar lending.

Payday lending, as, Chairman Brown, you outlined very well, this is typically a 2-week balloon payment loan that is due back in full on the borrower's next payday. Payday lending is an experiment that began in the early 1990s in this country, and the goal was to try to make more credit available to financially fragile consumers. Unfortunately, this experiment has not worked out too well.

When people get a payday loan, the only real requirements are that they have a checking account and that they have an income stream. If they have those, and the lender then uses their unique power to leverage the checking account and gain access to the borrower's checking account and income stream, that acts—that stands in for the underwriting.

About 12 million people use these loans each year. Why do they use them? Well, in Pew's nationally representative survey of payday loan borrowers, where we called people throughout the country and screened through about 50,000 people in order to get enough payday loan borrowers to give in-depth interviews to represent all borrowers across the country. We asked, what is your financial situation, and what payday loan borrowers said, 58 percent of them, was they have trouble paying their monthly bills half the time or more. And one-quarter of payday loan borrowers said they have trouble paying their monthly bills every single month.

Most have debt already. More than half of payday loan borrowers have credit card debt. Forty-one percent own homes, so there are mortgages. Many of them have student loans. Many of them have auto loans. People are carrying debt. Almost all payday loan borrowers have a credit score, and the average score is 517. This indicates that people are already struggling with debt. They are at the bottom of the barrel in terms of credit score.

They are failing out of the mainstream credit system. They are not trying to get into it. They have been there and they are failing out. This is really important to remember when we think about what is the right solution here and how can credit help them or how can it not help them.

When we ask people, why did you get your payday loan, what did you use the money for, 69 percent of borrowers said that the reason they got their payday loan, unsurprisingly, perhaps, was to help them pay their bills—rent, utilities, credit card bills. Only 16 percent said that they turned to a payday loan for some kind of unexpected expense, like a car breaking down or a medical emergency.

So, this paints a vivid picture of financial struggle and why people are turning to the loans. It also helps us understand why this product, why this market is not serving this consumer.

A payday loan typically requires a balloon payment of $430, on average, out of the borrower's next paycheck. The typical borrower is making about $30,000 a year. That is about $1,200 every 2 weeks. The payday loan is requiring them to sacrifice one-third of their next paycheck toward a payday loan. That is unaffordable and it is not working.

The message that I want to convey is there is a solution. There is a way out of this. The status quo is not working. Pew has recommended five policy recommendations to help address this problem.

The first one relates to an ability to repay principle. The payday loans are not working because they are fundamentally unaffordable. The way to address this is to require lenders to consider the borrower's ability to repay. If one-third of the paycheck is too much to pay, what is the right benchmark? Our benchmark, based on research, is 5 percent. Loans should not take more than 5 percent of a person's paycheck unless the lender is doing some really serious underwriting to make sure that the borrower can afford it.

Number two, spread costs evenly over the life of the loan. Simply turning the loans into installment loans is not going to work. We need to have some simple safeguards to make sure that the problems that we see in installment loan markets, with frontloading of fees and interest, large origination fees, giving incentive to refinance or flip loans, we need to protect against those.

Number three, guard against harmful repayment or collections practices. Generally, we need to make sure that borrowers have a little bit more power, a little bit more security to stop electronic payments in the face of unscrupulous lenders or overly aggressive debt collectors.

Number four, concise disclosure so people can get good information to make good decisions.

And number five, States should continue to set maximum allowable interest rates because data suggests that the small-dollar loan markets serving people with damaged credit are not price competitive.

Pew has done a case study in Colorado where they essentially implemented reforms along these lines in 2010, and what we saw there is that it worked. Access to credit has been maintained and borrowers are spending much less and being much more successful with reasonably structured loans with sensible safeguards.

Thank you very much.

Chairman BROWN. Thank you, Mr. Bourke.

Mr. Rothstein, welcome.

STATEMENT OF DAVID ROTHSTEIN, DIRECTOR, RESOURCE DEVELOPMENT AND PUBLIC AFFAIRS, NEIGHBORHOOD HOUSING SERVICES OF GREATER CLEVELAND

Mr. ROTHSTEIN. Thank you. Senator Brown and Ranking Member Toomey, I appreciate the opportunity to testify before you today. Outlined in this testimony, I hope to convey the importance of strong regulation around small-dollar lending, particularly from the Federal Government, as local authorities, such as my State of Ohio, continue to wrestle to ensure that consumers receive safe and affordable loan products.

It is imperative, as Nick discussed, that we look at the characteristics of the loan, such as APR interest and method of payback, to assess the quality of the products. First, the traditional payday loan model in Ohio is alive and, as in other States, does not serve families well. Research of actual borrowers continues to tell that

story in numerous ways, even in the report that was just released by the CFPB yesterday.

I say that it does not serve them well because the average family takes out eight to 12 loans per year from one lender, typically purchasing loans in back-to-back transactions. This is absolutely the typical Ohio customer. This means as soon as their loan is repaid, they immediately reborrow to cover other expenses. This is also the prototypical discussion of what we call the debt cycle.

Our housing and financial capabilities counselors in my office indicate that most clients that have one loan have about four other loans from other stores. Keep in mind that many families cannot afford to pay back the principal balance of the loan in just 2 weeks, let alone interest and principal. And if payback does occur, other monthly budget items, such as rent, utilities, food, and car payments, suffer. In sum, we see the people after they have exercised their freedom to take out these loans and they want out.

Second, payday lenders in Ohio have morphed into auto title and installment lenders. This is quite typical and quite often more expensive. In 2008, the General Assembly in Ohio passed a bipartisan bill to curtail interest rates. The new APR was 28 percent interest. This is a significant reduction, since lenders before had been charging 391 percent interest. Despite spending at least $10 million in a ballot referendum to reverse the decision, not a single payday lender in Ohio uses the short-term loan act that was passed. Rather, they use two antiquated mortgage lending laws to sell loans at essentially the same price, if not more, than before.

Most recently, as I indicated, in Ohio, stores are selling high-cost loans that use automobile titles as collateral rather than a postdated check. An auto title loan is often more dangerous than a payday loan in the sense that people can, and do, lose their cars once they are too far into debt. I have included in my testimony a three-part story from the *Akron Beacon Journal* about a working mother of three who lost her car and nearly her home after this loan. With the help of several nonprofits and the writer for the article, she was actually able to get her car back.

Installment loans, the newest payday product in Ohio, are offered by payday lenders and they carry a similar triple-digit interest rate and use the Credit Service Organization statute to sell loans for up to 12 months. One loan that I analyzed from a store about 5 minutes from our office cost a borrower $5,000 to borrow $2,000 over a 12-month period.

Finally, at NHS of Greater Cleveland, we practice what we preach. Since we advocate smart home ownership, we purchased our building in the recovering area of Slavic Village, Senator Brown's new neighborhood. Since we are notably critical of payday lending, we are developing two alternatives. Working with the innovative startup company Employee Loan Solutions, we will be working with large employers to provide safe, underwritten, low-cost loans through paychecks. The lender is a CDFI focused on providing low-income families with affordable financial products. There is underwriting. There is no prepayment penalties and certainly no balloon payments.

The other program is a small-dollar loan serviced and managed by NHS of Greater Cleveland. The intent is to comply with Ohio's

payday lending law of under 26 percent APR. We will be much lower than that. We will be the only group in Ohio to comply with Ohio's payday lending law.

As this Congress and Consumer Financial Protection Bureau consider rules and regulations around small-dollar lending, a floor on small-dollar loans will encourage high-quality innovation. Nick mentioned their principles through Pew. I would also recommend CFSI's principles around small-dollar credit. They are also quite strong.

Lenders should be required to fully assess a borrower's ability to repay a loan in full and on time without the need and use of cashing a check or electronic debiting an account. Just like mortgages or credit cards, ability to repay requirements protect borrowers from unsustainable debt. The litmus test for automatic payment should be that it is a convenience for the borrower, not a sidestep for debt collection laws.

I really do appreciate your time today and I am looking forward to question and answer and I am happy to, again, answer any questions that you may have. Thank you for your time.

Chairman BROWN. Thank you, Mr. Rothstein.

Professor Martin, welcome.

STATEMENT OF NATHALIE MARTIN, FREDERICK M. HART CHAIR IN CONSUMER AND CLINICAL LAW, UNIVERSITY OF NEW MEXICO SCHOOL OF LAW

Ms. MARTIN. Thank you very much. Good morning, Chairman Brown, Ranking Member Toomey, and other Members of the Subcommittee.

As Senator Brown indicated, my research focuses on high-cost loans, and I have done several empirical studies, including one in which we interviewed real borrowers curbside. I also work directly with consumers in our clinical law program, and as a result have had a tremendous amount of contact with actual borrowers of these types of loans. So, this borrower contact, I believe, informs my testimony today in a way that book research simply cannot.

As I understand the goals of the hearing today, they are to identify fair, affordable access to credit for all, but fair and affordable are not words that I would use to describe the loans that are the subject of this hearing.

We have not talked too much yet about interest rates, but I would like to do that for just a moment. Storefront payday loans, I think, as Mr. Rothstein said, typically carry an average rate of about 400 percent per annum and title loans about 300 percent per annum, but, of course, there is the risk of losing your car with those.

With the installment loans, though, that Mr. Rothstein mentioned, that are generally designed to get around State regulation, the rates can be much, much higher. For example, one consumer that I know borrowed $100 and paid back $1,000 over a year's time. The rate on that loan is 1,100 percent interest. And the important thing is that that loan is legal in many States. That is a legal loan.

The biggest challenge we have, though, in terms of regulating these forms of credit is in the area of online lending. This is a

growing segment. It is growing by leaps and bounds. Those rates are higher than storefront payday loans—800 to 1,000 percent is very typical—and there is very little regulation of these online lenders. The SAFE bill that was proposed by Senators Merkley, Udall, and others will be very helpful, but I think it is also very important for the CFPB to have as much power as possible to regulate that form of credit.

And on the topic of the CFPB, it is actually—as far as I am concerned, nothing is more critical at this moment than protecting the CFPB's ability to regulate this entire high-cost loan industry all across the spectrum of small-dollar lending, not just focusing narrowly on payday lending, because of the loopholes that Mr. Rothstein talked about.

You know, I also have been watching very closely and following every State law that has passed in order to curb these lending practices and watching in nearly every State as lenders find ways around the laws that pass. As new State laws pass, other than interest rate caps, interest rates and fees do not go down. Indeed, what happens is that they either stay the same, or usually, they go up after the new law. And, no matter how many lenders enter this market, no matter how many, the rate does not go down. So, what we can see is that the market is not working in this particular context.

And we heard from Ms. Klein about an Internet lending company that may offer a new product that could be 75 percent cheaper than existing online loans, or 50 percent cheaper than storefront loans. Keep in mind, those would still be 200 to 300 percent loans. So, even if that is OK, my real bone to pick is with the idea that somehow this Federal charter is going to make the rates go down. That is not the history. If history is any indication, additional freedom imparted on the industry under this charter will only cause the rates to go up, or, at best, to stay the same. In any event, any bill that is proposed by industry, if looking at that, consider the compliance record of the existing industry. Is this the place we want to look for our solutions?

So, what are the solutions and the alternatives? We have heard about some of them. One would be, of course, true underwriting of the loans, meaning the lender has to determine that the borrower actually has enough money to pay their regular bills plus the loan or the loan is not enforceable.

Another very important thing, based upon the recent CFPB paper that came out yesterday, would be to prohibit rollovers and limit the numbers of loans through a national data base, and that means if the lender did not use the national data base, then the loan would not be enforceable.

I think both of those are viable options. If lenders feel that this is too complex, there is always a much simpler solution, which would be a Federal interest rate cap. And, by the way, although I know not many politicians favor that, the general public very much does favor interest rate caps, and I have attached a paper to my testimony so indicating.

I guess the last thing I would say is I am very excited about other options that are being developed in the marketplace, the

CDFIs that Mr. Rothstein spoke about as well as the idea of having the U.S. Postal Service get into this business.

Thank you very much for your time.

Chairman BROWN. Thank you, Professor Martin, and all of you, thank you for your trenchant testimony.

You may have heard from Senator Toomey's and my opening statements that we have a sort of different view of this and the role of Government, but I see some seeds of hope in Mr. Bourke's testimony and Mr. Rothstein's attempts in Ohio, and I hope there is a way we can get to some of these solutions for the unbanked that Senator Toomey spoke about.

Let me specifically—I want to ask this directly to all of you, starting with Professor Martin—the Pew studies—I think there were three you did with some 50,000 calls to consumers, so a pretty good cross-section of people—show that consumers use payday loans even when they have cheaper credit liquidity available to them. Forty-one percent eventually paid off their loans using one of these options—credit cards, bank loans, pawn shops, other short-term loans. Borrowers have chosen to use payday loans when there is liquidity in their checking account in many cases.

Mr. Rothstein describes two products that Neighborhood Housing Services is developing. There have been reports about other affordable small-dollar products. You mentioned some of the examples in Colorado. Key Bank in Cleveland, a regional good-sized bank—midsized bank in Cleveland—has offered a $250 to $1,500 line of credit with a 14 to 19 percent interest rate, up to 5 years for repayment, two fees totaling $25. They say this product can be profitable.

So, my question, starting with Ms. Martin and moving from my right to my left, is why do borrowers use the high-cost payday loans when there are, in many cases, alternative affordable—alternatives available to them that are affordable? What do these choices tell us about borrowers' behavior?

Ms. MARTIN. So, I think, initially, there is a confusion on the part of borrowers about the rates. So, if they hear, oh, the rate is $15 per $100, they think that is a 15 percent per annum rate, even though it is only for 2 weeks. It is a 400 percent loan. And in my study, I found that there were people who thought that was actually going to be cheaper than using a 25 percent credit card, for example. So, that is part of it. Enumerancy, in general. You know, people cannot do math. That is a problem that we have seen in society.

And I think people also look at these—if there is a lender on every corner, they are thinking that is kind of a normal thing to do, and I have even heard people say, "Oh, no, I would not use a credit card for that. Those are only for emergencies." So, I think the advertising, the ubiquity of the industry makes people think this is a better option somehow.

Chairman BROWN. Mr. Rothstein.

Mr. ROTHSTEIN. I think Nathalie is right on. I think there are two things, also, that our financial counselors have noticed. One is a sense of optimism in that people are generally feeling that in 2 weeks, they will be in a better position than they are before, and

a lot of this has to do with just the nature of work and temp work and those kind of things, and often, they are not.

And then the second thing is, I would argue, and I think the Pew studies, the CRL studies have really shown, that after the first or second loan is taken out, the choice to take out other loans becomes dramatically reduced because they are going to be short for their other expenses after they pay back the loan or after the lender runs the check through that they have postdated. So, I think the argument of after the first or second loan how much of a choice it is is debatable.

Chairman BROWN. Mr. Bourke.

Mr. BOURKE. In our second report, we identified six reasons why people use unaffordable payday loans, and one of them is desperation. Thirty-seven percent of borrowers in our survey said that they have been in such tight financial circumstances that they would take any loan on any terms.

Other reasons relate to perception and reliance. A consistent theme that we have heard in focus groups with borrowers is that, hey, I already have enough debt. I already have enough bills. I do not need another bill. I do not want more debt. I have gotten in trouble with credit cards before. I am just going to get this payday loan because it looks like I can get in and get out quickly and I am not going to add another bill to the pile. The reality, of course, is very different.

There are several other reasons, but one thing I want to point out, a good way to think about this and analyze it, I think, is to compare what the product looks like or how it is packaged to the reality of the situation. And in the conventional payday loan market, the product is typically packaged as a short-term product for unexpected expenses. In fact, the industry will typically say, do not use these loans for long-term use or anything more than a temporary need.

But the business model of payday lending is built on extended usage and a lot of data shows this very clearly, including the payday loan study that came out yesterday from the CFPB. The vast majority of volume in the payday lending market, the vast majority of revenue comes from people who use the loans repeatedly over an extended period of time. And if most borrowers—or, I should say, if borrowers used the loans as packaged, the business model of payday lending would fall apart. It is absolutely reliant for its profitability on extended usage.

Chairman BROWN. Thank you.

Ms. Klein, is he right that your products from Enova and other companies are packaged for short-term one-time loans, but the model is something—your business model is something different?

Ms. KLEIN. So, just to be clear, I do not run a payday loan business. I mean, my product is an installment loan. I cannot speak for others in the industry. What I can say for Enova is that we proactively in every State where we can have been moving toward longer-term loans. What I really like about the installment loan is under its Federal regulation, there are clear and transparent disclosures up front. So, when a customer borrows from us, they see the principal amount, they see the APR, they see the total finance

charge in dollars, which may make more sense to a lot of customers than an APR calculation, and they see the payment amount.

So, really, in my opinion, you know, why do customers use these products? Because there is a need that is being unmet. If these other solutions people talk about were meeting the need, the products would not exist. So, there is absolutely a need and what we need to focus on is how do we bring higher-quality products to market at scale so that the millions of Americans who need them have access.

Chairman BROWN. Mr. Flores, you have had the Online Lenders Alliance. You have done studies for them. Is Mr. Bourke right about that, that the packaging for short-term one-time loans is different from the actual business model?

Mr. FLORES. Well, Senator, what I have tried to do with our studies is build data for the analysis of their product and how customers use their product. I have not done specific work for vendors or lenders within that industry. So, I cannot really comment on the business model versus the product.

Chairman BROWN. OK. Senator Toomey.

Senator TOOMEY. Thanks, Mr. Chairman.

Ms. Klein, we have heard just now the characterization of the lending that goes on in this industry, the ideas that there is indiscriminate lending. Basically, if you have got a bank account and a job, you get a loan. There are balloon payments. People do not consider—lenders do not consider a customer's ability to repay. Did it ever occur to you to consider a customer's ability to repay, or are you indifferent to getting your money back?

Ms. KLEIN. Thank you for asking that question. That is a great question. You know, obviously, if our customers cannot pay, we do not make money. So, if our customers are not successful, we are not successful.

Just to give you a little insight—again, I cannot speak for everyone in the industry, but as to how NetCredit evaluates that—we are spending a lot of money, typically $30 to $50 per funded customer, on underwriting. We are pulling prime data, a Vantage score, you know, similar score from a prime bureau. And we are also pulling alternative data from about five different data sources. So, we use all of this data up front to try to come up with a loan offer that would be appropriate.

Additionally, after a consumer expresses interest in that product, we are doing some sort of verification for everybody. Nobody gets an auto approval on the NetCredit loan. So, we are checking employment. For a lot of people, we are looking at bank statements. Because we are online, we are verifying identity. We do a ton of verification, and as a result of that, our approval rates are typically only 15 to 20 percent. So, this is not walk in, fog up a mirror. I do not know how you would do that in the online metaphor, but——

Senator TOOMEY. So you——

Ms. KLEIN. ——but that is not how we do our business.

Senator TOOMEY. To be clear, so, you are rejecting applications from 80 to 85 percent of the applicants because they do not meet your credit standards?

Ms. KLEIN. Correct.

Senator TOOMEY. Is that——

Ms. KLEIN. We reject 80 to 85 percent, and additionally, just to kind of speak on, well, these customers are desperate, not every customer that we approve chooses our product. And we see, especially online, it is much easier to comparison shop——

Senator TOOMEY. So, there is competition.

Ms. KLEIN. and so once you make an offer, at least 40 percent of people typically walk away, and that is fine, and they are looking for the right choice for them.

Senator TOOMEY. So, you are not able to set any old rate you like, because if you do, someone else who competes with you will set, presumably, a lower rate and competition imposes a discipline in this space. Is that a fair——

Ms. KLEIN. That is absolutely correct, and I would say, really, it has been recent, but in the past year, especially in the online space for installment lending, we have seen prices come down. I would like to think that NetCredit was one of the first lenders to start driving that effort, but we have actually seen other lenders innovating in the same way. And so I think competition can work online.

Senator TOOMEY. It seems obvious to me, but just maybe you could confirm. The kind of underwriting you do would not have been possible, certainly, 10 years ago, probably not even 5 years ago, but advances in technology and access to data and evolving techniques have made this kind of underwriting possible recently.

Ms. KLEIN. That is absolutely true. I mean, I will not waste too much of your time, but I could list off a ton of tools, data vendors that are available today that were never available historically, and we are constantly testing with new vendors. There is not a day that goes by where, in addition to the data we already use, we do not have a few other vendors where we are doing a retro study, we are saying, hey, here is some data, give us your data. How can we do better? How can we get smarter about underwriting? It is an ongoing effort.

Senator TOOMEY. Thank you.

Mr. Flores, I wanted to ask you a question and ask you to describe a little bit to us a program which, I think, has a name, called Operation Choke Point, if I have that right. My understanding of this is a systematic effort on the part of some bank regulators to pressure banks into not providing ordinary services to the short-term lending industry as a way to indirectly shut down this industry. Despite the fact that the industry is operating in a perfectly legal fashion and they might be very good and, in fact, profitable customers for the bank, it seems that some regulators believe that without any Congressional authority, they ought to be able to shut down an industry because they do not like it. Do I have that roughly correct, and could you——

Mr. FLORES. Yes, sir——

Senator TOOMEY. ——describe what is happening here?

Mr. FLORES. ——that is correct. I believe what they have done is take what would be a shotgun approach. I mean, many of the lenders who are licensed in the States to operate are operating in a legal business environment and I do not see the cause to restrict them from access to the payment systems to conduct their busi-

ness. Now, yes, there are unlicensed offshore vendors and I think that a more targeted approach to address the unlicensed operators would be much more appropriate in dealing with the bad actors than just shutting down an entire industry.

Senator TOOMEY. And, finally, if we had a new regulatory regime that forbids categories of transactions and puts Government dictated pricing limits on these transactions, is there any chance that some people who currently need and get access to credit will no longer have that access to credit?

Mr. FLORES. Absolutely. It is the nature of price controls. The 36 percent annual APR has been talked about a lot. In small-dollar lending, particularly to a high-risk customer group, given the cost of originating, servicing these types of credits, you cannot properly make those loans. Banks have gotten out of the business of small-dollar unsecured consumer credit, probably 15, 20 years ago when they migrated to credit cards and then overdrafts and then home equity lines of credit. So, it is a real problem.

The deposit advance program is an example. That is close to $5 billion of credit. And I talked to some people that were in the industry in those banks that say it is probably actually closer to $10 billion, but you see FSI's number of $4.3 billion of credit extended. That has gone away. The demand has not been ameliorated.

Where does that go? Well, if these customers are customers of those banks that offered the product, the next likelihood for them to do is then the overdraft, which is going to be a much more expensive option than that deposit advance product. So, you limit supply of certain products, you are going to force customers—unless you somehow deal with the demand, you are going to force customers into products that are not suitable for them.

Senator TOOMEY. Thanks very much. Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Senator Toomey.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. Thank you for holding this hearing.

So, there are 34 million families in the U.S. that are unbanked or underbanked, meaning they rely on check cashing, on payday lending or other financial services outside the traditional banking system. The cost for these families is huge. The average underbanked family makes about $25,000 a year and it spends about $2,400 a year just on interest and fees for basic financial services. In other words, that is nearly 10 percent of their annual income, about the same amount that they spend on food.

Now, a primary reason that they spend so much is they cannot get to bank branches. It is a lot harder to open a savings account or a checking account if there is no branch in your area, and banks are rapidly abandoning low-income and rural neighborhoods. According to SNL Financial, a research firm, banks are systematically closing their branches in areas where the median income is under $50,000 at the same moment that they are opening more branches in areas where the median income is over $100,000, and that trend is expected to continue in coming years.

So, a couple of months ago, a report from the Inspector General of the U.S. Postal Service recommended that the Post Office partner with banks and credit unions to provide basic financial serv-

ices—check cashing, small-dollar savings accounts. With Post Offices in every ZIP code, that would solve the access problem. In fact, 58 percent of Post Office locations are in ZIP codes with zero or one bank branches. The Post Office could leverage its infrastructure to ensure that low-income families have both access to banking services, that rural families have access to banking services, and that those services are offered at a lower price.

So, what I want to ask is, Professor Martin, do you think that partnering between the Postal Service and banks and credit unions could be a better way to serve low-income and rural communities and do it at a lower cost than the current alternatives?

Ms. MARTIN. I do actually think that this is a viable alternative. I think there are just a couple of things to keep in mind. One, in the report, the Inspector General indicates that a couple of sample studies or small, you know, start in a couple places first, see how it goes, see how the profitability goes. It is very important that those be started in areas without storefront payday loans so that there is no issue about the hours and those kinds of things.

And the other thing, of course, is who will be the partners and what will be the rates. But, assuming that the rates will be cheaper, as indicated in the report, I think this is a very viable alternative that should definitely be pursued.

Senator WARREN. Mr. Rothstein, would you like to comment on it?

Mr. ROTHSTEIN. Sure. Thank you, Senator. So, I think Professor Martin is right. I think the implementation phase would be the challenge. I think, theoretically, it makes sense, and it is actually done in Japan and Germany and other countries, which—the biggest hurdle, I think, besides implementation, would also be just sort of the—and we have heard some of those opinions just even recently, yesterday in Nashville and then here today, about the hostility toward the idea of the Government sector being involved in providing loans. So, I think that is the biggest hurdle.

Senator WARREN. OK. Mr. Bourke, do you wish to comment on this?

Mr. BOURKE. We are interested in the issue. We have not conducted research on it, but it is an issue we are interested in researching more.

I would like to say a more general comment about why millions of people today are opting or looking outside of the banking system for something that the banking system is not giving them. So, I will focus specifically on some research we recently published about prepaid debit card usage.

We found that the people who use general purpose reloadable prepaid cards, these are essentially checking accounts without checks. People can buy them on J-hooks in drug stores and use them as bank accounts. The driving factor of why people are using prepaid cards is to gain more control over their finances and to gain shelter from overdraft fees and the temptations of credit. People are seeking commitment devices to help them only spend the amount of money that they have and not get into trouble with credit and overdraft fees. Prepaid cards are giving that to them right now because, by and large, prepaid cards do not allow overdraft or spending more than people have.

And what we found, interestingly, is that seven out of eight prepaid card users either currently have or used to have a bank account. So, people are actually experienced in the banking system and they are starting to go outside of it.

So, whether it is the Postal Service or anything else, I would say this is a very important finding because we are seeing people looking for something that they are not getting from the banks, and I think we should keep this in mind when we are thinking about what the services are going forward.

Senator WARREN. Thank you very much. I see that my time has expired, and I just want to say, I think this gives us an opportunity to expand access, an opportunity to create some real competition here, and an opportunity to think more creatively about how it is that people of moderate income, how it is that people who live in rural areas get access to the banking services that they most need. And so I appreciate the comments on this.

Thank you very much, Mr. Chairman. It looks to me like we have a win–win here. I would like to take advantage of it.

Chairman BROWN. Thank you, Senator Warren.

Senator Heller.

Senator HELLER. Mr. Chairman, thank you and thanks for holding this hearing. I appreciate all of you being here and listening to you and the expertise that you bring to the table.

Last week, the Fed Chair came out and said that one of the reasons that the economy is struggling to recover is because many households have limited access to credit, either because of their credit histories or the value of their homes being underwater. So, for many people, traditional banking products are not available to them, and it cannot be more true than in the State of Nevada right now, where, unfortunately, we need the Nation in foreclosures, short sales, and bankruptcies. So, we have alternative financing quite available in the State.

Ms. Klein, I have a couple of questions for you. Customer satisfaction—what is the customer satisfaction on your product?

Ms. KLEIN. Sure. So, we survey our customers once a month for all of Enova's products. We consistently see greater than 90 percent satisfaction. We also see that nine out of ten would recommend this product to a friend, and that is saying a lot because people do not always want to talk about credit and how they are accessing credit. So, customers are very grateful for the products we provide and very satisfied with the service.

Senator HELLER. What is your percentage of return borrowers?

Ms. KLEIN. So, for NetCredit, because we are doing longer-term loans and we actually just launched this business in 2012, I do not have a lot of data on that. Our average loan is about 20 months. But, again, the loans are structured so that these customers can repay over time. I think we have talked a lot about the lump-sum payment. That can be difficult for some consumers, so we are trying to provide another option out there.

Senator HELLER. OK. Alternative financing—can that help an individual's credit score?

Ms. KLEIN. Absolutely. A product like NetCredit can. So, typically with a payday product or a 2-week product, the bureaus will not accept that data. So, at TransUnion and Experion and Equifax,

even if you wanted to report performance data, they will not take it. They do not see it as relevant to their main customer who is a bank who wants to know if they should write a mortgage loan or an auto loan or a student loan.

But, with these longer-term installment loans, the bureaus are happy to take that data, and we now have contracts with all three bureaus to start reporting our data. Again, these people have very low credit scores. I think you quoted a 517 or so average. We see that same, you know, 500 to 650 range. I think, without these products, people have no way to build back. So, this can be a starting point. These installment loans can get people back into the system, build credit with the major bureaus, and that way, they can access banking products in the future.

Senator HELLER. Do you have any success stories? We hear all the horror stories. Do you have any success stories of people avoiding foreclosures, losing their cars?

Ms. KLEIN. You know, I get emails all the time, so we actually have a feedback email, and I have that set to go directly to my inbox because I want to see firsthand the customer feedback, and definitely, we have customers all the time who email us. I would say, as our business grows, it is starting to be about one a day, and so I look forward to those emails. And people tell us, hey, this product was really a lifesaver. You know, without this product, I do not know what I would have done.

Another thing that is interesting, everyone talked a lot about monthly bills, and one comment I want to make, you know, we do ask customers how they use the product, and sometimes people will say monthly bills. And then when you ask a little further, they say, well, you know, my mom was really sick and she was in the hospital and I had a lot of medical bills, blah, blah, blah. Now, 6 months later, I am having a hard time paying my rent.

So, when people say "monthly bills" and you stop there and you do not ask, what was really the cause, a lot of times, we see it was unexpected expenses. But what they need the money for today is their rent. And so when they say monthly bills, what they really mean is something happened a week ago, a month ago, or 2 months ago that drowned my savings, and because of that, I now need to borrow.

Senator HELLER. Ms. Klein, thanks for you comments.

Mr. Chairman, I have no further questions.

Chairman BROWN. Thank you, Senator Heller.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chairman.

Mr. Flores, you argued in support of, I think it is H.R. 1566——

Mr. FLORES. Yes, sir.

Senator MERKLEY. ——which essentially strips State laws. In Oregon, we have a 36 percent cap, and we put it in place in 2007. Since then, the citizens of the State have the access to those loans that, with the up-front fees, the annualized interest rate may be higher, but, essentially, on a longer-term rollover—because you can only use the fees once—the cost is much, much less than before. So, they still have access to credit, so there is no access to credit issue here. They just get it at a much, much cheaper price. So, why would anyone in Oregon want to roll back those State provisions,

as you suggest? Maybe you could just give one or two very short points of why an Oregonian would want to go from a 36 percent cap to no limit.

Mr. FLORES. I do not think the bill precludes that companies could not offer——

Senator MERKLEY. There is no cap in the bill, right?

Mr. FLORES. Pardon me?

Senator MERKLEY. The bill—there is no cap in the bill.

Mr. FLORES. That is correct. What I want to say——

Senator MERKLEY. Why would anyone in Oregon want to go from a 36 percent——

Mr. FLORES. I think a national charter would not preempt local companies from abiding by the Oregon statute. My point is choice. If the customer wants to use that product, that is fine. But the issue is the Internet. They can go out there and see other products that are available, and with the advent of that, these boundaries, these State boundaries really have gone away——

Senator MERKLEY. Thank you very much. I did not see anything in there that explained why someone would choose a 500 percent loan and why they would want access to that when they have the advantage of a much lower interest rate currently.

Ms. Klein, you said you do not offer payday loans, so I went to your Web site here on the old pad and it immediately says upfront, payday loans. Why did you testify that you do not offer payday loans?

Ms. KLEIN. So, I believe my specific words were that I do not operate our payday loan business. Enova has multiple products. My area of expertise——

Senator MERKLEY. I see.

Ms. KLEIN. ——and the business that I have been running for 3 years is NetCredit——

Senator MERKLEY. OK.

Ms. KLEIN. ——which does only offer installment.

Senator MERKLEY. So when I see—go to Enova and I see a payday loan, and I checked a 14-day loan it is 683 percent, you do offer payday loans, but you also offer this new product in installment loans.

Ms. KLEIN. Correct. You know, Enova is actively moving and has actually transitioned several States in the past 2 years from payday loans to installment loans. But, we are so limited by State law that in some States, we are forced to offer just that 2-week solution, and that solution does not help people build credit——

Senator MERKLEY. OK. All right.

Ms. KLEIN. ——so, it is a shame, in my opinion, but it is what we have to work with.

Senator MERKLEY. Thank you very much. I found it very interesting that when we were debating putting a cap on payday loans in Oregon, the same arguments were made, that, somehow, citizens would feel they wanted more choice, the choice to have interest rates that drive them into a vortex of debt and drives them into bankruptcy. But, amazingly, since we passed this law in Oregon, I have never heard one Oregonian say that they are unhappy with the law, because they get the same access to credit but at phenomenally lower rates.

I was very struck by going to a food bank and having the director of the food bank say—the first thing she said to me was, "Thank goodness you passed that bill, because we used to have a stream of people coming to the food bank who were driven into bankruptcy by payday loans and now we do not."

If we can phenomenally increase the quality of life for millions of people across this country, why do we not do it? We have done it in Oregon. Why do we not do it across this country? Why would we possibly consider savaging State laws that—State laws that have improved the quality of life for millions of citizens?

I want to tell you, the main thing I am concerned about is the opposite, and that is the effort of folks to exploit loopholes to continue to offer extraordinarily high interest loans in States that have deliberately put caps into place. We heard about Ohio. Well, in Oregon we covered all consumer loans and, therefore, what we see is the two loopholes are basically Federal chartered organizations that can bypass the State laws, and second of all, we see online lenders who illegally take payments out of Oregonians' bank accounts through remotely generated checks and through electronic funds transfers. So, the SAFE Act that Senator Tom Udall and I are championing stops these predatory practices.

Mr. Bourke, should not a person have control over their bank account in order to make sure that folks violating Oregon State law not just reach in and take their funds away from them?

Chairman BROWN. And Mr. Bourke, answer very quickly. There are 10 minutes left in the vote and I want both Senator Menendez and Senator Vitter to get close to their 5 minutes, so give us a quick answer.

Mr. BOURKE. Absolutely. Online lending is growing, but it is not growing because of State regulation. Online lending is at the same level in all types of States, regardless of whether payday loan stores are there. That is one point I wanted to make.

Two, yes, we have seen in our research, and we will be publishing on this in the coming months, that in online lending especially, there is a big problem with people losing control of their banking accounts, being subject to unscrupulous lenders in some cases, aggressive debt collectors, and in some cases fraudsters who purchase information from lead generators.

Senator MERKLEY. Thank you very much.

Chairman BROWN. Senator Menendez.

Senator VITTER. We are not——

Chairman BROWN. I am sorry. Senator Vitter, and then Senator Menendez.

Senator VITTER. Thank you, Mr. Chair. Thank you all for being here.

First, I want to say that I am absolutely supportive of all efforts to enforce the law, Federal law, State law, to cut out any abuses, any predatory practices. However, having said that, I am very concerned that that has expanded to an overall effort to shut down that entire industry, whether folks are following the rules or not. And I have heard many documented examples of that that really raise my concern.

So, I wanted to ask Mr. Rothstein and Ms. Martin in particular, have you heard of Operation Choke Point and do you think it is

a broader effort and has morphed into a broader effort to shut down folks in that space, whether they are following law and the rules or not?

Ms. MARTIN. I actually am not familiar with it. I am sorry.

Senator VITTER. OK.

Mr. ROTHSTEIN. Senator, I had never heard of it until it was mentioned this morning. I will say, though, that in Ohio, we have, as I testified earlier, we have about four different competing different loan acts that are being used and I think it would be hard to argue that the one that lenders are using the most in the storefronts, which is called the Ohio Second Mortgage Lending Act, which was designed for mortgages, makes sense for payday lending.

Senator VITTER. OK. Let me go back to my concern. I have talked to a number of banks who have said their regulators are coming and telling them not to service folks in that sector, to stop that. And let me submit for the record an email that makes this point. This is from a bank to a customer who is in that business, and the relevant part is this. Quote, "Based on your performance, there is no way we should not be a credit provider. Our only issue is, and has always been, the space in which you operate. It has never been the service that you provided or the way you operate. You have obviously done a brilliant job. It is the scrutiny that you and now that we are under," close quote. So, I would ask to submit this for the record.

Chairman BROWN. Without objection, so ordered.

Senator VITTER. I also submit for the record a similar email, again, from a bank to a customer, saying, we cannot work with you anymore. And it gets the same message across in somewhat more scrubbed, less direct language.

Do you support regulators pushing banks to not service anyone in that space, irrespective of whether their customers in that space are following the rules or not? Mr. Rothstein.

Mr. ROTHSTEIN. Yes. So, Senator, the——

Senator VITTER. It is a yes or no, and you can elaborate——

Mr. ROTHSTEIN. I just want to make sure I understand your question.

Senator VITTER. Yes.

Mr. ROTHSTEIN. So, you are asking, do I support the restriction of capital——

Senator VITTER. Do you support regulators pushing their regulated banks to cutoff credit to these customers, irrespective of whether these customers in that particular space are following the law, following the rules, or not?

Mr. ROTHSTEIN. I would have to look at it more.

Senator VITTER. So that is a close question to you.

Mr. ROTHSTEIN. I just would have to look at the issue——

Senator VITTER. Ms. Martin.

Ms. MARTIN. Yes, I am really not sure, either, because I do not know—without any facts, I cannot answer it. Sorry.

Senator VITTER. Well, it was a pretty straightforward question. I find it very troubling that banks are being strongarmed to cutoff credit, to cutoff a lifeline to these businesses, even if these businesses are following the law. There is no issue in these two cases

and many other cases that they are not following the law, they are not following the rules. There is a determined effort from DOJ to the regulators to simply cut people out of that space, to cutoff their credit, to use other tactics to force them out of business.

