Testimony Of
Jean Ann Fox
Director of Financial Services
Consumer Federation of America

On Behalf Of
Consumer Action
Consumers Union
National Association of Consumer Advocates
National Consumer Law Center
(On behalf of its low income clients)
US PIRG
Woodstock Institute

Before
The Subcommittee on Financial Institutions and Consumer Credit

Regarding
H.R. 1214, the Payday Loan Reform Act of 2009

April 2, 2009

Chairman Gutierrez, Ranking Member Hensarling, and members of the Subcommittee, I appreciate the opportunity to offer our comments on payday lending and on H.R. 1214, the Payday Loan Reform Act of 2009. I am testifying today on behalf of the Consumer Federation of America,[1] as well as Consumer Action,[2] Consumers Union,[3] National Association of Consumer Advocates,[4] National Consumer Law Center (on behalf of its low-income clients),[5] USPIRG,[6] and the Woodstock Institute.[7]

We appreciate your interest in protecting consumers from predatory payday lending and the debt trap that results from offering small loans at extremely high rates secured by direct access to the borrower's bank account. American consumers are paying billions in usurious rates for loans that undermine scarce family resources, risk bank account ownership, and compound cash-strapped consumers' financial problems. We agree that payday lending and other similar products should be reformed. However we respectfully disagree with the methods used in H.R. 1214.

We oppose enacting legislation to sanction a predatory credit product that traps cash-strapped American families in a debt cycle of repeat borrowing. Congress outlawed these loans for Service members and their families in 2006 and should extend the same protections to all Americans. As American families struggle to make ends meet, protections against extremely expensive loans, unaffordable repayment terms, and loss of control of bank accounts are more important than ever. H.R. 1214 does not provide the protections that American consumers need or want.

H.R. 1214 authorizes single payment loans at 391 percent annual percentage rate (APR) or higher for shorter term loans. H.R. 1214 provides Congressional approval to the hazards of lending based on soliciting consumers to write unfunded checks held for future deposit or requiring consumers to sign over electronic access to their bank accounts. While the rate cap

---

[1] The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, founded in 1968 to advance consumers' interests through advocacy and education.

[2] **Consumer Action**, founded in 1971, is a San Francisco based nonprofit education and advocacy organization with offices in Los Angeles and Washington, DC.

[3] **Consumers Union** is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers.

[4] The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

[5] The **National Consumer Law Center (NCLC)** is a non-profit corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country.

[6] The **U.S. Public Interest Research Group (USPIRG)** serves as the federation of and federal advocacy office for the state PIRGs, which are non-profit, non-partisan public interest advocacy groups that take on powerful interests on behalf of their members.

[7] The **Woodstock Institute** is a Chicago-based policy and advocacy nonprofit that works locally, nationally, and internationally to promote community reinvestment and economic development in lower income and minority communities.

authorized by this bill does not preempt lower state caps, Congressional approval of triple-digit lending will undercut reform efforts in the states. The protections against the payday loan debt trap provided by this bill have proven ineffective in states that have tried them. The H.R. 1214 definition of payday loan creditors and payday loan products is so narrowly drafted that its provisions will be easily evaded. For example, most payday lending in Illinois will not be impacted by this legislation.

This legislation authorizes a predatory loan model that is the norm for state payday loan regimes and fails to provide substantial new protections in the states where payday lenders now operate under safe harbor carve-outs from state usury or small loan laws. Arizona voters rejected this same rate cap and repayment plan when they voted overwhelmingly to reject Prop 200 at the polls in November, despite the payday loan industry's expenditure of about $15 million. They understood that this is "no reform at all."

Enacting H.R. 1214 will slow the wave of reform at the state level which has been picking up momentum following Congressional action to protect Service members and their families from predatory payday lending. Key states, such as Ohio, have rejected 391 percent APR loans in favor of the state's traditional small loan cap. Congressional approval of balloon payment loans secured by unfunded checks at triple digit rates will undermine state reform efforts.

Instead of authorizing payday loans at 391 percent APR, we urge this Subcommittee to support Representative Jackie Speier's H.R. 1608 to cap the total cost of all forms of credit at 36 percent FAIR rate and to substitute the provisions of Representative Gutierrez' 2007 legislation, H.R. 2871, to provide real protections against unsafe banking practices fostered by payday lending.

Introduction to Payday Loans

Origins of Payday Lending

Payday lending has its roots in the long-illegal practice of "wage lending" or "salary buying," in the late 1800s. In those days, wage lenders would lend money in exchange for borrowers relinquishing their right to collect a certain portion of their future wages. A typical borrower might receive $5 on a Monday in return for promising to pay the lender back $6 on Friday.[8] This 20 percent fee on a one-week loan translated to triple-digit annual interest rates well in excess of states' interest rate caps on small loans.

Wage buyers argued that they were not subject to these caps because they were purchasing future wages at a discount in return for the immediate "sale" of the borrower's next paycheck – in other words, charging a fee for a service as opposed to originating a loan. Similar to today's payday borrowers, workers assigning their future wages often could not pay back the entire loan amount when due, and instead had to roll over their debt repeatedly.

States put an end to these lending practices in the early and mid 1900s by enacting strong regulations for small loans with annual interest rate caps ranging from 24 to 42 percent. These

[8] Christopher Peterson, *Taming the Sharks: Towards a Cure for the High Cost Credit Market*. University of Akron Press (2004).

usury caps largely remain in place for consumer lending, with a median rate of 36 percent among all states.[9] Payday lending reemerged in the 1990's as lenders sought and won safe harbor legislation in some states.[10]

Payday Loan Product and Industry

Payday loans are short-term cash loans based on personal checks held for future deposit or on electronic access to the borrower's bank account, depending on the terms of state laws. Borrowers write a personal check for the amount borrowed plus the finance charge and receive cash. Lenders hold checks until the next payday when loans and the finance charge must be paid in one lump sum, with a single paycheck. To pay a loan, borrowers can redeem the check for cash, allow the check to be deposited, or pay the finance charge to roll the loan over for another pay period.

Payday loans range from $100 to $1,000, depending on state legal maximums. The typical loan term is about two-weeks. The finance charge for a payday loan ranges from around $15 per $100 borrowed to $30, resulting in annual interest rates from 391 percent to 782 percent for a two-week extension of credit. Payday loans are subject to Truth in Lending requirements, per court decisions and a Federal Reserve Board ruling in 2000.[11]

In order to obtain a payday loan, a borrower merely has to have an open bank account, a source of income from a job or public benefits such as Social Security, and a valid form of identification. Lenders do not determine if a borrower can afford to repay the loan. Lenders do not use conventional credit checks, but use specialized credit reporting services that track the subprime market. While failing to repay is typically reported to mainstream credit reporting services, successful repayment of a payday loan does not improve a consumer's credit score.

Payday loans are made by payday loan stores, check cashers, pawn shops and some rent-to-own outlets. They are also marketed via toll-free telephone numbers and over the Internet. By the end of 2007, industry analysts reported about 23,600 payday loan outlets plus a growing online loan market in the United States. Stephens Inc. reported combined store and online annual loan volume of $50.7 billion, with $8.6 billion in loan fees paid by consumers.[12] The Center for Responsible Lending estimates that 19 million borrowers take out payday loans during a year.[13]

Payday lending at triple-digit rates is authorized by state laws or regulations in thirty-four states and is permitted for licensed lenders with no rate cap in Wisconsin. Fifteen states and the

---

[9] For a comprehensive discussion on the history of usury laws in the United States and their impact on small loans, see Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, Minnesota Law Review (forthcoming Winter 2008) and Lynn Drysdale & Kathleen Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today's Society* (2000).
[10] Jean Ann Fox, "The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry," Consumer Federation of America, November 1998.
[11] Federal Reserve Board, Official Staff Commentary § 226.2(a)(14)-2, issued March 24, 2000.
[12] Stephens Inc., Payday Loan Industry Report, April 17, 2008, page 34.
[13] Center for Responsible Lending, "Quick Reform Could Plug $5 Billion Hole in Worker Wallets," Issue Brief, January 2009.

District of Columbia do not authorize these extremely expensive or single pay period loans secured by personal checks. Twenty-nine payday loan states set rate caps, albeit very high caps, while six do not. (See Appendix A.)

