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United States Senate
Financial Institutions and Consumer Protection Subcommittee
Senate Committee on Banking, Housing, and Urban Affairs

By Electronic Delivery

RE: Hearing: "Are Alternative Financial Products Serving Consumers?" (March 26, 2014)

Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee:

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

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

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

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

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

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

Background: Payday loans and the financially fragile, "thick-file" consumers who use them

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

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

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

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

Typical payday loan applicants have poor credit scores in the low 500s,[3] indicating an assessment by credit reporting agencies that they are already overburdened with debt and/or struggling to meet financial obligations. More than half of payday loan applicants carry credit card debt, two in five payday borrowers own homes (many with mortgages), and many also hold other debt. Most payday borrowers *also* pay overdraft fees, and this fact is a reminder that payday loans do not eliminate the risk of overdrafting.[4]

Loan payments average one-third of a borrower's next paycheck—an unaffordable burden

When a payday borrower gets a loan, he or she usually uses it to help pay rent, utilities, or other bills. The loan temporarily solves these problems. However, on the borrower's next payday, the full amount of the loan—plus the fee—is due. For an average storefront loan, the amount due on payday is $430. For someone who makes $31,000 per year, the median payday borrower's income nationwide, $430 represents 36 percent of his or her bi-weekly income, before taxes. By contrast,

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[3] Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, "Payday Loan Choices and Consequences," Vanderbilt Law and Economics Research Paper, no. 12-30 (2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2160947.
[4] Pew's survey shows that most payday borrowers have overdrafted in the past year. See also Consumer Financial Protection Bureau, Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings (2013), http:// files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

Pew's research has found that most borrowers cannot afford to pay more than 5 percent of their pretax paycheck toward a loan payment while still meeting their other financial obligations.

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

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

The required lump-sum payment far exceeds the borrower's ability to repay, yet lenders maintain profitability by relying on some unique benefits granted to them by state laws. Payday lenders have the legal power to withdraw payment directly from borrowers' checking accounts on their next payday, prompting those without enough money left for rent or other bills to repay the loans and quickly reborrow, effectively paying an interest-only fee to reset the due date to the next payday. This extraordinary form of loan collateral, which is achieved through use of post-dated checks or electronic access to borrowers' checking accounts, acts as a "super lien" against the borrower's income stream that allows lenders to thrive even as they make loans to those who cannot afford them. This power to capture borrower income enables lenders to make small-dollar loans without underwriting them to ensure that the borrower can both repay the loan and meet other financial obligations without having to borrower again to make ends meet.

<u>The lump-sum payday loan is a failed product</u>

Policy discussion in recent years has focused on whether payday loan customers need more access to credit, and what rate of interest is appropriate for such loans. These are valid questions, but there is insufficient evidence to know whether consumers are better off with or without access to high-interest loans (even if the loans have affordable payments).

There is, however, sufficient evidence to conclude that conventional lump-sum payday loans harm consumers compared with loans that have affordable payments. It is clear that the lump-sum payday loan has inherent structural flaws that make it unaffordable and dangerous for consumers, and that new policies to eliminate this harmful product are warranted. Pew's research and analysis show that clearly, and just this week the Consumer Financial Protection Bureau (CFPB) released a

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[5] David Burtzlaff and Brittny Groce, Payday Loan Industry (Stephens Inc., 2011), 15.
[6] Robert DeYoung and Ronnie J. Phillips, "Payday Loan Pricing," (Federal Reserve Bank of Kansas City, Economic Research Department, February 2009), 7, http://www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf.
[7] Community Financial Services Association of America, "Is a Payday Advance Appropriate for You?" accessed Sept. 20, 2013, http://cfsaa. com/what-is-a-payday-advance/is-a-payday-advance-appropriate-for-you.aspx.

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

Pew's policy recommendations for the small-dollar loan market (payday and installment loans)

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

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

1. **Limit payments to an affordable percentage of a borrower's income**. Monthly payments above 5 percent of monthly pretax income are unaffordable for most borrowers. Loans requiring more should be prohibited unless rigorous underwriting shows that the borrower can repay the loan while meeting other financial obligations.