I find that deeply troubling, in part because it has no statutory basis and no statutory authority. We have rules. We should have rules. Maybe we need additional rules—we should debate them—about preventing any abuse, any predatory practices, et cetera. These are cases that do not involve any of that.

Thank you.

Chairman BROWN. Thank you, Senator Vitter. The basis is safe and sound practices, ultimately, and I would think that is where the regulators are looking here.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chair. I think this is an incredibly important hearing.

I have many of the concerns some of my colleagues have expressed, but I also look at the FDIC report that says that one in 12 American households is unbanked, meaning they do not have a checking or savings account at an insured depository institution. One in five American households is considered underbanked, meaning they have access to a deposit account, but they also rely on alternative financial services, such as nonbank check cashing or lending places. Together, these groups account for about 34 million households, about 61 million adults. That is about 20 percent of the American population.

So, while I am concerned about their access to credit and to capital and to be able to get access to the monies that they need to get by and the terms under which they borrow, I am mostly concerned that I have not heard any real meaningful efforts to create the access that these individuals need. I have heard reforms to the existing system, but I have not heard about alternatives, and that is concerning to me.

The other thing that is concerning to me is that I know in my home State of New Jersey, in fact, we have thousands of people who go online to borrow money, but these are entities that are offshore, which means there is no regulatory process in the United States that is supervising that.

So, Mr. Flores, with reference to that legislation that exists over in the House about creating a national charter for online short-term loans, what would that do both to the question of those who are offshore and the question of access to credit for people?

Mr. FLORES. Well, I think it would certainly help eliminate that offshore unlicensed question. But to your point on folks in New Jersey, the analysis we did of the 60 million applications, the top ten States are 20 percent of the States in the country, 56 to 63 percent of applications came from those top ten States. Five of those States, including New Jersey, New York, North Carolina, are States that prohibit or limit payday loans or other short-term credit. So, the demand is there. As you are saying, people are going online, looking for the product.

I think a national product with defined rules and regulations will benefit consumers such as your constituents in New Jersey and

others where State law inhibits their ability to gain access to credit.

Senator MENENDEZ. Ms. Klein, what is—I think we have a good understanding of traditional short-term or payday lending models that have existed in States for years, but I am curious to know of any innovations to changes to loan products that may create more flexibility for consumers and at the same time help them to build credit histories that will move them toward more mainstream banking. Is there anything that your company does, or are you aware of others in the industry? And I am happy to listen to others, as well.

Ms. KLEIN. Absolutely. Thank you for that question. And I really think the NetCredit product that Enova offers exemplifies what you are looking for. So, we have risk-based pricing. It is not a one-size-fits-all model. We can actually—we have the analytics and we have put the technology in place to distinguish high risk from low risk and price accordingly. We are giving customers the control to customize their payment amount, and again, in real time, as they change. If they want a lower payment, they see that tradeoff of it is going to take you longer to pay back and you are going to pay a higher total cost. So, giving the consumer transparency, power, control over designing their loan.

Credit building that you hit on is one of the most important pieces, and again, these short-term products that are 2 weeks, I think they serve a place in the marketplace for some people. I think they are an appropriate product if someone can afford to pay back in full. We have seen a lot of data that that is not the case for everyone. And so for those consumers who are looking for larger loan amounts and longer term, a product like NetCredit would be great.

The issue is, we are only in 12 States today. There are more States where you can offer a viable payday product that everyone here is saying is not ideal for a lot of people than States where you can offer a product like NetCredit that can build credit.

Senator MENENDEZ. Realizing that we have a vote on, I am going to yield the balance of my time so that my colleague——

Chairman BROWN. Thank you.

If you want to do one question, Senator Moran. Thanks for the work on prize-link savings you are doing, and, I mean, one really quick question, because the vote is imminent.

Senator MORAN. Mr. Chairman, thank you very much. I was not expecting you to be so considerate, but this hearing is important. I have three going on at the same time this morning.

But I wanted to, in listening to Senator Vitter, I would associate myself with his remarks. I do not understand why Members of Congress do not see this action by DOJ and banking regulators as a terrible intrusion upon Congressional authority. If there is a problem in this space, as Senator Vitter said, this is a matter to bring to Congress and for us to determine what the laws should be, what the regulation should ultimately result from that law. And so I miss the days in which there were Members of Congress who spoke for the role of Congress in making policy decisions as compared to deferring to regulators, and particularly in this case, to a regulator who is using their tremendous authority over financial

institutions to choke off access to credit to an industry that is currently legal.

So, this whole thing just is terribly troublesome to me on a broad philosophical point of view, and I would say that we have agreed to sponsor legislation for Federal regulation of this industry if we can find colleagues in this Committee and elsewhere to join with us in that effort, and so if there is a problem, let us make certain that Congress plays its Congressional role.

Mr. Chairman, thank you for the opportunity to speak.

Chairman BROWN. Thank you, Senator Moran.

Thank you to the whole panel. The vote is imminent, and Senator Moran and others, including I will do the same, will submit questions to you, and please get to us the answers as quickly as you can. Thanks for your input, and a good hearing. Thank you.

The Committee is adjourned.

[Whereupon, at 11:18 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF G. MICHAEL FLORES

CHIEF EXECUTIVE OFFICER, BRETTON WOODS, INCORPORATED

MARCH 26, 2014

Good morning, Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee. I am grateful for the opportunity to speak with you today on the issues of consumer credit and discuss the results of a study my firm recently completed on the customer and loan usage characteristics of online short term loans.

I have worked in banking and consulting for more than 30 years and in the past 15 years I have conducted research short-term consumer credit including overdrafts and payday loans and studied prepaid cards for the last 6 years. I am also on the faculty of the Pacific Coast Banking School at the University of Washington where I teach a retail banking course.

Based on my most recent research which was commissioned by the Online Lenders Alliance and analysis of other studies, the need for short-term, low dollar products is real and the demand is growing.

The Center for Financial Services Innovation estimates the underbanked annual demand for unsecured short-term credit to be more than $61 billion with:

- Overdrafts accounting for $8.3 billion (from a total of $38.3 billion in total overdrafts extended);
- Deposit advance of $4.3 billion which, in my opinion, will now move to overdrafts given the exit from this market by six large banks;
- Internet payday of $18.6 billion and Storefront payday equaling $30.1 billion.

The intent of the study was to:

- Build a first of its kind analysis within the industry to understand the data that is currently available from the specialty credit bureaus and lenders;
- Understand the strengths and weaknesses of the currently available data;
- Establish a baseline from which an annual update is planned;
- Catalogue and understand customer demographics and loan characteristics;
- Compare this data with all other available data including the Pew study and the CFPB report on storefront lending in order to add information to the discussion.

We analyzed:

- 60 million application records and nine million loan records from three specialty credit bureaus for a 4-year period beginning in 2009.
- Because of certain constraints in the credit bureau data, we augmented this with 1.6 million customer records from three lenders and four loan portfolios.
- The key findings track closely with Pew and CFPB with a few exceptions:
  - Customer median age is 39 with an annual income of $30,000 and is primarily paid bi-weekly;
  - The average loan amount was $388 with a range from $300 to $500 with the average loan amount increasing each year from $380 in 2009 to $530 in 2013;
  - The annual number of loans ranged from two to four with the 30 percent of the customers with only one loan;
  - The annual days' indebted range from 70 days to 106 days as compared to the Pew research of 144 days and the CFPB storefront analysis indicating 199 days of indebtedness.
  - Finally, the loan performance data from the credit bureaus indicate that 71 percent of loans were reported as paid and 89 percent had no charge-off flag.

I believe the growth of the loan amount as well as the intensity of usage measures has led to an important trend in the industry's move from a 2 week product to an installment product with longer terms.

These installment loans should be less expensive than the traditional 2 week product. That said, there is still value in the 2 week product because it fits into a continuum of credit services and is usually less costly than overdrafts which are less costly than returned NSF items.

Innovative companies, many of them operating exclusively on the Internet, are trying to design flexible products to meet that demand. The emergence of peer to peer lending is another example of this trend.

In my discussions with many of these companies, they say real innovation is limited because of the patchwork of legacy State laws governing access to short-term credit products.

Federal law is needed to establish the rules and regulations necessary to provide access to credit for consumers nationwide and allow companies the regulatory certainty they need to meet this growing credit need and to innovate and drive down costs. H.R. 1566 is designed to address this concern. The bill may need some work, but it has close to 50/50 bipartisan support in the House and offers the best current vehicle in Congress to help consumers.

Thank you for your time and I look forward to answering your questions.

PREPARED STATEMENT OF STEPHANIE KLEIN

DIRECTOR, NETCREDIT CONSUMER LENDING, ENOVA INTERNATIONAL

MARCH 26, 2014

My name is Stephanie Klein, and I am a Director of Consumer Lending for Enova, a global leader in online financial services headquartered in Chicago. Thank you for the opportunity to share Enova's experience before this Committee.

Senators, I am here to tell you about the exciting new credit solutions we have been developing, what we have learned, who we are serving, and how we can help underserved consumers have equal access to quality credit. We believe we can change the dynamics in the industry and provide a pathway toward upward mobility that will benefit millions of hardworking Americans who have been left behind by traditional Banks.

At Enova, since our launch in 2004, we have been using advanced technology and analytics to create products that meet consumers' evolving credit needs. I oversee NetCredit, one of Enova's newest installment loan products for U.S. consumers. With NetCredit, customers can borrow 1 to 10 thousand dollars and pay back in fully amortizing installments over 6 to 48 months. Payment amounts are typically just 6 to 8 percent of gross paycheck. We derived this ratio through rigorous testing, but we have also released a new tool where customers can vary their payment amount and see the impact on total duration and total cost of borrowing in real-time.

Our customer demographic presents a unique challenge when it comes to pricing. While our customers typically have moderate incomes, usually ranging from 40 to 60 thousand dollars per year, they also have very low credit scores. Compared to the average U.S. FICO score of 689, 90 percent of NetCredit customers score below 650, and the majority fall well below 600. In short, we are serving very high-risk borrowers who traditional Banks are not willing or able to serve.

Our answer to this challenge is a unique risk-based pricing algorithm. By leveraging multiple data sources and evaluating hundreds of variables, we've been able to successfully distinguish high-risk customers from low-risk customers and price accordingly. As a result of this innovation, our average interest rates are 50 percent lower than other leading online lenders and almost 75 percent lower than a typical payday loan product. Furthermore, because we use the simple daily interest method, customers can save money by making early payments when they have extra funds. In fact, roughly one-third of our customers choose to pay off their loans early.

Over the past 2 years, we've been working hard to foster relationships with the major credit bureaus and have dedicated significant resources to building the technology necessary to report performance data. We are very excited to help our customers build credit history in order to achieve a brighter financial future.

Now that I've told you about one example of how Enova is innovating and the benefits we can offer our customers, let me tell you about the significant challenges we face due to the current regulatory landscape. It is our belief that the current State laws do not adequately serve consumers. Instead of working toward innovative solutions that can be scaled across 50 States, we are forced to develop new products for individual States within the constraints of antiquated consumer credit statutes that were not drafted for current technologies or Internet lending. In many cases, instead of allowing customers a choice of quality credit options, current State law forces borrowers into single payment loans.

Our mission at Enova is to create high-quality, innovative products that can not only serve an immediate credit need, but can also help consumers achieve a better financial future. We have proactively shared our experience with groups like Center for Financial Services Innovation and the CFPB's Project Catalyst in an effort to promote policies that will help working families throughout the country achieve

equal access to quality credit. We envision uniform Federal standards that enable innovation to meet the needs of today's increasingly mobile, tech-savvy consumers.

I encourage you to support legislation to modernize our laws. Thank you, Chairman Brown and Committee Members, for permitting me to present this testimony. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF NICK BOURKE

DIRECTOR, SAFE SMALL-DOLLAR LOANS RESEARCH PROJECT, THE PEW CHARITABLE TRUSTS

MARCH 26, 2014

Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee, thank you for the opportunity to join in your discussion about alternative financial services. My commentary will focus mainly on small-dollar loans, including payday and installment loans. Also included below are observations based on Pew's latest research about general-purpose reloadable prepaid debit cards.

As the director of the small-dollar loans project at The Pew Charitable Trusts,[1] I appreciate the opportunity to engage with you on these important consumer finance issues. The following comments are informed by in-depth research that Pew has conducted over the past 3 years. This research includes nationwide telephone surveys (representative of all payday loan borrowers,[2] and all prepaid card users), more than a dozen focus groups with consumers across the country, a case study of Colorado's legislative decision to replace the conventional 2-week single-repayment payday loan with a 6-month installment loan, and other analysis.

I. Small-Dollar Loans (Payday and Installment Loans)

Pew has published three full-length reports in our *Payday Lending in America* series, as well as various summaries, all available at *www.pewtrusts.org/small-loans*. Data discussed throughout these comments are based on Pew's research as well as analysis of industry and regulatory data, unless otherwise noted. For your convenience, I have appended to these comments a two-page summary of key findings from our payday and small-dollar loan research, and a copy of Pew's policy recommendations for reform in this market.

Background: Payday Loans and the Financially Fragile, "Thick-File" Consumers Who Use Them

Thirty-five States allow conventional payday loans, and approximately 12 million Americans use payday loans annually. These are loans usually due in full on the borrower's next payday and secured by a postdated check or authorization to debit a checking account. The loans average $375, have a term of about 2 weeks, and carry an average fee of about $55 per pay period. The median borrower keeps a loan out for 5 months of the year and spends $520 on finance charges to repeatedly borrow the same $375 in credit.

Most payday borrowers (69 percent) in Pew's national survey reported that they turned to the loan to get money to pay ordinary living expenses, including rent, utilities, and credit card bills. Only 16 percent of borrowers used the loans for an unexpected expense, like a car repair or medical emergency.

The research paints a vivid picture of ongoing financial struggle. Six out of ten borrowers report that they have trouble paying bills at least half the time, with one quarter of all borrowers reporting that it is difficult to pay bills every month. Such persistent difficulty often leads to desperation. Thirty-seven percent of payday borrowers say that they have been in such a difficult situation that they would take any payday loan, on any terms offered. People who are facing such dire financial

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[1] The Pew Charitable Trusts is a nonprofit, research-based organization. Our work includes providing research and analysis to help ensure a safe and transparent marketplace for consumer financial services. We conduct research that identifies the needs, perceptions, and motivations of those who use payday and similar loan products, as well as the impact of market practices and potential regulations.

[2] Pew's telephone survey followed the highest methodological standards, including random digit dialing (RDD) to fixed-line and mobile phones in every State, a minimum of six attempts per phone number, and inclusion of Spanish speakers. The survey initially screened 49,684 respondents to identify a sufficient number of people who had reported using a payday loan (both storefront and online cohorts were established). Depending on the question, between 451 and 703 payday loan borrowers completed the in-depth opinion survey. The margin of error for usage and demographic data from the survey is 0.2 percentage points. For the in-depth opinion research, the margin of error is between 4.2 and 4.6 percentage points, depending on the question.

circumstances report feeling grateful to receive payday loans, which usually require little paperwork. Yet most also say that the loans take advantage of them.

While it is true that payday loan borrowers have few credit options available to them, it is not because they lack access to the mainstream credit market. Rather than being "thin-file" or "no-file" consumers who are creditworthy but unable to find lenders willing to do business with them, most payday loan borrowers are "thick-file" consumers who have substantial (negative) experience with debt. In other words, payday borrowers are not trying to get into the mainstream credit system; they are failing out of it.

Typical payday loan applicants have poor credit scores in the low 500s,[3] indicating an assessment by credit reporting agencies that they are already overburdened with debt and/or struggling to meet financial obligations. 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 other debt. Most payday borrowers also pay overdraft fees, and this fact is a reminder that payday loans do not eliminate the risk of overdrafting.[4]

Loan Payments Average One-Third of a Borrower's Next Paycheck—An Unaffordable Burden

When a payday borrower gets a loan, he or she usually uses it to help pay rent, utilities, or other bills. The loan temporarily solves these problems. However, on the borrower's next payday, the full amount of the loan—plus the fee—is due. For an average storefront loan, the amount due on payday is $430. For someone who makes $31,000 per year, the median payday borrower's income nationwide, $430 represents 36 percent of his or her bi-weekly income, before taxes. By contrast, Pew's research has found that most borrowers cannot afford to pay more than 5 percent of their pretax paycheck toward a loan payment while still meeting their other financial obligations.

Sacrificing one-third of their paycheck to repay a payday loan makes it harder for borrowers to pay their regular bills. Consequently, most renew or quickly reborrow a loan to make ends meet, with many retiring their debt only after a cash infusion, like a tax refund or assistance from family or friends, to repay the loan. While the loans are marketed as short-term fixes, they are usually experienced as long-term burdens. The average borrower carries payday loan debt for five months of the year, and most borrowing is consecutive (three-quarters of all payday loans originate within one pay period of a previous loan).

Lenders' profitability relies on this repeated usage. Industry analysts estimate that customers do not become profitable to payday lenders until they have borrowed four or five times.[5] Researchers at the Kansas City Federal Reserve found that "the profitability of payday lenders depends on repeat borrowing,"[6] a sharp contrast to official statements from the industry that payday loans are not meant as a long-term solution.[7] In Pew's analysis, lenders' reliance on long-term borrowing behavior indicates a fundamental flaw in the business model that can only be addressed by requiring loans to be structured differently (mainly, as installment loans).

The required lump-sum payment far exceeds the borrower's ability to repay, yet lenders maintain profitability by relying on some unique benefits granted to them by State laws. Payday lenders have the 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 repay the loans and quickly reborrow, effectively paying an interest-only fee to reset the due date to the next payday. This extraordinary form of loan collateral, which is achieved through use of postdated checks or electronic access to borrowers' checking accounts, acts as a "super lien" against the borrower's income stream that allows lenders to thrive even as they make loans to those who cannot afford them. This power to capture borrower income

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[3] 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.*

[4] Pew's survey shows that most payday borrowers have overdrafted in the past year. See also Consumer Financial Protection Bureau, "Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings" (2013), *http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.*

[5] David Burtzlaff and Brittny Groce, "Payday Loan Industry" (Stephens Inc., 2011), 15.

[6] Robert DeYoung and Ronnie J. Phillips, "Payday Loan Pricing", (Federal Reserve Bank of Kansas City, Economic Research Department, February 2009), 7, *http://www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf.*

[7] Community Financial Services Association of America, "Is a Payday Advance Appropriate for You?" accessed Sept. 20, 2013, *http://cfsaa.com/what-is-a-payday-advance/is-a-payday-advance-appropriate-for-you.aspx.*

enables lenders to make small-dollar loans without underwriting them to ensure that the borrower can both repay the loan and meet other financial obligations without having to borrower again to make ends meet.

The Lump-Sum Payday Loan Is a Failed Product

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 harmful product are warranted. Pew's research and analysis show that clearly, and just this week the Consumer Financial Protection Bureau (CFPB) released a new white paper[8] with yet more proof that the lump-sum payday loan is a failed product. The CFPB's analysis of millions of payday loan records vividly demonstrates that the payday loan is not the short-term product that it claims to be, and that costly, long-term borrowing is the rule and not the exception. The report also shows that anything short of fundamentally reforming how small-dollar loans are structured would be an inadequate policy response to these problems. Overall, the CFPB's latest report sets a high bar for what the policy solution needs to be, and it leaves little doubt that the CFPB should require an ability to repay standard for the small-dollar loan market. Pew's research shows that such reform would eliminate the worst problems in this marketplace without significantly impacting access to credit.

Pew's Policy Recommendations for the Small-Dollar Loan Market (Payday and Installment Loans)

Pew has called on policy makers to act urgently, and take one of two approaches to addressing this problem. Policy makers can choose to prohibit high-cost payday loans altogether (as 15 States have done), or permit them only with substantial structural reforms to ensure the loans have affordable payments and follow a few sensible safeguards to ensure a safe and transparent marketplace.

To support the CFPB and other policy makers, Pew has proposed five regulations for reforming payday loans. These rules will minimize harm to consumers and make all small-dollar loans more affordable. To ensure an effective and simplified regulatory environment for all lenders, these recommendations are intended to apply to all small-dollar loans, including payday and installment loans, with the exception of pawn loans. What follows is a summary (detailed recommendations are attached).

1. Limit payments to an affordable percentage of a borrower's income. Monthly payments above 5 percent of monthly pretax income are unaffordable for most borrowers. Loans requiring more should be prohibited unless rigorous underwriting shows that the borrower can repay the loan while meeting other financial obligations.
   This recommendation is intended to provide a clear yet flexible ability-to-repay standard, one that may accommodate lenders by providing for a low-cost and streamlined underwriting process while requiring most loans to be restructured as affordable installment loans (as opposed to unaffordable lump-sum repayment loans). Such a standard is flexible, easily accommodating various levels of income, pricing, and loan size.
2. Spread costs evenly over the life of the loan. Front-loading of fees and interest should be prohibited. Any fees should be spread evenly over the life of the loan, and loans should have substantially equal payments that amortize smoothly to a zero balance.
   This recommendation addresses a common problem found in installment loan markets intended to serve those with damaged credit histories. When origination fees or other front-loaded charges make the first month of a loan substantially more profitable for the lender than subsequent months, lenders have an incentive to encourage borrowers to refinance loans. When loans are frequently refinanced, borrower costs increase dramatically, lenders can mask defaults by inviting struggling borrowers to skip a periodic payment in exchange for for-

[8] The Consumer Financial Protection Bureau, "CFPB Data Point: Payday Lending" (2014), *http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.*

feiting previously repaid principal, and the overall length of indebtedness can extend indefinitely.

3. Guard against harmful repayment or collections practices. Policy makers should prevent or limit the use of postdated checks and automatic withdrawals from borrowers' bank accounts. They should also make it easier to cancel automatic electronic withdrawals and protect against excessively long loan terms. *This recommendation is focused on protecting borrower checking accounts by ensuring that borrowers have the power to stop payments or close accounts to avoid unscrupulous or fraudulent lenders. It also recognizes that some small-dollar loans could have affordable periodic payments yet require repayment terms that last an unconscionably long time unless policy makers require shorter terms or ensure that each periodic payment includes a substantial principal reduction.*
4. Require concise disclosures of periodic and total costs. Loan offers should clearly disclose, with equal weighting: the periodic payment schedule, the total repayment amount, the total finance charge, and the effective annual percentage rate (APR) inclusive of all fees.
   To make good decisions, borrowers need clear and reliable information.
5. Continue to set maximum allowable charges. Almost every State sets maximum allowable rates on some small-dollar loans because these markets serving those with poor credit histories are not price competitive. Policy makers may limit rates to 36 percent or less if they do not want payday lenders to operate, or somewhat higher if they do.

Research Shows Safeguards Can Work: A Case Study From Colorado

In 2010, Colorado lawmakers agreed that the State's 18-year experiment with conventional 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 6 months to repay the loans. 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. Pew's report, Payday Lending in America: Policy Solutions (2013), discusses the Colorado case study in detail.

Colorado's experience with their new payday loan law demonstrates that reforms such as those listed in Pew's policy recommendations are viable for both borrowers and lenders. There are at least eight clear benefits of Colorado's structural payday loan reform:

1. Borrowers maintained access to credit;
2. Lenders are still in business (half of stores still open in locations throughout the State);
3. Loan payments are more affordable (4 percent of paycheck now vs. 38 percent before);
4. The average borrower spends less ($277 now vs. $476 before);
5. Lender-charged bounced check fees are down 57 percent;
6. Defaults per year have declined 30 percent;
7. Making the loan safer and more affordable reduced the amount of oversight required to ensure consumer safety;
8. Credit counselors and elected officials report fewer people coming to them with payday loan problems.

Payday Borrowers Want Policy Makers To Act

On a final note regarding small-dollar loans, borrowers overwhelmingly want policy makers to act. Pew's nationally representative survey shows that, by a 3-to-1 margin, payday loan borrowers want more regulation of this market. Most borrowers favor requirements that would restructure payday loans into installment loans with more affordable payments. For example, eight in ten favor a requirement that loan payments take up only a small amount of each paycheck.[9]

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[9] The Pew Charitable Trusts, "Payday Lending in America: Policy Solutions" (2013), 22, *http://www.pewstates.org/research/reports/payday-lending-in-america-policy-solutions-85899513326.*

II. Prepaid Debit Cards and Why Some Consumers Are Turning Away From Banks

The following section highlights findings from recent Pew research about general-purpose reloadable (GPR) prepaid debit cards. GPR prepaid cards act like checkless checking accounts and are available from a wide range of companies, including many nonbank, alternative financial services providers as well as an increasing number of bank providers.

Millions of Americans are turning away from banks for some or all of their financial needs, because nonbank products are providing something most banks are not. A key finding from Pew's consumer research in the prepaid card market is that for many consumers, what they are seeking is better control over their finances—including safety from overdraft fees and security against overspending and the temptations of credit. Attempts to serve these consumers will be more successful if they are designed to help achieve these goals, and regulators should help ensure that consumers can successfully achieve the control and security that they seek. As explained further below, Pew's research has led us to conclude that GPR prepaid cards should not have overdraft or other automated or linked credit features, and that the CFPB should prohibit such features.

There Is a Large and Apparently Growing Group of Consumers Who Have Used the Banking System But Are Going Outside of It for Some or All of Their Financial Services Needs

Nationwide, 88 percent of GPR prepaid card users either have or used to have a checking account (59 percent of all prepaid users currently have a checking account). In other words, the vast majority of people who use prepaid cards have experience with bank accounts but have opted to go outside the banking system for some or all of their financial services.[10] (The prepaid card market is growing rapidly; a short summary of who uses prepaid cards is attached at the end of this comment letter.)

The Desire To Gain Control Over One's Finances—and Avoid Overdraft and the Temptations of Credit—Is Leading Millions To Seek Services Outside the Banking System

The fact that so many prepaid card users have or used to have bank accounts raises an important question: Why are so many people looking for financial services outside the banking system? Pew's nationally representative survey data show clearly that prepaid card users are trying to regain control of their financial lives, chiefly by avoiding debt; not spending more money than they have; avoiding overdraft fee; and insulating themselves from the temptations of credit.

[10] The Pew Charitable Trusts, "Why Americans Use Prepaid Cards" (2014), 7.
[11] Ibid., 14.

	Major Reason	Total Reason
Control Spending		
Avoiding credit card debt	52 %	67 %
Helping you not spend more money than you actually have	51	66
Dividing spending into budget categories	30	54
Control Fees		
Avoiding overdraft fees	46	63
Avoiding check-cashing fees	38	57
Make Purchases		
Making purchases online and other places that don't accept cash	51	72
Allowing you to conduct transactions more anonymously	35	56
You would not be approved for a checking account	26	44

Source: The Pew Charitable Trusts, 2014.[11]

And the reason that consumers are turning to prepaid cards to find this control is also clear: prepaid cards on the market today generally do not let consumers spend more money than they load onto the cards in the first place. In Pew's analysis, only eight percent of prepaid cards from the major national providers disclose an overdraft feature. The vast majority of cards explicitly disclose that overdraft is not possible (80 percent).[12]

Compare that to the checking accounts offered by the Nation's banks and credit unions, where overdraft penalty fees are ubiquitous, median charges are $25 per overdraft for credit unions or $35 for banks, and customers can typically be charged four such fees per day.[13]

A 2012 Pew survey showed that a strong majority of checking account holders nationwide feel that such overdraft programs are more harmful than helpful, and 75 percent of checking account customers said they would rather have a transaction declined than incur a $35 overdraft fee. New opt-in disclosures mandated in 2010 by the Federal Reserve have not resolved this situation: More than half of those who overdrafted since that time did not believe that they had opted in.[14]

Together, these findings show that when consumers choose prepaid cards, they are often seeking—and are generally finding—shelter from the risk of overdraft and overspending. Unfortunately, these benefits of prepaid cards may not last. Prepaid card providers typically retain the contractual right to change terms at any time for any reason, and there is little or no regulatory protection against overdraft or linked lines of credit. The CFPB should prevent overdraft and linked or automated lines of credit from proliferating in this market as a way of preserving the "prepaid" nature of the product and helping preserve the control mechanism that has drawn consumers to adopt it.[15]

Prepaid Card Users Do Not Want the Product To Have Overdraft or Linked Credit

Prepaid users want their cards to remain free of overdraft and automated or linked credit features. One driver of this sentiment is past experience. As noted

[12] The Pew Charitable Trusts, "Consumers Continue To Load Up on Prepaid Cards" (2014), 9-10, *www.pewtrusts.org/prepaid*.

[13] The Pew Charitable Trusts, "Checks and Balances: Measuring Checking Accounts' Safety and Transparency" (2013), *http://www.pewstates.org/research/reports/checks-and-balances-85899479785.*

[14] The Pew Charitable Trusts, "Overdraft America: Confusion and Concerns About Bank Practices" (2012), *www.pewstates.org/uploadedFiles/PCS_Assets/2012/SC-IB-Overdraft%20America(1).pdf.*

[15] For Pew's policy recommendations, see The Pew Charitable Trusts, "Consumers Continue To Load Up on Prepaid Cards" (2014), *www.pewtrusts.org/prepaid*.

above, the vast majority of prepaid card users have or used to have a bank account. Of these, 41 percent have closed or lost a checking account because of overdraft fees.[16] Thus, it is not surprising that 63 percent of prepaid users cite "avoiding overdraft fees" as a reason for using the card, with similar majorities saying they use the card for "avoiding credit card debt," and "helping you not spend more money than you actually have."[17]

Prepaid card users view mechanisms that would allow them to spend more money than they have as self-defeating. They find credit options tempting, and got a prepaid card to help them avoid the risk of overspending and overdraft fees. Altogether, 71 percent of prepaid users say they would not like to have the ability to overdraft their card balance for a fee, with 69 percent rejecting linked payday loans and 63 percent rejecting linked lines of credit. As one prepaid card user said in a Pew focus group, with credit features "it will turn into a credit card, and it will not be a prepaid card anymore. It will lose its meaning."[18]

Lessons From Prepaid

The case of prepaid cards demonstrates that there is a large and rapidly growing market for nonbank transaction accounts. Most prepaid cards offer the functionality of a checking account (direct deposit, ATM access, and in most cases electronic bill pay)[19] with one key distinction: no overdraft or ability to spend more than they have deposited. The fact that the majority of prepaid users also have a checking account strongly suggests that they are looking for services or features that banks are not providing. The strength of consumer opinion in favor of more control, and against overdraft and overspending, tells us what many consumers are looking for when they go outside the bank system. Yet bank checking accounts continue to place overdraft as a core product feature.

Looking forward, efforts to increase access to beneficial banking services must take these findings into account. Efforts that help consumers meet the goal of avoiding overdrafting and overspending will be more likely to succeed; efforts that do not take this goal into account or put consumers at risk will be more likely to fail. In May of 2012, the CFPB issued an Advance Notice of Proposed Rulemaking for the prepaid card market. In the announcement, CFPB director Richard Cordray noted that, while prepaid cards serve some of the most vulnerable among us, the cards also have far fewer regulatory protections than bank accounts or debit or credit cards.[20] When the CFPB takes the next step of proposing actual rules, it should ensure that overdraft and automated or linked lines of credit are firmly prohibited and do not spread into the prepaid card market.

In conclusion, I would like to thank you for allowing Pew to take part in this discussion. We especially hope that Congress will use its influence to help the Consumer Financial Protection Bureau to achieve its mission of enacting a strong, broad, fair, and principles-based regulatory policy for the small-dollar loan market. A summary of Pew's recommendations for small-dollar loan rules is attached and detailed information is available at *www.pewtrusts.org/small-loans*. My colleagues at The Pew Charitable Trusts and I would welcome the opportunity for further conversations at any time.

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[16] The Pew Charitable Trusts, "Why Americans Use Prepaid Cards" (2014), 8.

[17] Ibid, 14.

[18] Ibid., 21.

[19] Though prepaid cards generally have a version of deposit insurance and liability limits for unauthorized transactions, they are generally inferior to those on bank checking accounts—something policy makers should address. The Pew Charitable Trusts, "Consumers Continue To Load Up on Prepaid Cards" (2014).

[20] *http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-considers-rules-on-prepaid-cards/*

A series summary from THE PEW CHARITABLE TRUSTS | Oct 2013

Payday Lending in America

Series summary

Payday loans are controversial. They typically offer about two weeks of credit, due in full on the borrower's next payday, at annual interest rates of around 400 percent. While borrowers find fast relief, they are often left indebted for months, struggling to repay a loan that was marketed as a short-term solution. Proponents argue that payday loans are a useful form of credit for consumers who lack access to more conventional banking services, but opponents claim they overburden people who are already struggling to make ends meet.

The Pew Charitable Trusts' *Payday Lending in America* series details fundamental problems with payday loans and suggests solutions for promoting a safer and more transparent marketplace for small-dollar loans.

Selected findings

- 12 million Americans take out payday loans each year, spending approximately $7.4 billion annually. The average loan is $375.
- A payday loan is characterized as a short-term solution for unexpected expenses, but 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.
  - 69 percent of first-time borrowers use the loan for recurring bills (including rent or utilities), while just 16 percent deal with an unexpected expense such as a car repair.
- Payday loans are unaffordable.
  - Only 1 in 7 borrowers can afford the more than $400 needed, on average, to pay off the full amount of these lump-sum repayment loans by their next payday.
  - Survey and market data show that most borrowers can afford to put no more than 5 percent of their paycheck toward loan payment and still be able to cover basic expenses. In the 35 states that allow lump-sum payday loans, repayment requires about one-third of an average borrower's paycheck.
- Most payday loan borrowers have trouble meeting monthly expenses at least half of the time.
- 41 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.
- Payday loans do not eliminate overdraft risk. Most borrowers also overdraw their bank accounts.
- A majority of borrowers say payday loans take advantage of them. A majority also say they provide relief.
- Borrowers want changes to payday loans.
  - By almost a 3-1 ratio, borrowers favor more regulation of the loans.
  - 8 in 10 borrowers favor a requirement that payments take up only a small amount of each paycheck.
  - 9 in 10 favor allowing borrowers to pay back the loans in installments.

- Safeguards are needed to ensure affordability and protect consumers from the risk of lender-driven refinancing, noncompetitive pricing, excessive loan durations, and abusive repayment or collection practices.
  - Such safeguards can be applied in a way that works for lenders. Payday lenders continue to operate after a recent law change in Colorado, but borrowers spend less, and payments are far more affordable.
  - In states that enact strong legal protections, 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.

Policymakers should fix the problems with payday lending in the 35 states where it exists.

The Consumer Financial Protection Bureau and other state and federal policymakers should act now:

- 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.

Payday Lending in America reports

Who Borrows, Where They Borrow, and Why (2012)
How Borrowers Choose and Repay Payday Loans (2013)
Policy Solutions (2013)

Other resources available from Pew

Payday Loans Explained (video)
How Payday Loans Work (infographic)
Payday Loan Affordability Fast Facts (infographic)
Payday Borrowers Want Reform (infographic)
Pew's Policy Recommendations to Fix Payday Loan Problems (infographic)

For more information, please visit:
pewtrusts.org/small-loans

Contact: Andrea Risotto, communications officer, The Pew Charitable Trusts **Email:** arisotto@pewtrusts.org **Phone:** 202-540-6510

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

Excerpt from "Payday Lending in America: Policy Solutions"
The Pew Charitable Trusts (2013), www.pewtrusts.org/small-loans

Conclusion and initial policy recommendations

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

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

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

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

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

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

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

2. Spread costs evenly over the life of the loan

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

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

3. Guard against harmful repayment or collection practices

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

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

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

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

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

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

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

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

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

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

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

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

Borrowers want regulators to act

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

The limited benefits of access to credit

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

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

Summary of General Purpose Reloadable (GPR) Prepaid Card Users

U.S. consumers loaded about $65 billion onto prepaid cards in 2012, more than double the amount loaded in 2009.[21] The following data points provide a profile of prepaid card users:[22]

- 5 percent of adults, or about 12 million people, use prepaid cards at least once per month.
- The average prepaid customer reports household income of around $30,000 per year.
- Compared to the general population, prepaid card users are more likely to be renters, less likely to be married, more likely to earn less than $25,000, and more likely to be younger than 50 years old.

Summary of Pew's Policy Recommendations for GPR Prepaid Cards

Pew recommends the following policies be mandated by law or regulation:

- GPR prepaid cards should not have overdraft or other automated or linked credit features.
- Prepaid cardholders should be protected against liability for unauthorized transactions that occur either when a card is lost or stolen or a charge is incorrectly applied.
- GPR prepaid cardholders should have access to account information and transaction history.
- GPR prepaid cards should be required to provide information about terms, conditions, and fees in a uniform, concise, and easy-to-read format. This information should be included with the card packaging so that it is accessible pre-purchase at retail outlets as well as online.
- Prepaid card funds should be federally insured against loss caused by the failure of an institution.
- Pre-dispute binding arbitration clauses in cardholder agreements, which prevent cardholders from having the choice to challenge unfair and deceptive practices or other legal violations in court, should be prohibited.

For more information about Pew's prepaid card research, visit: www.pewtrusts.org/prepaid

[21] The Pew Charitable Trusts, *Why Americans Use Prepaid Cards* (2014), 13.
[22] Ibid., 1, 3.

PREPARED STATEMENT OF DAVID ROTHSTEIN

DIRECTOR, RESOURCE DEVELOPMENT AND PUBLIC AFFAIRS, NEIGHBORHOOD HOUSING SERVICES OF GREATER CLEVELAND

MARCH 26, 2014

Senator Brown and Ranking Member Toomey, my name is David Rothstein, director of public affairs for Neighborhood Housing Services of Greater Cleveland and research fellow in the asset building program with the New America Foundation. I appreciate the opportunity to testify before you today regarding small dollar lending, most commonly referred to as payday lending. For more than 10 years I have researched small dollar lending and financial services to low-income families.