Payday Loans Disproportionately Target Vulnerable Consumers

The Federal Reserve Board's Survey of Consumer Finances (SCF) conducted in 2007 and released earlier this year provides a portrait of families who acknowledged using a payday loan in the prior year compared to families who did not use these loans. The findings, issued as a report by the Center for American Progress, are consistent with earlier research.[14] Payday loan users tend to have less income, lower wealth, fewer assets, and less debt than families without payday loans. They are more likely to be minorities, single female head of household, and younger than non-payday loan users. These borrowers have less education than consumers who do not use payday loans and are much less likely to own their own homes. While nearly half of families who did not use payday loans described themselves as "savers," only one-quarter of payday loan users say they are savers.[15]

These findings confirm earlier research and regulator data which demonstrate that minorities, lower-income, and otherwise vulnerable families are the consumers most likely to be paying triple digit interest rates for single payment loans based on unfunded checks held by a payday lender. (For more demographic information on payday borrowers, see Appendix B.)

The Problem with Payday Lending

While payday loans are advertised as a way to deal with an occasional financial emergency, most borrowers find themselves in long-term, high-cost debt traps. This is because the predatory structure[16] of the payday lending business model sets these borrowers up for failure.

The fundamental problems with the payday loan product which result in borrowers being trapped in long-term debt include: (1) the high annual percentage rate on these loans; (2) the short time period in which a borrower has to repay the debt in one balloon payment; (3) the holding of a check or access the borrower's bank account as collateral; and (4) a lack of consideration of the borrower's true ability to repay. These are discussed in greater detail below.

---

[14] Amanda Logan and Christian E. Weller, "EZ Payday Loans: Who Borrows From Payday Lenders? An Analysis of Newly Available Data," Center for American Progress, March 2009, summary of findings at page 1.

[15] This is consistent with research from CFA which finds that a family earning $25,000 per year and no savings is eight times as likely to take out a payday loan in a year than the same income family with at least $500 in emergency savings.

[16] FDIC's Office of the Inspector General (OIG), Challenges and FDIC Efforts Related to Predatory Lending, Audit Report No. 06-011, June 2006. "Characteristics potentially associated with predatory lending include, but are not limited to, (1) abusive collection practices, (2) balloon payments with unrealistic repayment terms, (3) equity stripping associated with repeated refinancing and excessive fees, and (4) excessive interest rates that may involve steering a borrower to a higher-cost loan." Payday lending is listed as an example. "Payday Loans are small-dollar, unsecured, short-term advances that have high fees relative to the size of the loan. When used frequently or for long periods, the total costs can rapidly exceed the amount borrowed."

1. High Annual Percentage Rate (APR)
APR is a function of (1) the fee or interest charged on a loan and (2) the time a borrower has to repay their debt. Since payday loans have a relatively high fee and must be paid back within a short period of time, the APR on the typical two-week loan is about 400 percent.

2. Short Loan Term
When a borrower takes a payday loan, they must pay back the entire amount, plus a fee, on their next payday. The vast majority of borrowers will pay back their loan when due because it is the first thing they pay with their paycheck. Borrowers also want to avoid a "bounced" check and the resulting fees. The problem is that this does not leave them enough money to pay for rent, food, or other bills if they do not immediately get another payday loan.

The table below illustrates how a payday borrower earning $35,000 a year would be hard pressed to pay back the typical $300 loan, plus its $45 fee, in just one pay period. Even if the payday loan came with *no* finance charge, a borrower earning $35,000 a year cannot afford to repay the typical payday loan in a single payment on his or her next payday.

The payday lending two-week loan term traps borrowers in a repeat borrowing cycle, no matter what fee is charged.

	Cost of Two-Week Payday Loan		
	$0 per $100 (free loan)	$15 per $100 (391% APR)	$20 per $100 (521% APR)
Income and Taxes			
Income per half-month pay period	$ 1,458.33	$ 1,458.33	$ 1,458.33
Taxes	$ 17.79	$ 17.79	$ 17.79
Social Security	$ 96.33	$ 96.33	$ 96.33
Income after tax	**$ 1,344.21**	**$ 1,344.21**	**$ 1,344.21**
Payday loan payment due on $300 loan	**$300**	**$345**	**$360**
Paycheck remaining after paying back payday loan	**$ 1044.21**	**$ 999.21**	**$ 984.21**
Household Expenditures per 2 week period			
Food	$ 193.54	$ 193.54	$ 193.54
Housing	$ 516.21	$ 516.21	$ 516.21
Utilities	$ 128.00	$ 128.00	$ 128.00
Transportation	$ 165.42	$ 165.42	$ 165.42
Healthcare	$ 103.88	$ 103.88	$ 103.88
Total Essential Expenditures	**$ 1,107.04**	**$ 1,107.04**	**$ 1,107.04**
Money from paycheck remaining (deficit)	**$ (62.83)**	**$ (107.83)**	**$ (122.83)**

Source: 2007 Consumer Expenditure Survey, Bureau of Labor Statistics, households earning $30,000-39,999 annually
This example is of a borrower earning $35,000 a year, and excludes other costs such as childcare, clothing, etc. which are likely applicable to many payday borrowers.

3. Check Holding or Account Access

For most store-front lending, consumers are required to write a personal check for the amount of the loan plus the finance charge payable to the lender on the borrower's next payday. At the time the check is written, borrowers do not have sufficient funds on deposit to cover the check, but hope that on payday they will be able to cover the check.

Check holding makes the lender the first priority for payment out of the borrower's next paycheck. Failure to repay results in bounced check fees from the payday lender and the borrower's bank. It also results in a negative report to credit reporting services used by banks and retailers in deciding whether to accept payment by check or to open an account. Consumers can lose their check-writing privileges at retailers or become black-listed on ChexSystems, unable to open a new bank account due to bounced checks triggered by payday lending.

Check holding also fosters coercive collection tactics when lenders threaten criminal sanctions for failure to "make good" on the check used to secure the loan.[17]

Payday lenders who use debit authorization as security for a loan and as the payment method for a loan get direct access to the borrower's bank account when pay or benefits are deposited on payday. As soon as funds are deposited, the payday lender can withdraw payment. Repeat presentment of the check or debit for payment can trigger multiple NSF fees for consumers with low balances.

Loans based on writing unfunded checks have an adverse effect on consumers' bank account ownership. Recent research by Harvard Business School found that access to payday loans is associated with higher numbers of involuntary account closures where a bank closes a customer's account because it has been repeatedly overdrawn.[18]

4. No Consideration of Ability to Repay

Payday lenders do not consider any of a borrower's outstanding debt payments or other obligations.

Adverse Impacts for Payday Borrowers

These predatory elements of payday loans cause borrowers to take out one loan after another, without being able to fully retire their debt. The average payday borrower takes out nine loans a year and these loans tend to be taken on a consecutive basis, with more than one transaction per month.

Getting stuck in a pattern of repeat borrowing, where a person takes out a loan each pay period, can adversely impact their finances in myriad ways. In most cases, a payday borrower is worse off than if they had never taken that first payday loan. Independent academic research has shown

---

[17] CFA Testimony, Federal Trade Commission Workshop on Fair Debt Collection Practices Act, June 20, 2007.

[18] Dennis Campbell, Asis Martinez Jerez, and Peter Tufano (Harvard Business School). *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures*. June 6, 2008. Available at: http://www.bos.frb.org/economic/eprg/conferences/payments2008/campbell_jerez_tufano.pdf

that payday lending increases a borrower's chances of filing for bankruptcy, becoming delinquent on a credit card, having a hard time paying other bills, delaying medical care and prescription drug purchases, and losing their bank account. (For summaries of this research, see Appendix C.)

H.R. 1214 Does Not Protect Consumers from the Payday Lending Debt Trap

Alarmed at the number of payday borrowers trapped in long-term debt, many states have tried to curb payday lending abuses while allowing the industry to continue to charge triple-digit APRs. Some of the provisions adopted include renewal bans, cooling-off periods, and extended payment plans. While these measures sound promising, lenders have found ways to evade the intent of these provisions and continue to trap borrowers in long-term debt.

Fee Cap of Fifteen Cents Per Dollar Authorizes Triple-Digit Debt

For the typical two-week payday loan term, the fee authorized by H.R. 1214 translates to *391 percent APR*. For a one-week loan, loans would be authorized at *782 percent APR*. The news release announcing the bill states that consumers are currently subject to payday loans at interest rates from 261 percent to 913 percent annually, but fails to mention that H.R. 1214 will permit APRs of above 261 percent. Describing the costs allowed by the bill as pennies per dollar and not mentioning the very short loan period for payday loans can mislead people into believing that the bill sets a 15 percent annual interest rate cap.

