Memorandum

CITY OF DALLAS

Date October 3, 2014

To Honorable Members of the Budget, Finance & Audit Committee: Jerry R. Allen (Chair), Jennifer S. Gates (Vice Chair), Tennell Atkins, Sheffie Kadane, Philip T. Kingston

Subject Payday and Small-Dollar Loans: Research and Policy Solutions

On October 6, 2014, the Budget, Finance and Audit Committee will be briefed on Payday and Small-Dollar Loans: Research and Policy Solutions. The briefing will be presented by Nick Bourke, Director of Small Dollar Loans, of The Pew Charitable Trusts.

Please contact me if you need additional information.

Jeanne Chipperfield
Chief Financial Officer

Attachment

c: Honorable Mayor and Members of City Council
A.C. Gonzalez, City Manager
Warren M.S. Ernst, City Attorney
Craig D. Kinton, City Auditor
Rosa A. Rios, City Secretary
Daniel F. Solis, Administrative Judge
Ryan S. Evans, First Assistant City Manager
Eric D. Campbell, Assistant City Manager
Jill A. Jordan, P.E., Assistant City Manager
Forest E. Turner, Assistant City Manager
Mark McDaniel, Assistant City Manager
Joey Zapata, Assistant City Manager
Sana Syed, Public Information Officer
Elsa Cantu, Assistant to the City Manager

Payday and Small-Dollar Loans: Research and Policy Solutions

Nick Bourke, Project Director

October 6, 2014 – Dallas City Council

www.pewtrusts.org/**small-loans**

Pew's Small-Dollar Loans Project

- Research began in 2011
  - Unique, nationally representative borrower surveys
  - Focus groups, interviews, consumer complaint databases
  - Government data, corporate filings, advertising data, etc.

Payday Lending in America series of reports:

1. *Who Borrows, Where They Borrow, and Why*
2. *How Borrowers Choose and Repay Payday Loans*
3. *Policy Solutions*
4. *Fraud and Abuse Online: Harmful Practices in Internet Payday Lending*

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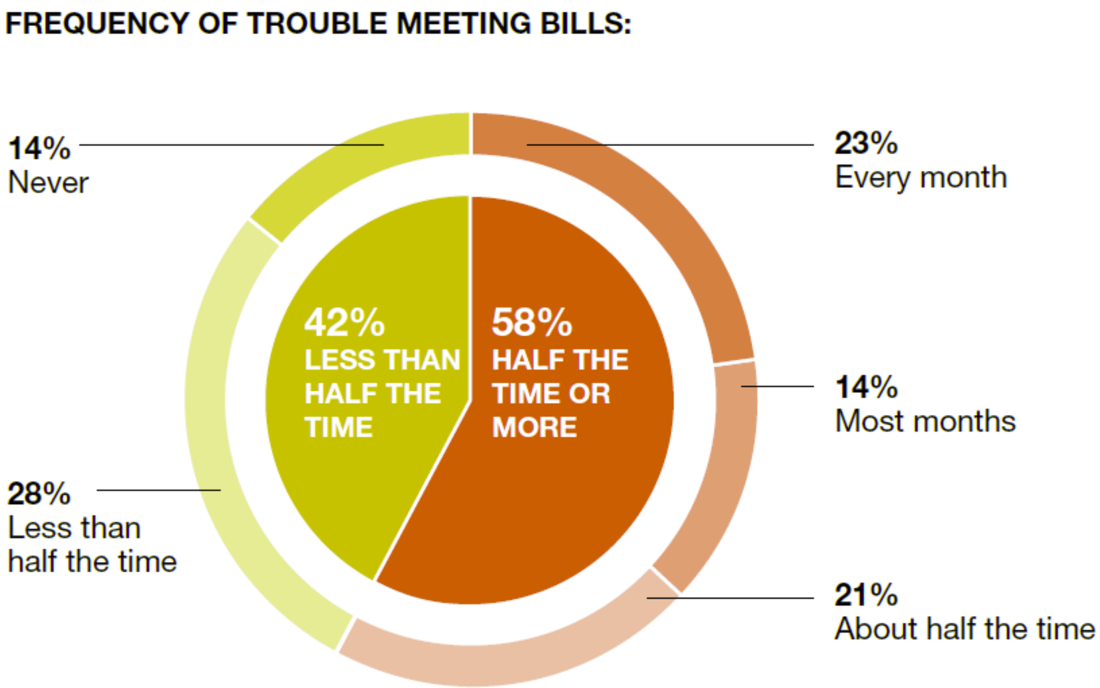
How Payday Loans Work