Outlined in this testimony I hope to convey the importance of strong regulation around small dollar lending, particularly from the Federal Government, as local authorities wrestle to ensure consumers receive safe and affordable loan products. It is imperative that we look at the characteristics of the loan such as the APR interest rate and method of payback to assess the quality of the product.

First, the traditional payday loan model in Ohio and alive in dozens of other States does not serve families well. Research of actual borrowers continues tell this story in numerous ways—the latest *Pew Charitable Trust Research* and day old report by the CFPB providing the most startling research to date. I say that it doesn't serve them well because the average family takes out 8 to 12 loans per year from one lender, typically purchasing loans in back-to-back transactions. This is absolutely the typical Ohio customer. This means as soon as their loan is repaid, they immediately reborrow to cover other expenses. This is also the prototypical debt cycle. Our housing and financial capabilities counselors indicate that most clients have loans from about four different stores. Keep in mind that many families cannot afford to pay back the principle balance of the loan in just two weeks let alone interest and principle. If payback does occur, other monthly budget items suffer such as rent, utilities, food, and car payments.

Second, payday lenders in Ohio morphed into auto title and installment lenders. This is also quite typical. And also more expensive. Ohio's battle to reform and better regulate payday lending continues marking an almost 8 year conflict. In 2008, the Ohio General Assembly passed a bipartisan bill to curtail the interest rate, loan amount, and number of loans per year in Ohio. The law requires lenders to not sell more than four loans per person per year and not more than 28 percent APR interest. The reduction is significant since lenders charge 391 percent APR interest. The day after Governor Strickland signed the legislation, payday lenders and their trade association announced that they would go to the ballot, to the voter, and try to reverse the law. Despite spending at minimum $10 million, they suffered a wide-margined defeat with voters. Yet, not a single payday lender in Ohio uses the law (Small Loan Act) but rather two antiquated mortgage lending laws to sell loans at essentially the same price, if not more, than before.

Most recently, lending in Ohio expanded to include selling high cost loans using automobile titles as collateral. An auto title loan is more dangerous than a payday loan in the sense that people can and do lose their car once they are too far into debt. I have included a 3-part story from the *Akron Beacon Journal* about a working mother of three who lost her car and nearly her home after this loan. Installment loans, the newest payday product, offered by payday lenders carry a similar triple-digit interest rate and use the Credit Service Organization law to sell loans for up to 12 months. One loan that I analyzed cost a borrower $5,000 to borrow $2,000 over a 12-month period.

Finally, At NHS of Greater Cleveland, we practice what we preach. Since we advocate smart home ownership, we purchased our building in the recovering area of Slavic Village. Since we are notably critical of payday lending, we are developing two alternatives. Working with the innovative start-up company Employee Loan Solutions, we will be working with large employers to provide access to safe, underwritten, low-cost loans through their paycheck. The lender is a CDFI focused on providing low-income families with affordable financial products. The other program is a small dollar loan serviced and managed by NHS of Greater Cleveland. The intent is to comply with Ohio's payday lending law, the only group in Ohio to do so.

As this Congress and the Consumer Financial Protection Bureau consider rules and regulations around small dollar lending, a floor on small dollar loans will encourage high-quality innovation.

Lenders should be required to fully assess a borrower's ability to repay a loan, in full and on time, without the use of repeatedly cashing a check or electronically debiting an account. Just like mortgages or credit cards, ability to repay requirements protect borrowers from unsustainable debt. But when lenders have the ability

to collect payments using postdated checks or electronic transfers, they know they will get paid even if it causes financial hardship or forces a borrower to take out another loan to pay off the first. Lenders should not be able to use postdated checks and electronic payments to access a borrower's bank account if they are unable to repay a loan. The litmus test is that automatic payment should be a convenience for the borrower not a side-step to debt collection laws.

I appreciate your time and commitment to ensuring that low- and moderate-income families are best served in the financial sector. I am happy to answer any questions that you may have.

Akron woman works through financial situation involving lender

By Betty Lin-Fisher
Beacon Journal consumer columnist

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Jamela Lott organizes her kitchen in her new home Wednesday in Akron. (Karen Schiely/Akron)

- Betty Lin-Fisher: Auto-title loans can be detrimental to consumers

Three weeks ago, Jamela Lott was homeless.

But today, Lott and her three young sons are living in a rented house in West Akron, thanks to the kindness of strangers because of Lott's problems with an auto-title loan company.

Last August, the single mother of five (two children are grown), was falling behind on rent and borrowed $900 from Loan Max in Akron. She used her 2001 Oldsmobile Alero as collateral for the loan, with a lien placed on the title.

Lott made some payments, but eventually was unable to keep up. Lott said she paid $938 on the original $900 loan, but was told she owed more than $1,600 or had to face repossession of her car.

She drives to work, takes children to day care and school, and drives to night school while working on an associate's degree.

In January, she and her sons became homeless and entered the program of Family Promise of Summit County, which provides temporary shelter to homeless families and offers assistance.

Family Promise reached out to me and said Lott was willing to share her story because of what officials say is a problem with auto-title loans causing hardships for people.

A previous column about Lott is online at www.ohio.com/betty. I wrote about consumer advocates' belief that auto-title loans are more troublesome than payday loans. If payments are missed, the car can be repossessed and cars often are the only asset some people have.

Consumer advocates say auto-title lending doesn't assess the borrower's ability to pay back the loan. They believe state law loopholes allow auto-title lending in Ohio.

Legislation passed in 2008 limited percentage rates and terms that payday lenders could offer. But auto-title lenders say they are not payday lenders and operate under two other state laws — the Small Loan Act and Mortgage Loan Act.

Consumer advocates say they have been unable to convince any legislators to change the laws.

There was outrage expressed after Lott's story was shared.

Jeff Wilhite, director of Family Promise of Summit County, said his agency has become aware of other victims of auto-title loan practices.

Wilhite said the agency wants to gather stories to share with legislators in an attempt to include auto-title lending under payday lending laws.

Letters can be sent to Family Promise, 77 W. Miller Ave., Akron, OH 44301 or by email to info@familypromisesc.org.

"I'll use some of my public service experience and connections to try to expedite that if we can," said Wilhite, who previously worked for the city of Akron and the Akron Metropolitan Housing Authority.

Lott received offers of help from strangers to get her out of the loan problem. A donor who asked to remain anonymous offered to pay the entire $1,600 amount, plus $50 for gas.

Lott's Family Promise case worker, Erica Ward, and I took the money to LoanMax, where workers accepted the payment and gave Ward a receipt, marking her debt as paid.

That same day, LoanMax officials said they did not want the cash.

Pat Crowley got involved as a spokesperson for the Ohio Consumer Lenders Association, an industry trade group with payday and auto-title lender members.

Crowley said LoanMax intended to write off Lott's loan, and said Lott had not discussed anything with them since she had an attorney via Legal Aid.

In the end, attorney Harry McKeen settled with the LoanMax officials to write off Lott's debt and return the donor's money.

LoanMax originally wanted Lott to sign a document stating she would not take action against them or discuss the matter.

Lott was uncomfortable signing such a request and eventually the matter was dropped. McKeen was told by LoanMax there would be no negative effect on Lott's credit (LoanMax does not report on customers to credit bureaus) and there would be no negative income tax implications for the loan payoff.

Meanwhile, Beacon Journal readers who learned of Lott's problems sent in $1,160 in donations. They were used to help Lott accumulate a security deposit and first month's rent for her house. The original donor contributed $325 to complete the security deposit/first month's rent and paid $175 to get electricity turned on.

I returned the rest of the money to the donor. "I'm very excited there were so many people in the community who were willing to help her," the donor told me. "I'm glad she's on her way. Unfortunately, I can't help everyone, but hopefully someday, she can pass it on."

Glad to be home

Lott said she has been touched by the generosity of strangers.

"I've been crying all the time. I know that God sends people," said Lott of her three-bedroom house she moved into last week. She has no furniture and is working on buying items and getting donations. Her kitchen has no appliances but the landlord is looking into assistance on that. She bought a crock pot this week and said she cooked spaghetti and kept the leftovers in her cold car.

"It's beautiful to be able to come home. Thanks for helping us get our own little warm place," she said.

Unfortunately, I was not able to return phone calls to everyone who left messages about this story.

Community Legal Aid officials said they are willing to help people who cannot afford an attorney and are having problems with auto-title lending. People may call 800-998-9454. Eligible consumers will be referred to an attorney.

A Legal Aid official said the agency wants to raise the issue with legislators about the "detrimental effect of auto title loan abuses on Ohio consumers."

McKeen said he is working for Norma Poalson, 68, of Akron, who said she took out a $600 loan in April for a now-deceased friend who needed a chair lift. When Poalson fell behind on her payments, LoanMax rolled over her loan and gave her another $600. Poalson said she has paid about $2,200 on the loan and owes another $1,690 or faces repossession.

Another consumer, Rasheeda Jackson, said she took out a $600 loan in August and fell behind and her car was repossessed in January. To get her car back, Jackson had to pay $890, including $600 to the repossession company, which charged her storage fees and tried to ask for money to get things out of her car if she didn't pay the full fees.

Another reader told me a story that a repossession company asked for $45 to get his belongings out of a repossessed car. He did not have the money and lost his belongings.

LoanMax, via Crowley, said they do not allow the repossession company to charge clients to collect personal belongings. Crowley said it was the first time they had heard of such policies and they immediately addressed it with the auction company. If such charges are imposed, Crowley said they would terminate their contract with the company.

Crowley said because of privacy issues, LoanMax could not comment about other specific accounts. They issued this statement:

"Loan Max consistently goes beyond what state and federal law require by providing additional disclosures to ensure their clients fully understand the terms of their service agreement. If a customer falls behind, Loan Max is always willing to work with our customers by providing additional time to pay and alternative payment plans. Although it is uncommon, if a vehicle is repossessed it is because the customer has ignored repeated attempts by the company to contact them and make a payment arrangement. Loan Max uses reputable recovery companies (typically the same companies used by other financial institutions such as credit unions and auto finance companies) but they cannot control the pricing and policies of these companies."

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PREPARED STATEMENT OF NATHALIE MARTIN

FREDERICK M. HART CHAIR IN CONSUMER AND CLINICAL LAW, UNIVERSITY OF NEW MEXICO SCHOOL OF LAW

MARCH 26, 2014

Thank you, Chairman and Members of the Subcommittee for the opportunity to provide this written testimony in connection with the hearing entitled "Are Alternative Financial Products Serving Consumers?" Below I provide a background of my credentials, describe some of my research on high-cost credit, describe the different forms of high-cost credit, and then explain why I believe that enacting a Federal usury cap is the simplest and most effective way to regulate these forms of credit.

I. Background

My Credentials and Research

I am the Frederick M. Hart Chair in Consumer and Clinical Law University of New Mexico School of Law. This endowed chair is thought to be the only one in the U.S. dedicated to consumer law issues. Although I write in other areas as well, the primary focus of my research is high-cost loan products (which include payday loans, title loans, and triple and quadruple-digit interest rate installment loans), and public attitudes about these forms of credit.

My research on high-cost lending includes the articles listed below, which can be found at *http://papers.ssrn.com/sol3/cf__dev/AbsByAuth.cfm?per__id=1313797.*

"Interest Rate Caps, State Legislation, and Public Opinion: Does the law Reflect the Public's Desires?" 89 *Chicago Kent L. Rev.* 1 (2013) (with Timothy Goldsmith).

"High-Interest Loans and Class: Do Payday and Title Loans Really Serve the Middle Classes?", 24 *Loyola Consumer L. Rev.* 524 (2012) (with Ernesto Longa).

"The Alliance Between Payday Lenders and Tribes: Are Both Tribal Sovereignty and Consumer Protection at Risk?", 69 *Wash & Lee L. Rev.* 751 (2012) (with Joshua Schwartz).

"Grand Theft Auto Loans: Repossession and Demographic Realities in Title Lending", 77 *Missouri Law Rev.* 41 (2012) (with Ozymandias Adams).

"Regulating Payday Loans: Why This Should Make the CFPB'S Short List", 2 *Harv. Bus. L. Rev. Online* 44 (2011), available at: *http://www.hblr.org/?p=1595.*

"1,000 Percent Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions", 52 *Arizona Law Review* 563 (2010).

"Double Down-and-Out: The Connection Between Payday Loans and Bankruptcy", 39 *Southwestern L. Rev.* 789 (2010) (with Koo Im Tong).

My Research Progression and Empirical Findings

I have done five empirical studies related to high-cost lending and attitudes toward high-cost lending.

First Study in 2009

I devised my first study, "1,000 Percent Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions", after meeting clients in our clinical law program that had taken out the loans. Before meeting these clients, I had no idea what the terms of these loans actually were. Once I saw the 1,000 percent interest rates, I had to learn more. As a person who believes markets can serve people and respond to competition and consumer complaints, I wanted to find out why the rates never seemed to drop even when more lenders entered the market. I also wanted to find out what people were using the loans for and whether consumers shopped based upon the rates. Finally, I wanted to determine if consumers knew the loans were interest-only loans when they took them out. I went into the study with an open mind, just trying to learn the facts. In the study, published in the Arizona Law Review, I and my students interviewed 109 consumers outside payday lending stores. Key findings of this study include:

People Do Not Shop for Payday Loans on the Price So the Market Does Not Reduce Cost

People do not shop for price when obtaining a payday loan but instead take out loans near home or work out of convenience, or go to lenders that friends or family members have used. This means that the market forces that would usually reduce prices through competition do not work. Indeed, regardless of how many new lenders enter the market, prices only go up, never down.

Most Customers Do Not Understand the Loans Before They Get Into Them

People have difficulty understanding the terms of the loans and are very surprised when they go in and make a payment of $80 on a $400 loan and the $80

payment does not reduce the principle on the loan at all. People also cannot calculate the annual percentage rate on the loan (for example, by multiplying the 14 day rate by 26 periods of 14 days within a year), and thus cannot easily compare the cost of this credit to other forms of credit.

Some people thought that a rate of $15 per $100 borrowed for 14 days (390 percent per annum) was less expensive than a credit card rate of 25 percent per annum. One woman was proud of herself for using these loans instead of student loans.

Customers' Use of the Loans

People do not use the loans for short term needs. Many people who use these are in continuous debt, often with more than one loan.

Many people reported having low cost or no cost options to taking out the loan, including doing without or asking a friend or family member. Getting the high-cost loan just seemed easier, until they saw how hard it was to pay back.

People generally are not able to pay the loans back as quickly as they thought they would.

People use the loans primarily for regular monthly expenses, not emergencies, which means these consumers are worse off the following month than they were before they took out the loan. They now have another monthly bill to pay.

Subsequent Empirical Research

Before I began the first study, I had no idea how many loans consumers carried at a time. I assumed most people used just one loan at a time. Discovering the use of multiple loans at a time led to my next study, an empirical analysis of the debts of over 1,000 bankruptcy debtors to determine what percentage of the debtors used payday loans in a State with lax regulations, and of those, how many loans the borrowers had. I discovered that 19 percent of debtors in the study used the loans, that nearly 70 percent of those with loans had more than one, that 37 percent had more than 5 loans, and that an astounding 14 percent had more than 10 loans.[1]

In my next study, I analyzed State data on title loans and discovered, among other things that title lenders do not underwrite the loans for affordability and that the loans create a high risk of repossession.[2] I then did a demographic study of borrowers, again using bankruptcy data, and discovered that most payday loan borrowers are not middle class people as the industry suggests but that these borrowers typically have lower incomes than the median income in their State and also have lower home ownership rates than the average.[3] These results have been recreated in numerous studies, including "Do Payday Loans Really Serve the American Middle Class? An Empirical Analysis", in a recent issue of the *Journal of Consumer Affairs.*

II. Background of Topic: Terms of Various Types of High-Cost Loans

There are many varieties of high-cost loans, a few of which are described here as background.

Payday Loans

A true "payday" loan is called a payday loan because its original purpose was to help a customer survive a short-term cash flow crisis between the time of the loan and the customer's next payday. In one common form of payday loan, a consumer borrows money at a rate of between $15 and $25 per $100 for a period of 14 days or less. In other words, if a consumer was paid 4 days ago but is already out of cash, she can go borrow, for example, $400 between now and her next payday (now 10 days away). To get that $400 at the $15 per $100 rate she would need a checking account and would write a check, or authorize an automatic debit, for $460 postdated to her next payday.

When payday comes, she can either let the check or debit clear, assuming the unlikely event that she now has this money, or she can go in and pay another $60 to borrow the same $400 for the next 2 weeks. When taken as an annual percentage rate, calculated by multiplying this rate by twenty-six 2-week periods over the course of a year, these terms result in an interest rate of 390 percent per annum or higher.

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[1] "Double Down-and-Out: The Connection Between Payday Loans and Bankruptcy", 39 *Southwestern L. Rev.* 789 (2010) (with Koo Im Tong).

[2] "Grand Theft Auto Loans: Repossession and Demographic Realities in Title Lending", 77 *Missouri Law Rev.* 41 (2012) (with Ozymandias Adams).

[3] "High-Interest Loans and Class: Do Payday and Title Loans Really Serve the Middle Classes", 24 *Loyola Consumer L. Rev.* 524 (2012) (with Ernesto Longa).

Typical State payday loan laws (in States that have them) limit interest and fees to $15 per $100 (390 percent or more) but only if the loan is 14–35 days in duration. These laws do not apply to longer loans.

Title Loans

Another type of high-cost loan is the auto title loan, for which consumers do not need bank accounts. Rather borrowers simply need an unencumbered automobile to secure the loan. These loans carry a typical interest rate of 25 percent per month or 300 percent per annum. While title loans typically carry lower interest rates than payday loans, they tend to be larger loans, increasing the chances that they will be difficult to repay and will create a debt trap. They also subject borrowers to the possibility of losing their vehicle, a risk not encountered with the other forms of high-cost loans.

Installment Loans

Yet another type of high-cost loan is the so called "installment loan." This is the new loan of choice for many lenders as these loans allow lenders to skirt State laws regulating loans made for 14 to 35 days.

The phenomenon of morphing loans into another form in order to avoid State laws is discussed in more detail below, but in short, lenders make installment loans to avoid State payday loan laws, simply by making loans with durations longer than 35 days. Longer loans fall outside the regulations and thus remain unregulated. In one such installment loan, a customer borrowed $100, to be repaid in twenty-six biweekly installments of $40.16 each, plus a final installment of $55.34. In total, this borrower paid a total of $1,099.71 on a $100 loan. The annual percentage rate on the loan was 1,147 percent.

III. Solutions to the Problems Caused by High-Cost Loans

There are many ways to legislate high-cost credit, but most methods that have been tried have failed. One method that has not failed is simply capping interest rates. Other possible solutions may exist, but each has its problems. For example, a law could be passed that would require that lender underwrite their loans. Lenders would need to ensure that borrowers could afford to make their regular monthly expenses and also pay back the loan. Otherwise, the loan could not be made. If the loan was made anyway, it would not be enforceable.

Another middle ground would be forbidding rollovers or back to back loans from the same lender or different lenders, and limiting the number of loans a consumer could take out in a given time frame. This could be enforced through a national database in which all loans would need to be placed. A well written law would provide that if a loan did not appear in the database, it would not be enforceable and the lender could not take any action to collect it.

Lenders dislike these options, claiming that the latter violates consumer privacy rights and that the former, the underwriting, is too complex. I agree that these options are complex. I also fear that lenders would find ways around compliance, similar to the loopholes they have used in the past. Because of these potential loopholes and also these complexities, I prefer a far simpler method of regulation, namely the implementation of a Federal usury cap.

A. There Is No Existing Federal Law on Interest Rate Caps for Loans to the General Public

There currently is no Federal law regulating interest rates on consumer loans. Until 25 years ago, most U.S. States had usury laws that capped interests on consumer loans. In the U.S., usury laws have historically been the main protection consumers have had against harsh credit practices. Usury dates back to the earliest recorded civilizations and has a very prominent role in early American laws.

The Supreme Court's decision in Marquette National Bank v. First Omaha Service Corp.,[4] concluded that the bank's State interest rate applied when a bank lent to an out-of-State customer, and after this decision, States began eliminating their usury caps in order to attract financial institutions to their States, with South Dakota and Delaware leading the way. The decision effectively deregulated State interest rate caps. No Federal law has filled this gap, nor have other solutions to high-cost lending been designed.

B. Only About a Third of States Effectively Regulate High-Cost Credit

Eighteen States plus the District of Columbia either forbid high-cost lending or cap interest rates at 36 percent or less. The rest of the States have either no regulation of consumer loans, have regulations that affirmatively allow the high-cost prod-

[4] Marquette Nat'l Bank v. First Omaha Serv. Corp., 439 U.S. 299 (1978).

ucts described above, or have piecemeal laws that apply to one or more of the various types of loans. The resulting legislative patchwork has kept legislatures and consumer protections organizations busy around the clock, but has not resulted in any overall decrease in high-cost loans or in interest rates on such loans. To the contrary, the high-cost lending industry is growing exponentially, faster than any other part of the consumer credit sector and rates are going up not down.

C. The Public Supports Interest Rate Caps on Consumer Loans, Even the Very Conservative Public

In every study or survey in which the public has been asked to comment, the American public overwhelmingly supports Government imposition of interest rate caps on consumer loans. A recent study I did with psychologist Tim Goldsmith proves this point. Our entire article is attached but other studies and survey all reach the same result.

First, a national survey by the Center for Responsible Lending shows that three out of four Americans who expressed an opinion think that Congress should cap interest rates, and 72 percent feel that the caps should be no higher than 36 percent.

State ballot initiatives glean the same results. For example, in Montana, 72 percent of the population supported a ballot initiative that ultimately resulted in a 36 percent cap on interest rates for all loans in Montana. Citizens of Kentucky also voted for a ballot initiative that ultimately capped all loans at 36 percent. Similarly, Arizonans overwhelmingly supported a ballot initiative that ended payday lending in the State. Additionally, in 2008, 68 percent of Ohioans supported a ballot initiative that purported to cap interest in the State at 28 percent.

Public opinion survey data show similar public proclivities in favor of interest rate caps. After hearing that payday and title lenders can charge 500 percent or more in Texas, 63 percent of Texans age 45 or older strongly agreed that the State should cap interest rates and fees, with 77 percent of respondents reporting that the cap should be 36 percent or less. In another survey taken by the Texas Fair Lending Alliance, and the Texas Faith for Fair Lending, 85 percent of people polled favored capping interest rates on payday and auto title loans at 36 percent APR or less. In Iowa, survey data showed that seven in ten Iowans believe payday loan rates and fees should be capped. In Rhode Island, the only State in New England to allow storefront payday lending, a public opinion poll showed that 62 percent of Rhode Islanders supported capping interest on payday loans. Finally, a public poll of Coloradans showed that 74 percent of Coloradans support a similar 36 percent cap.

Additionally, support for caps crosses party lines. In the attached study by Professor Tim Goldsmith and I, we set out to measure not just overall support for interest rate caps but political affiliation of those who favor caps on consumer loans. Our data show widespread support for interest rate caps across political lines. We did find that more Democrats favor interest rate caps than Republicans, with 94 percent of Democrats favoring caps and 73 percent of Republicans favoring caps.

What is remarkable, however, is just how many conservative people favor caps. Our data show that over 57 percent of people who report being "very conservative" politically and over 82 percent of those who report being "conservative" politically favor interest rate caps over no interest rate caps.

While wondering aloud why the public is not more active in seeking out laws that cap interest, we stumbled upon a possible explanation. First, many people incorrectly think interest rates are capped (over 58 percent for credit cards and over 43 percent for short-term loans), when in reality these rates are not capped. In other words, people misunderstand and overestimate the protection the law currently provides. Second, even among those who know that the law provides no caps, most are unaware that lenders in the State in which the study was conducted currently charge interest rates of 200 percent or more. Indeed, we found that 81 percent of the public was unaware of the costs of these ubiquitous loans. These poll data support the notion that 300 percent to 1,000 percent loans are not normal or usual, and the public opposes them. Interestingly, people who had themselves used the loans were even more in favor of caps than nonusers.

D. Loopholes: How Lenders Get Around Every State Law That Is Passed, Except Caps

Despite wide and deep public support for rate caps, uniform State interest rate caps that apply to all consumer loan products are few and far between. Moreover, those caps that do exist are often ineffective due to State laws' inability to regulate certain lenders, namely online lenders located offshore or affiliated with Indian tribes.

In States where complex statutes are passed to limit high-interest lending, even storefront lenders find ways around those laws, by changing the attributes of the

loans to avoid the laws, fitting within exceptions created by other laws on the books, or becoming credit service organizations (CSOs), which are exempt from the laws. This complex game of whack-a-mole makes regulating State by State an expensive yet ineffective endeavor.

1. The "Loan Term" Loophole

Loopholes happen. In the world of payday lending, they happen a lot. For example, payday lenders began appearing in New Mexico after the State repealed its General Usury statute (former NMSA 1978 §56-8-11-1) in 1991. For five very long and frustrating years, the New Mexico Legislature debated various payday lending statutes. Finally, during the legislative session of 2007, the Legislature adopted a law is similar to those of several other States. The regulation relies heavily on computer database enforcement mechanism for consumer qualification and reporting. Thirty-three States have laws that bear some similarity to this New Mexico law. None, however, curb high-cost lending abuses, despite legislative goals of curbing high-cost loan abuses.

The new law capped interest and fees at $15 per $100 for each period of 14 days or less, or 390 percent per annum or more. The new law also applied only to lenders engaged in the business of lending amounts of $2,500.00 or less, and defined a loan covered by the Act as one of 14 to 35 days in duration, for which the consumer gives the lender a check or debit authorization for the amount of the loan plus interest and fees.

In the end, this narrow definition gutted the legislation. The industry quickly switched to loan products that fall outside the statute, namely longer loans or those not involving a postdated check. This was done so that lenders could charge more than 390 percent per annum and avoid the database. Naturally, these loans that fall outside the definition are not regulated at all. Thus, many States have spent years attempting to regulate payday lending, but the resulting State laws have done nothing to change short-term lending at high interest rates.

Professor Robert Mayer reports on a similar legislative process in Illinois:

> Regulators in Illinois imposed rules in 2001 that were designed to [curb the number of payday loans and roll-overs]. Customers were allowed to borrow no more than $400; only two renewals were permitted, with some of the principal paid down each time; and a cooling-off period was mandated to prevent borrowers from using the proceeds of a new loan to pay off the old one. The State . . . promised to establish a database to track loan activity and enforce the rules.[5]

As in New Mexico, Illinois payday lenders quickly devised a new product to evade the rules. The statute applied to cash advances with a term of less than 31 days, so the industry created a 31-day loan not covered by the rules. As a result, all of the old abuses persisted.

A 2003 Illinois OFI report acknowledged that it remains quite common for borrowers to have multiple payday loans outstanding with several different payday loan companies. Similar end runs occurred in Oklahoma. Additionally, other States such as Florida, Illinois, and Michigan have tried to impose interest-free payment plans like one passed in New Mexico, but these laws have produced no meaningful reduction in the number of trapped borrowers.

2. Using Exceptions Created by Other Laws To Get Around State High-Cost Loan Laws

Other forms of loopholes also abound. In 2008, the Ohio State Legislature voted to rescind a 12-year-old law that exempted payday lenders from the State's usury laws, a vote Ohioans supported two to one. An existing short-term loan law purported to cap interest on all short-term loans at 28 percent, and also to give customers at least a month to pay off the loans. In response, lenders simply switched their licenses so they could offer payday loan look-alikes under two parallel lending statutes, the Small Loan Act or the Mortgage Lending Act. Making these changes was simple for lenders and they began offering even higher cost loans, as this industry Web site explains:

> By adjusting the loan amount to just above $500, payday loan lenders double the loan origination fees from $15 to $30. The Small Loan and Mortgage Lending acts allow the fees on top of the 28 percent interest, something the new payday lending law doesn't permit. Under the new HB 545 licensing

[5] Robert Mayer, "One Payday, Many Payday Loans: Short-Term Lending Abuse in Milwaukee County" (working paper, 8), available at *http://lwvmilwaukee.org/mayer21.pdf* (last accessed Aug. 6, 2009).

> scheme with the check cashing fees added, customers pay the same $575 to walk out the door with $500 in cash . . .
>
> A First American payday loan customer indicated he previously paid $75 for a $500 loan, First American charged him a total of $90 to borrow the same amount after the law changed. More than one Ohio payday loan company has structured their check cashing and loan operations as two separate entities to justify the fees.[6]

Then Ohio Attorney General Rich Cordray said his office found payday loans with APR's ranging from 128 to 700 percent immediately after the ballot initiative that purported to cap interest on consumer loans in Ohio at 28 percent.

3. Online Lending

Internet payday lending is growing quickly and many online lenders claim to be immune from State laws. Even where States have won cases holding that online lenders must comply with State laws, lenders often fail to do so. State regulators have again garnered precious resources to enforce their laws, often to no avail. The most recent survey by the Consumer Federation of America (CFA) notes that lenders continue to claim choice of law from lax jurisdictions, to locate off-shore, or to claim tribal sovereign immunity to avoid complying with State consumer protection laws.

The trial sovereign immunity loophole is particularly troubling, as it pits two traditionally disadvantaged groups, Native Americans and low-income consumers, against one another in a complex battle over who needs protection more. Under this model, lenders team up with Indian tribes to avoid State laws. Tribes engaged in off-reservation activities must comply with nondiscriminatory State laws, as must anybody else. Despite this requirement, tribes are immune from suit because they are separate sovereigns. Thus, while they must obey State laws, they can't be sued to enforce the laws or compel their compliance. This motivates lenders to seek out tribal partners as this industry Web site explains:

> Due to the strict regulations that are hitting the payday loan industry hard, many lenders are now turning to Indian Tribes to help them out. The American Indian Tribes throughout the United States have been granted sovereign immunity which means that they are not held subject to the laws that payday loans are currently going up against. There are 12 States which have banned payday lending but as long as their (sic) is an Indian tribe who runs the operation on this sovereign land, the lenders can continue their business even where payday loans have already been banned. Similar to the Casino boom, payday loans are the new financial strategy that many are using as a loophole through the strict payday loan laws. The revenue is quite high and promising for these tribes who often find themselves struggling. There are approximately 35 online cash advance and payday loan companies that are owned by American Indian tribes. . . . It is no surprise that many lending companies are currently seeking out American Indian Tribes in an effort to save their businesses by escaping U.S. lending laws. Tribal leaders are paid a few thousand dollars a month for allowing a payday lender to incorporate on tribal land. The more lenders that tribes allow to move onto their reservation, the larger the profit that they make.[7]

Often, as this excerpt clearly articulates, the lenders using this model are not tribes. Proving that the lenders are not entitled to tribal sovereign immunity is not easy, however. A simple Federal interest rate cap would eliminate this loophole as even tribes are bound by Federal law.

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[6] As another industry Web page explains: With news of the passage of Issue 5 in Ohio on Nov. 4, Check Into Cash began restructuring its loan product offerings throughout the Buckeye State to comply with the new law. On Nov. 5, the company ceased to offer payday loans and began offering a new product, microloans, which are short-term loans from $50 to $600 and permitted under Ohio's Small Loan Act. These new microloans are one way that Check Into Cash is striving to continue to serve its valued customers with the same level of service as it has in prior years. Even though this new Ohio legislation was designed to make it difficult to continue serving customers who desire payday advance services, Check Into Cash has pushed ahead, endeavoring to persevere with its ongoing commitment to customer service. "Check Into Cash Committed to Serving Ohio Customers", PRWEB (Nov. 18, 2008, 10:19 AM), *http://www.prweb.com/releases/checkintocash/ohio/prweb1628414.htm*), quoted in Martin, supra note 43, at 591 n. 151.

[7] "The Connection Between Indian Tribes and Payday Lending", *Online Cash Advance, http://www.online-cash-advance.com/financial-news/the-connection-between-indian-tribes-and-payday-lending#ixzz1Nt1vQu6h* (last accessed Jan. 11, 2012) (on file with the author).

E. Colorado: A Middle Ground To Consider But Still 200 percent

Despite all of the failures of State high-cost lending laws to reduce interest rates or otherwise eradicate onerous loan terms, Colorado has passed a law that does lower those rates somewhat. This law is worth studying for its possible implications for future Federal legislation.

Colorado's 2010 law has reduced the number of payday loans in the State as well as the interest rates on existing payday loans. The law sets a maximum loan amount at $500 and adds provisions designed to keep consumers from getting trapped in the usual payday loan roll-over cycle. Consumers also have the right to cancel a payday loan transaction by 5:00 p.m. the following day. Consumers may also choose to repay loans in one sum or pay the full amount over 6 months. The law also caps interest rates for these loans at 45 percent, but this rate limit does not include fees and other costs, which add significantly to the actual cost of the loans.

A recent study completed by the Pew Charitable Trust concludes that this new law has been effective in reducing rates on payday loans.[8] The dollar amounts of payday loans in Colorado have fallen almost 60 percent, and the number of loans fell from 1,110,224 loans in 2010 to 444,333 in 2011 after the law was implemented. Data from the Colorado Attorney General's office indicate that the new law appears to have dropped average effective APRs from 338.90 percent to 191.54 percent. In addition, quite significantly, the average number of payday loans consumers have taken out per year has fallen from 8.53 loans per person to 2.3 loans per person.

Nonetheless, the average contract finance charge has risen significantly, from $60 to $237 and many consumer protection groups are appalled that when fees and costs are included, the Colorado law allows interest rates of nearly 200 percent. There also has been an increase in "same-day-as-payoff" transactions, meaning the lender makes a new loan to a consumer on the same day the consumer pays their previous loan in full. This means lenders are easily getting around rollover limits.

In summary, Colorado has been more vigilant than any other State in working on a solution to the payday lending problem. The law it passed, while better than most, still has problems.

Few States have the will or the resources to go to the efforts to which Colorado has, making a Federal solution to the problem efficient and effective by comparison. Congress has regularly and effectively taken over areas of consumer and commercial law and should do so here as well. Nevertheless, Colorado's law should be studied by Congress before it acts.

F. Why a Federal Interest Rate Cap Would Work Best

Given the overall failure of States, a Federal usury cap is the only option that is certain to curb high-cost lending. Coordinating 50 States on this or any issue is complex and difficult work. Congress on the other hand need pass just one law to accomplish a national usury cap. Consumers can and do cross borders to borrow money, and States have no particular interest in caps. Moreover, the entire country is a common market, such that any State's regulation of interest rates inherently reaches across borders. Thus, there is a need for uniformity on interest rates across those borders, which only Congress can provide.

Congress unquestionably has the power to set Federal interest rate caps, through the Commerce Clause of the U.S. Constitution. Indeed, in recent years the regulation of consumer credit has become even more and more of a Federal, rather than a State, regime.

G. The Military Lending Act as a Starting Point for Congress

Congress already has experience setting a 36 percent cap that protects some but not all Americans. In 2007, Congress passed the Military Lending Act (MLA),[9] which purported to place a 36 percent interest rate cap on consumer loans and to prohibit lenders from engaging in predatory practices toward active-duty military members and their dependent family members.

In passing the MLA, military lenders were deeply concerned about the effects of predatory lending on military readiness. When they realized State lawmakers were unable or unwilling to pass laws protecting the troops, these leaders focused their efforts on passing Federal legislation. In 2006, the United States Department of Defense issued a report finding "that payday lending 'harms the morale of troops and

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[8] Susan K. Urahn, Travis Plunkett, Nick Bourke, Alex Horowitz, Walter Lake, and Tara Roche, "Payday Lending in America: Policy Solutions, Report 3 in the Payday Lending in America Series", The Pew Charitable Trusts, October 2013, 12–13, *http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_Payday_Policy_Solutions_Oct_2013.pdf.*

[9] 10 U.S.C. §987(b) and 32 CFR §232.4(b).

their families, and adds to the cost of fielding an all-volunteer fighting force.'" Congress noted that lenders were blatantly targeting the military by clustering in large numbers "near military bases" and using "military-sounding names" and also that military personnel lacked sophistication in financial matters and were easily taken advantage of.

While there was early evidence that the MLA curbed predatory lending to military communities, more recent evidence suggests that even the MLA is mired by loopholes. However, Congress can learn from these loopholes and pass an effective 36 percent cap, modeled after effective State law caps. Congress can learn from the experience gleaned from the MLA and pass a law that better serves all Americans. Finally, the Federal Government has the power to enforce a Federal usury cap through the Consumer Financial Protection Bureau, whereas most States lack sufficient enforcement power.

IV. Conclusion

Based upon years of research and a great deal of contact with low-income consumers, I honestly believe people are better off without the option to take out unlimited numbers of high-cost loans. This is especially true when current law in most States allows lenders to charge 1,000 percent per annum or more in interest and fees. These forms of credit cause far more harm than good. They are not safe, not affordable, and thus access to them is more of burden than a benefit.

These loans make cash flow problems worse. The two ways to eradicate cash constriction are to increase income or reduce costs. These loans increase costs and thus worsen the problem of limited income to meet expenses. If these loans cannot be made more affordable, the loans should not be made.

Moreover, as long as these forms of credit are around, alternatives for low and middle income people with poor credit will not be become available. Where the loans are legal, high-cost lenders are everywhere, outnumbering Starbucks, McDonald's, Burger Kings, and Walgreen's combined. With no underwriting, they are easy (too easy) to borrow from. As long as these lenders are in business under the terms described here, it will be difficult for States and the Federal Government to develop lower cost alternatives.

Thanks very much for reading and let me know if you'd like more information on any of these points.

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Interest Rate Caps, State Legislation, and Public Opinion: Does the Law Reflect the Public's Desires?

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II. Other Solutions for Fringe Economy Lending

INTEREST RATE CAPS, STATE LEGISLATION, AND PUBLIC OPINION: DOES THE LAW REFLECT THE PUBLIC'S DESIRES?