   This recommendation is intended to provide a clear yet flexible ability-to-repay standard, one that may accommodate lenders by providing for a low-cost and streamlined underwriting process while requiring most loans to be restructured as affordable installment loans (as opposed to unaffordable lump-sum repayment loans). Such a standard is flexible, easily accommodating various levels of income, pricing, and loan size.

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

   This recommendation addresses a common problem found in installment loan markets intended to serve those with damaged credit histories. When origination fees or other front-loaded charges make the first month of a loan substantially more profitable for the lender than subsequent months, lenders have an incentive to encourage borrowers to refinance loans. When loans are frequently refinanced, borrower costs increase dramatically, lenders can mask defaults by inviting struggling borrowers to skip a periodic payment in exchange

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

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

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.

   This recommendation is focused on protecting borrower checking accounts by ensuring that borrowers have the power to stop payments or close accounts to avoid unscrupulous or fraudulent lenders. It also recognizes that some small-dollar loans could have affordable periodic payments yet require repayment terms that last an unconscionably long time unless policymakers require shorter terms or ensure that each periodic payment includes a substantial principal reduction.

4. **Require concise disclosures of periodic and total costs**. Loan offers should clearly disclose, with equal weighting: the periodic payment schedule, the total repayment amount, the total finance charge, and the effective annual percentage rate (APR) inclusive of all fees.

   To make good decisions, borrowers need clear and reliable information.

5. **Continue to set maximum allowable charges**. Almost every state sets maximum allowable rates on some small-dollar loans because these markets serving those with poor credit histories are not price competitive. Policymakers may limit rates to 36 percent or less if they do not want payday lenders to operate, or somewhat higher if they do.

Research shows safeguards can work: A case study from Colorado

In 2010, Colorado lawmakers agreed that the state's 18-year experiment with conventional payday lending had led to unintended and harmful consequences. They dramatically changed the state's payday loan law, shifting from allowing lump-sum repayment loans due in full on the borrower's next payday to *requiring* that borrowers be allowed at least six months to repay the loans. This major change provided a research opportunity to study the small-dollar loan market and its impact on borrowers before and after the law change. Pew's report, *Payday Lending in America: Policy Solutions* (2013), discusses the Colorado case study in detail.

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

1. Borrowers maintained access to credit

2. Lenders are still in business (half of stores still open in locations throughout the state)

3. Loan payments are more affordable (4% of paycheck now vs. 38% before)

4. The average borrower spends less ($277 now vs. $476 before)

5. Lender-charged bounced check fees are down 57%

6. Defaults per year have declined 30%

7. Making the loan safer and more affordable reduced the amount of oversight required to ensure consumer safety

8. Credit counselors and elected officials report fewer people coming to them with payday loan problems

Payday borrowers want policymakers to act

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

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

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

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

There is a large and apparently growing group of consumers who have used the banking system but are going outside of it for some or all of their financial services needs

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

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

[10] The Pew Charitable Trusts, *Why Americans Use Prepaid Cards* (2014), 7.

The desire to gain control over one's finances—and avoid overdraft and the temptations of credit—is leadings millions to seek services outside the banking system

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

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

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

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

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

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

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[11] Ibid., 14

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

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

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

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

Prepaid card users do not want the product to have overdraft or linked credit

Prepaid users want their cards to remain free of overdraft and automated or linked credit features. One driver of this sentiment is past experience. As noted above, the vast majority of prepaid card users have or used to have a bank account. Of these, 41 percent have closed or lost a checking account because of overdraft fees.[16] Thus, it is not surprising that 63 percent of prepaid users cite "avoiding overdraft fees" as a reason for using the card, with similar majorities saying they use the card for "avoiding credit card debt," and "helping you not spend more money than you actually have."[17]

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

Lessons from prepaid

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

Looking forward, efforts to increase access to beneficial banking services must take these findings into account. Efforts that help consumers meet the goal of avoiding overdrafting and overspending will be more likely to succeed; efforts that do not take this goal into account or put consumers at risk will be more likely to fail. In May of 2012, the CFPB issued an Advance Notice of Proposed

[15] For Pew's policy recommendations, see The Pew Charitable Trusts, *Consumers Continue to Load Up on Prepaid Cards* (2014), www.pewtrusts.org/prepaid.
[16] The Pew Charitable Trusts, *Why Americans Use Prepaid Cards (2014)*, 8.
[17] Ibid, 14.
[18] Ibid., 21.
[19] Though prepaid cards generally have a version of deposit insurance and liability limits for unauthorized transactions, they are generally inferior to those on bank checking accounts—something policy makers should address. The Pew Charitable Trusts, *Consumers Continue to Load Up on Prepaid Cards* (2014).