H.R. 1214 has been characterized as providing stronger protection than twenty-three states now provide. Existing payday loan laws in 35 states result in loans that range from 235 percent to 1,955 percent or have no cap for a two week $250 loan. For a $250 two-week sample loan, twenty-three states permit loans at higher rates than H.R. 1214 permits, but, in most cases, not much higher. For example, H.R. 1214 permits 391 percent APR versus 396 percent in OK, 409 percent in NM, 460 percent in SC, 456 percent in AL, and 521 percent in CO.[19] In addition, ten of these twenty-three states set no rate cap on installment loans, making it very likely that lenders would reformat their loans slightly to continue charging the same higher rates they charge now.

Competition does not drive down the cost of payday lending. Any cap becomes the standard price for this product. As a spokesman for a large publicly traded payday loan operation told investors, "Now I know part of the creep up in losses is probably – *although there's no price competition, there is probably an increased demand to get that first customer*. And I think maybe some of the companies – and we're part of that – have eased up our underwriting to get that first customer."[20] (Emphasis added.) CFA surveys of payday loan outlets over the years have documented that most lenders charge the maximum rate permitted in the state.[21] By capping payday loans at 391 percent for a two-week loan, H.R. 1214 locks in extremely expensive rates for borrowers.

---

[19] Consumers Union, National Consumer Law Center, and Consumer Federation of America, "50 State Small Loan Scorecard," August 2008, http://www.consumerfed.org/pdfs/small_loan_scorecard_08.pdf
[20] Q2 2007 Advance America, Cash Advance Centers Inc. Earnings Conference Call, July 26, 2007, quoting John Hill.
[21] CFA surveys posted at www.paydayloaninfo.org in Research and Reports section.

Narrow Definition of a Payday Loan Allows Lenders to Avoid Regulation Entirely

In addition to these problems, legislation targeting solely the payday loan product is entirely circumvented by payday lenders if they can tweak their product so that it does not meet the definition of a payday loan. HR 1214 includes numerous requirements that must be met in order for a payday loan to fall under its purview. For example, the payday loan must be offered as closed-end credit, it must be for no more than 91 days, must be secured by a personal check or account access, and the credit must be extended by the payday lender or their affiliate. Payday lenders can slightly alter their product to ensure that they do not fall under this definition of a "payday loan" in many states.

For example, a payday lender could offer an open-ended loan as has been attempted by payday and car title lenders in Kansas, Virginia, and Pennsylvania; offer a higher-priced installment loan as is currently done in Illinois[22] and New Mexico; or partner with an independent entity that provides the payday loan, as is done in Texas. In addition, at least one major payday lender[23] offers their product securing it through means other than a personal check, which would exempt them from H.R. 1214's regulations.

While some states have traditional small loan laws with an underlying rate cap, ten payday loan states[24] do not. It is unlikely that payday lending in any state lacking an underlying small loan rate cap would be subject to this legislation as currently drafted. Also if a state's law does not forbid lenders to broker loans through independent third parties, the legislation will also not have much impact. Definitional problems are discussed in more detail below.

Definitions of "Creditor" and "Payday Loan" Open Loopholes Exploited by Lenders

H.R. 1214 Section (f)(2) defines a covered creditor as "a person who makes or offers payday loans and includes any affiliate of a creditor that offers or makes a payday loan, buys a whole or partial interest in a payday loan, arranges a payday loan for a third party, or acts as an agent for a third party in making a payday loan, regardless of whether approval, acceptance, or ratification by the third party is necessary to create a legal obligation for the third party; and any other person or entity that is engaged in a transaction that is in substance a disguised payday loan or a subterfuge for the purpose of avoiding the requirements of this section."

Key features (italics) in the definition of covered payday loans in (f)(3) of the bill, include:

- a *closed-end* credit transaction, *unsecured* by personal property;
- *excludes* credit card transactions under *open end* credit plan;

---

[22] In Illinois, payday lenders skirt the state's payday loan regulations by making five month installment loans. A $500 loan carries a $775 fee, equating to a 403% APR. Example on file with CFA.

[23] Rent-A-Center Financial Services offers signature loans which mimic a payday loan's cost and term in 17 states. Instead of securing these loans with a personal check, applicants must provide five personal references and mortgage servicer or landlord contact information.

[24] States without small loan rate caps include Delaware, Idaho, Illinois, Missouri, Montana, New Hampshire, New Mexico, South Dakota, Utah, and Wisconsin.

- a term of *91 days* or less, *$2,000* loan or less;
- finance charge exceeding *36 percent APR,* in which the consumer gets funds from and incurs interest or a fee payable to the creditor; and
- the borrower provides a *check* or other payment instrument to the creditor who agrees not to deposit or present the check for payment for more than *one day* or authorizes the creditor to initiate a *debit* or *debits* to the borrower's bank account by electronic fund transfer or *remotely created check* after 1 or more days.

The following forms of payday lending would not be subject to this law due to the definition of a creditor and/or a payday loan in H.R. 1214.

Open end payday loans, such as those used by major companies in Virginia,[25] by payday lenders attempting to circumvent a similar definition in the Military Lending Act,[26] and by companies that attempted to circumvent laws in Pennsylvania[27] and New Hampshire.[28] In states that permit open end credit to be offered by non-bank lenders, payday lenders would be likely to use this definitional loophole to avoid the provisions of H.R. 1214.

Payday loans made by *credit services organizations*, including almost all payday lending in Texas, would be likely to fall outside the bill's definition of a covered creditor. By operating as credit services organizations (CSO), payday lenders claim to be independent third-parties that, for a high fee charged to the borrower, arrange and guarantee loans between borrowers and unaffiliated lenders. H.R. 1214 defines "creditor" as the person who "makes or offers a payday loan" or "an affiliate of a creditor" that "offers or makes a payday loan…arranges a payday loan, or acts as an agent for a third party." Under the current CSO scheme in Texas, payday companies operating as credit services organizations may not meet the definition of a creditor as defined in this act because they purport to be an independent third-party, not an affiliate of the lender actually making the loan. It is also questionable whether the products offered by a CSO would fall within the definition of a payday loan in this bill. In Texas, there is no maximum loan amount, and publicly traded CSOs report that the lenders allow loans up to $3,000. While CSOs include their unregulated fees for purposes of disclosing a finance charge under Truth in Lending, we would expect CSOs to find creative ways to continue avoiding Texas law and to avoid any rate cap in this legislation if enacted.

---

[25] Example: An Advance America "Revolving Credit Agreement" for credit extended December 3, 2008 in Richmond, VA disclosed a 365 percent APR for loans with ACH Authorization and 456 percent without ACH Authorization for payment. Under the heading "Security Interest," the contract states: "Any ACH Authorization you may have signed in connection with this Revolving Credit Agreement is collateral for this loan." Contract on file with CFA.

[26] A Military Financial, Inc. "Rapid Cash" loan made just prior to the start of MLA rules to a Mayport, FL sailor cost 713.89% APR for a $971 loan with $698.32 in finance charges over four installment payments of $417.33 each. As of October 1, 2007 Military Financial advertised a "Rapid Cash Line of Credit" for up to 40% of monthly take home pay with no credit check and 99% approval.(Ad in *Navy Times*, p. 41, 12/24/07) Its FAQ web page states: "It is illegal to charge more than 36% for a closed end loan consumer loan (payday loans, title loans, etc.) A Rapid Line of Credit is not a closed end loan. It is a revolving line of credit that allows you to access the available funds in your account at any time." See www.militaryfinancial.com/Faq.aspx, visited 1/10/08.

[27] PA COURT DECISION ON OPEN END AEA LOANS

[28] NH BANKING COMMISSIONER RULING ON AEA OPEN END LOANS

"Installment" payday loans for longer than 91 days in duration would not come under H.R. 1214's definition of a payday loan. Most payday lenders in Illinois have morphed their single payment product into longer term loans (essentially building in loan flipping) to evade state limits on short term loans. Consumer advocates in Illinois report that 95 percent of "payday lending" is now structured as installment loans covered by the Illinois Consumer Installment Loan Act, which has no rate cap. Illinois "installment" payday loans still cost over 400 percent APR. The Governor of Illinois wrote to members of the Department of Defense Authorization Conference Committee in 2006, describing the "aggressive battle" waged by payday lenders in Illinois to circumvent consumer protections. "As soon as we instituted new payday loan restrictions that limit interest rates and apply to loans with terms of up to 120 days, the industry began offering loans with terms of 121 days so they could resume charging interest rates of 500 percent or more."[29]

Consumers in states that do not have an installment small loan rate cap would not be "protected" by H.R. 1214's 391 percent APR cap on two week loans. Lenders in these states could simply convert their loans to longer term transactions to evade the 91 day definition of a covered loan. (States include DE, ID, IL, MO, MT, NH, NM, SD, UT, and WI.)[30]

<u>Loan Security/Payment by Check Holding, Debit Authorization and Demand Drafts Unsafe</u>

a) Loans based on unfunded checks held for future deposit.