TIMOTHY E. GOLDSMITH* AND NATHALIE MARTIN**

Are consumers aware of the law on interest rate caps? Do consumers support interest rate caps in general or in the context of specific types of loans? Do consumers know that it is legal to charge 400% or more per annum for a loan in some states? If they do know that such rates are legal in some states, do they find these rates acceptable or problematic? We recently sought answers to these and related questions through a public opinion poll in the state of New Mexico, a poor, primarily Democratic state.[1] Because New Mexico has one of the highest consumer usage rates and highest concentrations of payday and title loan shops in the nation,[2] we thought it would be an ideal place to measure the public's knowledge of and interest in these ubiquitous loans.[3] We also measured knowledge of interest rate caps in the context of credit cards, as a point of comparison.

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1. *State and County Quick Facts*, UNITED STATES CENSUS BUREAU, http://quickfacts.census.gov/qfd/states/35000.html (last visited on September 13, 2013) (showing a poverty rate of 19% compared to a national average of 14.3%); David Weigel, *How the Democrats Won New Mexico: How did President Obama take New Mexico off the "swing state" map?*, SLATE.COM (Oct. 9, 2012), http://www.slate.com/articles/news_and_politics/politics/2012/10/new_mexico_has_become_a_safe_democratic_state_because_of_a_growing_hispanic_population_native_americans_and_bad_republican_talking_points_.html (reporting that New Mexico is now a safely democratic state and that ethnically, it is 46.7 percent Hispanic and 10.1 percent Native American).

2. McKernan, S., C. Ratcliffe, and D. Kuehn, *Prohibitions, price caps, and disclosures: A look at state policies and alternative financial product use.* Washington, D.C.: THE URBAN INSTITUTE, (Nov. 2010). These authors found that in New Mexico, the usage rate of payday loans was 15%, compared to 10% nationally, and that the usage rate for title loans was10% compared to 6% nationally. *Id.*

3. Author Nathalie Martin regularly speaks to the public about payday and title loans, both in and outside New Mexico. Understandably, people who live in states in which high-cost loans are illegal, or in any case, less prevalent often express surprise when they learn that it is legal in some states to change 1,000% or more for consumer credit. What is alarming is that even people within New Mexico seem to have little knowledge that this lending is taking place. One highly educated 50-year old woman who was participating in a governor's financial literacy Summit with Professor Martin in 2011 expressed disgust at the rates charged by pawnshops, which are capped at 48%. More recently, at a 2012, meeting of the Consumer Financial Protection Bureau held with leaders in Indian Country in New

Our data are consistent with that of previous studies showing that the general public overwhelmingly supports interest rate caps both in general and for certain types of loans. More uniquely, we also found that many consumers are unaware that there are no interest rate caps on many forms of consumer loans. These data are useful in explaining why consumers do not do more to change the law on interest rate caps.

Given that payday loans and other high-interest credit products are typically regulated through state statutes, these data raise fundamental questions about the efficacy of state legislation in regulating high-cost credit. More specifically, in situations in which there seems to be little to no political will among politicians to impose interest rate caps, does it matter that a majority of the general public believes there *should be* interest rate caps? Do these data suggest the need for more public education about the law and the legislative process, or is it simply a call for federal interest rate caps? Here, we report on these data, but do not attempt to answer these questions.

1. THE LAW AND POLITICS OF INTEREST RATE CAPS

A. The Law of Interest Rate Caps

There currently is no federal law regulating interest rates on consumer loans, although the Truth in Lending Act,[4] the Electronic Fund Transfer Act,[5] and other general federal laws apply to consumer lending. The issue of capping or limiting interest rates is thus left in the hands of state legislatures. In some parts of the country, primarily eastern seaboard states, state law sometimes caps the amount of interest and fees a lender can charge a borrower for any type of consumer loan in a way that is, as Professor Christopher Petersen describes it, undiluted and trim.[6] If the cap is 18%, no lender can charge more than 18% for a loan of any kind, including fees, no exceptions.

In most of the country, however, undiluted and trim interest rate caps are rare indeed. More specifically, eighteen states plus the District of Columbia either forbid payday lending or cap interest rates in a fashion that

Mexico, a high level official said he knew the loans were expensive but did not see how they could be 400%. This is because the loans are advertised in terms of costs per two-week (for example, $15 per $100 borrowed) period or even per day ($2.00 per day, less than a coffee).

4. Truth in Lending Act, 15 U.S.C. §§ 1601–1667f (2006).

5. Electronic Funds Transfer Act, 15 U.S.C. §§ 1693–1693r (2006).

6. Christopher Petersen, *Usury Law, Payday Loans, Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110, 1117 (2008).

makes lending undesirable for lenders.[7] The states that ban or cap payday loans at 36% or less are Arizona, Arkansas, Colorado, Connecticut, District of Columbia, Georgia, Maine, Maryland, Massachusetts, Montana, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Vermont, and West Virginia.[8]

B. The Politics of Interest Rate Caps

The politics of interest rate caps are sometimes counterintuitive. While one would think that Democratic states would be more likely to cap interest on consumer loans, given that Republican governments tend to eschew regulation that is not the case. Democratic states are no more likely to have interest rate caps than Republican ones. Of the states that *do* cap interest, four are swing states, ten are blue states, and ten are red states.[9] In the blue state in which this study was completed, New Mexico,[10] there has been a deep and abiding resistance to imposing interest rate caps on loans of any kind.[11] Conversely, the red states of Montana and Arizona[12] recently

7. CORPORATION FOR ENTERPRISE DEVELOPMENT, PROTECTIONS FROM PREDATORY SHORT-TERM LOANS 2 (2012), *available at* http://cfed.org/assets/scorecard/2013/rg_PredatoryLending_2013.pdf; *See also Payday Lending Statutes*, NATIONAL CONFERENCE OF STATE LEGISLATURES, http://www.ncsl.org/issues-research/banking/payday-lending-state-statutes.aspx (last updated Sept. 12, 2013).

8. CORPORATION FOR ENTERPRISE DEVELOPMENT, *supra* note 7; *See also Payday Lending Statutes*, *supra* note 7.

9. *Red and Blue States Map (Average Margins of Presidential Victory)*, WIKIMEDIA COMMONS, http://commons.wikimedia.org/wiki/File:Red_and_Blue_States_Map_(Average_Margins_of_Presidential_Victory).svg (last modified Feb. 16, 2013).

10. *Id.*

11. Payday lenders began appearing in New Mexico after the state repealed its General Usury statute (former N.M. STAT. ANN. § 56-8-11-1) in 1991. Prior to the summer of 2007, New Mexico was one of only two states that had no regulation of payday lending. Alexander Bartik et al., *Regulating Predatory Payday Lending: A State-by-State Analysis*, ROOSEVELT INST. AT YALE CTR. ON ECON. POL'Y (2007), *available at* https://www.efis.psc.mo.gov/mpsc/commoncomponents/viewdocument.asp?DocId=935476227, (last visited September 13, 2013). The other state is Wisconsin, which still has no payday lending regulation. For five very long and frustrating years, the New Mexico Legislature debated various payday-lending statutes.

Finally, during the legislative session of 2007, the New Mexico State Legislature adopted a set of changes to the New Mexico Small Loan Act of 1955 intended to address payday lending in New Mexico. These regulations went into effect in July 2007. The new law capped interest and fees at $15 per $100, which results in an effective interest rate of 390% or higher, but the new law applied only to lenders engaged in the business of lending amounts of $2,500.00 or less, and defined a loan covered by the Act as one of 14 to 35 days in duration, for which the consumer gives the lender a check or debit authorization for the amount of the loan plus interest and fees. N.M. STAT. ANN. § 58-15-3(A) (West 2013). In the end, this narrow definition gutted the legislation. The industry quickly switched to loan products that fall outside the statute, namely longer loans or those not involving a post-dated check. None of the new loans (typically called "installment loans") are regulated at all in the state. Thus, the state spent several years attempting to regulate payday lending but the resulting law has done nothing to change short-term lending or high interest rates.

12. *Arizona Payday Loan Reform, Proposition 200 (2008)*, BALLOTPEDIA, http://ballotpedia.org/wiki/index.php/Arizona_Payday_Loan_Reform,_Proposition_200_(2008) (last modified May 28, 2012)

kicked payday lenders out of their states, because, as a Montana ballot campaign explained, "400% is too much."[13]

C. A Look into the Loan Products in States without Caps

One might wonder what loans and lending practices look like in states in which interest rates are generally not capped. How high are the rates at which consumers borrow? Who uses high-cost loans? Even assuming that most borrowers are low-income borrowers with poor credit histories and thus few other lending options,[14] do rates respond to market forces and drop when more lenders enter a market? At least as to this last question, the answer seems to be no. Thus far, market forces have had little to no effect on interest rates for most high-cost loans.[15] Indeed, despite that high-cost lending is the fastest growing segment of the consumer lending business,[16]

(voters in Arizona defeated a payday sponsored ballot initiative, mandating an end to state statutes that allow 400% interest rates); *Montana Loan Interest Rate Limit, I-164 (2010)*, BALLOTPEDIA, http://ballotpedia.org/wiki/index.php/Montana_Loan_Interest_Rate_Limit,_I-164_(2010) (last modified July 6, 2012).

13. Celinda Lake & Joshua Ulibarri, *Results of a Statewide Survey on a Montana Ballot Initiative to Cap Interest Rates of Predatory Lenders*, LAKE RESEARCH PARTNERS (January 2010), http://www.consumerfed.org/pdfs/Publicmemo-MT-Payday.pdf; *Payday Lenders Less Popular than Liquor Stores*, CTR. FOR RESPONSIBLE LENDING (Feb. 23, 2011), http://www.responsiblelending.org/media-center/press-releases/archives/Payday-lenders-less-popular-than-liquor-stores-majority-of-voters-would-support-moratorium-according-to-San-Jos%C3%A9-poll.html#; *Poll Shows Support for Capping Payday Loan Rates and Fees*, THE VINDICATOR (January 25, 2013), http://www.thevindicator.com/news/article_2d0406f0-6714-11e2-997e-0019bb2963f4.html; *Montana Loan Interest Rate Limit*, BALLOTPEDIA, *supra* note 12 (reporting that nearly 72% of Montana voters voted to cap interest rates on payday and auto title loans at 36% APR); *Ohio Payday Lender Interest rate Cap, Issue 5 (2008)*, BALLOTPEDIA, http://ballotpedia.org/wiki/index.php/Ohio_Payday_Lender_ Interest_Rate_Cap,_Issue_5_(2008) (last modified Aug. 8, 2013).

14. This assumption may be wholly incorrect, but this is clearly what lenders say to justify their products and existence. *See* Karen E. Francis, *Rollover, Rollover: A Behavioral Law and Economics Analysis of the Payday-Loan Industry*, 88 TEX. L. REV. 611, 617 (2010) ("No matter which studies most accurately describe the loan-market participants, clearly payday borrowers are low-to-moderate-income individuals, many of whom have alternative credit sources or easily accessible cash.").

15. At least with respect to payday loans, increased numbers of lenders has not driven down prices. *See* Michael A. Garemko III, Note, *Texas's New Payday Lending Regulations: Effective Debiasing Entails More Than the Right Message*, 17 TEX. J. C. L. & C. R. 211, 219-20 (2012); Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563, 614 (2010) (stating, "The payday lending and other short-term lending industries are classic failed markets. The industry is young, having developed primarily in the 1990s. Thus, price competition is not yet necessary to create a strong market share. Rather, most lenders charge similar amounts for the same loan, typically the largest amount permitted by law."). Title loans may be somewhat different, however. Professor Jim Hawkins has found that that lenders compete on price at some level at least in Texas. *See* Jim Hawkins, *Credit on Wheels: The Law and Business of Auto Title Lending*, 69 WASH. & LEE L. REV. 535, 558-59 (2012).

16. *2011 Underbanked Market Sizing Study*, CTR. FOR FIN. SERVS. INNOVATION, Nov. 2012, at 1, *available at*
http://www.cfsinnovation.com/system/files/CFSI_2011_Underbanked_Market_Sizing_Study_November_2012.pdf. This is a newsletter for the Center for Financial Services Innovation (CFSI), which claims to be:

rates seem to hover between 400% and 1,000% on the most common high-cost loan products, regardless of how many lenders enter the market.

There are many varieties of high-cost loans, each with a variety of terms. One example is the so-called "installment loan" created to skirt a New Mexico state law requiring loans made for fourteen to thirty-five days to limit interest and fees to $15 per $100 borrowed for up to fourteen days per loan. In one such installment loan, described in a recent case brought against a lender by the state Attorney General's Office, a customer borrowed $100, to be repaid in twenty-six bi-weekly installments of $40.16 each, plus a final installment of $55.24.[17] In total, this borrower paid $100 in principal and $999.71 in interest for a total of $1,099.71 on the $100 loan. The annual percentage rate on the loan was 1,147%.[18]

Another example of a common form of high-cost loan in a state without caps is a true "payday" loan, so named because its original purpose was to help a customer to survive a short-term cash flow crisis between the time of the loan and the customer's next payday.[19] In a typical loan, a consumer borrows money at a rate of between $15 and $25 per $100, between now and payday, meaning for a period of fourteen days or less.[20] For example, if a consumer got paid four days ago but is already out of cash, she can borrow $390 from a payday lender and pay it back on her next payday, now ten days away. To get that $390 at the $15 per $100 rate, she would need a

> The nation's leading authority on financial services for underserved consumers. Through insights gained by producing original research; promoting cross-sector collaboration; advising organizations and companies by offering specialized consulting services; shaping public policy; and investing in nonprofit organizations and start-ups, CFSI delivers a deeply interconnected suite of services benefiting underserved consumers." A pro-payday and title loan industry group, CFSI's research is funded by Morgan Stanley.

Id. at 8. *See also* Fahzy Abdul-Rahman, *Small-Dollar Predatory Lending and Bad Loans,* GUIDE G-260 (Coop. Extension Serv., Coll. of Agric., Consumer, and Envtl. Sciences, La Cruces, NM), November 2012, *available at*, http://aces.nmsu.edu/pubs/_g/G260.pdf. Abdul-Rahman reports that between 1992 and 2000, the number of predatory lenders in New Mexico grew from one per 66,000 citizens to one for every 5,212 citizens. *Id.* He also notes that:

> In New Mexico, the highest concentrations of predatory lending stores tend to be in smaller cities and cities with high minority populations and/or high poverty rates, such as Gallup (880 people per lender), Grants (881 people per lender), and Farmington (1,647 people per lender), which collectively represent six times the rate in the rest of New Mexico in 2000.

Id. (citation omitted).

17. *See New Mexico, ex rel., Gary K. King v. B & B Inv. Grp.*, No. D-01010CV-2009-01916 at 1-2 (1st Dist. NM, Dec. 3, 2010); *see also* Felix Salmon, *Loan Sharking Datapoints of the Day*, REUTERS (Jan. 6, 2010), http://blogs.reuters.com/felix-salmon/2010/01/07/loan-sharking-datapoints-of-the-day/.

18. *King*, No. D-01010CV-2009-01916 at 1-2.

19. *See* Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 857 (2007) (explaining the mechanics of a typical payday loan); Francis, *supra* note 14, at 611-12 (describing a payday loan transaction).

20. *See* Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563, 564 (2010) (giving an example of a typical payday loan).

checking account. She would write a check or authorize an automatic debit for $460, post-dated to her next payday.[21] When payday comes, she can either let the check or debit clear, assuming the unlikely event that she now has this money, or she can go in and pay another $60 to borrow the same $390 for the next two weeks. The annual percentage rate for a loan of this kind is 400% or more, depending on the number of days for which the loan remains outstanding.[22]

Still another example of a common high-cost loan product in a state without caps is the auto title loan, for which customers do not need bank accounts.[23] Rather, they simply need an unencumbered automobile, which secures the loan. These loans carry a typical interest rate of 25% per month, or 300% per annum.[24] While title loans usually carry lower interest rates than payday loans, they tend to be larger loans, increasing the chances that they will be difficult to repay and will create debt traps.[25] They also subject the borrower to the possibility of losing their vehicle, a risk not endured with the other forms of high-cost loans described here.[26]

These are but a few examples of the types of loans that are available to consumers in states without caps.

II. PUBLIC OPINION ON INTEREST RATE CAPS AND OTHER LIMITS ON PAYDAY-STYLE LENDING

Our data augment a large body of existing data showing public support for interest rate caps either in general, or in the context of payday-style loans. For example, in Montana, 75% of the population supported a ballot

21. *Id.*

22. While some lenders argue that it is inappropriate to state a loan like this in terms of annual percentage rate, because the loans are short-term loans, they are not actually used as short-term credit. It is common for borrowers to have numerous loans per year and to roll them over repeatedly so borrowers are in loan like this most of the time. *See* Francis, *supra* note 14, at 613, 617-18.

23. Kathryn Fritzdixon, Jim Hawkins & Paige Marta Skiba, *Dude, Where's My Car Title?: The Law, Behavior, and Economics of Title Lending Markets*, 2014 U. ILL. L. REV. (forthcoming 2014); Nathalie Martin & Ozymandias Adams, Grand Theft Auto Loans: Repossession and Demographic Realities in Title Lending, 77 MO. L. REV. 41 (2012).

24. *See* Martin & Adams, *supra* note 23, at 60; Hawkins, Fritzdixon & Skiba, *supra* note 23, at 2.

25. *See* Martin & Adams, *supra* note 23, at 74. Notably, Professor Jim Hawkins has found that borrowers do not fully understand the costs of title loans. *See* Hawkins, *supra* note 15, at 557. The people he surveyed did not exhibit an understanding of the high relative cost of title loans compared to credit card debt. Only 25.71% (n = 9) recognized that a title loan is a lot more expensive than credit card debt, while 17.14% (n = 6) thought a title loan is a lot less expensive than credit card debt. 5.71% (n = 2) thought a title loan was a little less expensive than credit card debt, and 31.43% (n = 11) thought the two were about the same cost. While this small sample of people may not be indicative of borrowers generally, it is disturbing how few people understood the relative cost of their title loan."

26. Martin & Adams, *supra* note 23, at 78-80, 85-86.

initiative capping interest on all consumer loans at 36%.[27] Similarly, after hearing that payday and title lenders can charge 500% or more in Texas, 63% of Texans age forty-five or older strongly agreed that the state should cap interest rates and fees, with 79% of respondents reporting that they believe the cap should be 36% or less.[28] In another survey taken by the Texas Fair Lending Alliance[29] as well as Texas Faith for Fair Lending, between 79% and 85% of people polled favored capping interest rates on payday and auto title loans at 36% APR or less.[30]

In Iowa, survey data show that seven in ten Iowans believe payday loan rates and fees should be capped.[31] Arizonans overwhelmingly voted to end payday lending in the state.[32] Similarly, in 2008, 63% of Ohioans voted to cap interest in the state at 28%.[33] In Rhode Island, the only state in New England to allow payday lending, a public poll showed that 76% of

27. *Results of a Statewide Survey on a Montana Ballot Initiative to Cap Interest Rates of Predatory Lenders,* LAKE RESEARCH PARTNERS (Jan. 2010), http://www.consumerfed.org/pdfs/Publicmemo-MT-Payday.pdf; CTR. FOR RESPONSIBLE LENDING, *supra* note 13; *Montana Loan Interest Rate Limit,* BALLOTPEDIA, *supra* note 13 (reporting that nearly 72% of Montana voters voted to cap interest rates on payday and auto title loans at 36% APR); *Ohio Payday Lender Interest Rate Cap,* BALLOTPEDIA, *supra* note 13.

28. *Summary of AARP Poll of Texans Age 45+,* AARP (Jan. 2013), http://www.aarp.org/content/dam/aarp/research/surveys_statistics/econ/2013/Summary-of-AARP-Poll-of-Texans-Age-45-Plus-Opinions-on-Payday-Loan-Rates-and-Legislation-AARP.pdf; THE VINDICATOR, *supra* note 13; *Payday and Auto Title Lending,* LBJ SCHOOL OF PUBLIC AFFAIRS, CENTER FOR POLITICS AND GOVERNANCE, http://www.utexas.edu/lbj/cpg/docs/f3_2013_payday.pdf (last visited Sept. 20, 2013) (containing an excellent summary of existing Texas law).

29. The Texas Fair lending Alliance is a Texas coalition comprised of more than three-dozen financial, community and faith organizations a group dedicated to bringing increased regulation to the payday loan industry. *Texas Fair Lending Alliance,* UNITED WAY HOUSTON, http://www.unitedwayhouston.org/default/Texas%20Fair%20Lending%20Alliance-%20AEI%20Presentation.pdf (last visited Oct. 6, 2013).

30. Rudolph Bush, *Statewide Survey Shows Broad Support for Payday Lending Reform,* DALLAS NEWS CITY HALL BLOG (June 21, 2012, 9:41 AM), http://cityhallblog.dallasnews.com/2012/06/statewide-survey-shows-broad-support-for-payday-lending-reform.html/ (reporting that 79% of Texans polled favored capping interest rates on payday and auto title loans at 36% APR or less); THE VINDICATOR, *supra* note 13.

31. *Iowans for Payday Loan Reform: Iowa Poll Reveals Strong Bi-partisan Support for Payday Lending Reform,* IowaPolitics.com (Jan. 26, 2011), http://www.iowapolitics.com/index.iml?Article=224730 (reporting that 7 in 10 Iowans called for capped payday loan interest rates).

32. *Arizona Payday Loan Reform,* BALLOTPEDIA, *supra* note 12 (voters in Arizona defeated a payday sponsored ballot initiative, mandating an end to state statutes that allow 400% interest rates). Title loans are not restricted in Arizona, however, causing lenders to morph from payday loans to title loans. *See* Maureen West, *Payday Lenders Morphing Into Auto Title Lenders,* AARP (Dec. 10, 2010), http://www.aarp.org/money/scams-fraud/info-12-2010/payday_lenders_morphing_into_auto_title_lenders.html.

33. *Ohio Payday Lender Interest Rate Cap,* BALLOTPEDIA, *supra* note 13 (reporting that over 63% of Ohio voters voted in favor of capping the Ohio payday loan industry's interest rate at 28%); *2010 Payday Lending Poll Results,* CATHOLIC CONFERENCE OF OHIO (April 29, 2010), http://www.ohiocathconf.org/i/EJ/GraphWork04.pdf.

Rhode Islanders supported capping interest on payday loans.[34] Citizens of Kentucky similarly voted for a 36% cap on all loans.[35] Finally, in Colorado, voters agreed there was a need for a similar 36% cap.[36] On the national front, a survey by the Center for Responsible Lending showed that three out of four Americans who expressed an opinion thought that Congress should cap interest rates, and 72% felt that the caps should be no higher than 36%.[37] Indeed, no study has found a public desire *not* to cap interest rates.

Additionally, as the next section describes, the public seems to think such caps are in place even when they are not, suggesting that people are ill-informed about what the law actually provides. Our data show that at least in one small state with huge numbers of high-cost lenders, many people simply have no idea that 500% and 1,000% loans exist and perhaps more critically, they are uniformly surprised to hear that this type of lending is legal.[38]

III. THE STUDY

A. Introduction to Study Methodology

The purpose of our study was to assess the public's understanding of and attitudes about financial practices associated with borrowing and lending. We wondered how knowledgeable the general public is about current

34. Press Release, R.I. Office of the Gen. Treasurer, Coalition, Raimondo, Taveras Raise Awareness on Payday Lending Pitfalls (Apr. 17, 2012), http://www.ri.gov/press/view/16334 (reporting that 76% of Rhode Islanders polled support capping payday loan interest rates); *2010 Payday Lending Poll Results*, *supra* note 33.

35. *Kentucky Voters Support a 36 Percent Rate Cap on Payday Loans, Despite Database and Job Loss Threat*, KY. COALITION FOR RESPONSIBLE LENDING, http://kyresponsiblelending.org/wp-content/uploads/2012/10/Poll-data-fact-sheet.pdf (last visited Sept. 19, 2013).

36. Isabel Nicholson, *The Truth About Payday Loans: How Hardworking Coloradans Take the Bait and Get Caught in a Cycle of Debt*, BELL POL. CTR. (Feb. 15, 2008), https://bellpolicy.org/sites/default/files/PUBS/IssBrf/2008/02PaydayLoansweb.pdf.

37. *Congress Should Cap Interest Rates*, CTR. FOR RESPONSIBLE LENDING (March 2009), http://www.responsiblelending.org/payday-lending/policy-legislation/congress/interest-rate-survey.pdf; Christopher L. Peterson, *'Warning: Predatory Lender' - A Proposal for Candid Predatory Small Loan Ordinances*, 69 WASH. & LEE L. REV. 893 (2012), *available at* http://ssrn.com/abstract=1971971 ("Over a hundred different local governments around the country have adopted ordinances restricting high cost, small loans. This trend reflects the solid majority of the American public that opposes the legality of triple-digit interest rate loans and the long historical tradition of treating payday and car-title lending as a serious civil offense or even a crime.").

Id. at 893-95, n.1 (citing CTR. FOR POL. ENTREPRENEURSHIP, *Poll on Payday Lending Legislation* (Feb. 15, 2008), *available at* http://www.c-pe.org/download/PaydayLendingReform/PollPaydayLending.pdf (stating that a weighted sample of 500 Colorado voters found "74% of respondents are in favor of proposed legislation that will set a cap of 36% on the interest and fees that a company can charge for payday loans").

38. *See infra* notes 42-49 and accompanying text.

interest rates for various types of loans. We were also interested in what views people held regarding the role of government regulation in borrowing and lending, and more particularly, whether governments should cap interest on loan products. In the state in which our study was conducted, there are no interest rate caps for most loans,[39] and high-cost lenders and products are ubiquitous. This circumstance allowed us to test the hypothesis that people were unaware of the high interest rates even in a place in which high cost loans were extremely common. We gathered data on these and other topics and then investigated relationships between respondents' financial beliefs and attitudes on the one hand, and various personal demographics such as education and religiosity on the other. The results of the study have potential implications for influencing new legislation and revising existing legislation governing the high-cost lending industry.

B. Methods

We developed a twenty-eight-item survey to assess people's knowledge and beliefs about various financial issues. The questions and data discussed in this article are contained in Appendix A. The survey was administered to two separate groups of respondents through the Opinio survey system. Participants responded to the Internet survey at their own convenience using personal computers available to them.

Subjects. A group of 105 college students participated in the survey to partially fulfill a research requirement in an undergraduate psychology course. A second group of ninety-four participants was solicited through ads placed in local newspapers in several large cities throughout New Mexico. The public participants were remunerated with a $10 Wal-Mart card. The study was approved through the University of New Mexico's Institutional Review Board.

C. Results

1. General

We compared the college students and the general population by performing a chi-square test of independence[40] on the two groups' answers to each question. The groups differed significantly on several items, but these were mostly demographic questions such as age, education level, occupa-

39. For one exception, see Bartik, *supra* note 11 and accompanying text.

40. .DAVID C. HOWELL, FUNDAMENTAL STATISTICS FOR BEHAVIORAL SCIENCES 502-531 (7th. ed. 2010), *available at* http://yunika1106.files.wordpress.com/2013/03/fundamental-statistics-behavioral-sciences.pdf.

tion, and income—characteristics that would be expected to differ between a college group and the general population. In addition, we observed that students were less likely to have taken out loans, had borrowed less money on loans when they did take out loans, and guessed the annual percentage interest rates of loans as being somewhat lower compared to the public group. However, there were no significant differences for the remaining questions, so we combined the results for the two groups into a single sample of 199 participants to simplify analysis and reporting of the findings.

Appendix A shows the proportions of responses to each question for the combined sample of participants. The respondents were roughly two-thirds female, 50% students, and 60% thirty years of age or younger. Seventy percent had an annual income of $30,000 or less, and about two-thirds had graduated from high school or had some college education. Approximately 45% were registered Democrats and 42% percent identified themselves as either liberal or very liberal in their political/social views. In addition, 40% of the respondents identified themselves as either religious or very religious and 30% were Catholic, the largest religious category.

2. Findings Related to Beliefs about Interest Rate Caps

a. Credit Card Interest Rates

Questions 6 through 14 related to consumers' use and knowledge of the law related to credit cards.[41] Because part of the purpose of this Article is to share our finding that the public lacks knowledge about the laws of interest caps, as well as our findings of broad public bipartisan support for interest rate caps, this discussion focuses on questions related to these two topics. More information on related questions is available in Appendix A. As a starting point, 45% of the respondents had borrowed money on a credit card and most of these had carried over a balance from month-to-month. Question 6 asked, "When borrowing money with a credit card, do you believe the current law limits or caps the maximum annual percentage interest rate that a lender can charge?" Over 58% of participants thought that the current law *does* limit the amount of interest rates a credit card company can charge. In fact, the law contains no such limit, showing that well over half of the public is misinformed about the protections the law provides with respect to credit card interest rate caps.

41. More specifically, Questions 1-14 related to how often consumers pay off credit cards in full, what the actual interest rates are on credit cards, and whether the participants use credit cards, and what sized balances they carry, the results of which can be found *infra* Appendix A.

Question 7 asked those who thought there *was* a cap on interest rates on credit cards which of the following annual percentage rates (10% or lower, 25%, 50%, 200% or higher) was closest to the maximum annual percentage interest rate allowed by law for money borrowed on a credit card. Over 48% of participants thought the rate was 25% or lower, with 25% being the most common rate chosen by those who thought there was a cap. Question 8 asked "When borrowing money with a credit card, do you think the current law *should* limit or cap the annual percentage interest rate a lender can charge?" Over 90% of participants thought that the law should limit rates on credit card interest. Question 9 asked those who thought there *should* be a cap what that cap should be, giving the following choices: 10% or lower, 25%, 50%, 100%, or 200% or higher. Nearly 53% of participants thought the rate should be 10% or lower and over 29% thought the credit card rate cap should be 25%. Collectively then, over 82% of all participants thought credit card interest rates should be capped at 25% or less.

Question 10 asked participants to assume that Sally, a hypothetical consumer, charged items on her credit card, and that the credit card company knew that Sally would not be able to pay back the amount borrowed. The question then asked participants whether they believe it was legal for the lender to still lend her the money. The majority of the participants, nearly 59%, incorrectly thought the loan was illegal if the lender knew Sally had no ability to repay the loan. In the U.S., knowledge of an inability to repay a loan rarely affects the legality of a loan and certainly does not do so in the context of credit card debt.[42] Once again, these data show that the public is misinformed about the law related to credit card debt.

b. Storefront or Short-term Loans

Questions 15-23 related to participants' knowledge and use of storefront loans or short-term loans, which were defined in the study as a loan "due either on your next payday or in some other short period of time" where "[y]ou may also have to give your car title in exchange for the money." The definition of short-term loan was written broadly enough to incorporate payday loans, title loans, and triple-digit interest rate "installment loans," a relatively new product in New Mexico designed to get around a

42. *See* John Pottow, *Ability to Pay*, 8 BERKELEY BUS. L.J. 175, 175-77 (2011). This article discusses how new Consumer Financial Protection Bureau rules allow the agency to consider whether mortgage borrowers had an ability to pay when considering whether a mortgage loan is enforceable. The article also notes that considering a borrower's ability to pay is a total sea change in the world of U.S. consumer lending, calling it a "profoundly transformative innovation." *Id.* at 176. The article also notes that considering a borrower's ability to pay is common in European consumer law. *See id.* at 189-91.

new law limiting the rate on payday loans to 417% or less.[43] Question 15 asked, "When borrowing money with a short-term loan, do you believe the current law limits or caps the maximum annual percentage interest rate that a lender can charge?" Roughly 56% of participants said no, which is correct because as a general matter, New Mexico law does not cap interest on consumer loans.[44]

Even though nearly half of the participants (almost 44%) were ignorant of the law on interest rate caps and short-term loans, we were actually a bit surprised that so many New Mexicans *knew* that short-term loans carried no interest rate caps. One of us who works and writes in the area of payday and title loans extensively rarely encounters anyone in the middle class who knows that these rates are *not* capped. Perhaps people were more aware of the law than we expected because a rather astounding 23% of our participants reported having taken out a short-term loan. Previous New Mexico data show that 15% of New Mexicans use payday loans and that 10% use title loans.[45] These percentages are much higher than the estimated 5% of the population nationally that use high-cost payday or title loans.[46] New Mexico's high-cost loan usage rates could be even higher than we found, given that we only advertised our survey in major metropolitan areas, and that payday and title loan shops are even more concentrated in smaller towns in our state.[47]

Question 16 asked those people who *thought* there was a cap on storefront or short-term loans to predict which of five categories of rates they believed was the maximum annual rate. Only a tiny percentage of people in

43. *See* Martin, *supra* note 20, at 564 (description of the ways in which lenders have tried to get around existing laws and an example of a typical payday loan and a typical installment loan); Martin & Adams, *supra* note 23, at 42-43 (description of a typical title loan). *Id.* at 91 n.221. The survey instrument described a short–term loan as follows: During the next several questions you will be asked about short-term loans. By short-term loan we mean a loan taken out at a storefront lender and is usually due either on your next payday or in some other short period of time. You may also have to give your car title in exchange for the money. You will be asked what you think the law *is*, as well as what you think the law *should be* with respect to short-term loans.

44. *See* Bartik, *supra* note 11. New Mexico attempted to cap interest on payday loans at around 390% but the law contained a large loophole, through which lenders began offering payday loans without post-dated checks, which placed the loans outside the statute and made them completely unregulated. Technically then, payday loans are capped at 390% in the state and there is no cap on all other loans.

45. *See* Appendix A, Question 22; McKernan, Ratcliffe, & Kuehn, *supra* note 2. These authors found that in New Mexico, the usage rate of payday loans was 15%, compared to 10% nationally, and that the usage rate for title loans was10% compared to 6% nationally. While our 23% at first seemed higher than previous data from New Mexico, our data include payday and title loan usage, as well as other short-term loan like high-interest installment loans.

46. *Payday Lending in America*, PEW CHARITABLE TRUST 22-23 (July 2012), *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Payday_Lending_Report.pdf. (finding that 5.5% of borrowers reported using payday loans nationally).

47. Abdul-Rahman, *supra* note 16, at 1.

New Mexico who thought there *was* a cap on interest for storefront or short-term loans believed such a cap was 200% or more. Since existing loans carry a rate of far greater than 200%, these data are further evidence that many people are generally unaware of the true high cost of high-cost lending.

Question 17 asked, "When borrowing money with a short-term loan, do you think the current law *should* limit or cap the maximum annual percentage interest rate a lender can charge?" Approximately 86% of participants thought that the current law *should* cap interest and fees on storefront or short-term loans. Question 18 asked those who thought rates *should be* capped for storefront or short-term loans to choose a rate at which such loans should be capped. When faced with choices of 10% or lower, 25%, 50%, 100%, or 200% or higher, over 72% of participants felt that the closest approximation of the rate at which these loans should be capped was 25% or less. Interestingly, people who had themselves taken out short term loans were more in favor of interest rate caps than the general public, though not by a large margin. Over 95% of those who had taken out a short-term loan favored caps on short-term loans, whereas less than 85% of those who had not done so favored such caps.

Similar to the question asked with respect to credit cards, Question 19 asked participants to assume that our hypothetical consumer, Sally, took out a short-term loan, and that the lender knew that Sally would not be able to pay back the amount borrowed. It then asked participants if they thought the loan was legal. Approximately 56% of participants thought such a loan would *not* be legal, despite that, as with credit cards, the ability to pay back a short-term loan such as a payday, title loan, or installment loan, does not affect the legality of the loan.[48] Additionally, Question 21 asked partici-

48. This will change under the new Consumer Financial Protection Bureau regulations. As enacted, Dodd-Frank Section 1411(b) amends the Truth In Lending Act ("TILA") Chapter 2, 15 U.S.C. § 1631-51 (2006), by inserting a new section 129C. 15 U.S.C.A § 1639c (2013 West). Title XIV of Dodd-Frank is subtitled the "Mortgage Reform and Anti-Predatory Lending Act," and Section 1411 provides the following new obligation on all mortgage lenders (originators and brokers):

> Minimum standards for residential mortgage loans.
>
> (a) Ability to Repay. —
>
> (1) In general. —In accordance with regulations prescribed by the Board, no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.

Id. Dodd-Frank also provides that:

> (3) Basis for determination. —A determination under this subsection of a consumer's ability to repay a residential mortgage loan shall include consideration of the consumer's credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio or the residual income the consumer will have after

pants to predict the actual rate of interest on short-term loans. While 19% accurately reported that the typical loan rates were 200% or more, the other 81% had no idea that rates on payday, title, or installment loans were 200% per annum or higher. These data show a huge lack of awareness of the true cost of high-cost credit.

3. Cross-tabulated Data

As set out above, we also cross-tabulated data between pairs of questions. This analysis allowed us to investigate whether respondents who tended to answer a question in one way also tended to answer a second question in a certain way, and thus allowed us to examine the relationship between two different characteristics. For example, are socially conservative people (Question 25) more likely to oppose government regulation of interest rates (Question 28) than liberals? These crosstab analyses are more complex to perform and report, but they can uncover interesting relationships among participants' beliefs. The results are reported in Appendix B, in Tables B1 through B3. A significant chi-square test (i.e., $p < .05$) indicates that a person's response to one question tended to dictate their response to the other question. There were 124 statistically significant crosstab relationships in all, but many of these were expected dependencies between demographic characteristics, such as older respondents were more educated and had higher incomes. Appendix B shows significant crosstab relationships for selected questions. For each crosstab analysis, we report the conditional proportions of respondents in each row along with the results of a chi-square test.

Table B1 shows that in our sample of respondents, men were more conservative than women. The male-to-female ratio varied from 60:40 for those identifying as very conservative to 28:72 for those identifying as very liberal. Interestingly, there was little difference in the male to female ratios for political party (Question 24),[49] religious affiliation (Question 26), or

> paying non-mortgage debt and mortgage-related obligations, employment status, and other financial resources other than the consumer's equity in the dwelling. . . . A creditor shall determine the ability of the consumer to repay using a payment schedule that fully amortizes the loan over the term of the loan.

