

RECOMMENDATIONS ON PAYDAY LENDING

CALIFORNIA WORKING FAMILIES POLICY SUMMIT JANUARY 13, 2009

INTRODUCTION

Payday loans are small, short-term loans secured by the borrower's personal check. The typical two-week loan is costly, with lenders allowed to charge an annual percentage rate (APR) of up to 459 percent. Although marketed – and justified – as a short-term emergency advance on a borrower's paycheck, the data show that in reality, most borrowers use payday loans repeatedly, and pay a \$45 fee with each use.

- While not authorized by the legislature until 1996, by 2008, there were more than 2,400 payday lending stores in California, more than all Starbucks and McDonald's combined.
- California borrowers took out more than 10 million payday loans in 2006, totaling \$2.5 billion.
- Payday fees strip \$405 million from payday borrowers annually.

Payday loans are authorized in statute as an exception to the California's Finance Lender's Law, which regulates interest rates on loans of \$2,500 or less. To protect California residents from a defective financial product, the California legislature should enact a 36 percent Annual Percentage Rate (APR) cap on payday loans.

How do they Work? The borrower provides the lender with a personal check for the amount of cash received that day plus the fee. Lenders verify that a borrower is employed or receiving regular public assistance, but do not otherwise evaluate the ability of the borrower to repay the loan. For the maximum \$255 loan, a check is written for \$300 (the \$255 principal plus a \$45 fee). The lender promises not to cash the check until the loan comes due, usually on the borrower's next payday.

The day the loan comes due the borrower can return to pay it off or simply allow the lender to cash the check. If the borrower cannot pay back the payday loan and still get by until the next paycheck, however—which is frequently the case—the borrower pays off the loan, but then borrows back their payment with another payday loan either immediately or within a few days.

The Problem with Payday Loans: Borrowers Can't Pay Them Back and Get Stuck in the Payday Debt Trap. The combination of high fees, short repayment terms, and required balloon payments leads most payday customers to borrow repeatedly. Most simply cannot afford to pay back their \$255 and have enough income left over for other basic living expenses. Recent reports by the California Department of Corporations (DOC) found three key trends:

1. **Most of the one million payday borrowers are falling into the payday debt trap of repeated borrowing.**
 - Payday borrowers take out an average of 10 loans per year.
 - Nearly 450,000 borrowers had back-to-back spells of 6 loans or more. This translates to *paying back at least \$525 for an initial \$255 in credit.*
 - Borrowers with 6 or more loans per year account for more than 50 percent of all CA payday revenues.¹
 - Five percent of CA borrowers —57,147 borrowers—completed more than 19 consecutive transactions during 2006, or had payday debt *at least nine and half months out the year—paying \$1,110 back for one \$255 loan.* These 57,147 borrowers accounted for more than a quarter of the 10 million 2006 payday loans.²
2. **Very few borrowers used payday loans to meet true one-time or uncommon emergencies.** Less than 4 percent of borrowers take just one loan. Instead, the DOC found that 70 percent of borrowers report taking out payday loans to meet basic expenses (to pay bills, to buy groceries or other necessary household goods), rather than to cover short-term emergencies.
3. **Payday lenders target vulnerable populations.** Payday borrowers are disproportionately female (60%), African American (18%) and Latino (36%). African Americans, however, account for just 5 percent of the adult population eligible for payday loans (that is adults with checking accounts,) while Latinos make up only 23 percent.³ Until banned by federal legislation in 2006, military members were also heavy users of payday loans.

Better Alternatives are Available. Alternative small loan products such as a consumer finance loans, credit card cash advances, lines of credit, or signature loans are a few examples of the possibilities. California credit unions and banks are actively developing and marketing more affordable and responsible short-term credit products. For example, California’s largest credit union, Golden 1, offers a \$300 Lifeline Advance at 15 percent APR for customers who have an account with direct deposit.⁴ In addition, BBVA Bancomer USA, a bank with 30 locations primarily serving California’s Latino communities, is part of the Federal Deposit Insurance Corporation’s (FDIC) small-loan pilot program.⁵ Banks participating in this program offer small loans costing no more than 36 percent APR with a built-in savings component to borrowers who might otherwise consider a payday loan.

POLICY OBJECTIVE

Establish a 36 Percent APR cap to rein in payday lending.

Background

The federal government, 16 states and the District of Columbia have reined in abusive payday lending by establishing a reasonable usury cap on payday loans of 36 percent or less:

- At the request of the U.S. Department of Defense, Congress established a 36 percent APR cap on payday loans for members of the military and their families in 2006. In a report to Congress, the Defense Department concluded, “Education, counseling ... and sound alternatives are necessary but not sufficient to protect Service members from predatory lending practices or products that are aggressively marketed [to them].” The

California legislature enacted AB 7 in 2007 to ensure that DOC could help enforce this necessary protection.

- 16 states and the District of Columbia control payday lending by enforcing interest-rate caps. In recent years, OR, OH, DC, NH and DC have rolled back payday lending exemptions.
- Industry-sponsored ballot initiatives that would have weakened payday lending rate caps in Arizona and Ohio were defeated by 60-40 margins at the polls, despite industry infusions of more than \$15 million of opposition campaign spending in each state.

Only a Rate Cap Springs the Debt Trap. The payday lending industry has supported “reforms” in other states, including payment plans and “cooling-off” periods between loans. These reforms have been ineffective in stemming the problem of chronic borrowing. Because payday lenders are dependent upon trapped borrowers for their business model to be profitable, it reasonably follows that any regulations that garner industry support would leave the debt trap intact.

Recommended Actions

- A. The California State Legislature should enact a 36 percent annual percentage rate cap on payday loans.
- B. The Department of Corporations should collect and report additional data on the utilization and impacts of payday lending in California. By current statute and practice, the Department collects extremely limited data, which lacks depth and nuance, and fails to provide an adequate knowledge base for informing policy change.
- C. The U.S. Congress should enact a federal 36 percent APR cap, as proposed in S.3287 in July 2008.

¹ *California Deferred Deposit Transaction Law*, Report to the Governor and the Legislature as Required by Financial Code Section 23057, California Department of Corporations, March 2008, Table 2-1.

http://www.corp.ca.gov/pub/pdf/CDDTL07_Report.pdf These estimates assume borrowers who took out 6-12 consecutive loans averaged 9 loans per spell, those who took out 13-18 consecutive loans averaged 16; and those with 19 or more consecutive loans averaged 21 loans per spell. These totals are then divided by the 10.048 million total number of loans.

² DOC report, Table 2-1, summary of first column of consecutive transactions.

³ *2007 Department of Corporations Payday Loan Study*, Applied Management and Planning Group, December 2007, submitted to the DOC at <http://www.corp.ca.gov/pub/pdf/PDLStudy07C.pdf> p.65. Census 2000 data.

⁴ Information on Golden 1 Credit Union’s Lifeline Advance product is available at <https://www.golden1.com/ProductsServices/Loans/Consumer/lifelineadvance.aspx>. Lifeline Advance customers pay a one-time only \$15 administrative fee.

⁵ Information on the FDIC’s Small Loan Pilot Program, including a list of the 31 participating banks nationwide, is available at <http://www.fdic.gov/SmallDollarLoans/>.