Payday lenders require borrowers to write personal checks for the amount of the loan plus the finance charge as both security for the loan and as the payment device, encouraging unsafe use of bank accounts. Checks are part of the payment system, a substitute for cash, not an asset that should collateralize a loan. Severe laws meant to prevent check bouncing should not apply to people who simply fail to pay their debts. Borrowers do not have funds on deposit to cover the checks at the time they are written, a fact well known by lenders. This keeps these checks from being fraudulent "hot checks," but sets up a cascade of consequences when the borrower can't cover the check in full out of the next paycheck.

Loans based on check-holding create incentives for loan flipping and additional costs for borrowers. If the lender deposits the borrower's check on the due date and the borrower does not have sufficient funds to cover the debt, she will incur insufficient funds fees imposed by both the payday lender and the consumer's bank. When payday lending was legal in North Carolina, borrowers paid over $2 million in NSF fees to payday lenders, in addition to any charges owed to their bank.[31] Virginia regulators reported that 54,403 checks returned unpaid triggered $228,718

[29] Press Release, Governor Rod Blagojevich, Illinois, "Governor Blagojevich calls on Congress to pass federal payday lending protections for Military Personnel," September 7, 2006.
[30] Consumers Union, National Consumer Law Center, Consumer Federation of America, "50-State Small Dollar Loan Scorecard," August 2008, available at http://www.consumerfed.org/pdfs/small_loan?scorecard_08.pdf.
[31] As reported in the 2000 Annual Report of the North Carolina Commissioner of Banks, the total amount of NSF fees collected by payday lenders was $2,000,844. This was the last year payday lenders were authorized to operate in North Carolina. The report is available at www.nccob.org/NR/rdonlyres/5F7F31CF-2645-4CD2-8EE1-EE349F9F6AE8/0/cccon00.pdf.

in insufficient funds fees paid to payday lenders in 2007.[32] Consumers are strongly encouraged to renew loans to avoid double fees for a returned check.

Checks as security for loans give an advantage to the payday lender for debt collection. By holding the borrower's check, lenders get the ability to call the consumer's bank to check "funds availability." As soon as the bank tells the lender funds are available to cover the check, the lender goes to the bank to collect on the payday loan. Consumers who are juggling bill payment decisions lose all control over the timing for repaying a payday loan, since the lender can deposit the loan check at any time after the due date, precipitating NSF fees for other checks written. For example, the payday lender's decision about when to put through the check may cause the rent or mortgage check to bounce. Some lenders require multiple checks for a single loan, maximizing the number of NSF fees that will be charged if the loan is not repaid in full on the borrower's next payday.

Payday loans, because they tap funds from deposit of the borrower's next paycheck, are a modern form of wage assignment, a disreputable credit practice which, when done directly, is prohibited by the Federal Trade Commission's Credit Practices Rule. Instead of authorizing loans secured by unfunded personal checks, we supported the sponsor's H.R. 2871, introduced in 2007, to ban such practices in lending.

b) Loans secured by debit/s authorization undermines protections in the Electronic Fund Transfer Act.

Consumers lose control of their checking accounts when lenders condition the extension of credit on direct electronic access. While a borrower can stop payment on a paper check, the same right does not apply by law for a single debit. Consumers may ask their bank to revoke authorization for lenders to electronically withdraw funds, but savvy lenders can easily evade those efforts. A lender can too easily avoid a stop order on an electronic payment simply by breaking an electronic withdrawal into smaller segments or altering the amount by a few pennies to evade the description of the transaction in the stop order. As a result, consumers are confronted with multiple NSF fees when the payday lender makes multiple attempts to electronically withdraw funds from the consumer's checking account.

- For example, an Indiana consumer had insufficient funds to repay a $300 payday loan plus $35 finance charge on its due date. The lender's first electronic funds draft was returned for insufficient funds. The lender then broke the debt into three parts and submitted three electronic drafts for $167.50, $167.50 and $20, respectively. The borrower's bank charged a $26 "bounce protection" charge for each item which overdrew his account.[33]

Securing a payday loan or any other type of small loan with debit access to a bank account also exposes low-balance borrowers to multiple attempts to collect the debt, each triggering the bank's insufficient funds fees.

---

[32] Virginia State Corporation Commission, Bureau of Financial Institutions, 2007 Payday Loan Annual Report, page 7.
[33] On file with CFA.

- A Sailor based in Florida was charged $200 for ten returned check fees as a result of repeated attempts to debit his account to collect on one payday loan. His credit union charged $20 per returned debit as did the payday lender. The original $300 loan cost a $45 finance charge and 342.19% APR and listed the personal check presented electronically as "security" for the loan.[34]

Authorizing payday lending based on electronic access to borrowers' bank accounts also exposes borrowers to unsafe treatment of personal financial information because the practice requires that the payday lender collect and retain information about the borrower's bank account.

- A major payday loan chain was cited by state regulators in Washington and Idaho for obtaining borrowers' checking account PIN numbers during the loan application process without the borrower's knowledge. Washington regulators noted that obtaining and storing personal identification numbers of customers without their consent or knowledge was a prohibited practice that exposed consumers to the potential theft of funds and possibility of identity theft.[35] According to the Idaho Department of Finance, "examiners learned of instances where borrowers were asked to input PIN numbers into the lender's telephone key pad during the loan process. Check 'n Go would then electronically retrieve those PIN numbers and store them in its computer system for account balance verification purposes."[36]

Payday loans using repeat debit authorizations facilitate loan renewals (which lead to repeated payment of a high loan fee directly from the consumer's checking account) much more easily than loans based on presenting paper checks for payment. Online payday loans, all of which use debit authorization, frequently set loans up to automatically renew every payday with just payment of the finance charge withdrawn from the borrower's account by electronic funds transfer.

For example, for an initial loan of $200, the consumer would authorize a debit of $260 from her account two weeks from the date of the loan. Unless the consumer faxes a request three days in advance of the due date, two weeks after the initial loan the lender will deduct the $60 finance charge and renew the $200 loan for another pay cycle. Two weeks later, an additional $60 is debited and the $200 plus another $60 fee is still due two weeks after that. This cycle can continue for many weeks. The consumer has $120 withdrawn from his or her checking account in every four week period without reducing the loan balance of $200.[37]

H.R. 1214's explicit authorization of payday loans secured by single or repeated debit transactions undermines the protections of the Electronic Fund Transfer Act, which prohibits basing the extension of credit with periodic payments on a requirement to repay the loan

---

[34] Loan and credit union documents on file with Consumer Federation of America.
[35] Press Release, "State Files Largest Case Against Payday Lender," Washington State Department of Financial Institutions, August 16, 2006.
[36] News Release, "The Idaho Department of Finance Obtains Assurance of Discontinuance from Check 'n Go of Idaho, Inc.," Idaho Department of Finance, January 25, 2005.
[37] Jean Ann Fox, " Internet Payday Lending," Consumer Federation of America, November 2004, http://www.consumerfed.org/pdfs/Internet_Payday_Lending113004.pdf

electronically.[38] Since EFTA was enacted before single-payment payday loans became widely available, it is unclear whether single payment payday loans that permit renewals are "periodic," triggering the ban on requiring the borrower to sign an agreement to electronically access the account. By defining a covered payday loan as one based on "debit or debits," H.R. 1214 may be construed as over-ruling the long-standing protections of the Electronic Fund Transfer Act against requirements to pay debt electronically for periodic payments. The bill fails to close a gap in EFTA that should extend this protection to single debit payments.

Payday loans secured by debit access to the borrower's bank account which cannot be cancelled also functions as the modern banking equivalent of a wage assignment – a practice which is prohibited when done directly. The payday lender has first claim on the direct deposit of the borrower's next paycheck or exempt federal funds, such as Social Security, SSI, or Veterans Benefit payments. Consumers need control of their accounts to decide which bills get paid first and to manage scarce family resources. By authorizing payday lenders to have the first priority for funds in the bank account, H.R. 1214 will worsen the financial plight of consumers.

c) Demand Drafts Authorized

The definition of a payday loan in H.R. 1214 specifically authorizes a financial product - "remotely created check" - that is prone to fraud and has largely been discredited. These are "demand drafts," in which a creditor creates a paper check that withdraws funds from a consumer's bank account without the consumer seeing or signing the instrument. The legal theory is that the consumer has authorized the creation of a check, perhaps even orally, without ever signing a check. This method is highly prone to abuse and should be eliminated.[39] Every application for a payday loan requires consumers to provide their bank account routing number and other information necessary to create a demand draft as well as boiler plate contract language to authorize the device. The account information is initially used by online lenders to deliver the proceeds of the loan into the borrower's bank account using the ACH system. Once the lender has the checking account information, however, it can use it to collect loan payments via remotely created checks even after the consumer revokes authorization for the lender to electronically withdraw payments.