Id. The Credit Card Act provides a similar provision with respect to credit cards. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, § 109, 124 Stat. 1743 (2009) ("A card issuer may not open any credit card account for any consumer under an open end consumer credit plan, or increase any credit limit applicable to such account, unless the card issuer considers the ability of the consumer to make the required payments under the terms of such account."). *See generally* Pottow, *supra* note 42 (discussing the Dodd-Frank's Act's ramifications on the credit industry).

49. We acknowledge that political party affiliation does not predict attitudes on all issues and also that many complex attitudes go into determining whether a person believes or does not believe that interest rates on consumer loans should be capped. Given these complexities, our only goal was to test

religious beliefs (Question 27). The political/social distinction between men and women was maintained despite commonalities among these other characteristics.

Table B2 shows that support for government regulation of interest rates (Question 28) varied as a function of political/social views (Question 25). As one might expect, liberals, more so than conservatives, were more likely to favor government regulation of interest rates. However, somewhat surprisingly, even among those who identified themselves as very conservative, the majority (57%) believed that government should set limits on interest rates. Table B3 shows a similar relationship among political party and endorsement of government regulation of interest rates. Democrats were more likely to favor government regulation of interest rates than Republicans, but even among Republicans, 74% endorsed government regulation. Although not reported in Appendix B, we found a similar pattern of responses for the more specific questions about government regulation of interest rates for credit cards (Question 8) and short-term loans (Question 17).

Considered collectively, these data show deep, bipartisan public support for interest rate caps and raise abiding questions about whether the political system is working to create consumer protection laws that the public supports and desires. Based upon these data and assuming that politicians are elected to enact laws supported by the public, all politicians (regardless of political party) should support interest rate caps on either a state or national level.

CONCLUSION

Our data show widespread support for interest rate caps in two settings, credit cards and high-interest, payday and title-style loans. There is now a large body of survey data indicating that most Americans believe in interest rate caps. While our data show that more people who favor interest rate cap legislation are Democrats, the data also show that over 57% of people who report being "very conservative" politically and over 82% of those who report being "conservative" politically favor interest rate caps over no interest rate caps. Even in New Mexico, where there generally are no interest rate caps, the general public overwhelmingly favors caps.

the theory that democrats would be more likely as a whole to support interest rate caps that republicans, given that republicans generally favor less regulation rather than more. While this hypothesis proved true, a far larger percentage of republicans than we would have anticipated supported caps on interest rates.

These data raise fundamental questions about why the public is not more active in seeking out laws that cap interest. We think we know the answer. First, many people incorrectly think interest rates are capped (over 58% for credit cards and over 43% for short-term loans), when in reality these rates are not capped. In other words, people misunderstand and overestimate the protection the law currently provides. Second, even among those who know that the law provides *no* caps, most are unaware that lenders currently charge interest rates of 200% or more.

Indeed our data showed that when asked in Question 21, relating to the participants' knowledge of the average interest rate on a short-term loan, only 19% of participants knew that the actual rate was 200% or more. This means that even in a state in which there are no interest rate caps, where lenders regularly charge between 400% and 1,110% per annum for consumer loans, and where high-cost lenders are ubiquitous, 81% of the public is unaware of the costs of these loans. If the public was aware of current lending practices, these data suggest they would support enacting interest rate cap legislation.

APPENDIX A. SURVEY QUESTIONS AND RESPONSES

Below is the full set of survey questions and responses reported for the combined 199 participants (N=94 participants in the Public group and N=105 participants in the Student group). For questions where the proportions in a column do not sum to 100, then the remaining participants did not answer the question.

Question 1. Are you male or female?

Male	34.67
Female	65.33

Question 2. What is your age?

18-30	60.80
31-50	18.09
51 or older	21.11

Question 3. What is your education level?

High School Graduate or GED	39.20
Trade of Vocational Certificate	0.50
Associates Degree or Some College	28.64
Bachelor's Degree	17.59
Master's Degree	8.54
Doctor's Degree	5.53

Question 4. Which of the following categories best describes your job?

Student	52.26
Benefits recipient	0.50
Laborer	2.01
Office	3.02
Heathcare	5.03
Military	1.01
Sales	4.02
Education	5.03
Government	1.51
Management	2.51
Professional	6.03
Other	17.09

Question 5. What is your annual individual income?

less than $30,000	71.36
$30,000-$59,999	18.09
$60,000-$89,999	7.04
$90,000 or higher	3.52

Question 6. When borrowing money with a credit card, do you believe the current law limits or caps the maximum annual percentage interest rate that a lender can charge?

No	41.21
Yes	58.29

Question 7. If you answered yes to the previous question, which of the rates below do you believe is closest to the maximum annual percentage interest rate allowed by law for money borrowed on a credit card?

10% or lower	12.06
25%	36.68
50%	9.05
100%	0.50
200% or higher	1.51
I believe there is no maximum rate	40.20[50]

Question 8. When borrowing money with a credit card, do you think the current law *should* limit or cap the annual percentage interest rate a lender can charge?

No	8.04
Yes	90.45

Question 9. If you answered yes to the previous question, which of the rates below is closest to what should be the maximum annual percentage interest rate allowed by law for credit card loans?

10% or lower	52.76
25%	29.15
50%	8.04
100%	0.50
200% or higher	0.00
I believe there should not be a maximum rate	9.55

Question 10. Assume Sally charged items on her credit card, and the credit card company knew that Sally would not be able to pay back the amount borrowed. Do you believe it is legal for the lender to still allow her to borrow the money?

No	58.79
Yes	40.70

50. When there are slight variations in results from table to table, say between this figure and the first figure in Table 6, it means that once in a while, a person said they thought there was no cap, but then chose a cap in the next question. This was fairly rare, as these data show.

Question 11. How often do you think people pay off the full loan amount on credit card loans each month?

Rarely, if ever	27.64
20% of the time	40.70
40% of the time	19.10
60% of the time	9.55
80% of the time	2.01
Almost always	0.50

Question 12. On average, what would you guess is the actual annual percentage interest rate charged on credit card loans?

10% or lower	17.59
25%	65.83
50%	12.06
100%	2.51
200% or higher	1.01

Question 13. Have you ever borrowed money with a credit card?

No	53.77
Yes	45.23

Question 14. If you answered yes to the previous question, what is the largest balance (amount rolled over from month to month) that you have ever carried on a credit card?

less than $1,000	18.59
$1,000 to $4,999	13.57
$5,000 to $9,999	9.05
$10,000 to $19,999	4.52
$20,000 or more	1.51
I have never carried a balance on a credit card loan	52.76

Question 15. When borrowing money with a short-term loan, do you believe the current law limits or caps the maximum annual percentage interest rate that a lender can charge?

No	56.28
Yes	43.22

Question 16. If you answered yes to the previous question, which of the rates below do you believe is closest to the maximum annual percentage interest rate allowed by law for money borrowed on a short-term loan?

10% or lower	9.55
25%	19.10
50%	12.56
100%	3.02
200% or higher	4.52
I believe there is no maximum rate	51.26

Question 17. When borrowing money with a short-term loan, do you think the current law *should* limit or cap the maximum annual percentage interest rate a lender can charge?

No	13.07
Yes	86.43

Question 18. If you answered yes to the previous question, which of the rates below is closest to what should be the maximum annual percentage interest rate allowed by law for short-term loans?

10% or lower	40.20
25%	32.66
50%	13.07
100%	2.01
200% or higher	0.00
I believe there should not be a maximum rate	12.06

Question 19. Assume Sally took out a short-term loan, and the lender knew that Sally would not be able to pay back the amount borrowed. Do you believe it is legal for the lender to still allow her to borrow the money?

No	56.28
Yes	43.22

Question 20. How often do you think people pay off short-term loans under the loan terms, without borrowing the money again right away?

Rarely, if ever	25.63
20% of the time	28.64
40% of the time	22.11
60% of the time	15.08
80% of the time	5.53
Almost always	2.51

Question 21. On average, what would you guess is the actual annual percentage interest rate charged on short-term loans?

10% or lower	14.07
25%	28.14
50%	32.66
100%	5.53
200% or higher	18.59

Question 22. Have you ever taken out a short-term loan?

No	76.38
Yes	22.61

Question 23. If you answered yes to the previous question, what is the largest short-term loan you have had?

less than $1,000	10.55
$1,000 to $4,999	9.05
$5,000 to $9,999	3.52
$10,000 to $19,999	0.50
I have never had a short-term loan	76.38

Question 24. With which political party are you registered?

Democrat	44.72
Republican	21.11
Independent	14.57
None	19.60

Question 25. How would you rate your political/social views?

very conservative	7.54
conservative	17.09
neutral	33.67
liberal	27.14
very liberal	14.57

Question 26. How would you describe your religious affiliation?

Catholic	29.65
Protestant	12.56
Jewish	2.51
Muslim	0.50
Other	27.64
None	27.14

Question 27. How would you rate your religious beliefs?

very religious	9.55
religious	30.15
neutral	20.60
not very religious	16.58
not religious at all	23.12

Question 28. Do you believe the government should set limits on interest rates?

No	12.56
Yes	86.93

APPENDIX B: CROSSTAB ANALYSES OF SELECTED QUESTIONS

Below are crosstab analyses of selected pairs of questions. In each case, the combined group of 199 participants was used. The numbers in each cell refer to the proportion of respondents who answered the first question (row) one way, broken out by how they answered the second question (column). If the proportions in the rows vary significantly, then there is a dependency on how respondents answered the two questions. The last row in each table shows the proportion of responses collapsing across the row categories.

Table B1. Comparison of Question 25 (row: How would you rate your political/social views?) and Question 1 (column: Are you male or female?). Chi-square = 10.18, $p < .05$

	Male	Female	Totals
very conservative	60.00	40.00	100
conservative	29.41	70.59	100
neutral	43.28	56.72	100
liberal	24.07	75.93	100
very liberal	27.59	72.41	100
Total	34.67	65.33	100

Table B2. Comparison of Question 25 (row: How would you rate your political/social views?) and Question 28 (column: Do you believe the government should set limits on interest rates?). Chi-square = 30.89, $p < .01$

	No	Yes	Totals
very conservative	42.86	57.14	100
conservative	17.65	82.35	100
neutral	14.93	85.07	100
liberal	1.85	98.15	100
very liberal	6.90	93.10	100
Total	12.56	86.93	100

Table B3. Comparison of Question 24 (row: With which political party are you registered?) and Question 28 (column: Do you believe the government should set limits on interest rates?). Chi-square = 11.26, $p<.05$

	No	Yes	Totals
Democrat	5.68	94.32	100
Republican	26.19	73.81	100
Independent	10.34	89.66	100
None	15.38	84.62	100
Total	12.56	86.93	100

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM G. MICHAEL FLORES

Q.1. Regulators have long made clear that the ability to repay means repaying a loan without "loan flipping," i.e., frequent renewals or reborrowing. The Online Lenders Alliance study shows as many as 57 percent of customers in some cases were unable to pay back the loan without taking out another loan in the same month. This study also found that 29 percent of loans were not reported as "paid."

What do these findings tell us about the sustainability of these loans?

A.1. This 57 percent metric indicates that some customers use the product as a monthly cash flow tool and that there are a smaller group of customers that are high frequency users and the single pay product is not necessarily best suited for their needs.

The 29 percent metric is indicative of high risk borrowers. These may be outstanding loans that have yet to reach their payment data of classified as delinquent or charged-off. As such, higher risk equates to higher costs. In a commercial banking environment, 3 percent delinquency is at the upper end of acceptability for consumer loans (see *http://www.federalreserve.gov/releases/chargeoff/*).

Q.2. Please describe how these findings may evidence that an ability to pay rule is needed for these types of loans.

A.2. For short-term, low dollar loans, a better criterion is "likelihood to repay" rather than "ability to repay." For loans that average $400, underwriting for ability to repay would significantly add to the cost and make originating these loans unprofitable. Likelihood to repay measures the history of an individual to honor their obligations for low-dollar debts including utility payments, rent, etc.

Q.3. Payday loans are advertised as 14-day or 30-day loans. Lenders market small-dollar credit loans, such as payday loans, as a "safe," "sensible financial choice," and "the best alternative to meet their current needs" for a "one-time fixed fee."

Pew found that borrowers were on average indebted for 144 days, and CFPB found that they were indebted for 199 days. You testified that the Online Lenders Alliance consumer study shows that consumers have an average of 70 to 120 days of indebtedness per year.

How do these findings reinforce that the short-term small-dollar products are not in fact designed to be repaid according to their terms?

A.3. These products are designed to meet a specific need. My research also finds that the average advance amount has steadily increased since 2009 which indicates a shift in consumer needs. An installment or line of credit product may be more suitable to meet these shifting needs. As I stated in my testimony, the payday product fits into a continuum of credit products starting with overdrafts and progressing in terms of dollar amount, duration, payment scheduling, secured, etc. Removing any of these products from the continuum creates a gap that the consumer must fill with a less

than optimal solution. Adding products provides flexibility and choice so that the consumer will find solutions that meet their specific requirement or circumstance.

Q.4. As a witness at the U.S. House of Representatives Subcommittee of Financial Institutions and Consumer Credit hearing on access to consumer credit in 2012, you stated that divergent States regulations "deny alternative financial services providers the ability to achieve scale thereby reducing costs now associated with operating in all 50 States."

What actions would you recommend the Consumer Financial Protection Bureau (CFPB) take to provide a level of uniformity and Federal oversight of these products, which would in turn allow industry to scale products nationwide and reduce costs?

A.4. To my understanding, the CFPB provides consumer protection oversight but cannot provide a national platform from which standardized products are authorized to exist. I believe that Congress must authorize a national platform.

In terms of establishing national guidelines, the CFPB could be invaluable in going after nonlicensed, off-shore entities that do not conform to any State or Federal statutes.

I believe that a national usury cap of 36 percent would eliminate credit to millions of consumers who have credit scores under 550.

Q.5. The most recent report released by the CFPB shows that 58 percent of borrowers who take out payday loans on a monthly basis are recipients of some kind of benefits—Social Security, SSDI, unemployment—or retirement income. The white paper the CFPB released last year found that 22 percent of all borrowers are on some form of public assistance or relying on retirement income.

Payday is usually advertised as a short-term stopgap to fill a consumer's financial needs until the borrower receives some new source of income. This is not the case for borrowers on a fixed income from Government assistance or in retirement.

How safe are these products for individuals living on fixed incomes?

A.5. If indeed, there is a timing gap to pay an expense, then the short-term advance product is appropriate.

If the premise is that benefits recipients have or will have no other source of income in the future, then that would say we have a group of citizens who have a permanent reliance on benefits. I would have to disagree in that the median age of payday loan users is 39 and that Social Security recipients may only represent a small fraction of users. Additionally, Social Security recipients may earn other income with no limitation past the age of 66. Also, unemployment benefits presuppose that the consumer will one day be employed again. Remember, these loans are a stop gap measure and most users are only in the product for approximately 2 years.

I do not believe that any agency can look into the needs of individuals and State that certain products are inappropriate. That said, there must be a variety of products available to meet individual needs as "one size does NOT fit all!"

Q.6. Should we be concerned that Government benefits payments are going to companies that may be taking advantage of borrowers?

A.6. Actually, many of these benefits are paid by the taxpayers in terms of unemployment taxes and contributions throughout their lifetimes toward social security. I do not believe that the Government has a role in telling people how to spend income that they have paid for throughout their lives.

Q.7. Payday loan contracts are considered simple in comparison to the terms associated with other consumer credit products, such as mortgages, credit cards, and other alternative small-dollar loans like auto-title and installment loans. However, it is clear that borrowers have trouble understanding and assessing their ability to repay since consumers who use these products are in continuous debt.

Can you explain why it is common for borrowers to inaccurately predict their ability to repay in full the loan and their likelihood for taking out subsequent loans?

A.7. No, I have not undertaken a behavioral study on this subject.

Q.8. What type of disclosures would be most useful?

A.8. I am unsure if the disclosure can be any clearer. If an expanded disclosure is inevitable, then a sample of the average loan usage and costs incurred of the loan company's customer base may prove useful.

Q.9. How would disclosing APRs help borrower assess the actual cost of the loan?

A.9. I have never been a proponent on APR as a useful metric for loans less than 1 year in duration. It is the same reasoning that overdrafts do not disclose APR's. The fee for a short-term advance is the most easily understood metric a borrower can have. Consider the APR for a $100,000, 30-year mortgage, while the APR may state 5 percent, the cost of borrowing for the 30-year term is close to the original principal amount. Which is more misleading, $45 for a $300 advance for 2 weeks with the APR of 320 percent or $93,256 for a $100,000 mortgage with a 5 percent APR?

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM G. MICHAEL FLORES

Q.1. Do you think most unbanked or underbanked Americans are capable of handling their own finances, or do you feel that Government needs to step in and "protect them from themselves" by such actions as credit rationing or denying them certain credit products?

A.1. I believe that there should be sufficient choices for the consumer. Most of these consumers are very capable money managers in that they must constantly make choices of how to spend their scarce resources.

Q.2. Some argue that States should not be rationing credit because in some cases consumers act irresponsibly and get deeply in debt. Do you agree, or do you support Government stepping in and rationing credit? Some also argue that loan prices should be set by the free market and should not be subsidized by the Government. What do you think about this issue? Should unbanked and underbanked consumers who pose higher credit risks have their loans

subsidized or be given some type of governmental support, or should rates be set through the free market?

A.2. In any population, there are a small percentage of consumers who account for the majority of volume. The Pareto Principle is a decision-making technique that statistically separates a limited number of input factors as having the greatest impact on an outcome, either desirable or undesirable. Pareto analysis is based on the idea that 80 percent of a project's benefit can be achieved by doing 20 percent of the work, or conversely, 80 percent of problems are traced to 20 percent of the causes.

Regardless of the amount of credit that may be authorized or restricted for a consumer, there will still be the Paretian long tail distribution.

The market is the best arbiter in that most artificial factors limiting the market will have unintended consequences.

Government subsidies are not the ultimate solution, the answer is a robust economy with dynamic job creation and upward mobility for consumers.

Q.3. As you undoubtedly know, the Post Office Inspector General's Office has recently proposed that the Post Office be allowed and encouraged to begin offering small loans and other alternative financial services products through partnerships with banks and credit unions. Their report claims, for example, that the Post Office could offer a $375 loan repayable over 5 to 6 months at a rate of 28 percent APR that would generate a profit of $48 for the Post Office (and its banking partners). Do you find the analysis persuasive?

A.3. This is very dangerous territory for bank in that the Post Office becomes another vendor and must be managed accordingly. This is an example of "rent-a-charter." This could create credit and reputational risk for the bank. Also, there has not been a successful loan model for small dollar loans that can be profitable at 28 percent. For the past 25 years, I have advised banks that they cannot make a profitable loan under $5,000 given their funding, operating, credit administration, compliance and credit loss cost structures. That is why banks used credit cards, overdrafts and home equity loans for consumer loans.

Consider the funding costs of the loans the bank would carry on their books. Then one must consider the operating costs including credit administration and compliance the loss ratio of these loan is approximately 15 percent. If one looks at the following Federal Reserve data for consumer loan delinquencies (see *http://www.federalreserve.gov/releases/chargeoff/delallnsa.htm*), it is difficult to imagine the regulatory not having severe heartburn over a type of credit that exhibits a delinquency and charge-off rate greater than 5 times the banking industry's average:

Delinquency Rates
All Banks, NSA

	Real estate loans				Consumer loans			Leases	C&I loans	Agricultural loans	Total loans and leases
	All	Booked in domestic offices			All	Credit cards	Other				
		Residential [1]	Commercial [2]	Farmland							
2013:4	5.78	8.36	2.44	1.99	2.50	2.45	2.56	0.96	0.88	0.93	3.58
2013:3	6.10	8.61	2.80	2.10	2.43	2.47	2.40	0.81	0.98	1.06	3.76
2013:2	6.65	9.19	3.22	2.26	2.38	2.41	2.34	0.82	1.01	1.16	4.06
2013:1	7.23	9.74	3.77	2.61	2.49	2.67	2.31	0.91	1.08	1.44	4.45
2012:4	7.64	10.19	4.09	2.49	2.76	2.78	2.73	0.87	1.18	1.26	4.73
2012:3	8.09	10.63	4.59	2.79	2.81	2.84	2.78	0.70	1.27	1.60	5.02
2012:2	8.00	10.27	4.92	2.99	2.72	2.79	2.65	0.68	1.38	1.52	5.02
2012:1	8.35	10.40	5.65	3.23	2.88	3.10	2.64	0.93	1.52	1.87	5.33
2011:4	8.58	10.53	6.05	3.06	3.21	3.32	3.09	0.95	1.66	1.69	5.56
2011:3	8.65	10.29	6.62	3.33	3.15	3.47	2.82	0.94	1.87	1.84	5.68
2011:2	8.78	10.30	6.98	3.66	3.15	3.50	2.78	0.98	2.08	2.19	5.82
2011:1	9.24	10.51	7.83	3.96	3.40	3.89	2.87	1.30	2.41	2.73	6.28
2010:4	9.26	10.51	7.88	3.39	3.78	4.22	3.27	1.60	3.01	2.48	6.51
2010:3	9.60	10.67	8.48	3.57	4.02	4.59	3.41	1.72	3.38	2.91	6.85
2010:2	9.68	10.72	8.61	3.53	4.10	4.90	3.24	1.82	3.54	3.27	6.99
2010:1	10.24	11.36	9.13	3.78	4.69	5.88	3.38	2.42	3.89	3.48	7.50

Charge-Off Rates
All Banks, NSA

	Real estate loans				Consumer loans			Leases	C&I loans	Agricultural loans	Total loans and leases
	All	Booked in domestic offices			All	Credit cards	Other				
		Residential [1]	Commercial [2]	Farmland							
2013:4	0.35	0.49	0.17	0.11	2.04	3.15	0.95	0.05	0.28	0.08	0.59
2013:3	0.37	0.47	0.21	0.02	2.03	3.19	0.88	0.02	0.26	0.11	0.61
2013:2	0.54	0.73	0.30	0.03	2.18	3.62	0.73	0.17	0.29	0.01	0.71
2013:1	0.67	0.90	0.35	0.14	2.34	3.78	0.88	0.38	0.32	-0.01	0.83
2012:4	0.89	1.07	0.67	0.27	2.48	3.78	1.12	0.17	0.39	0.35	0.99
2012:3	1.28	1.74	0.67	0.28	2.41	3.74	1.03	0.35	0.49	0.24	1.20
2012:2	1.02	1.23	0.76	0.33	2.57	4.15	0.94	0.22	0.52	0.29	1.11
2012:1	1.10	1.39	0.75	0.20	2.67	4.29	1.00	0.11	0.51	0.15	1.17
2011:4	1.34	1.40	1.35	0.36	2.99	4.53	1.34	0.32	0.76	0.22	1.43
2011:3	1.38	1.52	1.28	0.31	3.52	5.63	1.26	0.18	0.76	0.13	1.53
2011:2	1.54	1.67	1.44	0.34	3.51	5.58	1.30	0.12	0.82	0.27	1.65
2011:1	1.59	1.71	1.51	0.37	4.46	6.96	1.71	0.19	1.05	0.38	1.92
2010:4	2.12	1.99	2.46	0.47	4.90	7.70	1.93	0.74	1.45	0.90	2.38
2010:3	2.04	1.91	2.36	0.40	5.28	8.55	1.81	0.54	1.73	0.71	2.49
2010:2	2.16	2.14	2.36	0.44	6.70	10.97	2.05	0.72	1.76	0.52	2.83
2010:1	2.27	2.44	2.10	0.41	6.70	10.50	2.39	0.88	1.87	1.04	2.93

Q.4. The Internet has revolutionized Americans' buying habits and greatly increased their product choices. Consumers today, regardless of where they are located, can obtain essentially whatever commercial product they need when it is not available locally by going online, getting the best available price and having it delivered to their door. Should consumers in every State have the same ability to get well-regulated small loans and other financial services through the Internet if such products are not otherwise available locally?

A.4. Yes, absolutely.

Q.5. Michael Flores' recent study, Online Short-Term Lending, points out that the primary alternatives to payday loans are often significantly more costly than payday loans. Given that finding, would underserved consumers who now rely on potentially less costly payday loans be helped or harmed if additional States or the CFPB prohibited or severely restricted access to these loans? If credit products like payday loans or banks' deposit advances are eliminated, what happens to the demand for such products?

A.5. My analysis indicates that the $5 million loss of deposit advance products will cost consumer significantly more because their options are limited to mush more expensive overdrafts and slightly more expensive payday loans (if the consumer is in a State that allows these loans).

The consumer is ultimately hurt when credit options are limited.

If most legal credit options are eliminated and demand for credit is not assuaged, then consumers will be forced into unlicensed or illegal options.

Q.6. In States with arbitrary rate caps not set by the market, are consumers who pose significantly higher credit risks really able to get the credit they need?

A.6. It is very difficult for these consumers to access credit from licensed and legal sources.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MORAN FROM G. MICHAEL FLORES

Q.1. Many have criticized what they claim is a lack of price competition in the current marketplace for small consumer loans. Do you believe that the current patchwork of proscriptive State laws is limiting competition, preventing lenders from achieving otherwise available economies of scale or preventing innovative products from reaching a wider marketplace? What can Congress do to help make innovative products like Ms. Klein's company is offering in a limited number of States accessible for all consumers?

A.1. In a more open market with consistent rules from coast to coast, consumers will benefit from price competition from a variety of companies wishing to compete for their business.

I believe a national operating platform that is proposed in H.R. 1566, is a viable approach and should be considered by the Senate.

Q.2. Given the diversity of State lending laws, is it realistic to think that more affordable, better suited, yet commercially viable short term installment loans that fit with today's consumer mobil-

ity and technology trends can be offered without some type of Congressional action?

A.2. No, there must be a national platform to allow a rollout of products which costs can be spread across all markets.

Q.3. You mentioned that a House bill, H.R. 1566, is the best approach suggested so far for meeting consumers' credit needs. Can you explain why you believe this bill can provide a real solution to the credit access problems faced by millions of American families?

A.3. This bill will provide an operating platform to allow companies to operate and compete for a consumer's business. Operating in a 50 State environment will allow companies to achieve economies of scale in order to offer price competitive products. The more companies who compete will also push innovation and lower process, to the ultimate benefit of the consumer.

Q.4. When issuing rules implementing the Dodd-Frank Act, the OCC made the following very clear and compelling comment regarding the importance of uniform national lending standard for national banks:

"Throughout our history, uniform national standards have proved to be a powerful engine for prosperity and growth. National standards for national banks have been very much a part of this history, benefiting individuals, business and the national economy. In the 21st Century, the Internet and the advent of technological innovations in the creation and delivery of financial products and services has accentuated the geographic seamlessness of financial services markets, highlighting the importance of uniform standards that attach based on the product or service being provided, applying wherever and however the product or service is provided. However, the premise that Federally chartered institutions would be subject to standards set at the Federal, rather than State-by-State level, does not and should never mean that those institutions are subject to lax standards . . . [Any] concerns that have been expressed that Federal consumer protection rules were not sufficiently robust should be addressed by the CFPB's authority and mandate to write strong Federal consumer protection standards, and its research-based and consumer-tested rulemaking processes envisioned under the Dodd-Frank Act."

Isn't H.R. 1566, the House bill you mentioned that would create a Federal charter for qualified online nonbank lenders, aimed at giving these lenders the same operating efficiencies as national banks, letting them to innovate by giving them the ability to lend nationwide, subject to strong Federal regulation, ensuring that consumers everywhere can benefit from better, more innovative financial products, which necessitates uniform national standards as the OCC pointed out?

A.4. Yes as I mentioned in the preceding answer.

Q.5. Your testimony notes that "Innovative companies, many of them operating exclusively on the Internet, are trying to design flexible products to meet" consumer credit demands, but that many in industry tell you that "real innovation is limited" because of diverse State lending laws. How do you see these State laws affecting consumers as they seek to obtain innovative, more affordable small

loans and other financial products through the Internet? Would Federal legislation open up credit access?

A.5. The Internet is the ultimate (to date) disruptive technology. State laws and State barriers to entry worked when we all lived in an analogue world where consumer were limited to products and services offered by businesses who had physical operations in the market where the consumer lived. Some of these State laws were designed to protect local businesses from out-of-State competition. Businesses today must adapt to today's realities and cannot be protected from companies who may be able to provide a better product or service at less expense.

While I understand the "States' rights" argument about overreach by the Federal Government, it is a fait accompli that consumers have access to products and services from all over the globe.

I believe Federal legislation would, indeed, open up access to credit and allow the development of a variety of products designed to meet unique needs of consumers.

One last point I would like to make. During the questioning, Senator Merkely asked about the Oregon law that prohibits payday loans. While the Oregon law does have a 36 percent rate cap, it does allow for a $10 per $100 origination fee (up to $30) for each new loan in addition to the 36 percent interest. This is a hybrid payday product and companies can make this loan because of the origination fee. If consumers find this product useful for their circumstances, a national charter would not inhibit companies from offering this loan.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM NICK BOURKE

Q.1. The FDIC and consumer groups have advocated for small-dollar products that have four features:

a. reasonable APRs;
b. repayment period longer than 90 days;
c. ability to repay principal;
d. and the borrower demonstrates an ability to repay the loan in full.

Some lenders have responded to criticism of the payday product by moving toward installment loans. You stated in your testimony that installment loans are an encouraging market solution for consumers. As an example of an installment product, Enova offers a 7 months and 13 months installment product in New Mexico with APRs of 389 percent and 393 percent, respectively.

As industry moves toward lengthening repayment terms, is it possible to address the issue of affordability of small-dollar credit products without addressing all four of the features mentioned? Please explain why or why not.

A.1. 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. More rigorous ability to repay standards are required, as well as other safeguards. Pew's research has demonstrated that most payday loan borrowers cannot afford to spend more than 5 percent of their periodic pretax income on loan payments (for example, a typical borrower making $2,500 per month could not afford loan payments of greater than $125 per month). Loans that meet this 5 percent benchmark may merit streamlined regulatory underwriting requirements if policy makers wish to promote access to credit for those with damaged credit histories.

However, any loan that requires periodic payments in amounts that exceed 5 percent of a borrower's gross periodic paycheck must be rigorously underwritten to ensure the borrower can repay the loan and all other expenses without reborrowing. These requirements generally will result in installment loans, though they do not preclude the possibility of loans that could last shorter than 90 days.

Pew does not have a specific recommendation regarding the price of small-dollar loans that are marketed to those with damaged credit histories. However, setting maximum allowable prices is warranted in markets, such as this one, where there is evidence that competition does not put downward pressure on prices or where consumers are inherently vulnerable. 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 (for more information, see Pew's recently released fact sheet, *How State Rate Limits Affect Payday Loan Prices*).

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. Meanwhile, the Consumer Financial Protection Bureau must take action to ensure that all small-dollar loans are safe and transparent. The CFPB should enact a strong ability to repay standard, and require several commonsense safeguards for small-dollar loans. These safeguards include requirements for substantially equal payments that amortize smoothly over time, and for spreading fees and costs evenly over the life of the loan to reduce the risk of loan flipping, i.e., lender-driven refinancing that creates long-term indebtedness and drives up cost. More discussion is provided in our response to Question 2 below.

For more information: Please see *Pew's Policy Solutions* report (2013). Section 3 (starting at page 26) discusses factors for ensuring affordability in installment loan markets. Section 4 (starting at

page 33) discusses important considerations for payday loan reform, including a number of common problems found in installment loan markets in addition to the ability to repay problem. Pew's detailed policy recommendations are found on pages 44–47.

For more on the lack of price competition in payday loan markets, see *How State Rate Limits Affect Payday Loan Prices* (The Pew Charitable Trusts, 2014).

A collection of Pew's research on small-dollar lending, including summaries and interactive displays, is available at *www.pewtrusts.org/small-loans*.

Q.2. You stated in your testimony that "lenders' reliance on long-term borrowing behavior indicates a fundamental flaw in the business model that can only be addressed by requiring loans to be structured differently (mainly, as installment loans)."

What research has Pew conducted to determine if similar rollover behaviors are expected from an installment product?

A.2. Pew's *Payday Lending in America* series of reports has demonstrated the significant gap that exists between how payday loans are packaged and marketed (i.e., as short-term, fixed-fee products for temporary needs) and how most borrowers experience them (the average borrower is dealing with an endemic financial shortfall, is in payday loan debt for 5 months, and pays $520 in finance charges, nearly ten times the advertised price of a typical payday loan). The conventional payday loan business model relies on this gap for its profitability. Analysis of State regulatory data shows that nearly all lender revenue comes from repeat borrowers: Lenders make 97 percent of their revenue from borrowers who use three or more loans per year, and 63 percent of revenue from those using 12 or more loans per year. Consecutive usage is the norm. According to the CFPB, 80 percent of loans originate within 14 days of a previous loan, and half of all loans occur within a continuous sequence often or more loans.

Similar problems can occur in installment loan markets. For example, installment loans with front-loaded or unaffordable payments can lead to refinancing and nontransparent cost structures, as described in the following excerpt from Pew's *Policy Solutions* report (2013), at pages 33–34 (citations are not included below but can be found in the original report):

> 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 6-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.

There are two lender incentives to encourage refinancing that can cause borrowers financial harm.

[1] 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. 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.

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), policy makers must be aware of the strong link between origination fees and loan flipping.

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, policy makers should limit the use of origination fees in small-dollar loan markets. Possible approaches include limiting fees to a nominal amount, 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.

[2] 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. 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. Lawmakers sometimes address this problem by requiring lenders to use the standard actuarial method. 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.

Q.3. Lenders offerings small-dollar installment credit products claim they can help borrower build a credit history and improve credit scores. Enova testified that they have been working to foster relationships with the major credit bureaus, and hope to help consumers build credit history.

Can you explain how these products have improved the credit scores for individual consumers?

Conventional payday lenders making lump-sum and installment payday loans generally do not report to credit bureaus. Nonbank installment lenders generally do report to credit bureaus. There has been little research on the credit score trajectory of nonbank installment loan customers. In order for customers to be successful in using installment loans and improve their credit scores, it is crucial that the loan payments are affordable and fit within their ability to repay.

It is worth noting that access to additional credit will not lead to better outcomes for some borrowers. Customers who turn to high-interest small-dollar loans often have very low credit scores because they are already heavily indebted and/or struggling to make ends meet. For example, rather than being "thin file" or "no file" consumers who are creditworthy but lack access to main-

stream credit, most payday loan borrowers are "thick file" consumers who have substantial experience with debt. More than half of payday loan borrowers carry credit card debt, two in five own homes (many with mortgages), and many also hold student loans, auto loans, and other debt. The average payday loan applicant has a credit score in the low 500s, indicating an assessment by credit reporting agencies that payday borrowers are already overburdened with debt and/or struggling to meet financial obligations. For more information, see Pew's Policy Solutions report (2013), at pages 26–27 (the section entitled, "The Limited Benefits of Access to Credit").

Q.4. Payday loans are advertised as 14-day or 30-day loans. As Pew stated in the Payday Lending in America series, lenders market small-dollar credit loans, such as payday loans, as a "safe," "sensible financial choice," and "the best alternative to meet their current needs" for a "onetime fixed fee."

You testified that borrowers were on average indebted for 144 days, and CFPB found that they were indebted for 199 days. The Online Lenders Alliance consumer study shows that consumers have an average of 70 to 120 days of indebtedness per year.

Please explain how do these findings reinforce that the short-term small-dollar products are not in fact designed to be repaid according to their terms?

A.4. These findings demonstrate a large gap between how a product is packaged and how it is experienced. As demonstrated below, this gap exists because of loan structures that promote frequent refinancing and business models that cannot be profitable without such frequent refinancing.

A. Most payday loan borrowers are in long-term financial distress, and they turn to payday loans for funds to cover regular monthly costs.

- Payday borrowers routinely struggle to pay their bills: 58 percent report having trouble paying regular bills at least half the time, and one-quarter have trouble paying bills every single month.
- 69 percent of payday borrowers turned to a payday loan for help paying recurring expenses (such as rent, mortgage, utilities, credit card bills, and so on).

B. Payday loans are fundamentally unaffordable because they take too much of a typical borrower's next paycheck, undermining their ability to repay the loan and keep up with regular bills.

- A typical payday loan requires a payment of $430 on the borrower's next payday, or 36 percent of a typical borrower's gross (pretax) paycheck.
- Most borrowers can afford to pay no more than 5 percent of their pretax paycheck toward a loan while meeting other financial obligations without having to borrow again to make ends meet.

C. When loan payments exceed borrowers' capacity to repay, extended usage is the norm.

- Unaffordable payments lead to consecutive reborrowing: 80 percent of payday loans originate within 14 days of a previous loan.
- The average payday borrower is in debt for 5 months of the year, even though many borrowers sought to avoid "more debt" or "another bill."
- The average borrower pays $520 in fees per year, far higher than the $55 "fixed fee" for the average payday loan.

D. The payday loan business model requires extended usage to be profitable

- Almost all payday revenue comes from repeat borrowers: 97 percent of loans go to those using three or more per year, and 63 percent of loans comes from those who use 12 or more per year.
- The business model is not profitable until the average borrower uses four to five loans per year.

Payday and other small-dollar loan business models are fundamentally reliant on this pattern of unaffordability and reborrowing for their profitability—a fact that represents one of the most striking failures of this marketplace and one which policy makers have too often overlooked. Going forward, regulators should monitor the percentage of revenue that payday and installment lenders receive from loan refinancing, because high rates of refinancing are indicative of poor underwriting or other harmful practices.

Q.4. The most recent report released by the CFPB shows that 58 percent of borrowers who take out payday loans on a monthly basis are recipients of some kind of benefits—Social Security, SSDI, unemployment—or retirement income. The white paper the CFPB released last year found that 22 percent of all borrowers are on some form of public assistance or relying on retirement income.

