Center for Responsible Lending's Response to *Reframing the Debate about Payday Lending* by Liberty Street Economics

Robin Howarth, Senior Researcher
M William Sermons, Executive Vice President

June 2016

The primary issue with payday lending, and the one from which most of its other harms flow, is the intentional structuring of the payday loan product as a debt trap for vulnerable borrowers. The Center for Responsible Lending (CRL) and many others have documented the built-in payday loan features that result in the rollover debt trap: lack of underwriting for ability to repay, high fees (typically 400% APR or higher), unaffordable principal payments, and first-in-line access to a borrower's checking account as collateral.[1] The authors of Liberty Street Economics' *Reframing the Debate about Payday Lending* utilize a straw man approach in attempting to refute consumer harm in payday lending.[2] This includes front and center attacks on a number of legitimate, but secondary objections to payday lending including excess profits, spiraling fees, neighborhood targeting, cognitive errors on the part of borrowers, and the like. Liberty Street's attacks are superficial and fail ultimately to robustly address any of the above listed objections. It's disappointing then, to wait until the very end of their piece for the "Reframing", only to find out that – "It's All about the Rollovers" – something that has been widely known for some time.[3] The authors have in fact reiterated rather than reframed the prime driver of consumer harm from the payday product, and that is the payday lenders' debt trap by design.

CRL and others have shown that repeat borrowing is central to the lender's business model, a fact that has been invariant since payday lending's founding and is irrespective of the form of lender ownership, storefront or online delivery, or the current borrower makeup of the lender's portfolio.[4] Our analysis of state regulatory data shows that 85% of payday loans go to borrowers with seven or more loans a year. [5] Similarly, the CFPB in its 2013 analysis of lender-provided payday loan data found that three-quarters of loan fees from their consumer sample came from borrowers with more than ten transactions in a one year period. [6] Most recently, in June 2016, new CFPB research examining millions of payday loan transactions found that approximately 60% of loans are taken out on the same day that the previous loan is repaid, and 85% within 60 days. This industry-wide average persists even when accounting for states with "rollover bans" that do not stop the harms of repeated back-to-back transactions.[7] Payday lending executives and allies have themselves acknowledged the importance of repeat borrowings, or rollovers, to the bottom line: "…. [T]he theory in the business is [that] you've got to get that customer in, work to turn him into a repetitive customer, long-term customer, because that's really where the profitability is"[8] and "in practice, consumers mostly either roll over or default; very few actually repay their loans in cash on the due date."[9].

The Liberty Street authors give a pass to the disingenuous claims of payday lending proponents that the payday loan is mostly used as a product to meet emergency financial needs, despite strong evidence to the contrary. Several studies have shown that the majority of borrowers take out payday loans to cover shortfalls in meeting everyday living expenses between paychecks.[10] This shortfall persists and results in an inability to repay the loan when due, hence, the near ubiquitous rollover. (The Liberty Street authors fail to note that only 15% of loans to new borrowers are repaid at the maturity of the first loan without re-borrowing before the next paycheck.[11])

What percentage of payday borrowers show evidence of long periods of indebtedness for a supposedly short term liquidity fix? The CFPB found the median number of days of indebtedness per borrower to be 199 over a twelve month period for its sample of approximately 15 million loans in 33 states.[12] Looking at the same data from another angle, 67% of borrowers took out seven or more loans in a year with the vast majority of these borrowers being flipped into a new loan immediately or within a few days of paying off the prior loans, racking

up an additional fee each time. Seven loans taken in rapid succession, for what is essentially floating the same debt, will usually result in fees that exceed the amount of borrowed principal. So for example, a typical loan fee of $15 per $100 dollars, applied to a loan of $350 borrowed for a two week period and rolled over seven times, results in aggregate fees of $368.

It should be noted that a large percentage of borrowers experience far longer loan sequences than seven. The CFPB found that 34% of borrowers took out between 11 to 19 loans in a year, and an additional 14%, 20 or more loans. In this last category, approximately seven out of eight borrowers are unable to pay off their loan without re-borrowing before their next paycheck so that they would pay $1050 in fees for 20 loans floating the same debt of $350 under the terms of the first example above. It's notable that even NonPrime101, an entity that has close ties to payday lending service providers, recognizes that almost one-third of payday borrowers in their sample are stuck in the product for at least 3.5 years: "From the original 1000 [borrowers], 302 persisted for the entire 3.5 years." (p. 2)[13]

While Liberty Street reluctantly admits that there may be a problem with rollovers (although they understate the phenomenon's prevalence among borrowers), they posit that wholesale regulation should not proceed until additional study determines the extent of over-optimism in the borrowing population. Most research into such questions of cognitive errors in the finance arena occurs in highly controlled laboratory situations. This research has proven very difficult to translate into "the field" of actual payday lending behavior. Over-optimism is just one of the factors that researchers look at with respect to borrower behavior - others include strong responses to uninformative advertising, overestimation of search and switch costs and time-inconsistent preferences. [14] More than one of these factors are likely at play: borrowers clearly do not take out payday loans anticipating that they are going to lose their bank accounts, pay fees well in excess of the amount borrowed and then default, or be unable to pay for critical monthly expenses due to the immediate claim on their paycheck by payday lenders recouping fees and borrowings (all common outcomes).[15] Be that as it may, insights from the field of behavioral economics cannot be used to fix a fundamentally flawed product driven by unaffordability.