The use of remotely created checks is common in online payday loan contracts.

- ZipCash LLC "Promise to Pay" section of a contract included the disclosure that the borrower may revoke authorization to electronically access the bank account as provided by the Electronic Fund Transfer Act. However, revoking that authorization will not stop the lender from unilaterally withdrawing funds from the borrower's bank account. The contract authorizes creation of a demand draft which cannot be terminated. "While you may revoke the authorization to effect ACH debit entries at any time up to 3 business

[38] Reg E, 12 C.F.R. § 205.10(e). 15 U.S.C. § 1693k states that "no person" may condition extension of credit to a consumer on the consumer's repayment by means of a preauthorized electronic fund transfer.
[39] The Federal Trade Commission settled four cases for $16 million that involved telemarketers and Wachovia Bank which involved the use of demand drafts to withdraw unauthorized funds from consumers' accounts. The complaint alleged that the defendants had illegally purchased leads containing consumers' unencrypted bank account numbers for use in telemarketing. (FTC Press Release, January 13, 2009).

> days prior to the due date, *you may not revoke the authorization to prepare and submit checks on your behalf until such time as the loan is paid in full."* (Emphasis added.)[40]

Remotely created checks are subject to fraud and are often used by those who cannot obtain an ACH merchant account. In 2007 the *New York Times* reported on fraudulent demand draft use by telemarketers at Wachovia.[41] The National Association of Attorneys General urged the Federal Reserve Board to ban demand drafts outright in a 2005 proceeding.[42] In 2007, CFA and other organizations urged the Board to either prohibit the use of demand drafts or extend EFTA protections to these transactions.

Use of a demand draft to secure a payday loan and to collect payment on a payday loan undermines existing consumer protections in the payment system. Consumers have the right under EFTA to revoke the authorization to pay the loan through electronic withdrawals from their bank accounts. However, consumers who exercise that right will still have no control, other than closing their account, over continued withdrawals using remotely created checks authorized by H.R. 1214.

To the best of our knowledge, no state payday loan authorization law permits lenders to use a demand draft to secure or collect payment on a loan. In fact, some states specifically prohibit payday loans to be made via the Internet where demand draft use is common. Permitting a lender to write a check to withdraw funds from the consumer's bank account exposes borrowers to fraud, deprives consumers of dispute rights for unauthorized debit transactions under EFTA, leaving a victim on her own to sort out the charges and resulting insufficient funds and overdraft fees from other payments that are returned unpaid due to presentment of the demand draft. While the Federal Reserve enacted a requirement in 2005 that changed the warranty for demand drafts from the consumer's bank to the financial institution that accepted the demand draft for deposit. While this was a positive action, it provides little consumer protection.

<u>Roll-Over Provisions Do Not Stop Repeat Lending</u>

H.R. 1214 prohibits making more than one loan at the same time to a consumer, presumably at one loan outlet or with one lender. The prohibition does not extend to all loans offered by all lenders.

H.R. 1214 prohibits new loans from being made to borrowers in a repayment plan by the same lender or for at least 13 days after a repayment plan is completed, but it does not prohibit loans from being made by any other lender to a consumer who has already pledged her next paycheck to cover a loan.

The bill prohibits knowingly accepting payment in whole or in part for a repayment plan payment with money from another payday loan by the same lender, but does not apply to using the proceeds of a second loan to repay a loan not in the repayment plan, limiting this provision's

[40] Loan Supplement (ZipCash LLC) Form #2B, on file with CFA.
[41] Charles Duhigg, "Bilking the Elderly, With a Corporate Assist," *New York Times,* May 20, 2007
[42] National Association of Attorneys General, Comments to Federal Reserve Board, Docket No. R-1226 (Proposed Amendments to Regulation CC/Remotely Created Checks), May 3, 2005.

usefulness at preventing borrowers from having more than one loan at a time. This provision makes H.R. 1214's limits on multiple loans less effective than they first appear. It prohibits rolling over a loan and defines a prohibited "rollover" as a transaction where the borrower pays a finance charge only and extends the loan plus a new finance charge for another pay cycle.

The bill does not ban multiple loans from all lenders. It does not include any enforcement method, such as a database, to prevent multiple outstanding loans. There is no way to prevent a borrower in an extended payment plan from getting a loan from another lender. While the bill prohibits using the proceeds of one loan to make a plan payment, a lender cannot identify the source of cash used to make a payment. The limitations in this bill are simply not enforceable.

The bill's rollover ban also does not prevent the most common form of repeat lending, in which borrowers on payday bring in cash and "buy back" the original payday loan check. Lenders immediately will "re-loan" the loan principal, write up a new contract, take a fresh check as security for the loan, and obligate the borrower to repay the same finance charge next payday. While this is technically not a roll-over, it has the same impact on the borrower's budget and indebtedness. It is the pattern of back-to-back lending that characterizes transactions in states that sought to curb "roll-overs." For example, Florida and Oklahoma[43] both employ fee caps, renewal bans, payment plans, cooling off periods, and loan tracking databases.

- About half (49 percent) of all subsequent loans are taken out within 24 hours of the previous loan being paid off.
- Nearly 90 percent of all subsequent loans are taken out within the same two-week pay period of the previous loan being paid off.
- 94 percent of all subsequent loans are taken out within the same month of the previous loan being paid off.
- The average borrower has 1.5 transactions every month.

Contract Requirements and Collection Provisions Do Not Make H.R. 1214 Beneficial

H.R. 1214 includes these protections against contract terms and abusive collection methods. The bill bans:

- Threatening or seeking to have consumers prosecuted in criminal court to collect the loan;

- Taking or attempting to take an interest in personal property to secure a loan;

- Filing or initiating a legal proceeding (lawsuit or arbitration) when a loan is in an extended payment plan. The loan is not in default if the borrower keeps up with extended payment plan terms;

- Taking any power of attorney;

[43] See "Oklahoma Trends in Deferred Deposit Lending," Veritec Solutions LLC (June 2008) and "Florida Trends in Deferred Presentment," Veritec Solutions LLC (July 2008). Subsequent loan data is from a public records request and is on file with CRL.

- Several onerous contract provisions, including a confession of judgment clause, a waiver of right to a jury trial unless the waiver is included in an arbitration clause allowed by this bill; and a mandatory arbitration clause that is oppressive, unfair, unconscionable, or substantially in derogation of the rights of consumers.

The bill also prohibits contracts that waive the rights of consumers under the law or any claim or defense arising out of the loan contract, as well as lenders who attempt to collect or charge attorney's fees, court costs, or arbitration costs incurred in connection to a loan.

These provisions do not add meaningful new protections or limit the abusive terms of the loan product itself. It is already an unfair practice to threaten criminal prosecution for failure to repay a payday loan, to take a confession of judgment, or to include contract terms that are oppressive, unfair, or unconscionable under the Federal Trade Commission Act, the FTC's credit practices rule, the Fair Debt Collection Practices Act, state common law, and/or many state laws that apply to payday lenders.

Coercive collection tactics made possible by the design of payday loans is a particular problem. Despite state prohibitions on threatening or using criminal prosecution to collect on a payday loan in almost all circumstances, payday lenders and their debt collection agencies have been charged with collection abuses by state enforcement officials and in private litigation.[44] For example, Florida's Attorney General won final default judgment in 2007 against debt collection firm Ellis Crosby & Associates, Inc., and Ted Ellis Crosby individually, for illegally collecting payday loan debts from thousands of consumers across the country. The charges are summed up as follows:

"Defendant ECA and Defendant CROSBY illegally contacted consumers at work, engaged in harassing, oppressive and abusive conduct, failed to identify themselves as collections agents, falsely represented themselves as law enforcement officers or attorneys, falsely threatened legal action, falsely threatened criminal arrest, threatened violence, misrepresented that the consumer had committed a crime, falsely represented the amount due, falsely implied they were government investigators, falsely stated their office is in a federal building, falsely claimed that an Order of Homeland Security prevented disclosure of their address, falsely threatened to seize computers, falsely stated that non payment would result in arrest, and falsely stated that the sum owed could only be paid in full."[45]

It would be much more effective protection to prohibit lenders from soliciting unfunded checks than to attempt to prevent lenders from threatening consumers with criminal sanctions for failure to make good on the check used to obtain the loan.