Rulemaking for the prepaid card market. In the announcement, CFPB director Richard Cordray noted that, while prepaid cards serve some of the most vulnerable among us, the cards also have far fewer regulatory protections than bank accounts or debit or credit cards.[20] When the CFPB takes the next step of proposing actual rules, it should ensure that overdraft and automated or linked lines of credit are firmly prohibited and do not spread into the prepaid card market.

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

Sincerely,

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Encl.: (1) Two-page payday loan research summary; (2) Four-page detailed policy recommendations for small-dollar loans; (3) One-page summary of prepaid card users and Pew's policy recommendations for prepaid

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

Payday Lending in America

Series summary

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

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

Selected findings

- 12 million Americans take out payday loans each year, spending approximately $7.4 billion annually. The average loan is $375.
- A payday loan is characterized as a short-term solution for unexpected expenses, but the reality is different.
    - The average borrower is in debt for five months during the year, spending $520 in interest to repeatedly reborrow the loan.
    - 69 percent of first-time borrowers use the loan for recurring bills (including rent or utilities), while just 16 percent deal with an unexpected expense such as a car repair.
- Payday loans are unaffordable.
    - Only 1 in 7 borrowers can afford the more than $400 needed, on average, to pay off the full amount of these lump-sum repayment loans by their next payday.
    - Survey and market data show that most borrowers can afford to put no more than 5 percent of their paycheck toward loan payment and still be able to cover basic expenses. In the 35 states that allow lump-sum payday loans, repayment requires about one-third of an average borrower's paycheck.
- Most payday loan borrowers have trouble meeting monthly expenses at least half of the time.
- 41 percent of borrowers have needed a cash infusion, such as a tax refund or help from family or friends, to pay off a payday loan.
- Payday loans do not eliminate overdraft risk. Most borrowers also overdraw their bank accounts.
- A majority of borrowers say payday loans take advantage of them. A majority also say they provide relief.
- Borrowers want changes to payday loans.
    - By almost a 3-1 ratio, borrowers favor more regulation of the loans.
    - 8 in 10 borrowers favor a requirement that payments take up only a small amount of each paycheck.
    - 9 in 10 favor allowing borrowers to pay back the loans in installments.

- Safeguards are needed to ensure affordability and protect consumers from the risk of lender-driven refinancing, noncompetitive pricing, excessive loan durations, and abusive repayment or collection practices.
    - Such safeguards can be applied in a way that works for lenders. Payday lenders continue to operate after a recent law change in Colorado, but borrowers spend less, and payments are far more affordable.
    - In states that enact strong legal protections, the result is a large net decrease in payday loan usage. Rates of online borrowing are similar in states with payday loan storefronts and those with none.

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

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

- Limit payments to an affordable percentage of a borrower's periodic income.
  (Research indicates that monthly payments above 5 percent of gross monthly income are unaffordable.)
- Spread costs evenly over the life of the loan.
- Guard against harmful repayment or collection practices.
- Require concise disclosures that reveal both periodic and total costs.
- States should continue to set maximum allowable charges on loans for those with poor credit.

Payday Lending in America reports

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

Other resources available from Pew

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

For more information, please visit:

pewtrusts.org/small-loans

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

Conclusion and initial policy recommendations

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

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

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

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

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

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

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

2. Spread costs evenly over the life of the loan

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

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

3. Guard against harmful repayment or collection practices

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

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

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

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

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

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

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

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

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

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

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

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

Borrowers want regulators to act

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

The limited benefits of access to credit

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

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

Summary of General Purpose Reloadable (GPR) Prepaid Card Users

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

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

Summary of Pew's Policy Recommendations for GPR Prepaid Cards

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

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

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

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