Payday is usually advertised as a short-term stopgap to fill a consumer's financial needs until the borrower receives some new source of income. This is not the case for borrowers on a fixed income from Government assistance or in retirement.

How safe are these products for individuals living on fixed incomes?

Should we be concerned that Government benefits payments are going to companies that may be taking advantage of borrowers?

A.4. Pew's research has found that 41 percent of borrowers use a cash infusion, like a tax refund or help from family or friends, to repay a payday loan. Academic research has found that payday loan balances outstanding decline during the early months of the year when tax refunds are distributed. An average payday loan payment requires 36 percent of an average borrower's bi-weekly income. This figure will average 15 to 20 percent for someone who receives income monthly instead. Pew's research indicates that most borrowers can spend no more than 5 percent of their income on payday loan payments while meeting other expenses. Therefore, without a cash infusion, many people on fixed incomes have difficulty retiring payday loan debts because of the loan's lump-sum payment structure.

Q.5. Payday loan contracts are considered simple in comparison to the terms associated with other consumer credit products, such as mortgages, credit cards, and other alternative small-dollar credit like auto-title and installment loans. However, it is clear that borrowers have trouble understanding and assessing their ability to repay since consumers who use these products are in continuous debt.

Can you explain why it is common for borrowers to inaccurately predict their ability to repay in full the loan and their likelihood for taking out subsequent loans?

What type of disclosures would be most useful?

How would disclosing APRs help borrower assess the actual cost of the loan?

A.5. Under a lump-sum loan structure, only a product's 2-week cost is clear, but very few loans are made to customers who repay them without quickly reborrowing. This gap means that the product's stated cost is dramatically different from how much the borrower ultimately spends. As an example, when Colorado had lump-sum payment loans under its previous law, the stated cost represented only 13 percent of the dollars spent by an average customer annually. After the law change created a transparent installment product, the stated cost represented 87 percent of the dollars spent by an average customer annually.

Excerpts from *How Borrowers Choose and Repay Payday Loans* and *Policy Solutions* follow:

> More than three-quarters of borrowers in Pew's survey stated that they rely on the payday lender to provide accurate information, but information is provided only about a two week product, even though borrowers end up indebted for an average of 5 months. Because the loans do not amortize, paying just the fee—the salient price that borrowers are instructed to pay if they cannot afford full repayment—does not reduce the amount owed, leaving them no closer to eliminating the debt. Therefore relying on the lender for accurate information makes the ultimate cost and duration of the debt extremely difficult to predict.
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> 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.
>
> 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.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM NICK BOURKE

Q.1. Do you think most unbanked or underbanked Americans are capable of handling their own finances, or do you feel that Government needs to step in and "protect them from themselves" by such actions as credit rationing or denying them certain credit products?

A.1. A key policy goal should be to ensure a safe and competitive marketplace, in which all potential borrowers of small-dollar loans can choose products based on transparent information that allows them to predict costs accurately. Unfortunately, there is extensive evidence that the small-dollar loan market fails this test.

For example, consider the large gap that exists between how a payday loan is advertised or packaged and how it is experienced. As demonstrated below, this gap exists largely because of loan structures that encourage frequent refinancing and business models that cannot be profitable without such frequent refinancing.

A. Most payday loan borrowers are in long-term financial distress, and they turn to payday loans for funds to cover regular monthly costs.

- Payday borrowers routinely struggle to pay their bills: 58 percent report having trouble paying regular bills at least half the time, and one-quarter have trouble paying bills every single month.
- 69 percent of payday borrowers turned to a payday loan for help paying recurring expenses (such as rent, mortgage, utilities, credit card bills, and so on).

B. Payday loans are fundamentally unaffordable because they take too much of a typical borrower's next paycheck, undermining their ability to repay the loan and keep up with regular bills.

- A typical payday loan requires a payment of $430 on the borrower's next payday, or 36 percent of a typical borrower's gross (pretax) paycheck.
- Most borrowers can afford to pay no more than 5 percent of their pretax paycheck toward a loan while meeting other financial obligations without having to borrow again to make ends meet.

C. When loan payments exceed borrowers' capacity to repay, extended usage is the norm.

- Unaffordable payments lead to consecutive reborrowing: 80 percent of payday loans originate within 14 days of a previous loan.
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D. The payday loan business model requires extended usage to be profitable

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- The business model is not profitable until the average borrower uses four to five loans per year.

Payday and other small-dollar loan business models are fundamentally reliant on this pattern of unaffordability and reborrowing for their profitability—a fact that represents one of the most striking failures of this marketplace and one which policy makers have too often overlooked.

Fifteen States do not have payday lending stores, usually because they have declined to exempt payday lenders from the State's usury laws. Existing research is inconclusive as to whether individuals fare better with or without access to high-interest credit, but the research is clear that where high-interest credit is available, borrowers who use loans with affordable payments fare better than those who use loans with lump-sum payments.

Some States have decided to allow high-interest credit, but with limits on how many loans, or how much money, a customer may borrow at a time or in a year. In Colorado, officials recognized that payday loans were working poorly, largely because their payments were unaffordable. The 2010 reform they passed, requiring at least 6 months to repay in affordable installments, instead of a 2-week balloon payment, has succeeded as a result. An excerpt from Pew's *Policy Solutions* report follows, describing why Colorado officials elected to fix the failed balloon-payment payday loan, rather than leaving it intact and attempting to mitigate its harm through limiting its usage:

> Some States with loan-rationing strategies have decreased the volume of borrowing, 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 bor-

rowers 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 6 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.

Q.2. Some argue that States should not be rationing credit because in some cases consumers act irresponsibly and get deeply in debt. Do you agree, or do you support Government stepping in and rationing credit? Some also argue that loan prices should be set by the free market and should not be subsidized by the Government. What do you think about this issue? Should unbanked and underbanked consumers who pose higher credit risks have their loans subsidized or be given some type of Governmental support, or should rates be set through the free market?

A.2. There are many financial products that a minority of customers use irresponsibly or poorly, while most use them successfully, as designed. With products like these, financial education and disclosures are good tools to preserve the benefits of the products for most customers, but help the minority avoid harm. In contrast, payday loans are used as designed by few customers, and the product's balloon-payment structure predictably leads to a situation where most borrowers fail. Approximately 80 percent of loans are made within 2 weeks of a previous loan's due date, indicating that customers do not have the ability to repay the loans without quickly reborrowing.

Unbanked consumers are generally ineligible for payday loans, because they cannot provide access to their checking account via postdated check or ACH as collateral for the loan. While payday loan borrowers have poor credit scores, an excerpt from *Policy Solutions* follows, explaining that the driver of high payday loan prices is not credit loss (borrower risk):

> 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.

On the question of pricing, the same lenders charge similar borrowers very different prices for the same loans, based on State interest rate limits. In some States, lenders charge more than double for the same loan what they charge in other States. In States that have set lower-than-average limits on payday loan prices (but still above 36 percent APR), access to credit has not been significantly constrained. Another excerpt from Policy Solutions follows:

> Nearly all States have set maximum interest rate limits for some types of loans. All 13 original colonies did so. 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. Even in the 35 States that allow high-interest, lump-sum payday loans, 28 limit the permissible charges. In other words, small-dollar loan markets normally operate with State-mandated price limitations. Previous research finds that payday borrowers do not focus primarily on price when taking out a loan, but rather on convenience and speed. Further, demand for payday loans is not sensitive to price. 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." In such circumstances, setting maximum allowable rates can ensure that borrower costs resemble those in a marketplace with price competition.
>
> 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. In States where conventional payday loans are offered, lenders generally do not compete on price; they tend to cluster prices at the maximum al-

> lowed, and then compete on customer service and location. 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.

For more on the lack of price competition in payday loan markets, see *How State Rate Limits Affect Payday Loan Prices* (The Pew Charitable Trusts, 2014).

Q.3. As you undoubtedly know, the Post Office Inspector General's Office has recently proposed that the Post Office be allowed and encouraged to begin offering small loans and other alternative financial services products through partnerships with banks and credit unions. Their report claims, for example, that the Post Office could offer a $375 loan repayable over 5 to 6 months at a rate of 28 percent APR that would generate a profit of $48 for the Post Office (and its banking partners). Do you find the analysis persuasive?

A.3. In the example cited, a customer would borrow $375 and repay approximately $423 ($48 in interest and fees) over 5.5 months. The Inspector General's report used the example of a 25 percent annualized interest rate plus a $25 loan fee. The resulting APR would be approximately 46 percent. Such a loan would produce $48 in revenue, but the report did not estimate the loan's profitability. Insufficient information about losses and overhead is available to project the profitability of the hypothetical loan described. Small-dollar loans are available from some credit unions, a few nonbank alternative lenders, and a few banks at rates similar to the one discussed here. Nonbank lenders have lowered prices substantially when States have reduced allowable prices (without corresponding declines in access to credit), though no conventional storefront lenders offer loans at prices approximating 46 percent APR.

Q.4. The Internet has revolutionized Americans' buying habits and greatly increased their product choices. Consumers today, regardless of where they are located, can obtain essentially whatever commercial product they need when it is not available locally by going online, getting the best available price and having it delivered to their door. Should consumers in every State have the same ability to get well-regulated small loans and other financial services through the Internet if such products are not otherwise available locally?

A.4. Federal standards are appropriate to ensure a basic floor for product safety. Pew has outlined detailed policy recommendations in order to make payday loans safer. But a Federal charter for payday lenders would undermine the authorities over interest rates and consumer protections that traditionally have resided with States.

Q.5. Michael Flores' recent study, *Online Short-Term Lending,* points out that the primary alternatives to payday loans are often significantly more costly than payday loans. Given that finding,

would underserved consumers who now rely on potentially less costly payday loans be helped or banned if additional States or the CFPB prohibited or severely restricted access to these loans? If credit products like payday loans or banks' deposit advances are eliminated, what happens to the demand for such products?

In thinking about consumers' costs, it is crucial to know whether one product is a substitute for another, or whether it is instead one used in addition to another. It is not clear that payday loans on net help customers spend less on other products, like overdraft. Demand for credit is also not fixed, but is instead shaped by convenience, advertising, and perceptions of providers. An excerpt on overdraft substitution from How Borrowers Choose and Repay Payday Loans follows:

> Payday loans are sometimes promoted as a cost-effective alternative to checking account overdrafts. (A major storefront and online payday lender encourages borrowers to "use payday loans to stop a bank overdraft or NSF fee," and a prominent online payday loan Web site states, "avoid costly overdraft fees and charges!") However, more than half of payday loan borrowers report having overdrafted their accounts in the past year, and 27 percent report that a payday lender making a withdrawal from their bank account caused an overdraft. Moreover, Pew's prior research has shown that the vast majority of those who overdraw their accounts do so by mistake, not by intention. Although people choose payday loans in order to avoid overdrafts, many end up paying payday loan fees and overdraft fees as well.
>
> Although it is unclear how much payday borrowing may reduce or increase the likelihood of checking account overdrafts, Pew's research shows that payday loans do not eliminate overdraft risk. Prior research has found that some payday loan borrowers are explicitly choosing to use the loans to avoid overdrafts and bounced checks, but Pew's survey research demonstrates that borrowers are incurring overdraft fees anyway.

An excerpt on credit demand from Pew's comment letter to the OCC and FDIC follows:

> Another important area to consider after a policy shift occurs is whether customers who used a product that has been altered will substitute an inferior product. The CFPB's recent white paper examined the small number of banks that offer deposit advance products. At those banks, 15 percent of all eligible checking account customers are utilizing deposit advances. Other data indicate that only four percent of adults use storefront payday loans, and even fewer use online payday loans. In other words, where banks are offering payday-like loans, they are experiencing very high levels of usage compared to payday loan usage in the general population. Conversely, where banks do not offer such loans, there is no evidence of higher usage of payday loan stores. Thus, it should not be assumed that

> bank deposit advance borrowers will shift to storefront or online payday loans.
>
> Pew's research also shows that people are no more likely to seek cash advances online when storefronts are not unavailable in their communities. The rate of online borrowing in States that essentially prohibit storefront payday lending is identical to the rate of online borrowing in States where payday loans are available from stores. These figures have important implications as we think about substitution as compared with demand generation in the broader small-dollar credit market.
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> Pew's research with storefront and online payday borrowers indicates that people who find themselves unable to pay bills are often not choosing between formal credit products. Instead, they choose between a variety of options, with a majority saying they would cut back on expenses, delay paying bills, borrow from family or friends, or sell or pawn possessions if they did not have access to payday loans. Thus it is important to place bank deposit advance loans in the larger context of borrowers' decision making, recognizing that they are choosing between many options, and will not necessarily be motivated to seek the services of conventional payday lenders because of a lack of payday loan options at banks.
>
> Because of a deposit advance's unaffordability, it is unclear whether it functions as a substitute for other credit products or overdrafts, or whether deposit advance borrowers simply pay more fees as they use both products. The CFPB report's finding that 65 percent of deposit advance customers overdraft too is instructive. While it is still unclear whether deposit advances on net increase or decrease overdrafts, it is clear that they do not eliminate overdraft risk, and most borrowers pay fees for both.

Q.6. Your report says (p. 46) that "PEW does not recommend law changes in the 15 States that do not have payday lending, because such a change may not benefit consumers." On the other hand such a change may benefit consumers if they need a credit product that State law currently prohibits. Do you think consumers are better off with a properly structured and regulated loan at a market based rate than to have no loan available due to an prohibitive cap?

A.6. Lump-sum payday loans are not properly structured in the 35 States that have them, because they consistently exceed a borrower's ability to repay (though not a lender's ability to collect, via postdated check or ACH). As to whether people already struggling with debt fare better with or without access to additional high-interest credit, an excerpt from *Policy Solutions* follows:

> 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. Typical payday loan applicants have poor credit scores in the low 500s, 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. 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 policy makers 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.

Q.7. In your written submission to this Committee dated March 24, you discussed in-depth a report from the CFPB, *CFPB Data Point: Payday Lending* that was not publicly available until the following day, March 25. How did you come to have access to this report ahead of its public release?

A.7. Media members with embargoed copies of reports sometimes call Pew for comment while they work on stories in advance of an embargo lifting. In these instances, media members may share embargoed copies of a report in order to gain Pew's perspective on the report for their piece. Pew received the CFPB report on March 24 in this way in order to provide comments to the media.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM NICK BOURKE

Q.1. Mr. Bourke, Harris Interactive recently conducted a national survey that found that payday loan borrowers indicated their experience was better than expected or as expected 96 percent of the time in regards to terms and 92 percent of the times in regards to cost. It also found that 84 percent of borrowers said it was very easy or somewhat easy to repay their loans. Given this survey's result and the fact that consumers appear to value the option of payday loans, how does this reconcile with the ever present criticism of payday lenders from various advocacy groups?

A.1. Pew has also found that people in difficult circumstances are grateful to receive credit And because payday loans are usually due on the day a customer receives income, they are indeed repaid, though usually followed by a quick reborrow. This additional borrowing is a result of a lump-sum repayment that consumes an average of 36 percent of a person's bi-weekly income. Customers usually cannot afford to cover basic expenses after repaying a lump-sum loan. An excerpt from *How Borrowers Choose and Repay Payday Loans* follows:

> In deciding whether to borrow from a payday lender, more than 3 in 4 borrowers rely on lenders to provide accurate information about the product, and lenders describe loans as "safe," "a sensible financial choice," and "the best alternative to meet their current needs" for a "one-time fixed fee." The product's stated 2-week duration appeals to the borrower's desire for a quick cash infusion as well as the conflicting desire not to be in ongoing debt. In reality, both desires cannot be met. But a payday loan's unrealistically short repayment period suggests otherwise by enabling people in difficult situations to think that the loan can solve their problem at an affordable fixed cost so they can avoid asking for help, cutting back further, or creating another ongoing bill.
>
> The ultimate cost and duration of the loans are highly unpredictable and bear little resemblance to their 2-week packaging. Average borrowers end up indebted for 5 months, paying $520 in finance charges for loans averaging $375, largely because they see their only choices as making a lump-sum repayment retiring their entire debt, which they cannot afford, or paying fees to continuously pay back and reborrow the loan, which they can afford but which does not reduce what they owe. Once they have borrowed, neither choice is viable, leaving them indebted far beyond their next payday. This experience leaves borrowers torn—grateful to have received respectful customer service and credit when they sought it, but feeling taken advantage of by the loan's cost and frustrated by the difficulty of repayment.

Q.2. A study entitled, "Consumer Borrowing After Payday Loan Bans" was recently published by Jacob Goldin and Tatiana Homonoff professors at Princeton and Cornell. The study examines the changes in consumer borrowing behavior when they lose access to payday loans, specifically the effect of payday loan restrictions at the State level. The study finds that payday loan bans do not reduce the amount of individuals who take out alternative financial services products, but instead force consumers to choose different inferior credit options. Do you believe research should continue to be to done to fully understand how regulations will affect consumers and their access to credit, before more haphazard rules and regulations for the short-term lending industry are enacted? Has PEW considered increasing their research on payday lending in an effort to focus on how to provide and not limit credit options for consumers?

A.2. Pew has conducted extensive research on payday lending, and has studied the literature on the topic. It is unclear whether people fare better or worse with access to high-interest loans, but it is very clear that they fare better with loans that have affordable (usually installment) payments compared to high-interest loans that have balloon payments. Pew's policy recommendations show how loans can be better for borrowers and viable for lenders, alleviating the substantial problems in the small-dollar, high-cost credit marketplace. The recommendations follow:

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 policy makers 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 nonrevocable 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 6 months or less, and a majority set the maximum loan amount at $500 or less.

Policy makers 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 6 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 over-

sight 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, policy makers 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, 6 months is long enough to repay $500, and in consumer finance installment loan markets, approximately 1 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 op-

erate. 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*.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM NATHALIE MARTIN

Q.1. The FDIC and consumer groups have advocated for small-dollar products that have four features:

a. reasonable APRs;
b. repayment period longer than 90 days;
c. ability to repay principal;
d. and the borrower demonstrates an ability to repay the loan in full.

Some in the industry have responded to this criticism of the payday product by moving toward installment loans. Enova offers a 7 months and 13 months installment product in New Mexico with APRs of 389 percent and 393 percent, respectively.

As industry moves toward the lengthening repayment terms, is it possible to address the issue of affordability of small-dollar credit products without addressing all four of the features mentioned? Please explain.

A.1. In my opinion no.

Q.2. Payday loans are advertised as 14-day or 30-day loans. Lenders market small-dollar credit loans, such as payday loans, as a "safe," "sensible financial choice," and "the best alternative to meet their current needs" for a "one-time fixed fee." Pew found that borrowers were on average indebted for 144 days, and CFPB found that they were indebted for 199 days. The Online Lenders Alliance consumer study shows that consumers have an average of 70 to 120 days of indebtedness per year.

How do these findings reinforce that the short-term small-dollar products are not in fact designed to be repaid according to their terms?

A.2. The findings absolutely lead to this conclusion. The entire business model is based upon repeat users, and the industry has said so in many contexts publicly. This fact comes out in litigation

all over the country, as well as in empirical studies. There is little profit in the short term use.

The CFPB report released in March also showed that for first time users, 15 percent of customers pay off and don't go back. 20 percent default. That means 64 percent do not use these as a short term product. Those 64 percent are the bread and butter of the business model, the ones the lenders want in their portfolios.

Q.3. In your written testimony you stated that "in States where complex statutes are passed to limit high-interest lending . . . lenders find ways around those laws by changing the attributes of the loans to avoid the laws, fitting within exceptions created by other laws on the books, or becoming credit service organizations (CSOs), which are exempt from the laws." You further stated this is a " . . . complex game of whack-a-mole makes regulating State by State an expensive yet ineffective endeavor."

How would you propose addressing this issue?

What actions would you recommend the Consumer Financial Protection Bureau (CFPB) take to provide a level of uniformity and Federal oversight of these products?

A.3. The CFPB should implement broad rules that apply to all small dollar loans products, that require underwriting to ensure the borrower can pay his or her regular bills and also repay the loans, both principal and interest. The CFPB should limit the number of loans that can be taken out and require that in order to be enforceable, the loans must be placed in a national database and tracked.

Q.4. The most recent report released by the CFPB shows that 58 percent of borrowers who take out payday loans on a monthly basis are recipients of some kind of benefits—Social Security, SSDI, unemployment—or retirement income. The White Paper they released last year found that 22 percent of all borrowers are on some form of public assistance or relying on retirement income.

Payday is usually advertised as a short-term stopgap to fill a consumer's financial needs until the borrower receives some new source of income. This is not the case for borrowers on a fixed income from Government assistance or in retirement.

How safe are these products for individuals living on fixed incomes?

A.4. The products are unsafe for almost everyone who uses them (the exception being those with real, rare, emergencies who expect a great deal more income or assets in the future). They are particularly bad for those on fixed income. These loans make it much harder to make ends meet during the next benefit period. I also know some lenders specialize in "serving" people on disability or social security. They know the borrowers involved will never be able to pay back the principal and that is part of the business palm.

Q.5. Should we be concerned that Government benefits payments are going to companies that may be taking advantage of borrowers?

A.5. This is a huge problem and yes we should be very concerned. As mentioned above, I have heard of a small town in New Mexico where five lenders line main street and all or four of five specialize in making loans to people who receive public benefits. This is how

I learned firsthand that lenders do not want anyone paying off the principal. It would clearly be impossible the way they loan to people on such a low fixed income. That is part of the model. Make loans that people will not be able to pay off and make money on fees forever.

We know lenders also discourage people from paying off their loans and in one reported case in New Mexico, an employee of a lender told a borrower that the borrower was better off using their tax return at Walmart. That opinion is attached. Some lenders also call borrowers on their way home from repaying a loan and offer them another loan, this time in a larger amount, perhaps in hope that this time, the loan will not be paid off.

There are other situations in which this same thing is happening, meaning that Federal benefits are going to high-cost lenders. For example, some tax preparers themselves take most of the primary welfare benefit in America today, the earned income tax credit, which is designed to alleviate poverty. In both cases, the situation you mentioned and the situation with the tax preparers, we are literally funneling taxpayers' money away from the intended beneficiaries and into the lender's pockets. The lenders in turn give political campaign contributions to politicians who will ensure that the law continues to support these practices. No one benefits except the lenders and the politicians who get the contributions. Everyone else in society suffers.

Q.6. Payday loan contracts are considered simple in comparison to the terms associated with other consumer credit products, such as mortgages, credit cards, and other alternative small-dollar credit like auto-title and installment loans. However, it is clear that borrowers have trouble understanding and assessing their ability to repay since consumers who use these products are in continuous debt.

Can you explain why it is common for borrowers to inaccurately predict their ability to repay in full the loan and their likelihood for taking out subsequent loans?

A.6. Some borrowers are confused about the rate because the rates are stated in terms on $15 per $100 borrowed or $20 per $100 borrowed. They think this is 15 or 20 percent per annum but the rate is just for 2 weeks or less. The actual interest rate on such a loan is 390–500 percent per annum. They think it sounds cheaper than a 25 percent credit card, for example. Also people in society have trouble doing math.

Q.7. What type of disclosures would be most useful?

How would disclosing APRs help borrower assess the actual cost of the loan?

A.7. There was a great study done where researchers wrote the APRs and some other information on the outside of the envelope people received when applying for a payday loan. See Marianne Bertrand and Adair Morse, *Information Disclosure, Cognitive Biases and Payday Borrowing,* University of Chicago Booth School of Business (2009), available at *http://ssrn.com/abstract=1532213,* last accessed August 7, 2013. This approach worked meaning that people who had other options or did not really need the money

were deterred from taking out the loans. The approach taken in this article should be considered carefully.

In my experience, lenders try not to draw attention to the APR, try to distract borrowers from seeing it, if they provide the APR at all.

Q.8. Lenders offerings small-dollar installment credit products claim they can help borrower build a credit history and improve credit scores. Enova testified that they have been working to foster relationships with the major credit bureaus, and hope to help consumers build credit history.

Can you explain how these products have improved the credit scores for individual consumers?

A.8. Very few high-cost lenders report to the credit agencies meaning that use of these products has helped very few. I do know that World Finance has big signs outside their storefronts saying that they do report to credit agencies. I suppose this could help a few consumers and I know for fact that some consumers use this lender for that reason, rather than other high-cost lenders. Of course some people will ultimately default on high-cost loans and the reporting will hurt those consumers.

I would like to know specifically what Enova has actually done to help consumers on this issue.

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STEPHEN T. PACHECO
RV

STATE OF NEW MEXICO
COUNTY OF SANTA FE
FIRST JUDICIAL DISTRICT

STATE OF NEW MEXICO, *ex rel.*
GARY K. KING, Attorney General,

Plaintiff,

v. Case No. D0101-CV-2009-01917

FASTBUCKS HOLDING CORPORATION, *et al.*,

Defendants.

DECISION AND FINAL ORDER

THIS MATTER having come before the Court for a non-jury trial on liability and appropriate remedies, and the Court having heard all evidence presented by the parties and reviewed the closing arguments submitted by the parties, finds and determines:

1. This Court has subject matter jurisdiction of the action and personal jurisdiction over the parties, and venue is proper.

2. The Attorney General is the proper party to bring this action. *See* NMSA 1978, § 57-12-8.A (1977).

3. "Unfair or deceptive trade practices and unconscionable trade practices in the conduct of any trade or commerce are unlawful." NMSA 1978, § 57-12-3 (1971).

4. Subpart E of Section 57-12-2, NMSA 1978 (2009), provides:

> "unconscionable trade practice" means an act or practice in connection with the sale, lease, rental or loan, or in connection with the offering for sale, lease, rental or loan, of any goods or services, including services provided by licensed professionals, or in the extension of credit or in the collection of debts that to a person's detriment:
>
> (1) takes advantage of the lack of knowledge, ability, experience or capacity of a person to a grossly unfair degree; or

(2) results in a gross disparity between the value received by a person and the price paid.

5. In 2007, the Legislature enacted statutory reforms to regulate *payday* loans. *See* §§ 58-15-32 - 58-15-39, NMSA 1978 (2007). It appears from the Legislature's 2007 reforms that its concern was with the costs of loans to consumers, rather than what a lending device is named. To be sure, it would be difficult for a legislative body to fathom all the clever permutations of lending devices that might be designed or what names such devices might be given.

6. Although the 2007 reforms address payday loans, the Unfair Trade Practices Act (UPA) addresses the very type of unconscionable lending practices at issue in this matter. The UPA prohibits alternative means of engaging in unconscionable trade practices, and Defendants have engaged in both of those prohibited means in that they have taken advantage of the lack of knowledge, ability, experience or capacity of persons to a grossly unfair degree *and* their extensions of credit have resulted in gross disparities between the value received by persons and the prices paid. *See* § 57-12-2.E(1) & (2).

7. After enactment of the 2007 legislative reforms, Defendants fashioned their loans and business practices so as to circumvent regulation of payday loans. They dramatically increased their use of installment loan products and decreased the use of payday loans. Given the obvious reversal in the usage of the two loan products after the legislation was enacted in 2007, this Court rejects as pretextual Defendants' justification that they promoted installment loan products over payday loans due to customers not having checks.

8. Defendants took advantage of borrowers' lack of knowledge, ability, experience or capacity to a grossly unfair degree by deliberately steering borrowers into loans that subjected them

to higher interest rates and that kept them locked into recurring cycles of debt. Defendants are experts in the loan products they created and demonstrated their superior knowledge of the alternative loan products through their explicit actions to maneuver around the regulation of payday loans, through the measures they took to attempt to maintain and emphasize the availability of "installment loan products," and by diverting borrowers away from regulated, less expensive payday loans.

9. Defendants provide incentives to their representatives for steering borrowers into the more expensive installment loan products and away from less expensive loan products, and for promoting prolonging and recurring inescapable indebtedness to Defendants. For example, Rose Figueroa testified that "[w]e just basically don't let anybody pay off," and that "[w]e tell them how their tax refund is better used at Wal-Mart . . . than at FastBucks, and we basically talk them into making a payment and continuing to be our customer." She was congratulated for her approach and used as an example for how other employees of Defendants could conduct themselves to earn the conspicuous financial rewards that were imparted upon her. This Court rejects Witness Coyazo's explanation for the "[w]e just basically don't let anybody pay off" comment as disingenuous, particularly given that it immediately preceded "[w]e tell them how their tax refund is better used at Wal-Mart." It is clear from the context that Ms. Figueroa was referring to not allowing *the same* borrowers to pay off their loans when they were able to, rather than replacing borrowers who paid off their loans with new borrowers.

10. Examples of how Defendants dissuade borrowers from taking out payday loans and steer them into installment loan products include Defendants using "smooth selling language," training and instructing store managers to portray payday loans in less favorable terms than

installment loan products, and misleading borrowers on the characteristics of payday loans as compared to installment loan products.

11. Defendants encourage borrowers of installment loan products to "pay off" one loan with a new loan, which would be expressly prohibited if the borrower had taken out payday loans rather than installment loan products. *See* § 58-15-34.A & E. By promoting installment loan products in lieu of payday loans, Defendants also avoid the provisions of Section 58-15-35, which require lenders of payday loans to "offer the consumer the opportunity to enter into an unsecured payment plan for any unpaid administrative fees and principal balance of the payday loan," allow consumers of payday loans to enter into payment plans for any unpaid administrative fees and the principal balances of payday loans, and give consumers of payday loans the opportunity to retire their delinquent debt obligations over a minimum 130-day repayment period without incurring interest–all benefits to borrowers that Defendants avoid by promoting installment loan products.

12. Testimony shows that borrowers did not understand the differences between payday loans and installment loan products and that those differences were not explained to them.

13. Defendants' exploitation of the disparity in knowledge and insights into the various loan products that they possess as compared to their customers is exemplified in their efforts to promote installment loan products and thereby engage in practices that would be prohibited when a loan is fashioned as a payday loan and by their efforts to subject their consumers to loan terms that are more detrimental to consumers than those of payday loans. Their actions take advantage of their customers lack of knowledge of the intricacies of the loan options to a grossly unfair degree.

14. Defendants' installment loan products carry Annual Percentage Rates (APRs) of 520 to 650 percent. The high APRs and prolonged repayment terms result in detrimentally expensive

loan products. Defendants' loan practices have resulted in some borrowers paying back more than twice the amount they borrowed. One borrower repaid $889.26 more in interest on his installment loan product than he would have for a payday loan. Another borrower incurred a repayment obligation of $4,680.48 for a $934 installment loan product. Another borrower incurred a repayment obligation of $2,303.71 for an $800 installment loan product. The evidence illustrates a pattern of Defendants manufacturing exorbitantly expensive repayment obligations through their use of the installment loan products. The evidence shows a gross disparity between the value received and the prices paid for installment loan products.

15. Given borrowers' financial conditions, it was knowable *ab initio* that they would be unable to repay their loans without accruing exorbitant interest.

16. Defendants' essentially acknowledge through their own admissions that they take advantage of borrowers' desperate financial conditions and argue that the "value" of their loan products is increased due to that desperation.

17. This Court rejects Defendants' asserted conceptualization of "value," which would essentially encourage their exploitation of borrowers' desperate conditions that are intrinsic to their argument without considering the disparity in knowledge of the available loan products. Interestingly, the same argument that "value" increases based on a borrower's desperate financial circumstances could have been made to define the "value" of payday loans, yet the Legislature placed limitations on those loans.

18. Given that Defendants have engaged in unconscionable lending by taking advantage of the lack of knowledge, ability, experience or capacity of persons to a grossly unfair degree *and* extending credit that has resulted in gross disparities between the value received by persons and the

prices paid, this Court finds that Defendants shall pay restitution. *See* § 57-12-2.E(1) & (2). However, while the Court agrees that the proper measure of restitution for consumers victimized by practices that violate the UPA is the amount of consumer loss, the Court rejects the Attorney General's position on the amount of consumer loss. The Attorney General asserts that the amount of restitution should be "the total sum of monies FastBucks collected in excess of principal from the ILPs, minus any deficiencies incurred on individual loans with borrowers who took out multiple ILPs from FastBucks." The Attorney General's position would place no time value of money on the loans. This Court finds that the amount of consumer loss is best represented by the difference in the amounts the borrowers paid under the installment loan products and the amounts they would have paid had they taken out payday loans, minus any deficiencies incurred on individual loans. This formulation takes into account equitable considerations, including the public policy considerations made clear by the Legislature in its 2007 reforms.

19. This Court further finds that Defendants shall be permanently enjoined from originating installment loan products that provide terms that do not accord with those statutory consumer protections to which payday loans are subject.

20. Except to the extent they accord with the statutorily required terms of payday loans, Defendants' installment loan products and loan agreements by any other name that share the same or similar terms as their installment loan products are prohibited by Section 57-12-2.E and are unenforceable as a matter of New Mexico law.

21. The Court denies the request for civil penalties.

22. The Court denies Defendants' claim of equitable estoppel because they have failed to satisfy the elements thereof.

IT IS ORDERED that Defendants shall pay restitution for the differences in the amounts the borrowers paid under the installment loan products and the amounts they would have paid had they taken out payday loans, minus any deficiencies incurred on individual loans.

IT IS FURTHER ORDERED that Defendants shall be, and hereby are, permanently enjoined from originating installment loan products that provide terms that do not accord with those statutory consumer protections to which payday loans are subject.

IT IS DECLARED that, except to the extent they accord with the statutorily required terms of payday loans, Defendants' installment loan products and loan agreements by any other name that share the same or similar terms as their installment loan products are prohibited by Section 57-12-2.E and are unenforceable as a matter of New Mexico law.

Michael E. Vigil

MICHAEL E. VIGIL
DISTRICT COURT JUDGE

Notice on date of filing to:

KAREN MYERS, JOHN THOMPSON, WILLIAM KELLER
DONALD F. KOCHERSBERGER III

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM NATHALIE MARTIN

Q.1. Do you think most unbanked or underbanked Americans are capable of handling their own finances, or do you feel that Government needs to step in and "protect them from themselves" by such actions as credit rationing or denying them certain credit products?

A.1. What the Government needs to do is to listen to what the American people have to say about regulating high cost loans, rather than to this industry and the politicians who have received campaign contributions from them. The American public, including people from both political parties, has spoken loudly and clearly. The public favors interest rate caps of 36 percent or less on all consumer loan products. No survey or empirical study has found otherwise. This country has always had double digit interest rate caps since its founding. Interest rate caps are part of our culture and our heritage. They are also common in other developed democracies. Having no caps is a relatively recent phenomenon, beginning in the late 1970s and early 1980s. Most people are shocked and disturbed to hear that it is legal to lend money at over 36 percent and some think that 36 percent is itself abusive.

What is presumptuous and paternalistic is for politicians to listen to the high-cost loan industry rather than their constituents on this point. If constituents knew their own elected officials' true views and voting records on these issues, the public might vote certain politicians out of office.

Q.2. Some argue that States should not be rationing credit because in some cases consumers act irresponsibly and get deeply in debt. Do you agree, or do you support Government stepping in and rationing credit? Some also argue that loan prices should be set by the free market and should not be subsidized by the Government. What do you think about this issue? Should unbanked and underbanked consumers who pose higher credit risks have their loans subsidized or be given some type of governmental support, or should rates be set through the free market?

A.2. Rationing is having the Government allow only a particular amount of something (such as gasoline or food) when there is a shortage. Clever use of the word, but I am not buying it. There has never been more credit in any economic system in history than what we have seen in the United States in the last decade.

As a society, we do the opposite of rationing credit. The U.S. recently has given virtually unlimited credit to people who have no way of paying it back, helping them dig a deeper financial hole and providing more barriers to entry to the middle class. There is more credit in the system than there should be, evidenced by the recent financial crisis. We gorged ourselves on it and it crashed the global economy.

My own research and that of many others show that people take out many payday and title loans, then default, yet lenders still make money off the loans.

Existing mainstream lenders could serve more low-end consumers and still make a profit. They have chosen not to. They would just rather invest in options that are more profitable, like high-cost lenders.

Even assuming that some credit options will go away based upon future regulation, this is not rationing. I think consumers will be better off once some of the market players are gone. Twenty-two States plus the District of Columbia agree. This is not radical, just common sense. Credit at any cost? No think you. Some loans are bad enough that they should be illegal and are illegal in many States.

Q.3. As you undoubtedly know, the Post Office Inspector General's Office has recently proposed that the Post Office be allowed and encouraged to begin offering small loans and other alternative financial services products through partnerships with banks and credit unions. Their report claims, for example, that the Post Office could offer a $375 loan repayable over 5 to 6 months at a rate of 28 percent APR that would generate a profit of $48 for the Post Office (and its banking partners). Do you find the analysis persuasive?

A.3. So far this is not an analysis. Feasibility and profitability studies still need to be done. What is exciting about the model, which is used in many countries around the world, and exciting about the idea in general, is that the infrastructure of the post office already exists.

The U.S. postal service is being forced by Congress to prefund retiree health benefits, which itself is a questionable requirement imposed by Congress. If Congress is going to stick with this requirement, it should in turn approve the USPS to provide these loans. This would be a way to use the huge postal infrastructure to benefit consumers. Of course this assumes the resulting credit would be cheaper for consumers, something the future studies would have to confirm. The studies would also need to confirm that the post offices would generate at least some minimal income but on this side of the equation, it seems they would. Even a little profit for the post office would be a win–win. The post offices are already in operation and adding this feature would not significantly increase overhead or operations costs.

Banks might themselves complain about how this could conceivably eat into their profits but do they have the standing to make that argument, now that they have pulled branches out of so many neighborhoods while at the same time providing funding and infrastructure for the high-cost lending industry? Let's hope not.

Q.4. The Internet has revolutionized Americans' buying habits and greatly increased their product choices. Consumers today, regardless of where they are located, can obtain essentially whatever commercial product they need when it is not available locally by going online, getting the best available price and having it delivered to their door. Should consumers in every State have the same ability to get well-regulated small loans and other financial services through the Internet if such products are not otherwise available locally?