---

[44] See, CFA Testimony, FTC Workshop on Fair Debt Collection Practices Act.
[45] State of Florida v. Ellis Crosby & Associates, Inc., Complaint for Declaratory Relief, August 24, 2005 at 2.

Small Loan Interest Rate Caps: A Proven Way to Protect Consumers and Ensure Access to Responsible Credit

Fifteen states and the District of Columbia employ comprehensive rate caps on all small loan products at or around 36% APR.[46] In some of these states, payday lending at triple-digit rates has never been legal; in others, state policymakers reined in payday and other high-cost lenders with a rate cap after seeing how the destructive effect of these loans on family finances.

Similarly, due to concerns that members of the military were becoming heavily indebted to payday lenders, Congress approved a 36% APR rate cap to protect active-duty service members and their families from these high-cost loans. As a result, over a third of the U.S. population is not subject to the payday lending debt trap. This approach is affirmed by a recent national survey, where over 70 percent of respondents supported an interest rate cap of 36% APR or less.[47]

North Carolina is one of these states that once had payday lenders, but no longer does. A study of low- and moderate-income households in the state shows that North Carolinians with financial emergencies do not miss payday loans, but instead use a variety of other, often better, alternatives. For example, credit products such as overdraft lines of credit, consumer finance installment loans, and credit card cash advances are used by households facing financial shortfalls in that state. A progress report from the Department of Defense concluded that affordable loan options to the military increased after the cap and that military debt relief societies were able to reduce assistance given to indebted members of the military because of the reduction in payday loan usage.[48]

Programs at the state and federal level have been instituted to provide a wide range of affordable small loan products. The FDIC is actively encouraging banks under its purview to craft and market small loan products at 36 percent or less to the general population. The FDIC Guidelines for Responsible Small Dollar Lending call for rates of no more than 36 percent annual interest, affordable and amortizing payment schedules, and sound underwriting to determine the borrower's ability to repay the loan.[49] The FDIC is currently conducting a pilot project with over thirty banks to evaluate the optimal features for responsible small dollar lending.

Similarly, the Pennsylvania State Treasurer has taken an active role in spurring responsible small loans offered by credit unions by keeping state funds on deposit at these institutions. Seventy-nine credit unions with 211 locations now offer the Better Choice loan, launched in 2006. Since the program began, credit unions have made nearly 15,000 loans totaling $6.8 million dollars in

[46] These fifteen states include Arkansas, Connecticut, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Vermont, and West Virginia.
[47] Congress Should Cap Interest Rates: Survey Confirms Public Support for Cracking Down on High-Cost Lending, Center for Responsible Lending (March 2009).
[48] Department of Defense, Report on Implementation of Limitations on Terms of Consumer Credit Extended to Service Members and Dependents, July 22, 2008.
[49] FDIC, Affordable Small-Dollar Loan Guidelines, Press Release updated November 4, 2006.

volume, saving nearly $5 million in interest and fees that would have been charged by traditional payday lenders.[50]

Affordable credit products are not the only strategy needed to help households more effectively deal with a financial shortfall. Borrower surveys reveal that many households are not taking out a payday loan because of a single financial emergency, but instead have expenses that regularly exceed their income. For these households who may not be able to financially handle additional debt burdens at any interest rate, non-credit strategies may be more appropriate. These may include budget and financial counseling; getting help from friends, family, or an employer; negotiating with a creditor; setting up different bill payment dates that better align with the person's pay cycle; and putting off a purchase for a few days.

To this end, efforts to help low- and moderate-income families build emergency savings should also be supported. There is some evidence that a lack of savings may make it more likely that households seek out payday loans. For example, the Consumer Federation of America found that families earning $25,000 per year with no emergency savings were eight times as likely to use payday loans as families in the same income bracket that had more than $500 in emergency savings. Policies and programs that encourage and facilitate emergency savings among low- and moderate-income households would help alleviate the need for small loans, allowing households facing financial shortfalls to rely on their own savings rather than taking on additional debt.

Better Policy Options than Enacting H.R. 1214

We urge the Subcommittee to replace the language in H.R. 1214 with the provisions in H.R. 2871, sponsored by the Chairman in 2007. That bill extends the Military Lending Act ban on basing loans on unfunded checks or electronic take-over of consumers' bank accounts to all Americans.

We support Representative Jackie Speier's H.R. 1608 to cap rates for all forms of consumer credit at 36 percent annually including interest, fees, and other costs. A blanket usury cap provides the only effective protection for consumers against extremely expensive credit and avoids the loopholes and definitional problems that plague bills targeted at a specific product. For example H.R. 1608 would apply the same rate cap to the bank equivalent to payday lending which H.R. 1214 does not. H.R. 1608 puts all consumer lenders on the same basis, is widely supported by voters, and won approval at the ballot box in two key states last fall.

We urge no action on H.R. 1214 as currently written. Thank you for the opportunity to testify before the subcommittee today.

---

[50] "Pennsylvania Treasurer McCord to Pennsylvanians: You Have A Better Choice for Short-Term Loans," March 12, 2009, http://www.centredaily.com/pr_news_wire/storey/1168139.html, viewed March 15, 2009.

Appendix A: State Legal Status of Payday Lending

States combat high cost credit through several legal strategies. In Georgia, payday lending is explicitly prohibited and a RICO violation. New York and New Jersey prohibit payday lending through their criminal usury statutes, limiting loans to 25 percent and 30 percent annual interest, respectively. The Arkansas constitutional usury cap prohibits payday loans.

Payday lending is not specifically authorized and is de facto prohibited by several state small loan rate caps. These states include Connecticut, District of Columbia, Maryland, Massachusetts, North Carolina, Pennsylvania, Vermont, and West Virginia.

Four states permit loans based on checks held for deposit under traditional small loan laws or at a much lower rate than typical payday lending. The Maine Uniform Consumer Credit Code caps interest at 30 percent for small loan companies but permits tiered fees that result in 261 percent APR for a two-week \$250 loan. Oregon permits a one-month minimum term payday loan at 36 percent interest plus a \$10 per \$100 initial loan fee. As a result a \$250 one-month loan costs 154 percent APR for the initial loan, and 36 percent APR for any subsequent loans. New Hampshire capped payday loan rates at 36 percent APR, effective in 2009. The lowest cost payday loan law was enacted by Ohio last year, capping rates at 24 percent APR.

<u>Recent Legislative Actions in States</u>

As the adverse impact of payday lending has become apparent, state efforts to prohibit payday lending or to apply meaningful restrictions on its most abusive features have been growing significantly. No state has legalized payday lending since Michigan enacted its law in 2005 and four states that previously allowed it have either banned or strictly regulated it. North Carolina permitted its payday loan law to sunset. Ohio enacted a 28 percent annual rate cap for payday lenders last year, which was unsuccessfully challenged by the industry in a ballot initiative.

Last fall, voters in Arizona rejected by a wide margin a ballot initiative promoted by the payday lending industry that was very similar to the provisions of H.R. 1214. In the only two instances where voters were asked whether they wanted payday lenders to charge 391 percent APR for quick and easy credit, voters overwhelmingly supported a rate cap of 36 percent or less. Even though the Arizona Prop 200 offered consumer-friendly sounding “reforms” such as a repayment plan, voters rejected the industry-funded ballot initiative whose key purpose was to preserve the right to charge almost 400 percent APR for loans forever.

In recent years, Oregon and New Hampshire enacted 36 percent annual rate caps, with Oregon requiring that payday loans must be offered for a term of at least one month. While the Oregon law permits a \$10 per \$100 loan fee for the first one-month loan, lenders can only charge 36 percent interest for any renewals or subsequent loans, bringing the annual percentage rate to about 154 percent for the first one-month loan and 36 percent subsequently.

The District of Columbia repealed its law allowing payday lending, while the Arkansas Supreme Court ruled that payday loan fees violated the state’s constitutional usury cap. Legislation to curb payday lending or cut the cost of loans has received high-profile support in a number of other states, including Virginia, South Carolina, Washington, Kentucky, and Colorado. The Governor of Kentucky announced this month that he will support a 36 percent rate cap on payday lending at next year's legislative session. In addition, the New Hampshire Senate voted in March, 2009 to cap rates on consumer loans of $10,000 or less at the same 36 percent cap applied this year to payday and car title loans.

Appendix B: Payday Borrower Demographics

Lenders claim that their customers are middle class and middle income.[51] The most reliable data on borrowers comes from customer applications collected by regulators as licensees are inspected, not from industry-funded telephone surveys drawn from customer lists provided by lenders. This summary of studies supports the latest findings from the Federal Reserve Survey of Consumer Finances as reported by the Center for American Progress.