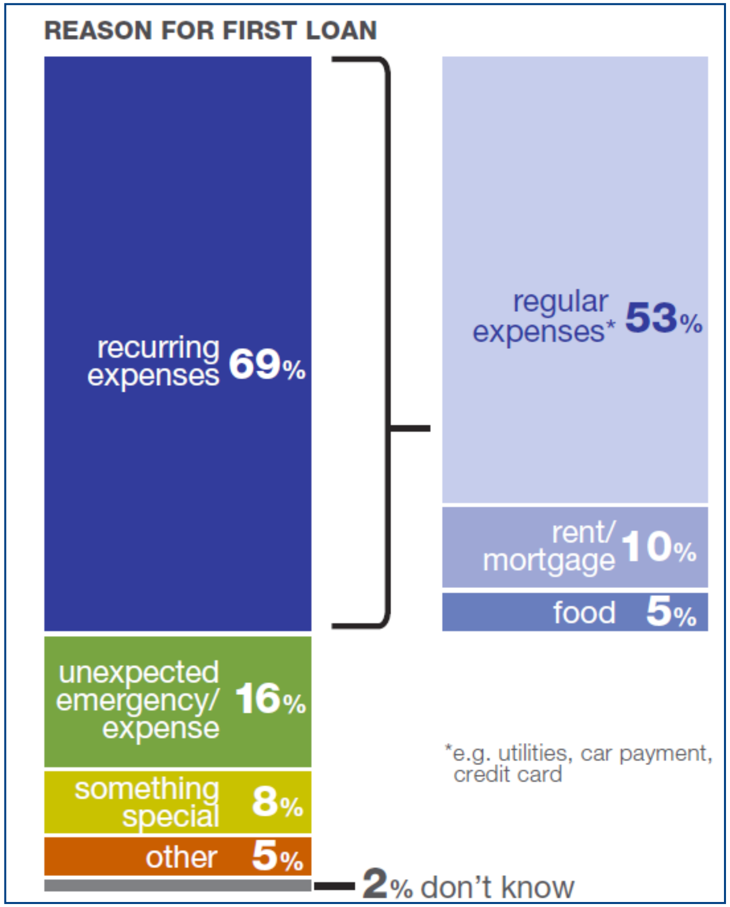
- Packaged as “short-term” loans for “temporary needs”
  - Obtained from storefronts, online, some banks (“deposit advance”)
- Little to no underwriting
  - Borrower has an income source and checking account; no history of fraud
- Lender can debit bank account to collect (deferred presentment)
- Short repayment period, tied to borrower pay cycle
  - If borrower cannot pay in full, pays fee to renew, or borrows again
- Avg. loan is $375
  - Fee per 2 wks: $55 store, $95 online, $35 bank (now discontinued)

Profile of Payday Borrowers

- 12 million users per year, spending more than $7 billion
- Have a checking account → *These are bank customers*
- Have income – about $30,000 per year
- "Thick File" credit histories
  - More than 90% have a credit score – low 500s
  - Most have credit cards – usually maxed out

Most Use Payday Loans for Monthly Bills





A Core Problem:
— Payday Loans Are Fundamentally Unaffordable

- Typical payday loan takes **36%** of borrower's pretax paycheck
  - *Far too much* – undermines ability to meet other financial obligations without borrowing again
- *But what percentage would be more reasonable*?
- Most borrowers cannot afford to pay more than **5% of their pretax paycheck**
  - As shown by national survey data, underwritten installment loan markets, conventional payday loan fee amount, CO case study