A.4. Absolutely. Of course the question is "what is a well-regulated loan?" For me, it includes a reasonable interest rate, underwriting for ability to pay both regular bills and principal and interest on the loans, and a limit on the total number of loans a consumer can take out.

Q.5. Michael Flores' recent study, *Online Short-Term Lending,* points out that the primary alternatives to payday loans are often significantly more costly than payday loans. Given that finding, would underserved consumers who now rely on potentially less costly payday loans be helped or harmed if additional States or the CFPB prohibited or severely restricted access to these loans? If credit products like payday loans or banks' deposit advances are eliminated, what happens to the demand for such products?

A.5. I strongly disagree with the idea that payday loans and other high-cost loans of 400–1,100 percent interest are cheaper than these other costs, overdraft fees, etc. . . . The data do not uniformly support this conclusion. Moreover, many studies show that people are better off once payday and other high-cost lenders leave their State. I have seen no proof from any source that people are better off in places where high-cost loans are available. If anything, the opposite is true.

Q.6. Do you support or oppose the PEW recommendations? Could you please explain your reasoning?

A.6. I am not familiar with all of the PEW recommendations, but can agree that these features are needed in the short-term loan market:

- reasonable APRs;
- repayment periods longer than 90 days;
- loan structures that permit borrowers to repay principal along with interest as a loan progresses; and
- underwriting for all loans.

I myself believe that other features are also desirable. There must be a limit on the number of loans people can have out at any one time on order to make the underwriting make sense. Also, I am less inclined to favor a law like Colorado's, which allows interest rates of up to 200 percent, and less tolerant in general of triple digit interest rates. This is in part because I have seen the harm done to many consumers who are stuck in these loans for long periods of time, and who are deeply sorry they took out the loans, and also because I know the public supports interest rate caps, even the conservative public.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER FROM THOMAS J. CURRY, COMPTROLLER OF THE CURRENCY, SUBMITTED BY CHAIRMAN BROWN

Office of the Comptroller of the Currency

Washington, DC 20219

March 25, 2014

The Honorable Sherrod Brown
United States Senate
Washington, DC 20510-3505

Dear Senator Brown:

Thank you for your letter dated March 21, 2014, regarding H.R. 1566, the "Consumer Credit Access, Innovation and Modernization Act." The Office of the Comptroller of the Currency (OCC) shares the goal of providing underserved communities and unbanked populations greater access to innovative and affordable financial products and services. You inquired whether the OCC still holds the views that were expressed by Deputy Comptroller Grovetta Gardineer in her July 24, 2012, testimony before the U.S. House of Representatives Subcommittee on Financial Institutions and Consumer Credit, regarding H.R. 6139, similar legislation that was introduced last Congress.

In her testimony, Deputy Comptroller Gardineer stated the OCC's view that, by creating federally chartered National Consumer Credit Corporations (NCCCs), the proposed legislation would raise new concerns regarding consumer protection and safety and soundness. The OCC was concerned that H.R. 6139 could have a number of unintended and undesirable effects for the population that it was designed to benefit. In particular, H.R. 6139 raised serious consumer protection, compliance, and safety and soundness issues by creating a new federal charter for companies concentrating on products and services most prone to abuse and that are most often targeted to minority populations, low-income neighborhoods, and communities with high concentrations of our military servicemembers.

You also inquired whether the OCC has the same views with respect H.R. 1566, which was introduced in the 113th Congress. Our preliminary review of H.R. 1566 indicates that the issues that prompted our concerns with H.R. 6139 are fundamentally the same. Moreover, these high cost products would now be provided on an Internet-only platform thereby increasing the potential for abusive lending practices.

As Deputy Comptroller Gardineer noted in her testimony, the products and services at issue in the legislation include those that the OCC has largely extinguished from the national banking system. As referenced in the OCC's recent guidance on Deposit Advance Products issued on November 26, 2013, the OCC encourages national banks and federal savings associations to respond to customers' small dollar-credit needs in a responsible manner and with reasonable terms and conditions.

I hope this is responsive to your inquiry. If you have additional questions, please do not hesitate to contact me or Carrie Moore, Director, Congressional Liaison, at (202) 649-6737.

Sincerely,

Thomas J. Curry
Comptroller of the Currency

LETTER FROM JOHN W. RYAN, PRESIDENT AND CEO, CONFERENCE OF STATE BANK SUPERVISORS

April 2, 2014

The Honorable Sherrod Brown
United States Senate
Washington, DC 20510

The Honorable Patrick Toomey
United States Senate
Washington, DC 20510

Dear Senators Brown and Toomey:

On behalf of the Conference of State Bank Supervisors (CSBS),[1] I want to thank you for the opportunity to submit a letter for the record of your Subcommittee's March 26, 2014 hearing entitled, "Are Alternative Financial Products Serving Consumers?" State regulators value the diversity of the financial services market place, and our members recognize that a variety of businesses exist to meet consumers' varying credit and financial services needs. We applaud your Subcommittee's efforts to examine this issue.

In brief, there are three core tenants that the committee must consider when analyzing alternative credit markets and consumer access thereto. First, states respond to both consumer and market needs. The citizens of the individual states, through their legislatures and other elected officials, have determined the contours of the financial services companies operating within their borders, the state regulatory regimes overseeing such businesses, and the consumer protection standards such companies must meet.

Second, state-federal regulatory partnerships work. Cooperative federalism in the financial services realm has long been a successful supervisory approach, proven by well-established state and federal agency relationships that result in coordinated action, including with the Consumer Financial Protection Bureau. A payday loan is an inherently local financial transaction, and therefore requires oversight by regulators with an intimate knowledge of the relevant market as well as the national perspective brought by federal counterparts.

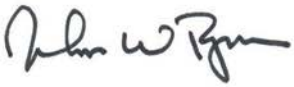
[1] CSBS is the professional membership organization for state banking regulators from all 50 States, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. Our members supervise banks of all sizes, including most of the small community banks in the United States. For more information, see www.csbs.org.

1129 20th Street, N.W. • Ninth Floor • Washington, DC • 20036
www.csbs.org • 202-296-2840 • FAX 202-296-1928

Lastly, federal charters are only granted in very limited circumstances. The vast majority of industries and businesses in the United States -- large and small -- thrive and successfully meet important consumer needs without a federal charter. Congress has historically only usurped state chartering authority to support a specific government initiative with an extraordinarily compelling public purpose. Neither government initiatives nor an extraordinary public purpose has been presented by those seeking to broadly preempt state payday lending laws.

State regulators share Congress's concerns regarding under banked consumers and pledge to work with Congress to address this important social and economic problem. We look forward to further engagement with Congress, expanding on core aspects of state regulation and cooperative federalism as your subcommittee continues its examination of payday lending and other forms of short term consumer credit.

Sincerely,



John W. Ryan
President and CEO

STATEMENT SUBMITTED BY THE AMERICAN FINANCIAL SERVICES ASSOCIATION

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER PROTECTION

* * *

HEARING ENTITLED:
"ARE ALTERNATIVE FINANCIAL PRODUCTS SERVING CONSUMERS"

* * *

WEDNESDAY, MARCH 26, 2014

* * *

STATEMENT FOR THE RECORD

SUBMITTED BY
THE AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. Chairman,

The American Financial Services Association (AFSA) and its member companies commend you and you colleagues for holding this important hearing on the need that millions of Americans have to access small dollar consumer credit market. As the trade association representing traditional installment lenders, AFSA welcomes this opportunity to provide you with testimony about how the traditional installment industry meets the credit needs of millions of American families in a safe and affordable fashion.

AFSA is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. Its more than 350 members include consumer and commercial finance companies, auto finance/leasing companies, mortgage lenders, mortgage servicers, credit card issuers, industrial banks and industry suppliers.

History of Small-Dollar Lending

To help understand the traditional installment lending industry, it is important to know its origins. Traditional installment lenders have been around for more than 100 years. They are community-based lenders located in cities and towns nationwide that provide consumers with small loans to buy goods and services.

In 1916, a group of lenders, along with charitable community organizations, promoted state laws that would make unsecured personal loans more readily available. The result of their efforts was the Uniform Small Loan Law, landmark legislation that the authors intended to be adopted by the states to provide an exception to usury laws so that consumers could legally obtain small amounts of credit at reasonable rates that allowed lenders to make a profit. As the new industry attracted capital, average wage-earners found that they could obtain loans from these personal finance companies for personal and family household purposes. As the companies expanded, they began to serve their customers through branch offices located in the neighborhoods where people lived or worked. The branch offices emphasized convenience and personal service.

Traditional Installment Loans

The same myriad qualities and attributes that initially drove the traditional installment loan industry have carried through to modern times. Traditional installment lenders continue to provide individualized service to the customers they serve in their communities.

Traditional installment loans are structured to help borrowers meet a financial need within their budget, repay the loan in substantially equal monthly payments and build a positive credit history. Traditional installment loans allow consumers to access small-dollar loans that represent financial freedom, flexibility and safety.

Traditional installment lenders work with borrowers to create a monthly budget based on their current income and expenses to determine if the borrower has the ability to repay the loan, and set the monthly payment at an affordable amount. Traditional installment loans are fully amortizing, meaning that part of each payment pays down the principal as well as the accumulated interest.

Traditional installment lenders report their customers' payment behavior to credit bureaus, which can help them build or strengthen a credit history over time. Traditional installment loans do not charge penalties for early repayment, or prepayment, and do not require large one-time balloon payments. Traditional installment loans are structured to provide borrowers with a plan for disciplined debt reduction.

Traditional installment loans provide customers with access to funds that:

- Can be repaid in affordable substantially equal monthly payments, or installments, reducing both principal and interest each month;
- Fit within the customer's monthly budget based on current income and expenses;
- Build a positive credit history, as traditional installment lenders generally report to credit bureaus;
- Do not allow for prepayment penalties or balloon payments.

Importantly, traditional installment loans are distinct from other types of small-dollar loans primarily because of their structure. Unlike other types of small-dollar lenders, traditional installment lenders underwrite their loans, meaning they consider a customer's ability and willingness to repay the loan. Likewise, the schedule of repayments for a traditional installment loan is no less than thirty (30) days. Additionally, the annual percentage rates (APR) on traditional installment loans are substantially lower than for payday, pawn or auto title loans. Structured in this time-tested fashion, traditional installment loans provide borrowers with a plan for disciplined debt reduction.

Consumers Served by Installment Lenders

In addition to hourly workers, traditional installment lenders serve the "unbanked" and "underbanked" – consumers who do not have or do not regularly use traditional banking services such as savings and checking accounts. Many of these consumers have poor or thin credit histories, making it hard for them to qualify for other forms of credit. Yet, traditional installment lenders have been making responsible and affordable loans to these very consumers for many decades.

Last year, the Center for Financial Services Innovation (CFSI) published a report[1] detailing four reasons that borrowers of small-dollar credit used these products, which CFSI defined as payday loans, pawn loans, deposit advance loans, auto title loans and non-bank installment loans. CFSI's research determined that consumers use small-dollar credit: 1) for unexpected expenses such as an automobile repair, 2) to cover misaligned cash flow, 3) to make up for exceeding income, or

[1] Bianchi, Nicholas and Rob Levy. *Know Your Borrower: The Four Need Cases of Small-Dollar Credit Consumers.* December 2013. Available at http://www.cfsinnovation.com/CFSI_KnowYourBorrower.pdf.

4) for planned purchases such as a new appliance. Of these "need cases," installment lending was used most often for planned purchases (51%) and to pay for unexpected expenses (29%). Installment loans were rarely used by borrowers with misaligned cash flow.[2]

Consumers from all walks of life and all ends of the credit spectrum have varying credit needs, which the CFSI study reinforced. "Our findings provide further evidence that [small-dollar credit] consumers are not a homogeneous market that can be served with a one-size-fits-all approach."[3]

Traditional installment lenders fully support and comply with the Equal Credit Opportunity Act (ECOA), which prohibits any kind of age discrimination. Specifically, the ECOA provides that: "It shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction (1) on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract); (2) because all or part of the applicant's income derives from any public assistance program."[4]

Endorsed by State Legislators

Both the National Black Caucus of State Legislators and the National Hispanic Caucus of State Legislators adopted resolutions in recent years acknowledging the need for small-dollar credit in which they emphasized that the "key structural qualities of loans that are safe and affordable are that the lender makes good faith efforts to assess the borrower's ability to repay the loan and that the loan is repayable in substantially equal installments of principal and interest, with no balloon payments."[5] [6] These resolutions describe traditional installment loans. They do *not* describe other forms of non-bank loans that increasingly characterize themselves as "installment loans."

FDIC Pilot Showed Banks Can't Compete in the Space

Small-dollar loans are not sustainable products for banks, as demonstrated by the Federal Deposit Insurance Corporation (FDIC)'s Small-Dollar Loan Pilot Program conducted in 2008 and 2009. The pilot, which recognized the obvious need for responsible and affordable small-dollar credit, concluded with 28 bank participants. The banks that participated in the pilot offered closed-end installment loans with APRs at 36 percent or less, including origination fees.

The FDIC touted the program as a success, although the majority of the banks in the pilot could not make a profit on small-dollar loans. The "success" of the program was based on using the products to build relationships and cross-sell other more profitable products to customers.

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[2] *Ibid*, Table 1, p. 12
[3] *Ibid.*
[4] 15 U.S.C. Sec. 1691(a)
[5] National Black Caucus of State Legislators. *Resolution BFI-13-14: Promoting Safe and Affordable Lending Practices.* Available at http://www.nbcsl.org/public-policy/resolutions/item/624-business-financial-services-and-insurance-resolution-bfi-13-14.html (December 2012).
[6] National Hispanic Caucus of State Legislators. *Resolution 2013-10: Promoting Safe and Affordable Lending Practices.* Available at http://www.nhcsl.org/94/resolution/promoting-safe-and-affordable-lending-practices (November 2013).

"About three-quarters of pilot bankers indicated that they primarily used small-dollar loans to build or retain profitable, long-term relationships with consumers and also create goodwill in the community."[7]

The pilot participants found that the costs of launching, marketing and offering small-dollar loans were similar to other loans. "As a general guideline, pilot bankers indicated that costs related to launching and marketing small-dollar loan programs and originating and servicing small-dollar loans are similar to other loans. However, given the small size of [these loans], the interest and fees generated are not always sufficient to achieve robust short-term profitability. Rather, most pilot bankers sought to generate long-term profitability through volume and by using small-dollar loans to cross-sell additional products."[8]

"Banks other than those in the pilot provide small-dollar loans, but it is likely that most banks do *not* offer these loans. Pilot bankers and other banks that have started or have expressed interest in starting a small-dollar loan program indicated that the primary obstacles to entry are the cost of launching and maintaining the program and concerns about defaults."[9]

The FDIC concluded that "the relationship-building small-dollar loan model is as costly to originate as other, larger loans because of the 'high-touch' nature of the loan delivery process."[10] The high-touch nature and the associated business costs with making small loans means that lenders must charge rates above 36 APR to make a profit.

Thus, while the FDIC touted the program as a success, a careful review of the findings shows that without significant changes to the banks' lending programs, including a request for government guarantees, the majority of the banks in the pilot could not make a profit on small-dollar loans. Rather, the alleged "success" of the program was based in part on using the products to build relationships and cross-sell other more profitable products to customers. Moreover, to the extent the banks found that they might be able to make small-dollar loans, they based those conclusions upon establishing business practices that closely resembled the business practices of traditional installment lenders – AFSA's members. Traditional installment lenders have already learned how to, and for many decades have, made responsible and affordable small-dollar loans to consumers who need access to small amounts of credit and who are not served by the traditional banking system.

APR

Every loan, regardless of type or size, has certain expenses built into the APR, as indicated in the FDIC Pilot Program. These costs are directly related to the work the lender puts into making each loan, such as underwriting, rent, salaries, licensing and regulatory compliance. These fixed costs and overhead expenses are the same for each loan, whether the loan is for $1,000 or

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[7] *A Template for Success: The FDIC's Small-Dollar Loan Pilot Program.* FDIC Quarterly 4, no. 3. 2010. Available at http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/smalldollar.html.
[8] *Ibid.*
[9] *Ibid.*
[10] *Ibid.*

$20,000. So in general, bigger loans tend to have higher costs but lower APRs, while smaller loans will have lower costs and higher APRs. In many cases, APR will have an inverse relationship with a borrower's out-of-pocket costs.

APR tells a borrower the interest rate, but not the cost in actual dollars and cents to be paid over the life of the loan. Paying the same rate for a longer period of time makes the overall cost goes up. Illinois Attorney General Lisa Madigan notes on her website that the least expensive alternative to payday loans is the small consumer loan, due in part to their longer repayment term. "In addition to having lower interest rates, small consumer loans have longer terms than payday loans – typically lasting about a year or more. Stretching your payments out over time is one way to help keep them manageable."[11]

In a recent report, CFSI noted that "much of the debate about small-dollar credit has heretofore focused on price, as expressed in Annual Percentage Rates (APR), as a primary determinant of quality. While affordable prices are certainly one aspect of high-quality small-dollar loans, what is 'affordable' to any given borrower depends on many factors, including the loan's size, repayment period, interest rate and fees, as well as the individual borrower's unique financial situation. … In other words, whether a loan is affordable or not depends on underwriting, structure and pricing – not on price alone."[12]

In its March 2013 Semi-Annual Report, the Consumer Financial Protection Bureau (CFPB) recognized the difficulty in using APR to compare small-dollar loans and that consumers are most concerned about obtaining a loan quickly and conveniently. "While the cost of obtaining a loan may be a major consideration when deciding to take on debt and selecting which credit product to use, it is not the only factor in a consumer's decision-making process. For example, in some surveys, borrowers of small dollar amounts have overwhelmingly cited the speed, convenience and near-certainty that they will be approved for a loan as the primary considerations for using these products. … Consumers on the subprime end of the credit scale potentially hav[e] fewer credit options."[13]

States highly regulate the terms and conditions (and often the maximum rates) for small-dollar loans. States seek to ensure availability of credit while recognizing that small transactions have high transaction costs. In states that have no cap, lenders study the market and price their products commensurate with the cost of capital, staff expenses, underwriting and anticipated losses.

With little statistical information about small installment loans available, AFSA began surveying its members about installment loans. Last year, the association published a report on "Preliminary Findings from the AFSA Member Survey of Installment Lending." The report

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[11] Illinois Attorney General Lisa Madigan. *The Truth about Payday Loans*. At http://www.illinoisattorneygeneral.gov/consumers/paydayloans.html.

[12] *The Compass Guide to Small-Dollar Credit*. February 2014. Available at http://www.cfsinnovation.com/content/compass-guide-small-dollar-credit.

[13] *CFPB Semi-Annual Report*. March 2013. p. 38. Available at http://files.consumerfinance.gov/f/201303_CFPB_SemiAnnualReport_March2013.pdf.

examined 2.4 million installment loans made between April and September 2012. The data show that "the highest APRs are associated with the smallest loans, which are also the loans with the shortest maturities."[14]

The report compared loans in Pennsylvania, which has a 36 percent rate cap, with loans in Texas, which does not have a rate cap. Borrowers in both states have similar credit scores, with 84.9 percent of Pennsylvanians and 89.3 percent of Texans having credit scores under 660 – meaning that the majority of borrowers in both states would be considered subprime.

Because of the rate cap in Pennsylvania, 98.9 percent of small-dollar loans were for amounts greater than $1,000. But in Texas, 71.7 percent of small-dollar loans were for amounts less than $1,000. These numbers suggest that small loan sizes are generally unavailable in Pennsylvania and that borrowers in the state may be taking out larger loans than needed. This example "highlights difficulties that occur when rate ceilings prevent subprime borrowers from obtaining loans in the sizes they desire and have to obtain larger loans than necessary to be able to obtain loans at all."[15] As a result, borrowers in Pennsylvania have to repay more principal, which could pose a financial risk for them.

Additional borrowing for a longer period of time means consumers have higher finance charges – or higher overall costs – despite a lower APR. In Pennsylvania, most loans had APRs from 19 to 36 percent, while in Texas, most loans had APRs from 49 to 99 percent. Yet Pennsylvanians also had higher monthly payments than their Texas counterparts. In Pennsylvania, 56 percent of the loans had monthly payments greater than $150, while in Texas, only 16 percent of the loans had monthly payments greater than $150.

Comparing the loan amounts, terms, and monthly payment amounts of loans in Pennsylvania and Texas demonstrates that APR caps are not in consumers' best interests.

Regulation of Traditional Installment Lenders

All of the federal and state statutes and regulations affecting corporations, partnerships and proprietorships generally apply to traditional installment lenders – including regulations issued by the Federal Trade Commission, the Consumer Financial Protection Bureau, the Federal Reserve Board, the Department of Housing and Urban Development, the Treasury Department, and the Securities and Exchange Commission, and various state regulators. In addition, traditional installment lenders are subject to a multitude of state financial institution statutes, and are regulated in every state in which they operate. In short, states highly regulate the terms and conditions a licensed lender may impose in consumer small loan transactions. Traditional installment lenders are required to follow all state and federal consumer protection laws, and routinely are examined and audited by state agencies and regulators to ensure compliance.

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[14] Durkin, Thomas. *Preliminary Findings from the AFSA Member Survey of Installment Lending*. June, 2013. (Included as Appendix A.)
[15] *Ibid.*

Most states' provisions are enforced by a division of the state banking or insurance department, which is frequently empowered to supplement the statutes by enacting rules and regulations. Elsewhere, similar powers rest with other agencies or departments, such as states' departments of commerce or corporations. Finance companies are typically required to be licensed by each state in which they operate. Many states' laws require consumer loan licensees to report regularly (usually annually) on their operations to the state supervisory authorities. In practically all states, annual examinations by these authorities are required by law, and examinations at other times are permitted. The costs of such examinations, in addition to the annual license fee for each operating office, are borne by the licensees in most states.

Refinancing

Loan refinances by traditional installment lenders are based on sound underwriting. In contrast to payday loans, where the loan rolls over if the full amount is not repaid by the due date, traditional installment lenders re-evaluate the borrower's situation, then make a new loan if the borrower demonstrates an ability to repay.

When traditional installment loan borrowers refinance a loan – whether to lower their monthly payment amount or to borrow more money – the lender underwrites a new loan in much the same way that a lender helps a homeowner refinance a mortgage. Consumers are re-evaluated for ability and willingness to repay the loan, and only if the underwriting criteria are met does the refinancing move forward.

Conclusion

Traditional installment lenders provide a responsible form of small-dollar credit for consumers, many of whom would be classified as subprime. Traditional installment loans are fully underwritten considering a consumer's ability to repay and report to credit bureaus. Traditional installment loans are fully amortizing with equal, affordable monthly payments. APRs may seem high compared to other forms of credit, but small-dollar loans cost the same to make as large loans. Traditional installment lenders are commercially sustainable businesses that do not rely on customers' deposits. They are highly regulated in each of the states in which they operate. Ancillary products are sold in conjunction with traditional installment loans, but are optional. The only collateral that traditional installment lenders accept is personal or titled property. When borrowers refinance with traditional installment lenders, a new loan is underwritten.

Again, thank you for the opportunity to provide you with testimony on how the traditional installment loan industry is meeting the small dollar credit needs of millions of Americans in the safest and most affordable manner. If you have any questions please contact AFSA Executive Vice President, Bill Himpler at 202-466-8616 or bhimpler@afsamail.org.

Appendix A

June 24, 2013

Summary of Preliminary Findings from the AFSA Member Survey of Installment Lending

1. Government ceilings on interest rates extend to the farthest reaches of recorded history.

2. In contemporary US, most controversial are current ceilings on smaller loan sizes in some states where advocate individuals and groups would like to see ceiling rates much lower.

3. As long as four decades ago a federal study commission showed that production and risk costs of making small installment loans *compared to the amount of the loan* meant that lending rates would need to be higher on these loans than on other consumer credit before legal lenders would be interested in lending. The commission showed statistically what the Russell Sage Foundation had argued beginning almost a century ago, leading to development of the Uniform Small Loan Law in 1916.

4. Findings from the AFSA survey of lenders are consistent with hypotheses developed many years ago from the economic theory of credit rationing. These hypotheses suggest that users of small dollar amounts of installment credit from secondary credit sources are "rationed" borrowers in an economic sense, those borrowers unable to obtain as much credit as they need or want from primary lenders at low rates. Specific findings include:

- Most loans (more than 85 percent) clearly are subprime on the basis of credit scores. (Table 1)
- These installment loans are both small and short term. More than 80 percent of the loans are made for $2000 or less and almost 90 percent for two years or less. (Table 2) These are precisely the loans the federal study commission determined would require high rates.
- High APRs are due to both small size and high risk. (Table 1 and Table 3)
- Loans are made with low payments to satisfy both demand among rationed borrowers for small payments and supply by lenders who also are interested in easy repayment. Almost 50 percent of the loans have payments of $100 or less monthly and more than 83 percent $150 or less. (Table 4)

5. Survey results demonstrate clear evidence of lending risk. Delinquency among loans made is correlated with:

- Loan size (inversely, Table 6).
- Credit Score (inversely, Table 7).
- APR (directly, Table 8).

6. Loans vary substantially by state, due to regulatory differences that limit the locations acceptable to lenders.

- Frequency of lending varies sharply among states. States with low rate ceilings have few loans (Table (9).
- There are loans made to residents of low rate Arkansas, but almost all of them (99 percent) are to residents of counties that border other states, especially Oklahoma, Missouri, Louisiana, and Texas. This suggests the loans actually are made elsewhere.
- Compared to loans to Texas residents, loans to residents of low-rate Pennsylvania:

- Are much less common.
- Are considerably larger. (In Pennsylvania fewer than 1 percent of loans are made in size under $1000 compared to almost 70 percent in Texas, Table 10.)
- Have considerably lower APRs. (In Pennsylvania, more than 99 percent of loans carry APR 19 to 36; in Texas 96 percent carry APR 49 to 99, Table 11.)
- Have larger payment amounts due to larger sizes. (In Pennsylvania about 55 percent of loans have payment amount greater than $150, compared to about 16 percent in Texas, Table 12.)
- Have about the same borrower credit scores, for loans where scores are recorded (Table 13). Larger loans at the same score suggests many Pennsylvania borrowers are borrowing more than they need or want in order to obtain loans at all.
- Are more expensive in total finance charges. This can happen when the rate ceiling in Pennsylvania prevents borrowers from obtaining Texas-type small loans there and they must borrow more than they need and for an extended period (Table 14).

June 24, 2013

Preliminary Findings from the AFSA Member Survey of
Installment Lending

Interest rate ceilings on loans of money or goods are possibly the oldest continuously running controversy. Found in recorded history as early as the ancient Babylonian Code of Hammurabi (c. 1770 BC), imposed rate ceilings probably extend even farther back into unrecorded tribal antiquity. Historical evidence shows that through much of history ceilings have been evaded, which suggests, at a minimum, that ceilings have been continuously controversial (for extended historical discussion, see Homer and Sylla 1996 and Gelpi and Julien-Labruyere 2000, included in the references at the end of this paper).

Today in the twenty-first century United States, a good deal of the modern argument over interest rate ceilings concerns a variety of consumer lending products and processes sometimes collectively referred to as "small dollar." High interest rates on smaller loans have attracted the attention of various individuals and organizations who would like to see these rates much lower. Much of the discussion has centered on single-payment so called "payday loans" found in many states and which exhibit very high Annual Percentage Rates (APRs), but sometimes other kinds of loans like small dollar installment loans become lumped into such discussions. Typical APRs on these other loans are much lower than on payday loans though higher than on some other familiar kinds of consumer credit. Heretofore, it seems that relatively little is recently known about this other small dollar form of consumer lending, despite discussions that sometimes lump such lending with payday. The purpose of this paper is to provide background, some discussion of relevant economic theory, and a look at some newly available statistical information on small dollar installment lending.

Background

At the outset, it seems worthwhile to review the reasons why small loans exhibit high interest rates in the first place. This phenomenon arises from the economic fact of "production cost economies of size." In other words, lending costs rise as loans become larger (because of the need for more careful screening, the need to take and record more payments over time, etc.), *but well less than proportionately*, due to production cost economies of size. A multi-million dollar loan to a top-rated international corporation may cost more to investigate, book, and collect than a small loan to a risky consumer, *but not per loan dollar*.

As a result, the loan charge to cover production costs is going to have to be higher for the small loan per loan dollar. For small loans, the dollar production cost of the loan looms large not in total but rather relative to the dollars of the loan. Much of the production cost arises from the necessity of maintaining lending locations entailing rent charges, employing personnel who must be paid salaries, and acquiring office supplies and equipment with prices and amortizations. There also is the cost of the lending capital itself and the cost of risk, which can also be substantial relative to loan amount for small loans. Almost by definition, a borrower in need of a small loan is going to be a risky borrower.[16]

[16] The credit card industry has spent huge sums of money to automate the lending process for small amounts of credit and reduce overall lending costs, but this impersonal kind of lending is not available to all consumers, especially the riskiest ones. Evidence from the Federal Reserve's most recent Survey of Consumer Finances in 2010 shows that only 68 percent of families (economic units) have credit cards. And, riskier borrowers who have credit cards may also quickly reach their smaller credit limits but occasionally still need additional credit to meet some emergency or for some other need or desire. The basic theory of why credit-constrained consumers

To cover the average cost of extending a small size loan, a lender will need to charge a number of dollars for the loan that is large *relative to the amount of the loan*, even though the dollar amount of the cost is not in itself very large. Despite the loan size, the lender still needs enough revenue to justify obtaining and maintaining the lending location, hiring and paying the personnel, acquiring the supplies and equipment, raising the capital, and allocating the risk cost. Translating these necessities for small loans into an Annual Percentage Rate as required by Truth in Lending makes the disclosed rate appear very high, even though the dollars involved are much less startling. This anomaly occurs simply because the production cost looms large relative to the loan dollars involved and the short term of the loan on which the lending cost must be recovered.

Difficulties surrounding the relationship of production cost to loan amount and maturity on small loans is hardly a new question. It is worth recalling that the National Commission on Consumer Finance (NCCF) extensively discussed the matter in its *Report* to the Congress in late 1972. The NCCF was a federal study commission established by Title IV of the federal Consumer Credit Protection Act of 1968, the same law that established Truth in Lending as Title I. According to Section 404: "The Commission shall study and appraise the functioning and structure of the consumer finance industry, as well as consumer credit transactions generally. The Commission in its report and recommendations to the Congress, shall include treatment of the following topics: 1) The adequacy of existing arrangements to provide consumer credit at reasonable rates...." The Commission consisted of three members of the Senate, three members of the House of Representatives, and three public members appointed by the President. The Commission had a staff of economists and lawyers and retained the services of a number of outside economists and lawyers as consultants. In addition to its extensive *Report*, the Commission also issued six volumes of supporting technical studies.

In Chapter 7 of its *Report*, the Commission explored the relationship among lending production costs, rate ceilings, and credit availability for consumer finance companies making small installment loans. As part of its investigations, the Commission undertook extensive data gathering and empirical work. To study costs of consumer finance companies, the Commission engaged the late Professor George J. Benston of the University of Rochester, the leading expert in the country at the time on the use of statistical cost studies of production processes of financial institutions (see Benston 1975 and Benston 1977). While the Commission undertook its work many years ago, the underlying principles have not changed and the Commission's work remains illustrative. As a first look at small loan lending more recently, it is useful to examine the Commission's findings.

One of the Commission's interesting findings based upon its cost studies was how the annual percentage rates necessary before a consumer finance company would make loans of small sizes would have to be quite high, approaching triple digits at the smaller loan sizes, due to the necessity of covering production and risk costs with only small amounts of loan dollars. Adjusting the Commission's findings for inflation over the years since then, the Commission's cost work suggests the necessity of APRs of at least 43 percent before installment finance companies would make loans of $1600 today. Smaller loans would require even higher rates because of the necessity of recouping the production costs from even smaller loan amounts.

In more detail, since the time of the Commission's *Report*, there has been substantial domestic inflation. The smallest loan sizes the Commission explored in 1972, $100 and $200, in 2012 had the purchasing power of about $549 and $1098. It is possible similarly to adjust the underlying production

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can obtain more credit only at higher rates is in Juster and Shay (1964), especially Appendix I, discussed here later. See also, Durkin, Elliehausen, Staten, and Zywicki (forthcoming, 2013), Chapters 3 and 5.

costs the Commission explored for inflation to look at the relationship between costs and loan interest rate necessary to cover costs in today's dollars. Adjusting directly for changes in the consumer price index over this period is not unreasonable because much of the operations of consumer finance companies making such loans has not changed very much. While some cost-causing features of lending have undoubtedly changed over the decades, for example, office automation has reduced record keeping costs, most have not. Consumer finance company lenders still must pay personnel costs, rents, equipment costs, utilities, postage, and taxes. Salaries and benefits of employees per price-adjusted loan dollar likely have not decreased, even with office automation, because the more sophisticated nature of the technologies employees now use for record keeping and today's more stringent regulatory obligations require better educated and trained employees.

Translating the Commission's findings directly into today's dollars, the Commission's conclusion was that the Annual Percentage Rate on today's $549 loans for one year would have to exceed 94 percent before lenders would be willing to make such loans at the risk level the Commission suggested was necessary to "allow for enlargement of the market through a higher degree of risk acceptance" (National Commission on Consumer Finance 1972, p. 144). Further, rates on today's $1098 loans would need to exceed 56 percent before lenders would consider loans of this size, and rates would have to exceed 36 percent for any loan size less than $2196 (see discussion and table in National Commission on Consumer Finance 1972, p. 144).

Even then, these conclusions about necessary rates assumed that loans would be made for a one year period. The Commission specifically noted that shorter term loans would need even higher APRs because the loans would be outstanding and earning revenue even less time but the operating costs would still need to be recovered. According to the Commission, "Recognizing that loans of [typical small sizes found then], the required APR will be higher than in Exhibit 7-16 [of the Commission's *Report*] because the costs of putting the loan on the books and servicing it must be recaptured over the shorter time" (National Commission on Consumer Finance 1972, p. 145). The Commission's cost estimates also assumed monthly payments. Operating costs would be higher for loans with more frequent payments because they would require more personnel costs for servicing the more frequent payments, other things equal.

The historical record demonstrates the seriousness of the Commission's concerns over credit availability. Well known to the Commission, beginning in 1910 the Russell Sage Foundation had undertaken a philanthropic program to fight illegal loan sharks then prevalent in many places. The Foundation proposed for passage in the various states model legislation known as the Uniform Small Loan Law and advocated its acceptance. This model act provided for exceptions to low state rate-ceiling laws to permit state-licensed lending entities to provide small dollar cash loans to consumers legally. By the 1960s, almost all states had passed a version of this law. Even so, well known inadequacies of legal rates on the smallest loan sizes had come to the National Commission's attention and were the motivating factor in its study of this area and its recommendations at the end of 1972.[17]

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[17] The Uniform Small Loan Law's early choice of 3½ percent rate per month was based on the Russell Sage Foundation's studies of cost and experience of remedial loan companies and other small loan lenders at the time (see Clark 1931, pp. 46-7, Robinson and Nugent 1935, pp. 115-7), and Carruthers, Guinnane, and Lee 2009, p. 13).

Even then, the Foundation recognized that most lending costs are fixed, so that a 3½ percent ceiling made a $100 loan less profitable than a $300 loan, discouraging production of the smaller loans. The Foundation's position on transparency and simplicity of the transaction prevented it at first from supporting any particular remedy for this problem, however, such as allowing the lender to charge a higher percentage finance charge for smaller loans or a fixed fee per loan (see Carruthers, Guinnane, and Lee 2009). Either of these changes would complicate the

Hypotheses from the Economic Theory of Credit Rationing

In their economic analyses of the consumer's credit decision, Juster and Shay (1964) explained why consumers may sometimes be willing to borrow at high rates of interest (see also Durkin, Elliehausen, Staten, and Zywicki 2013, Chapter 3, for further discussion). To summarize, Juster and Shay argued that many products purchased using credit provide benefits over a period of time. Examples include car purchase for transportation to place of employment, home or car repair, and emergency health care expenditures. Such benefits imply a rate of return and a present value that can be compared with the cost of acquiring the product or service, and acquisitions that produce returns greater than costs are wealth and utility increasing. Limited empirical evidence at that time suggests that the return on durable assets can be quite large for many households (see Poapst and Waters 1964 and Dunkelberg and Stephenson 1975).

Juster and Shay's analyses produced two types of outcomes, an equilibrium outcome and a rationing outcome. Consider a simple example in which there are two borrowing rates, a lower rate charged by primary lenders and a higher rate charged by secondary lenders. Both lenders have an absolute limit on the amount that can be borrowed.

The consumer investing in high return durable goods or necessary household services will borrow when the rate of return on the purchases is greater than the lending rate of primary lenders. In the equilibrium case, the amount borrowed does not exceed the limit set by primary lenders, and the rate of return on investment, the interest rate (discount rate), and marginal rate of time preference are all equal in equilibrium.

However, discontinuities in market availability of borrowing can prevent consumers from taking advantage of potentially utility-increasing opportunities or needs through borrowing. Notably, rationing can prevent a consumer from borrowing further at lower rates, if the consumer exhausts availability of credit at the lower rate charged by primary lenders. In this case the borrower might well consider secondary lenders. The rate of return on the expenditures could be as high as the higher rate charged by secondary lenders (or even greater than the higher borrowing rate in which case the preferred amount of borrowing exceeds the secondary lenders' limit).

Based on this theory, users of high APR credit products would be expected to have characteristics of rationed borrowers. Unrationed borrowers generally would not find high APR credit products attractive.[18] Within this theoretical context, Juster and Shay identified characteristics that likely distinguish rationed and unrationed borrowers. Their distinction between unrationed and rationed borrowers is useful in assessing consumers' use of high APR credit products.