Payday Loan Borrowers Are Low to Moderate Income
The Colorado Attorney General's office supervises licensed payday lenders and collected a sample of customer records over five years of inspections. Borrower demographics of over 21,955 separate applications collected during 1,446 compliance examinations show that the typical payday loan customer is a thirty-six year old single woman, making $2,219 per month. Consumers earning $2,500 or less per month ($30,000 per year) make up nearly two-thirds of all borrowers. The majority (62.8 percent) of all Colorado borrowers is in the lowest three income occupations of laborer, office worker, or benefit recipient.[52]

Payday Loan Borrowers are Disproportionately Minorities
The Center for Responsible Lending found that payday lending locations cluster in African American and Latino neighborhoods in California. Even when controlling for factors such as income, educational attainment, and the presence of retail space, payday lenders are 2.4 times as concentrated in neighborhoods with the highest levels of African Americans and Latinos, as compared with largely white neighborhoods. The resulting drain of $247 million in fees from these neighborhoods threatens to make families more financially insecure and exacerbates already present wealth disparities. [53]

An academic 2001 survey of low-income families in Charlotte, North Carolina's largest city, found that African Americans were about twice as likely to have borrowed from a payday lender in a two-year period as whites and that African Americans were five times more likely than whites to take out multiple payday loans, controlling for many socioeconomic characteristics. The same study found that payday lenders clustered in working-class neighborhoods and disproportionately favored high-minority neighborhoods.[54]

Texas payday loan borrowers are typically African American and Hispanic, according to an academic study based on analysis of a database of 145,000 payday loan applicants during 2000-2004 from a "large payday and pawn lender" in Texas. While only 11 percent of Texas adults are Black, 43 percent of payday loan borrowers were. Despite lower bank account ownership by Hispanic families (24 percent nationally are unbanked compared to ten percent for the population

---

[51] Community Financial Services Association, "Payday Advance Customer Profile," at www.cfsa.net/govrelat/pdf/Payday_Advance_Customer_Profile.pdf
[52] Colorado Uniform Consumer Credit Code Administrator, "Payday Lending Demographic and Statistical Information: July 2000 through December 2007, February 4, 2008.
[53] Wei Li, Leslie Parrish, Keith Ernst, and Delvin Davis. Predatory Profiling: The Role of Race and Ethnicity in the Location of Payday Lenders in California. Center for Responsible Lending (March 26, 2009).
[54] Michael A. Stegman, "Payday Lending," *Journal of Economic Perspectives, Vol. 21, Number 1, Winter 2007,* at 174.

as a whole, according to the Federal Reserve's Survey of Consumer Finances),[55] 34 percent of payday loan borrowers were Hispanic, compared to 29 percent of Texas adults. The Skiba/Tobacman study also found that 62 percent of borrowers were female and that the median annual pay was $18,540, compared to Census data for Texas of $19,617. Only 34 percent of borrowers own their own home.[56]

Payday Loan Borrowers Are Benefit Recipients

A California Department of Corporations-commissioned survey found that 10.6 percent of payday loan users are public benefit recipients, plus 4.9 percent listed disability and 2.9 percent listed retirement as their regular source of income.[57] Consumer Federation of America testified before the House Subcommittee on Social Security in 2008 that Social Security and Supplemental Security Income, and other public benefit recipients are paying $860 million per year in payday loan finance charges, with exempt funds direct deposited to bank accounts as security for these high cost loans.[58] This proportion is echoed by the Colorado Uniform Consumer Credit Code data identifying ten percent of borrowers list "benefits" as their source of income.

[55] Maude Toussaint-Comeau, "Changing Hispanic demographics: Opportunities and constraints in the financial market," Chicago Fed Letter, No. 192, August 2003, at 3.

[56] Paige Marta Skiba and Jeremy Tobacman, Table 1.

[57] California Department of Corporations study of payday lending, reported by California Budget Project, "Payday Loans: Taking the Pay Out of Payday," September 2008, available at www.cbp.org. Telephone survey conducted in 2007.

[58] Jean Ann Fox, Consumer Federation of America, Testimony on Protecting Social Security Beneficiaries from Predatory Lending and Other Harmful Financial Institution Practices, Subcommittee on Social Security, Committee on Ways & Means, June 24, 2008.

Appendix C: Research on the Adverse Impact of Payday Loans on Borrowers

Payday loan borrowers are worse off than consumers who have no access to payday loans. Colby College researchers simulated families trying to pay bills in spite of budgetary constraints over a 30 month period. "Borrowers" who used the typical volume of payday loans per customer per year for this industry were found to be worse off financially than those without access to payday loans.[59]

Using payday loans causes financial hardship for families. A University of Chicago Business School doctoral student compared households in states with and without access to payday loans over a five year period and found that access to payday loans increases the chances a family will face hardship, have difficulty paying bills, and have to delay medical care, dental care, and prescription drug purchases.[60] These finding are bolstered by findings in the Detroit Area Study (DAS), conducted by a University of Michigan law professor. Comparing payday loan users with similar low to moderate-income households in Detroit who did not use payday loans, the DAS found almost three times the rate of bankruptcy, double the rate of evictions and phone cut-off, and almost three times the rate of having utilities shut off.[61]

Using payday loans increases the chance of losing a bank account. Harvard Business School researchers examined involuntary bank account closures in states where payday loans are available and states where these loans are prohibited to determine the impact of loan availability on account closure. Advocates argue that using payday loans leads consumers to overdraw accounts while lenders claim that the ability to get payday loans saves consumers from otherwise overdrawing their accounts. The study found that an increase in the number of payday loan outlets in a county is associated with an eleven percent increase in involuntary bank account closures, even when other variables such as income and poverty rate are taken into account. To test the theory, researchers looked at Georgia, a state that bans payday loans but is surrounded by states that permit the product. Counties at least 60 miles from the border with payday loan states had a 15.6 percent decline in account closures when Georgia expelled payday lending.[62]

Payday loan users who also have credit cards are twice as likely to become delinquent on the card. Researchers at the Chicago Federal Reserve Bank, Vanderbilt University, and the University of Pennsylvania examined a large sample of payday loan users who also had a credit card from a major issuer. They found that taking out a payday loan makes a borrower almost twice as likely as other credit card customers to become seriously delinquent on their credit card

[59] Bart J. Wilson, David W. Findlay, James W. Meehan, Jr., Charissa P. Wellford, and Karl Schurter, "An Experimental Analysis of the Demand for Payday Loans," April 1, 2008 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1083796

[60] Brian T. Melzer, "The Real Costs of Credit Access: Evidence from the Payday Lending Market," November 15, 2007 http://home.uchicago.edu/%7Ebmelzer/RealCosts_Melzer.pdf

[61] Michael S. Barr, "Financial Services, Savings, & Borrowing Among LMI Households in the Mainstream Banking & Alternative Financial Services Sectors," Federal Trade Commission, October 30, 2008.

[62] Dennis Campbell, Asis Martinez Jerez, and Peter Tufano, "Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures," June 6, 2008 www.box.frb.org/economic/eprg/conferences/payments2008/campbell_jerez_tufano.pdf

during the next year. For all credit card users, the seriously delinquent rate is 6 percent while for payday loan borrowers in this sample, the rate is around 11 percent.[63]

Payday loans have a fifty-fifty chance of causing defaults in the first year of use. Researchers at Vanderbilt and the University of Pennsylvania examined a large sample of payday loan files at a Texas payday lender and found that over half (54 percent) of borrowers defaulted on loans during the first year. By the time loans are written off by the lender, borrowers have repaid fees equaling about 90 percent of their initial loan principal but are counted as defaults for the full amount of the loan.[64]

Using payday loans causes borrowers to file for bankruptcy. In a large Texas study, researchers found that payday borrowers were about twice as likely to file for bankruptcy in the next two years. They filed for bankruptcy at higher rates than similarly situated payday loan applicants who were turned down for payday loans. And, the bankruptcy impact was strongest on women, blacks and homeowners.[65] When they filed for bankruptcy, their payday loans accounted for about 11 percent of their total annual interest burden.

[63] Agarwal, Sumit, Skiba, Paige Marta and Tobacman, Jeremy Bruce. Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles? (January 13, 2009)
http://ssrn.com/abstract=1327125

[64] Paige Marta Skiba and Jeremy Tobacman, "Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default," August 21, 2008.
http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=1636

[65] Paige Marta Skiba and Jeremy Tobacman, "Do Payday Loans Cause Bankruptcy?" October 10, 2008
http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=2221

Appendix D: H.R. 1214 Does Not Protect Consumers from the Payday Lending Debt Trap

Alarmed at the number of payday borrowers trapped in long-term debt, many states have tried to curb payday lending abuses while allowing the industry to continue to charge triple-digit APRs. Some of the provisions adopted include renewal bans, cooling-off periods, and extended payment plans. While these measures sound promising, lenders have found ways to evade the intent of these provisions and continue to trap borrowers in long-term debt.