A Benchmark for Identifying Problematic Loans: The 5% Payment-to-Income Threshold

- Most borrowers cannot afford to pay more than **5% of their pretax paycheck**
- A benchmark for identifying the most harmful loans
  - For a borrower making $31,000 annually, the 5% threshold yields payments of about $60 biweekly compared to about $430 required by a typical payday loan today
  - In this example, loans requiring payments of more than ~$60 biweekly (or ~$130 monthly) should be considered potentially dangerous to the borrower and subject to additional regulatory scrutiny

Unaffordable Payments Drive Extended, Consecutive Usage

- Average borrower in debt for 5 months of the year
- Average borrower pays $520 per year
- Consecutive usage is the norm
  - 80% of loans originate w/in 14 days of a previous loan
  - Half of all loans occur within a sequence lasting 10+ loans

A Core Problem:
— Business Model *Requires* Extended Use

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- Nearly all revenue comes from repeat borrowers
  - 97% of loans go to those using 3+ per year
  - 63% of loans go to those using 12+ per year

Extended usage is the key driver of revenue

- The business model is predicated on these outcomes
  - Need average of 4 to 5 loans per customer before becoming profitable

Online lending:
Same fundamental problems,
plus widespread fraud and abuse

Widespread Problems in the Online Payday Loan Market

- Most lenders not licensed by states where they make loans
- 1 in 3 online borrowers experienced auto-renewals
  - Some "installment" loans include payments not applied to principal
- 30% of borrowers threatened by lenders or debt collectors
- 2 in 5 borrowers report personal information sold
- Overdrafts and unauthorized withdrawals
- 22% report losing or closing a bank account due to loans
- 9 in 10 complaints are about online loans (1/3 of market)
- More expensive than storefront loans (650% APR typical)

Online Borrowing Not Driven By Regulation of Stores

- **States like Texas that have stores also have people borrowing online.** The share of people borrowing online is similar in states that have stores and those that do not.
- **Consumer complaints about online lending are rising *everywhere***. The share of people filing complaints is consistent across the states.

EXHIBIT 9:

METHOD OF ACQUIRING PAYDAY LOANS BY STATE LAW TYPE

Percentage of adults reporting payday loan usage in the past five years

	BORROW FROM STOREFRONT ONLY	BORROW FROM ONLINE OR OTHER	NUMBER OF INTERVIEWS
National	4.01%	1.48%	33,576
Permissive states	5.22%	1.37%	17,881
Hybrid states	5.06%	1.28%	5,565
Restrictive states	1.29%	1.58%	10,130

Research shows that better outcomes are possible while maintaining access to credit.

Outcomes: Lump Sum Payday Loan vs. No Payday Loan

Payday Loan → Harm

Melzer (food stamps)

Skiba & Tobacman (bankruptcy)

Carrell & Zinman (reenlistment eligibility)

Melzer (delinquency)

Campbell et al (bank account loss)

Chang & Perry (food insecurity)

Payday loan → Benefit

Morse (natural disasters)

Edmiston (use of credit)

Morgan & Strain (bounced checks)

Zinman (employment)

Mixed

Bhutta et al (credit score)

Hynes (crime, unemployment)

Bhutta (delinquencies, overdrawing credit lines)

Wilson et al (lab game)

Caskey (lit. review)

Outcomes:
Lump Sum Payday Loan vs. Installment Loan

2010: Colorado required payday loans to become installment loans.

Eliminated the conventional, 2-week payday loan.

Replaced it with a 6-month installment loan featuring:

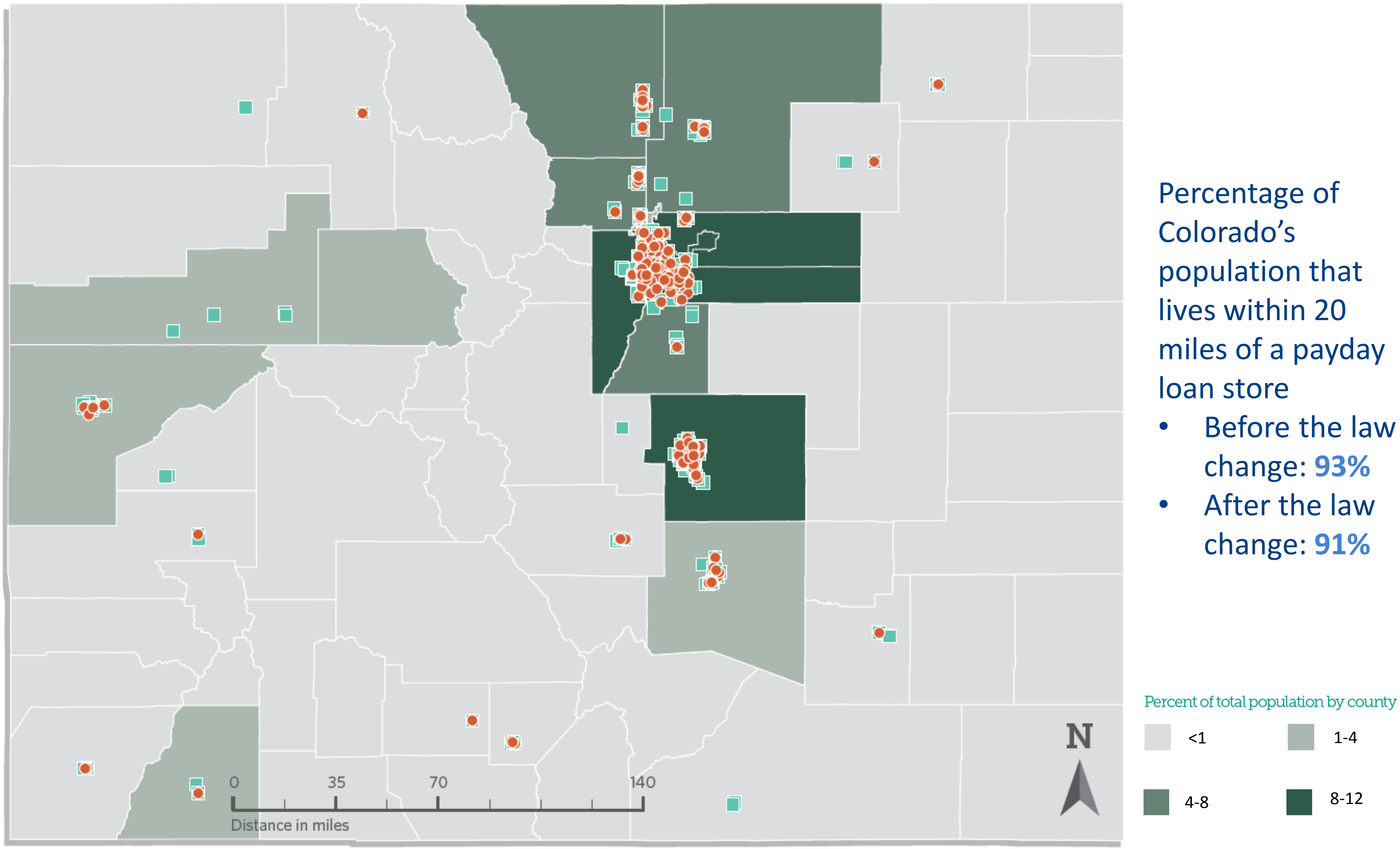
- Affordable payments
  - Average borrower pays 4% of paycheck, not one-third+
- Fully amortizing loan with equal installment payments
  - No front-loaded charges, can repay early w/o penalty
- Reduced (but still high) cost: Avg. APR 129% w/ interest and fees

Outcomes:
Lump Sum Payday Loan vs. Installment Loan

In 2010, Colorado required payday loans to become installment loans

1. Maintained access to credit

Stores Still Widely Available After Law Change



Location open after law change (Aug. 1, 2013)

Location open before law change (April 1, 2010)

Percentage of Colorado's population that lives within 20 miles of a payday loan store