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transaction. Graduated rate ceilings, which allow higher rates on smaller loans, later became a common feature in state small loan laws.

[18] A large, disproportionate percentage of unrationed borrowers using high APR credit products would raise a question whether the credit use is irrational, as marginal borrowing rates for unrationed borrowers are normally relatively low. But surveys of users of high rate consumer credit products have found that they are not representative of the population as a whole or even of credit users generally, but rather are more limited in their credit options. For discussion, see Durkin, Elliehausen, Staten, and Zywicki, Chapter 8.

Specifically, rationed borrowers are likely to be in early family life cycle stages. For them, rates of return on household investment tend to be high. They tend to have relatively low or moderate current incomes and little discretionary income, making the sacrifices in current consumption to pay for large expenses personally costly. And because of their moderate incomes and relatively young age, rationed borrowers generally would not have accumulated large amounts of liquid assets. At this stage in the life cycle, their liquid asset holdings have a high subjective yield due to precautionary savings motives.

In these cases, subjective yields on any liquid asset holdings are higher than nominal yields for many consumers because of strong precautionary motives. Many consumers use liquid assets grudgingly even when events occur that impair their earning potential or require large expenditures. Their reluctance to use liquid assets stems from a belief that the worse the current situation, the greater is the need to maintain reserves for future emergencies (Katona 1975). As a consequence, subjective yields on liquid assets are often substantially greater than nominal yields.

Unrationed borrowers, in contrast, typically are in later family life cycle stages or have relatively higher incomes or assets. Unrationed borrowers in later life cycle stages or with more income may have relatively few high return household investment opportunities. For them, high income may provide discretionary amounts that allow for relatively large expenditures without costly reductions in current consumption. Moreover, their age or income may allow them to accumulate some discretionary savings. Consequently, subjective yields on liquid assets can be substantially lower for unrationed borrowers than for rationed borrowers. Availability of low cost discretionary income and liquid assets for acquisition of durable goods and important services would make unrationed borrowers generally unwilling to pay high interest rates for additional credit.

Consumer credit markets have changed considerably since Juster and Shay's study. Advances in information availability and in the technology to manage and analyze large amounts of information have improved lenders' ability to assess risk. Credit reporting through automated credit reporting agencies (credit bureaus) is now close to comprehensive. Credit reports thus generally reflect a consumer's complete credit history, making information in credit reports more useful for predicting future payment performance. In addition, the development of credit bureau scores has made statistical credit evaluation available to all lenders. Lenders' requirements for borrowers' equity in the purchases have also relaxed, as terms to maturity have lengthened for most closed end installment credit, and down payment requirements have also been reduced. Furthermore, home equity lines of credit and cash out refinancing of mortgage loans have developed to allow consumers to finance acquisition of durable goods using savings from equity in their homes. Thus, today many consumers are more able to finance a greater proportion of their household investment through primary lenders at the lower rates they offer.

Nonetheless, higher cost credit products from secondary lenders have also proliferated. Unsecured credit has become more widely available through bank credit cards, and many borrowers today use bank credit cards in much the same way as Juster and Shay described borrowers using unsecured personal loans (see Bizer and DeMarzo 1992, Brito and Hartley 1995). Competition has extended availability of bank credit cards to many consumers who previously would have had difficulty qualifying for them. As a result, unsecured credit is now available to more consumers at lower cost than in the past.

There also are various "subprime" versions of credit cards, automobile financing, mortgage loans, and other credit. As this term suggests, such products are mostly used by those who exhibit greater amounts of credit risk than mainstream consumers and likely are more credit constrained at low rates. These subprime products allow consumers to finance a larger share of the value of household durable goods and services, borrow more heavily against future income, and obtain credit despite previous

problems repaying debts. The financial crisis of 2008-2009 disrupted aspects of subprime credit markets, but after necessary reevaluation and restructuring, these credit sources are unlikely to go away.

There also are new short term subprime cash-lending products to go with the small loan industry that has existed for decades and pawn lenders prevalent for centuries. The payday lending industry allows consumers to obtain an advance on their next paycheck, automobile title lenders offer small loans secured by consumers' automobiles, and income tax refund anticipation loans have enabled consumers to obtain an advance on expected tax refunds. Small installment loans are different from these other products because their multipayment nature suggests they can be better adapted to the budgets of rationed borrowers.

Juster and Shay suggested several empirically testable hypotheses about rationed and unrationed borrowers' demand for credit. Looking at the hypotheses relevant for small installment lending, they predicted that:

(1) unrationed borrowers' demand for credit would be more sensitive to interest rates than rationed borrowers' demand;

(2) a simultaneous increase in the interest rate and term to maturity that reduces the amount of monthly payments would increase borrowing by rationed borrowers and decrease borrowing by unrationed borrowers;

(3) and, more generally, that rationed borrowers would respond more strongly than unrationed borrowers to differences in monthly payments.

Juster and Shay tested these hypotheses in an experimental study in which a panel of consumers was asked to express preferences for different hypothetical sets of credit terms. Consumers were classified into rationed and unrationed groups based on their income and family life cycle stage, and responses were used to compute elasticities of credit demand for rationed and unrationed groups.

Evidence from the experimental data was consistent with the predictions of Juster and Shay's theoretical model. The evidence strongly supported hypotheses that unrationed borrowers' demand was more sensitive to interest rates than rationed borrowers' demand (hypothesis 1) and that a simultaneous increase in the interest rate and term to maturity that reduces the amount of monthly payments increased rationed' borrowers' demand and decreased unrationed borrowers' demand (hypothesis 2). They also found that rationed borrowers responded more strongly than unrationed borrowers to changes in monthly payments (hypothesis 3).

Significantly, Juster and Shay's analysis reconciled the apparent inconsistency noted at that time between consumers' lack of sensitivity to interest rates and the predictions of neoclassical economic theory as handed down from Fisher (1907, 1930) and Seligman (1927): Rationed consumers, whose demand for debt exceeded the amount available at going interest rates and who, therefore, were not sensitive to these interest rates, likely comprised a large majority of the population at that time. Thus, aggregate data from then and earlier largely reflected the behavior of these rationed borrowers. The aggregate data obscured the behavior of the smaller group of unrationed borrowers, who were sensitive to interest rates.

The hypothesized large proportion of rationed consumers at the time also provides insight into consumers' lack of knowledge of interest rates also noted then: Rationed consumers do not need to know the interest rate to minimize credit costs. Rationed consumers

find the longest available maturity and shop for the lowest monthly payment (payment size is perfectly correlated with interest rate for a given loan size and maturity). Juster and Shay found that knowledge of interest rates actually paid on recent credit transactions was concentrated mainly among the unrationed consumers, who need to know the interest rate to make rational credit decisions. Nevertheless, at that time, before Truth in Lending, many of the unrationed borrowers also underestimated or did not recall the rate paid. Later studies have shown that lack of knowledge has changed in the years since Truth in Lending went into effect in 1969 (see Durkin and Elliehausen 2011, Chapter 7).

Juster and Shay believed that the proportion of unrationed consumers (and, therefore, consumers' overall sensitivity to interest rates) would increase gradually over time. They pointed to secular growth in consumer income and a trend toward longer terms to maturity as factors that would shift consumers from rationed to unrationed groups. In addition to the factors identified by them, advances in creditors' ability to assess and price risk have likely reduced the proportion of rationed consumers in the population in recent years. It seems that all these factors likely have reduced the proportion of rationed borrowers in the marketplace, but certainly not to zero.

There also were limited subsequent empirical tests of Juster and Shay's theory. In an experimental study, Walker and Sauter (1974) presented to a random sample of consumers pairwise comparisons of five alternative sets of financing terms for a household appliance. The sets of financing terms varied in terms of interest rate, product price, monthly payment size, and amount of downpayment. For each of ten possible pairs of alternatives, consumers chose the alternative that they preferred. Comparing the responses of lower income and higher income consumers, Walker and Sauter found that greater proportions of lower income consumers than higher income consumers preferred alternatives with lower monthly payments regardless of interest rate over sets with higher monthly payments or positive downpayment. They interpreted these results as consistent with Juster and Shay's hypotheses.[19]

More recently, Attanasio, Goldberg, and Kyriazidou (2000) used automobile purchase data from the 1987-1995 Consumer Expenditure Surveys to estimate interest rate and maturity elasticities for households hypothesized to be more or less likely to be rationed. Both their modeling and their statistical work are somewhat technical, but they provided evidence based on actual consumer behavior that credit choices of households likely to be rationed are sensitive to loan term (hence, other factors being equal, to

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[19] Walker and Sauter's analysis has several technical flaws that diminish its contribution to understanding consumers' credit preferences, however (see Burstein 1978). For instance, they did not take into account that the size of monthly payment is not independent of price, downpayment, interest rate, and term to maturity. Some of the alternatives were clearly preferable to others, and choice between a higher product price or a higher interest rate is a matter of indifference for all consumers when the monthly payment and the downpayment are the same. Several pairs of alternatives did involve tradeoffs that theory predicts would cause rationed or unrationed borrowers to choose one or the other of the alternatives, but Walker and Sauter's classification of consumers as rationed or unrationed consumers solely on the basis of income is inadequate. (For example, a household in retirement may have low income but would not normally be rationed because demand for credit would often be low.) Walker and Sauter reported statistically significant differences by education, occupation, marital status, and sex. However, they did not discuss how such differences might be related to Juster and Shay's or any other hypotheses about consumers' behavior.

the size of monthly payments). In contrast, they found that credit choices of households likely to be unrationed were sensitive to the interest rate but not loan term. Classifying consumers as rationed or unrationed on the basis of age or income alone is not precise, since rationing involves both high demand for debt and limited resources for servicing the debt.[20] Nonetheless, these findings provide additional support for Juster and Shay's theoretical model of consumer credit use.

Available information specifically about the characteristics of borrowers of small installment loans suggests the likelihood of their being rationed by primary lenders, although the only study specifically of these borrowers (undertaken for the National Commission on Consumer Finance) is also quite old (Durkin 1975). This study shows that at that time small loan borrowers were concentrated among the lower income segments of society. The results of a survey of borrowers showed that most of them belong to the parts of the population that often had trouble at the time obtaining credit elsewhere. Many of them reported being turned down elsewhere.

Recent Experience

With this as background, what does this mean for small dollar installment cash lending lending today? Little statistical information about small installment loans or borrowers has been available, but recently the American Financial Services Association has surveyed its members about small dollar installment loans. The survey collected information on the characteristics of 5.2 million installment loans outstanding as of the end of December, 2012. To focus on the most current lending, the discussion here reflects loans outstanding on December 31, 2012 and that were made in the previous six months. There were 2.5 million of these loans made by surveyed companies during this six month period.

Evidence from this survey suggests that the overwhelming majority of these loans were subprime in nature (discussed in more detail below). About half of the loans reported a credit score, and about 85 percent of them can be classified as subprime (Table 1). Among the loans with scores, about 27 percent were deep subprime, with scores below 551. Only about 2 ½ percent of the loans with scores went to borrowers with good credit standing (fifth column from left in the table). In other words, most of the customers for this kind of installment loans probably were ineligible for much credit from mainstream lenders.

The subprime character of these loans immediately suggests some specific hypotheses about small installment loans based ultimately upon the work of Juster and Shay. (Among the hypotheses about these loans, the fourth concerns the geographic distribution of the loans, suggesting they may not be available everywhere. Consequently, the other hypotheses apply only to the areas where the loans are available.)

First, the loans likely are quite small. Since they are mostly subprime in character, many of them likely are made to borrowers who have little availability of credit at primary lending sources or who have loans from primary lenders but have exhausted any further credit availability from them and are only

[20] Attanasio, Goldberg, and Kyriazidou also estimated their model for age groups (less than 35 years and 35 or older) interacted with education (high school diploma or less and some college or college degree). Partial derivatives were not statistically significant except for the group of households headed by persons less than 35 years of age with a high school diploma or less education. For that group, the partial derivative with respect to maturity is statistically significant and positive. As lower levels of education are associated with lower income, this group is likely to have booth high demand and limited resources.

eligible for relatively small loans at secondary (subprime) lenders. This suggests that large loans are unlikely.

Second, the loans likely exhibit relatively high APR's both because they are small and because they are made to risky borrowers.

Third, consistent with the findings of Juster and Shay, the loans likely are of appropriate size to keep the payments low and within budgets of subprime consumers. This would come about because credit constrained consumers will demand longer maturities and smaller payments whenever possible and lenders will be more likely to lend in a way where payment size of constrained consumers suggests a greater likelihood of receiving the money back.

Fourth, because rate ceilings vary substantially among the states, prevalence and characteristics of these loans probably vary substantially among the states as well.

Examination of the survey data produces findings consistent with each of these hypotheses. First, survey results show that these cash loans are mostly quite small. Almost 83 percent of the loans were made in amounts of $2000 or less (sum of the first three lines of Table 2). This suggests they were substitutes for amounts of credit otherwise available on credit cards, likely indicating these customers were unable to obtain credit using cards, or at least as much credit as they preferred. Consistent with their generally small size, these loans also exhibited short maturities: Almost 90 percent were made for a term of 24 months or less (sum of first three columns of Table 2). Almost 70 percent had terms of one year or less.

Not surprisingly, loan size and maturity are correlated. The smallest loans have the shortest maturities and larger loans longer maturities (demonstrated by the slant of the numbers in Table 2 downward to the right). The relationship between size and maturity so that the largest loans have the longest maturities, likely is an attempt to fit the loan payments effectively into monthly budgets. This is unlike payday lending where the single-payment payday loans are due in one lump, probably causing frequent budget difficulties.

Second, the survey results also show that the APRs on these loans are higher than on the most familiar mainstream kinds of credit for consumers like mortgage credit and credit card credit. APRs range upward to and over 100 percent on an annual basis for the smallest loans (Table 3). The loans also show an inverse relationship between loan size and APR: the highest APRs are associated with the smallest loans, which are also the loans with the shortest maturities. This is exactly what the National Commission on Consumer Finance predicted in 1972 that a competitive market would produce. Further, the range of rates is right where the National Commission predicted in 1972 they would have to be, based on its cost studies, before lenders would be willing to make loans of this kind.

Third, consistent with suggestions from Juster and Shay, the survey results also demonstrate directly what appears to be an attempt to fit repayments into households' budgets. Virtually all the smallest loans have monthly payments of $100 or less (less than two tanks of gas in recent months), and up to $1000 loans $150 or less (intersection of the first two lines of Table 4 with the first three columns).

The survey also shows that, on balance, installment borrowers are slightly younger than the population average (not in table). Further, there is some indication that smaller loans more often go to younger borrowers and larger loans to older ones (Table 5), but neither relationship is especially strong. Rather, there is indication that borrowers of all ages borrow in amounts across the board, but with some limited tendency toward a direct relationship between age and loan size.

In sum, the survey of installment lending shows that the industry makes mostly small subprime loans with short maturities, the kind of loans that might be expected of secondary lenders as predicted by Juster and Shay. The Annual Percentage Rates of charge on these loans are relatively high by the standards of many common (and larger) kinds of loans made to middle class consumers, but the rates are right where the National Commission on Consumer Finance predicted a generation ago they would have to be before lenders would make this sort of loan. There is evidence of attempt to make repayment plans fit into budgets, which is much different from the single-payment nature of other subprime cash loans like payday, auto title, and pawn loans. Although there is indication that younger consumers tend to borrow in smaller amounts, this relationship is not strong and loans of all sizes range across all age groups.

Further Evidence of Lending Risk

The survey results also demonstrate further evidence of the relationship between various loan features and after-the-fact measurement of lending risk in this lending segment. For instance, the survey showed that about one quarter of the loans were in some state of delinquency on the survey date (December 31, 2012), a high proportion. A portion of these loans (though not all) are destined for eventual repayment but probably with some (costly) difficulties, like employee reminders and even potential legal action for some of them.

There are clear correlations between delinquency on the survey date and loan features. For example, small loans are much more likely to be delinquent than larger loans (Table 6). More than 35 percent of the smallest loans were delinquent on the survey date (even though likely most of this money is headed eventually toward repayment, even with some difficulty), but only about 10 percent of the largest loans. This undoubtedly reflects the greater willingness of lenders to take chances with smaller amounts of money than large amounts.

Likelihood of delinquency is definitely correlated with credit score (Table 7). More than a third of the loans in the lowest score group were in delinquent state on the survey date, but only about 5 percent of those in the highest score grouping. This relationship is not surprising, but it is very strong. Based on this evidence, it is easy to conclude that both loan size and credit score are predictors of risk. (The totals in this table differ slightly from Table 6, because not all loans report a credit score.)

The fact of greater risk on loans with different sizes and credit scores clearly shows itself in the relationship between delinquency and APRs charged (Table 8). Simply stated, riskier loans, as demonstrated by their actual delinquency state on the survey date, are also the ones that receive the highest APRs. This demonstrates the common-sense notion that lenders are willing to make loans to the riskiest borrowers only if they receive compensation for the risk.

While loan size clearly is also a factor, with the smallest loans exhibiting the highest APRs, the smallest loans also are the riskiest and for that additional reason are going to be associated with high APRs. Again, this is consistent with the contentions of the National Commission on Consumer Finance in 1972 and noted above that only sufficient rates would "allow for enlargement of the market through a higher degree of risk acceptance" (National Commission on Consumer Finance 1972, p. 144). It is possible to contend that causality is the other way and the high APRs cause the delinquency, but this seems unlikely in most cases, since calculations show that higher APRs have a much greater impact on lenders' revenues (and compensation for the costs of risk) than they do on monthly payments, since repayment of the principal sum and not interest on the loan represents the dominant share of the payment amount, as it also does on other kinds of small dollar credit..

Differences Among States

To examine the fourth hypothesis above, that prevalence and characteristics of installment lending vary substantially among the states according to regulatory features, it is possible to array the loans according to residence area of the borrowers. By concentrating on totals, the discussion so far masks any differences that may exist among the states. Differences among state may arise either because of differences in local demand or because of variations in supply factors, notably including variations in regulation. As the National Commission on Consumer Finance pointed out in its report in 1972, demand for small cash loans is widespread but legal rate ceilings will alter supply.

Distribution of the loans in the database according to the residence of the borrower (zip code) shows large differences in concentration of these loans among the states. One state (Texas) accounts for one quarter of the surveyed loans, and only nine states combined account for about three quarters of the loans (Table 9). In contrast, there were fewer than 1000 loans each made to residents in zip codes of 18 states, including the populous states of Minnesota, Maryland New York, New Jersey, and Massachusetts. Sixteen states, including Massachusetts, New York, and New Jersey had fewer than 100 loans.

Median loan size made also varied sharply among the states. All nine of the states with the largest number of loans outstanding showed median loan size made of $1000 or less. In contrast, ten other states showed median loan size made of more than $3000, including Colorado and Washington at more than $4000 (not in table).

Geographic distribution of these closed end cash loans naturally reflects the distribution of the lending locations or offices where lenders make these closed end loans, and the location of the offices reflects rate ceilings. All of the nine states that account for the bulk of the small loan lending are states permitting relatively high rates of charge on these small loans. In contrast, all of the states with very few loans are low rate states.

It is, of course, possible for borrowers to approach a lender in another state if regulatory differences suggest greater availability of lending offices and credit there. For this purpose, Arkansas offers a good test. It is a known low rate state, but the survey shows more than 20,000 loans made to Arkansas residents despite this regulatory distinction. Arkansas is especially noteworthy because it borders four of the states identified in Table 9 as states with many small closed end cash loans (Texas, Tennessee, Oklahoma, and Louisiana).

Examination of the zip codes of Arkansas loans shows that almost all of the borrowers reside in the 31 counties that border other states, in particular Oklahoma, Missouri, Louisiana, and Texas. Consequently, it seems probable that most of these small loans were made by lenders across the state border. In sharp contrast, only 313 of the 20,566 Arkansas loans were made in the 44 interior counties, despite inclusion there of the largest population centers in the state, the Little Rock and Pine Bluffs areas. Likely at least some, if not all, of the loans in the interior counties also involved borrowing across the state line.

Loans to borrowers in other low rate states also may be made across state lines, but it seems that unless rates on the smallest loan sizes are relatively high, small dollar lenders are not going to populate these states and loans actually made by lenders who do locate there are going to be considerably different from the loans made in states with many loans. California and Pennsylvania provide examples. Neither has an especially high rate ceiling on the smallest sizes and neither borders another state with this

characteristic. In fact, the loans actually available to the residents of these two states are much different from those in the states permitting higher rates on the smaller sizes, for instance, Texas.

Using Pennsylvania for the comparison state, cash lending was much more common by surveyed companies in Texas during the period of the lending survey. There were 23.9 loans outstanding at surveyed companies in Texas on the survey date per 1000 population, but only 1.5 loans per 1000 population in Pennsylvania. Furthermore, the loans had very different characteristics.

Loans in Pennsylvania are much larger than in Texas. In Pennsylvania, the survey found almost no loans of $500 or less and only about 1 percent of the loans at $1000 or less (Table 10).[21] This Pennsylvania distribution compares to about 42 percent of Texas loans in the smallest size and almost 70 percent in amount of $1000 or less. This difference suggests that small loans sizes are mostly unavailable in Pennsylvania but also the potential that borrowers in Pennsylvania might sometimes need to borrow more than they really prefer in order to find lenders willing to make any loan.

Other comparisons are consistent with the loan size difference. For instance, APRs on Texas loans are higher (Table 11). This is consistent with the contention of the National Commission on Consumer Finance that high rates are necessary on small loans in order for the lenders to be able to recover lending costs on the small dollars of credit involved. In Pennsylvania, almost all loans were made at APRs from 19 to 36 percent but the mostly smaller loans in Texas showed rates 49 to 99 percent, in line with what the NCCF suggested would happen. (Looking more closely at the Pennsylvania distribution, more than 80 percent of the loans carried APRs of 25 to 27 percent, reflecting the rate ceiling at the upper end of this range (not in table)). Almost all of the rest of the loans carried APRs of 22 to 24 percent.) Payment size also reflected loans size difference. In Pennsylvania, almost 55 percent of the loans were made with monthly payment size greater than $150; the corresponding proportion in Texas was about 16 percent (Table 12).

It is interesting to note that the difference in credit scores is not as pronounced between the states as the other loan characteristics (Table 13). Clearly, most borrowers in both states can be considered subprime (scores below 661. It is possible that lenders in Pennsylvania are willing to take the risks of making larger loans with some borrowers, albeit a smaller number than in Texas. It is possible that this reflects individual lender favorable experiences with certain borrowers that make them willing to grant the loans despite subprime credit scores or no credit scores. (Almost all Pennsylvania loans had scores.) It also again suggests the possibility that some Pennsylvania borrowers may be taking larger loans than they otherwise would prefer if smaller loans were available under the state's lower rate ceilings.

This highlights difficulties that occur when rate ceilings prevent subprime borrowers from obtaining loans in the sizes they desire and have to obtain larger loans than necessary to be able to obtain loans at all. A first difficulty arises from the potential risk that these consumers may not have the requisite self discipline or show enough care to retain in their reserves the excess funds they must borrow beyond what they want to borrow. If they also spend the additional funds, this increases their repayment burden beyond what it would be with a smaller loan. Simply put, they have to repay more principal over a longer time and this can pose financial risks for them.

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[21] It appears that the bulk of the Texas loans at surveyed companies were made under Chapter 342, Subchapter F of the Texas Finance Code, a provision that allows higher rates on loans of $1300 or less. There is no comparable provision of Pennsylvania law. For recent discussion of Section 342 of the Texas Code see Hutchings and Nance (2012).

A second difficulty is that the additional borrowing for a longer time also means higher finance charges, despite the lower APR. It is easy enough to see this effect from some examples using typical APRs and loan sizes in Texas and Pennsylvania.

Suppose a credit constrained borrower in Pennsylvania needs or wants a $500 loan, a typical small loan in Texas, but it is unavailable from either primary or secondary lenders in Pennsylvania. In Texas, suppose this small loan would entail 6 monthly payments of $107.88 at APR of 95 percent. Total finance charge over the six months would be $147.31 (top panel of Table 14).

Suppose also that a secondary lender in Pennsylvania is unwilling to make a Texas-type small loans but is willing to lend a typical Pennsylvania-type small loan. This entails a loan of $2000 at 27 percent. To keep the payments roughly equivalent, the loan is made for 24 payments of $108.76 (lower panel of Table 14). The problem is that the finance charge more than quadruples despite the lower APR, due to the larger loan and longer maturity.

The calculus is similar if the borrower wants a $1000 loan, a typical large loan for these Texas small dollar lenders. In this case where the Texas lender would make this loan at 72 percent APR for 12 months of payments of $119.28. Such a loan is illegal in Pennsylvania.[22] A borrower there in need of a $1000 loan but unable to obtain one because of the ceiling might instead obtain a $2000 loan at 27 percent, assuming the borrower qualifies for the larger loan. Using the same example for the Pennsylvania loan, it would involve almost the same payment size as the Texas loan ($108.76 in Pennsylvania at 27 percent APR versus $119.28 in Texas at 72 percent APR). But because the loan would be both larger and longer in Pennsylvania, the finance charge would accrue for a longer time and in total would be considerably more than on the shorter Texas loan at higher APR, assuming the Pennsylvania borrower even qualifies for the larger loan at the lower rate. It is not at all clear that these Pennsylvania borrowers are better off when looking for small loans under the Pennsylvania rate ceiling than they are in Texas where the rate ceilings are much higher but small loans are available.

Finally, the survey results show that Texas borrowers are somewhat younger than their counterparts in Pennsylvania (Table 15). In Texas, the survey found that about 29 percent of loans were to borrowers under age 35, compared to about 19 percent in Pennsylvania. This also is consistent with the Juster-Shay conception of rationed borrowers

[22] The small number of such loans visible in Table 11 probably are loans made by telephone, mail, Internet, or to individuals who subsequently moved to Pennsylvania from some other state.

Table 1. Credit Score

Installment Loans Outstanding End of September 2012
and Made During Previous Six Months

	Credit Scores					
	≤551	551-619	620-659	660-699	≥700	All
All	27.2	42.4	15.8	12.2	2.4	100.0

Notes for Tables 1 through 5:

Values are percents of the total.

Columns and rows may not add exactly to totals because of rounding.

Source for Tables 1-14: Installment Loans Survey.

Table 2. Installment Loan Maturities (Months)

	1-6	7-12	13-24	25-36	37-120	>120	All
Loan Amount (TIL Amount Financed)							
< $501	15.5	15.3					30.8
501-1000	0.4	26.0	0.7				27.2
1001-2000	0.2	11.1	12.7	0.6			24.6
2001-5000		0.1	7.1	6.1	0.7		14.0
5001-10,000			0.3	2.3	0.6		3.1
>$10,000				0.2	0.1		0.3
All	16.1	52.6	20.8	9.1	1.4		100.0

Table 3. APR (Percent)

	<18	19-36	37-48	49-99	100-199	≥200	All
Loan Amount (TIL Amount Financed)							
< $501		0.1	1.1	18.1	11.4		30.7
501-1000		1.3	7.0	17.5	1.3		27.2
1001-2000		5.2	9.4	10.0			24.6
2001-5000		11.7	2.3				14.0
5001-10,000	0.1	3.0					3.2
>$10,000		0.3					0.3
All	0.1	22.0	7.3	57.3	13.1	0.2	100.0

Table 4. Payment Amount (Dollars)

	<50	50-100	101-150	151-200	>200	All
Loan Amount (TIL Amount Financed)						
< $501	1.9	28.7	0.2			30.8
501-1000	0.1	14.6	12.2	0.2	0.1	27.2
1001-2000		3.0	16.4	5.1	0.1	24.6
2001-5000		0.3	6.0	6.3	1.4	14.0
5001-10,000				0.3	2.9	3.1
>$10,000					0.3	0.3
All	2.0	46.6	34.7	11.9	4.8	100.0

Table 5. Age of Borrower

	18-24	25-34	35-44	45-54	55-64	≥65	All
Loan Amount (TIL Amount Financed)							
<$501	5.5	7.2	5.8	5.5	4.1	2.6	30.8
501-1000	1.9	5.2	5.7	6.0	4.9	3.4	27.2
1001-2000	0.9	4.0	5.4	6.0	4.9	3.2	24.5
2001-5000	0.3	2.0	3.2	3.7	2.9	1.9	14.0
5001-10,000		0.4	0.8	1.0	0.7	0.3	3.2
>$10,000			0.1	0.1	0.1		0.3
All	8.7	18.9	20.9	22.3	17.7	11.5	100.0

Table 6. Delinquency and Loan Amount

	<$500	501-1000	1001-2000	2001-5000	5001-10000	>$10,000	All
Delinquent:							
Yes	35.3	25.2	20.1	13.4	10.1	10.6	23.3
No	64.7	74.8	79.9	86.6	89.9	89.4	76.7
All	100	100	100	100	100	100	100

Table 7. Delinquency and Credit Score

	<550	559-659	660-699	650-699	≥700	All
Delinquent:						
Yes	33.9	20.2	14.0	10.1	5.5	21.3
No	66.1	79.8	86.0	89.9	94.5	78.7
All	100	100	100	100	100	100

Note for Tables 6 through 8:

Values are percents of each column.

Columns and rows may not add exactly to totals because of rounding.

Table 8. Delinquency and APR (Percent)

	<18	19-36	37-48	69-99	100-199	≥200	All
Delinquent:							
Yes	9.5	12.4	21.8	28.6	36.9	50.7	23.2
No	90.5	87.6	78.2	71.4	63.1	49.3	76.8
All	100	100	100	100	100	100	100

Table 9. States with Many and Few Loans

States with Many Loans:	Percent of Total	Median Size (Dollars)
Texas	25.0	598
Georgia	8.6	755
Tennessee	8.2	745
South Carolina	7.3	731
Oklahoma	6.6	789
Illinois	5.9	1000
Alabama	4.9	552
Louisiana	4.2	674
New Mexico	3.8	556
Total Nine States	74.5	

Examples of Populous States with Very Few Loans[1]	Number of Loans	
Minnesota	918	*
Maryland	172	*
New York	96	*
New Jersey	62	*
Massachusetts	12	*

Notes for Table 9:

[1] After rounding, each of these states accounts for 0.0 percent of the total. In addition, there also were 13 additional states not listed in the table with fewer than 1000 loans.

* Not enough loans to construct a meaningful average size.

Table 10 Installment Loan Maturities (Months)

Pennsylvania Loans

Maturities (Months):	1-6	7-12	13-24	25-36	37-120	>120	All
Loan Amount (TIL Amount Financed)							
< $501		0.1					0.1
501-1000	0.3	0.4	0.1				0.8
1001-2000	0.6	4.1	9.6	0.6			15.0
2001-5000	0.1	0.8	24.3	32.5	0.6		58.3
5001-10,000			1.5	18.5	3.7		23.8
>$10,000				0.8	1.2		2.0
All	1.0	5.5	35.5	52.5	5.5		100.0

Texas Loans

	1-6	7-12	13-24	25-36	37-120	>120	All
Loan Amount (TIL Amount Financed)							
< $501	27.8	13.9					41.7
501-1000		27.1					27.1
1001-2000		25.1	3.1				28.3
2001-5000			1.9	0.5			2.5
5001-10,000			0.1	0.3			0.4
>$10,000							
All	27.8	66.1	5.2	0.8			100.0

Table 11 APR

Pennsylvania Loans

APRs (Percent):	<18	19-36	37-48	49—99	100-199	≥200	All
Loan Amount (TIL Amount Financed)							
< $501							0.1
501-1000		0.7		0.1			0.8
1001-2000		14.9		0.1			15.0
2001-5000		58.3					58.3
5001-10,000		23.8					23.8
>$10,000		2.0					2.0
All		99.7		0.2			100.0

Texas Loans

	<18	19-36	37-48	49—99	100-199	≥200	All
Loan Amount (TIL Amount Financed)							
< $501				41.5	0.2		41.7
501-1000				27.0			27.1
1001-2000		0.7		27.6			28.2
2001-5000		2.5					2.5
5001-10,000		0.4					0.4
>$10,000							
All		3.7		96.1	0.2		100.0

Table 12. Payment Amount

Pennsylvania Loans

Payments (Dollars):	<50	50-100	101-150	151-200	>200	All
Loan Amount (TIL Amount Financed)						
< $501		0.1				0.1
501-1000	0.1	0.5	0.1			0.8
1001-2000		8.6	5.7	0.7		15.0
2001-5000		1.8	28.4	23.8	4.3	58.3
5001-10,000				2.4	21.4	23.8
>$10,000					2.0	2.0
All	0.2	11.1	34.1	26.9	27.7	100.0

Texas Loans

	<50	50-100	101-150	151-200	>200	All
Loan Amount (TIL Amount Financed)						
< $501	6.2	35.5				41.7
501-1000		12.6	14.5			27.1
1001-2000		0.1	14.5	13.7		28.3
2001-5000			0.5	1.6	0.4	2.5
5001-10,000					0.4	0.4
>$10,000						
All	6.2	48.2	29.5	15.3	0.8	100.0

Table 13. Credit Score

Pennsylvania Loans

Scores:	<551	551-620	621-660	661-700	≥700	All
Loan Amount (TIL Amount Financed)						
< $501						
501-1000	0.2	0.2	0.1	0.1	0.1	0.7
1001-2000	3.6	5.7	3.1	1.5	0.8	14.8
2001-5000	15.8	22.1	12.3	5.7	2.6	58.5
5001-10,000	5.7	9.2	5.3	2.7	1.0	24.0
>$10,000	0.5	0.8	0.5	0.2	0.1	2.0
All	25.9	38.0	21.2	10.2	4.6	100.0

Texas Loans

	<551	551-620	621-660	661-700	≥700	All
Loan Amount (TIL Amount Financed)						
< $501	10.0	14.3	5.4	1.7	0.4	31.8
501-1000	6.8	11.6	5.4	2.2	0.5	26.4
1001-2000	8.0	14.7	8.6	4.3	0.9	36.4
2001-5000	0.7	1.8	1.2	0.6	0.1	4.5
5001-10,000	0.1	0.3	0.1	0.1		0.7
>$10,000						0.1
All	25.6	42.6	20.8	8.9	2.0	100.0

Table 14. Examples of Loan Terms and Charges on Typical Small and Large Loans in Texas and Pennsylvania

Texas Loans

Small loan

Amount	$500
APR	95 percent
Maturity	6 months
Payment size	$107.88
Interest	$147.31

Large loan

Amount	$1000
APR	72 percent
Maturity	12 months
Payment size	$119.28
Interest	$431.32

Pennsylvania Loans

Small loan

Amount	$2000
APR	27 percent
Maturity	24 months
Payment size	$108.76
Interest	$610.25

Large loan

Amount	$4000
APR	27 percent
Maturity	36 months
Payment size	$163.30
Interest	$1878.83

Table 15 Borrower Age

Pennsylvania Loans

	18-24	25-34	35-44	45-54	55-64	≥65	All
Loan Amount (TIL Amount Financed)							
<$501			0.1				0.1
501-1000	0.1	0.2	0.2	0.2	0.2	0.2	1.0
1001-2000	0.8	2.5	3.6	3.3	2.9	2.2	15.3
2001-5000	1.9	9.5	13.9	14.2	10.6	6.6	56.7
5001-10,000	0.4	3.0	6.3	7.2	5.4	2.1	24.4
>$10,000		0.3	0.6	0.7	0.6	0.1	2.3
All	3.3	15.5	24.6	25.6	19.6	11.3	100.0

Texas Loans

	18-24	25-34	35-44	45-54	55-64	≥65	All
Loan Amount (TIL Amount Financed)							
<$501	7.2	9.5	8.0	7.6	5.7	3.9	41.9
501-1000	1.8	5.4	6.3	6.8	5.5	4.0	29.9
1001-2000	0.6	3.6	5.5	6.7	5.5	3.4	25.2
2001-5000		0.4	0.6	0.7	0.5	0.2	2.5
5001-10,000		0.1	0.1	0.1	0.1		0.5
>$10,000							
All	9.6	19.0	20.5	21.9	17.3	11.7	100.0

Notes for Tables 10 through 13 and Table 15:

Values are percents of the total.

Columns and rows may not add exactly to totals because of rounding.

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EMAIL SUBMITTED BY SENATOR VITTER

[redacted]

From: [redacted]
Sent: Monday, February 03, 2014 8:16 AM
To: [redacted]
Subject: Thank You

Gentlemen, thank you for taking the time to update us on Friday.

In spite of the strange market and excessive scrutiny, you have done very well.
Congratulations.

I wanted to thank you for your loyalty.
I know you had options other than [redacted]
Thanks for staying with us.

Based on your performance, there's NO WAY we SHOULDN'T be a credit provider.
Our only issue is, and it has always been, the space in which you operate.
It has never been the service that you've provided or the way you operate.
You've obviously done a brilliant job.
It is the scrutiny that you, AND NOW THAT WE, are under.

We'd like to stay in touch.
I promise we will keep an open mind.
Thanks again.

[redacted]
Executive Vice President and Manager

[redacted]

[redacted]

[redacted]

[redacted] recently performed an industry review to evaluate risk characteristics associated with typical customers as well as industry trends. Such a review can result in decisions to modify policies or controls, set concentration limits or exit an industry outside our risk tolerance.

During recent reviews of the payday lending industry, we have determined that the services provided by clients in this industry are outside of our risk tolerance. As such, we will no longer be able to provide financial services to businesses that operate in that industry. This decision impacts your business and will necessitate the closing of your accounts.

Next Steps

The complexity of closing your [redacted] accounts and transitioning services is unique to your situation, and [redacted] is committed to helping you through this transition. This work will need to begin immediately. Our intention is to exit the business relationships by [redacted] We understand that in some cases, the complexity of services may require a longer exit timeline.

We will work with you to schedule a meeting in the coming days to formalize the transition plan.

Sincerely,

[redacted] [redacted]

[redacted]

[redacted] are registered trademarks of [redacted]