H.R. 1214, the Payday Loan Reform Act of 2009, contains a number of provisions which try to temper the worst elements of the product, while not addressing the high APR, short loan term, or other practices that make these loans predatory. Some of these provisions include: (1) a cap on fees of fifteen cents per dollar borrowed; (2) a ban on renewals; (3) a limit of one loan at a time; and (4) the opportunity to use an extended payment plan up to twice a year. In addition, because these regulations apply solely to payday loans as narrowly defined in the legislation, lenders could alter their product slightly to avoid these provisions entirely. The following section addresses each of these provisions in turn and how lenders render them ineffective at stopping the debt trap.

<u>Fee Cap of Fifteen Cents per Dollar Borrowed</u>

HR 1214 seeks to set a ceiling on payday loan fees of fifteen cents for every hundred borrowed. While this would be a reduction in some states which currently allow higher fees, it would still allow payday lenders to charge about 400 percent APR on the typical two-week loan. As detailed in a previous section, even if a lender provided a free loan to a borrower (as many advertise for an initial loan), the borrower would have trouble paying back just the principal on a single paycheck.

Competition does not drive down the cost of payday lending. Any cap becomes the standard price for this product. As a spokesman for a large publicly traded payday loan operation told investors, "Now I know part of the creep up in losses is probably – *although there's no price competition, there is probably an increased demand to get that first customer*. And I think maybe some of the companies – and we're part of that – have eased up our underwriting to get that first customer."[66] (Emphasis added.) CFA surveys of payday loan outlets over the years have documented that most lenders charge the maximum rate permitted in the state. By capping payday loans at 391 percent for a two-week loan, H.R. 1214 locks in extremely expensive rates for borrowers.

<u>Renewal Bans</u>

Almost every state allowing payday lending has some sort of restriction on the renewal of payday loans. Only five states—Kansas, Nevada, Texas, Utah, and Wisconsin—allow unlimited

---

[66] Q2 2007 Advance America, Cash Advance Centers Inc. Earnings Conference Call, July 26, 2007, quoting John Hill.

renewals. Many policymakers enact renewal bans to address concerns that these ostensibly short-term loans are repeatedly rolled over into long-term debt.

Payday lenders routinely circumvent the intent of renewal bans by having borrowers pay off their loan and immediately take out another; this process is termed a "back-to-back" transaction. Because these types of transactions technically do involve paying off the loan—if only for a moment before a new loan is originated—they are not considered renewals.

Regulator data from Florida and Oklahoma show their lack of effectiveness. Nearly half (45 percent) of repeat payday transactions in Florida occur as soon as the 24-hour cooling-off period expires, and 88 percent of these are originated before the typical borrower receives their next paycheck.[67] Data from Oklahoma reveals a similar trend with 87 percent of loans taken out during the same pay period that a previous loan is paid off.[68] So, while a brief pause in lending does occur, the borrower is still flipped into another loan and continues to be in long-term debt. The experiences in Florida and Oklahoma are similar to data from the nation's largest lender, Advance America, which shows 46.5 percent of transactions were originated on the same date as a previous loan was paid off.[69]

<u>Limiting Borrowers to One Loan at a Time</u>

Several states restrict the number of payday loans a borrower can have outstanding or employ limits on the total indebtedness a borrower can have at any given time. Loopholes in these types of provisions are rampant, with many states merely requiring that the borrower sign a statement that they have no other loans outstanding. Since this limitation is applied to an individual borrower, another member of the household can simply visit the payday lender to take out an additional payday loan for the family. Even if effectively enforced, these types of provisions still allow a borrower to take out 24 consecutive two-week loans per year—thus remaining indebted to a payday lender the entire time.

<u>Extended Payment Plan</u>

H.R. 1214 establishes a repayment plan to be provided once every six months to borrowers who request it within seven days of a loan's due date. Borrowers are not eligible for the plan until six months after fully paying off the prior plan. Under the design of this plan, consumers cannot be charged additional finance charges or interest fees for using the plan.

While a repayment plan is in effect, the same lender cannot extend a new payday loan to a borrower. In addition, the borrower must wait another 13 days after completing the plan before being eligible to get a new loan. While this feature of the bill might appear to help consumers

---

[67] Response to public records request of Florida data collected by Veritec, provided by the Florida Office of Financial Institutions and Securities Regulation on June 16, 2003, on file with CRL.
[68] Response to public records request of Oklahoma data collected by Veritec, provided by the Oklahoma Department of Consumer Credit on August 29, 2007, on file with CRL.
[69] Advance America Prospectus. December 17, 2004, pg 37-38. 42.3 percent of transactions were consecutive transactions defined as loans entered into on the same day as a previous payday loan was paid and 4.2 percent were direct renewals, defined as simple extensions of an outstanding payday loan by paying only the applicable finance charge.

trapped in repeat borrowing, experience from the states that have tried repayment plans shows it is not an effective remedial reform.

The availability of an extended payment plan does not make payday lending safe or affordable for borrowers. Regulator data from the states that have attempted this program demonstrates that less than two percent of eligible transactions employ a repayment plan. Payday lenders discourage repayment plan use among borrowers by playing up the fact that a borrower cannot take out another payday loan while they are in a payment plan, nor during the cooling-off period which follows. The table below summarizes payment plan take-up rates in states that have already incorporated this provision into their payday lending regulations.

	% of Eligible Transactions Employing Payment Plan/Grace Period	**Payment Plans as % of Total Transactions**
Florida[70]	0.42%	0.42%
Michigan[71]	2.42%	1.33%
Oklahoma[72]	1.84%	1.14%
Washington State[73]	Not Available	1.20%

Lenders have little incentive to cast these plans in a positive light to borrowers, because they make less money if the borrower enters a payment plan, rather than continuing to take a new loan each pay period. Specifically, one state regulator reports that lenders have tweaked their product

[70] *Florida Trends in Deferred Presentment*, Prepared by Veritec Solutions LLC for the Florida Department of Banking and Finance. (August 2007). Available at http://www.veritecs.com/FL_trends_aug_2007.pdf.
Payday borrowers in Florida may request a 60 day grace period the day before their loan is due and must make an appointment with a credit counselor within 7 days.

[71] *Michigan Trends in Deferred Presentment*, Prepared by Veritec Solutions LLC for the Michigan Office of Financial and Insurance Services (July 31, 2007). Available at http://www.michigan.gov/documents/cis/OFIS_DPST_REPORT_204749_7.pdf. Payday borrowers are eligible for a payment plan in Michigan after eight transactions over a 12 month period. The lender may charge a $15 set up fee. The borrower can then pay back their debt over three installments.

[72] *Oklahoma Trends in Deferred Deposit Lending*, Prepared by Veritec Solutions LLC for the Oklahoma Department of Consumer Credit. (May 2007). Available at http://www.veritecs.com/OK_Trends_05_2007.pdf.. Payday borrowers may request a payment plan in Oklahoma prior to the due date of their 3rd, 4th, or 5th consecutive loans. The lender may charge a fee of 10% or $15, whichever is less. The borrower then pays back their debt over the next four paydays in equal installments and must wait 15 days after paying the loan off before taking out a new payday loan.

[73] Data is based on reporting from 92% of the industry. See *2006 Payday Lending Report*. Washington State Department of Financial Institutions (2007). Available at http://www.dfi.wa.gov/cs/pdf/2006_payday_report.pdf. Payday borrowers in Washington State are eligible for a payment plan after taking out four successive loans and before the default of the last loan. Lenders may charge a one-time fee of up to 15 percent of the first $500 of principal owed and 10% of the remaining principal balance. Borrowers are given at least 60 days to pay back their debt in three or more installment payments.

slightly after implementation of a payment plan measure so that borrowers do not become eligible for the plan.[74]

[74] For example, borrowers are eligible for Colorado's payment plan after taking out four consecutive loans (defined as loans taken within five days after a previous loan is repaid). The state regulator office reports that lenders have made their borrowers ineligible for payment plans in the following ways: (1) requiring at least a six day cooling off period after the third consecutive loan, (2) offering an interest free loan after the third consecutive loan (loans without finance charges do not count towards payment plan eligibility under the law), and (3) refusing origination of a 4th consecutive loan, which would presumably drive borrowers to another payday lender. See *Springing the Debt Trap* by the Center for Responsible Lending for more details.