- Before the law change: **93%**
- After the law change: **91%**

Outcomes:
Lump Sum Payday Loan vs. Installment Loan

In 2010, Colorado required payday loans to become installment loans

1. Maintained access to credit

2. Kept lenders in business (half of stores still open)

	Before Law Change (Conventional Payday Loans)	After Law Change (Payday Installment Loans)	Difference
Total number of individual consumers to whom loans were made in year	279,570	238,014	-15%
Number of licensed locations	505	238	-53%
Borrowers per store	**554**	**1,000**	**81%**

*Large lenders that also offer **check cashing** have consolidated much less (17%) compared to those that do not (55%).*

Outcomes:
Lump Sum Payday Loan vs. Installment Loan

In 2010, Colorado required payday loans to become installment loans

1. Maintained access to credit
2. Kept lenders in business (half of stores still open)
3. Payments more affordable (4% of paycheck now vs. 38% before)
4. Average borrower spends less ($277 now vs. $476 before)
5. Lender-charged bounced check fees down 57%
6. Defaults per year have declined 30%
7. Making the loan safer and more affordable means less oversight required to ensure consumer safety
8. Credit counselors and elected officials report fewer people coming to them with payday loan problems

Summary

- Research overwhelmingly shows:
  - Payday loans are fundamentally unaffordable
  - The payday business model *requires* extended use
- Colorado case study shows that installment loans – with affordable payments and sensible safeguards – work far better for borrowers and are viable for lenders
  - Colorado lowered costs and improved affordability while maintaining access to credit

Evaluating the Evidence on High-Cost, Small-Dollar Lending

Lump Sum PDL	<	**No Loan**	Outcomes analysis mostly a wash, tending toward "No Loan." Clear evidence of fundamental unaffordability and business model problems point strongly toward reform.
Lump Sum PDL	<<	**Installment**	Available evidence is clear and convincing. Compared to lump-sum, installment loans **with Colorado-like safeguards** are better for consumers and more transparent for the market.
Installment	?	**No Loan**	There is little available evidence.

There's a problem. How to respond?

Policy makers should:

- Eliminate payday loans; or
- Fundamentally reform them

Fundamental reform

In general, any promoter of access to credit should reject lump sum loans in favor of installment loans. But installment loans can be harmful too without proper regulatory guidance:

Ability to repay standards

+

Some sensible safeguards to ensure
a healthy installment loan market

+

Continue to set maximum allowable charges

Pew's Recommendations

- Wherever high-cost lending continues to exist, it must be substantially reformed
  - Consumer Financial Protection Bureau (CFPB) reforms are coming
  - States will need to react and fill in gaps

- Pew's recommendations:
  - **Apply to all small-dollar loans**
  - Policymakers in the 15 states that do not have payday lending should not change their laws

Pew's Policy Recommendations

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 pay the loan while meeting other financial obligations.

A flexible ability to repay standard

What payments result from a 5% threshold?

Income		Max. Monthly
Annual	**Monthly**	**Payment**
$18,000	**$1,500**	**$75**
$30,000	**$2,500**	**$125**
$48,000	**$4,000**	**$200**
$60,000	**$5,000**	**$250**

- *5% affordability threshold applies to the size of each payment, not to overall loan amount or cost.*
- *Fully scalable:*
  - *Any loan size*
  - *Any income level*
  - *Price agnostic*

2 Spread costs evenly over the life of the loan

Front-loading of fees and interest should be prohibited. Any fees should be paid evenly over the life of the loan, and loans should have substantially equal payments that amortize smoothly to a zero balance.

Protections against installment loan flipping

(Simply converting to installments is not sufficient)

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3 Guard against harmful repayment or collections practices

Policymakers 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.

Safeguarding borrower checking accounts

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.

Clear information to help make informed decisions

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. Policymakers may limit rates to 36 percent or less if they do not want payday lenders to operate, or somewhat higher if they do.

A Market Lacking Price Competition

How much does a $500 payday loan cost?

	Advance America	Ace Cash Express	Check into Cash	Check n Go
Florida	$55	$55	$53	$55
Michigan	$65.45	---	$65.45	$65.45
Kansas	$75	$75	$75	$75
Alabama	$87.50	$87.50	$87.50	$87.50
Texas	$102	$152	$125	$127

Costs listed on company websites as of November 1, 2013

A Market Lacking Price Competition

State grouping	Average cost to borrow $300 for 5 months	Median stores per 100,000 residents
Lower than average rate cap	$281	3.0
Average rate cap	$435	7.2
Higher than average rate cap	$528	14.9
No rate cap	$604	12.9

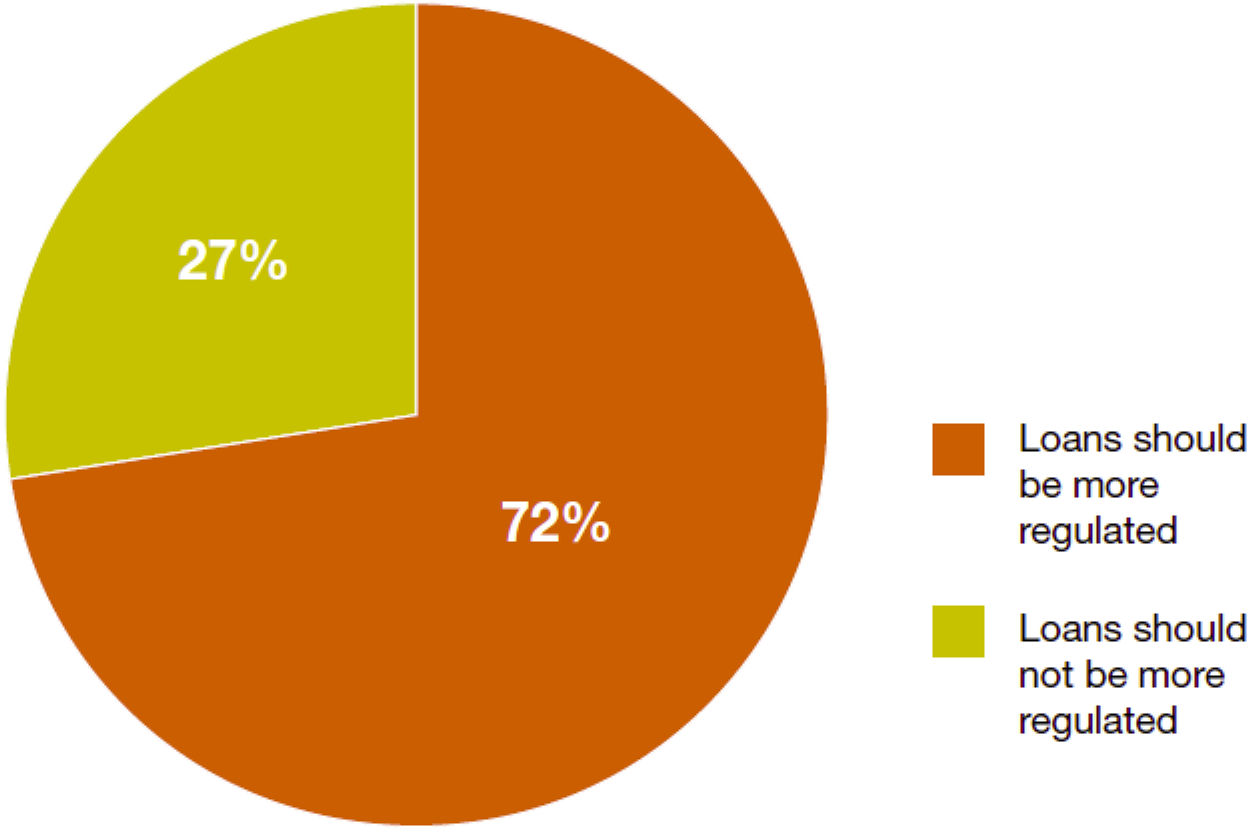
Borrowers Want Policymakers to Act

Borrowers Have Torn Feelings

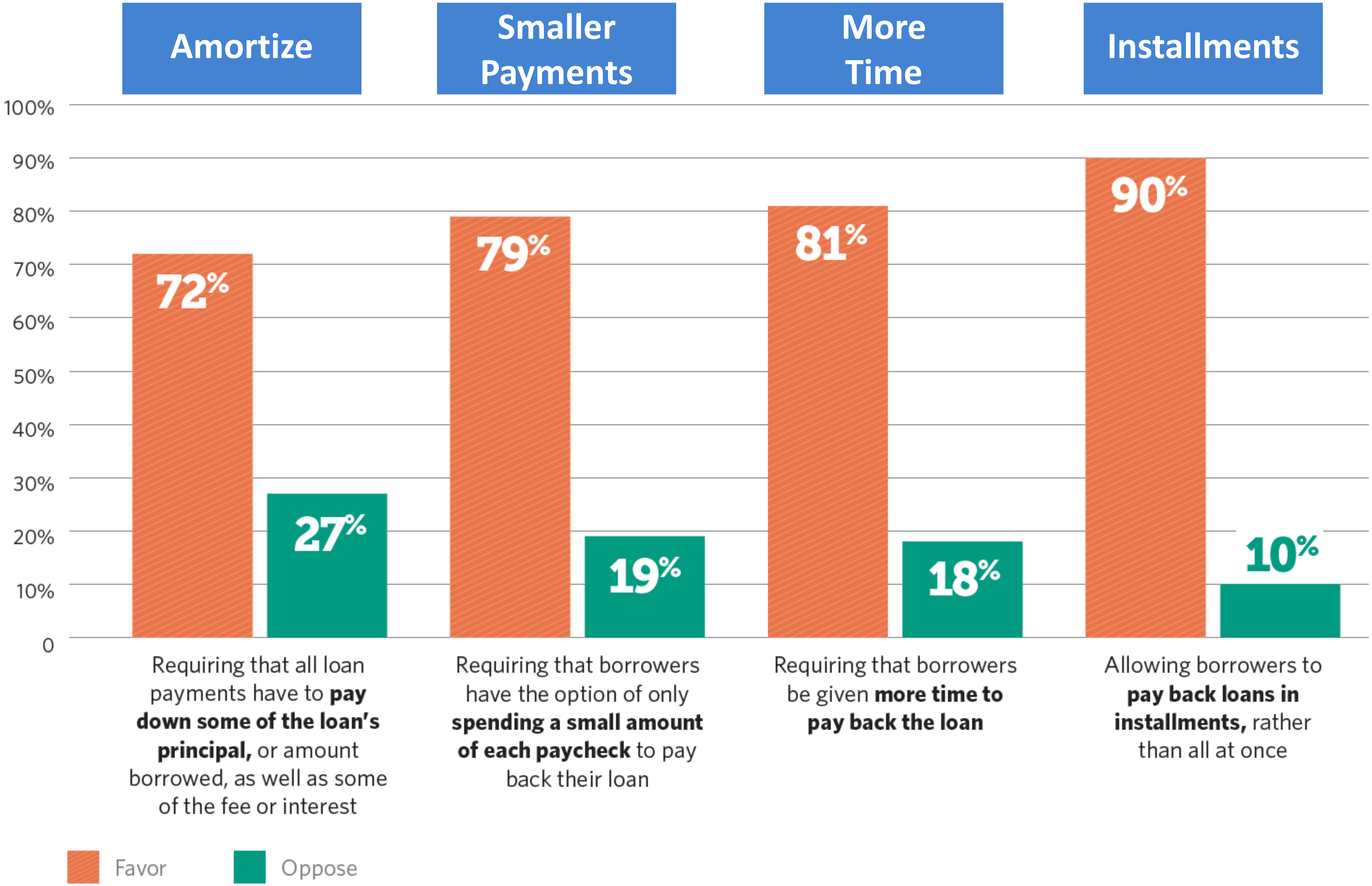
- Grateful to receive cash
- Friendly customer service from local stores
- But 55% feel the product takes advantage of them

BORROWERS FAVOR MORE REGULATION

ALL PAYDAY BORROWERS



Borrowers Overwhelmingly Support Requiring Installment Payment Structure



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