The Liberty Street authors sidestep an additional and related pernicious aspect of the payday debt trap - the lender's direct access to the checking accounts of borrowers for repayment. Both CRL and more recently the CFPB have shown that this access, combined with the lack of affordability of the loan relative to borrower's ability to repay, can result in numerous NSF and/or overdraft fees (typically $35 per event) when presentments are made by the lender. Our research of payday lending using state regulatory and checking account transaction data showed that nearly half of all borrowers experienced an NSF or overdraft fee in their checking account within two weeks of a payday transaction in the same account.[16] In the same vein, a CFPB report released in April of this year looked at payday lending activity (332 lenders) at the checking account level of almost 20,000 payday borrowers across a number of states.[17] They found that half of these borrowers were charged an average of $185 in bank penalties, usually NSF and/or overdraft fees, as a result of often repeated attempts to access borrowers' accounts for payment when bank balances were insufficient.

These devastating charges are not surprising given that the payday lender's business model is built on such outcomes. Indeed, this cascading, but less visible burden on a payday borrower's finances, is evidence that Liberty Street's focus was too narrow in their semantic quibble with the word "spiraling" as it relates to the accrual of contractual payday loan fees. For the many borrowers that experience bank checking account penalties, when added to the accumulating amount of contractual lender fees due to numerous loan rollovers, the net cash flow effect of the initial small dollar loan does indeed spiral out of control.

Finally, the Liberty Street authors are concerned that "economists do not agree" about the perils of payday lending as measured by such proxies as involuntary bank closure, complaints against lenders, difficulty paying bills and the like. We find that on balance the academic research strongly supports the premise of long-term harm to payday borrowers.[18] However, what is undisputed in all of the legitimate research, academic or otherwise, is the high percentage of loans that go to borrowers that become trapped in long term, sequential use of the loan product, often sending them on a downward trajectory towards insolvency. These consumers deserve strong federal and state protections and access to credit on fair terms. Their welfare shouldn't be held hostage to the proclivities of a small group of economists who would extend the research horizon indefinitely. Delay is clearly not in the best interests of current (and prospective) payday borrowers whose pockets are drained by the fees of payday lenders to the tune of $11.2 million every day. [19]

---

[1] Susanna Montezemolo, *Payday Lending Abuses and Predatory Practices,* in *The State of Lending in America and its Impact on U.S. Households*, Center for Responsible Lending, September, 2013, available at http://responsiblelending.org/sites/default/files/uploads/10-payday-loans.pdf , also
The Pew Charitable Trusts, *How Borrowers Choose and Repay Payday Loans*, February 2013, available at http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf, also
Michael A. Stegman, 2007. "Payday Lending." *Journal of Economic Perspectives*, 21(1): 169-190, available at https://www.aeaweb.org/articles?id=10.1257/jep.21.1.169

[2] Liberty Street Economics, *Reframing the Debate about Payday Lending,* October 2015, available at http://libertystreeteconomics.newyorkfed.org/2015/10/reframing-the-debate-about-payday-lending.html

[3] From the 2006 Department of Defense *Report on Predatory Lending Practices*,

> "For example, when some states banned "rollovers," meaning the borrower could extend the loan for another fee without paying it back, payday lenders attempted to circumvent this reform by offering back-to-back transactions. The borrower paid off the loan and immediately opened a new one for the same amount. This had the same detrimental effect on the borrower, and also allowed the payday lender to call the transaction a "new" loan, even though they were handing back the same amount of money. Even when the transactions are separated by a couple of days or a week, the borrower is still caught in the cycle of debt. If they were using these loans as an occasional boost to get to the next payday, they would have only a few loans a year, with weeks or months between". (p. 47) available at http://www.dtic.mil/dtic/tr/fulltext/u2/a521462.pdf, also

Uriah King and Leslie Parrish, *Springing the Debt Trap: Rate Caps are Only Proven Payday Lending Reform,* Center for Responsible Lending, December, 2007, available at www.responsiblelending.org/payday-lending/research-analysis/springing-the-debt-trap.pdf

[4] Ibid, *Phantom Demand,* Center for Responsible Lending, July 2009, available at http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf

[5] Susanna Montezemolo, *Payday Lending Abuses and Predatory Practices,* in *The State of Lending in America and its Impact on U.S. Households*, Center for Responsible Lending, September, 2013, *available at http://responsiblelending.org/sites/default/files/uploads/10-payday-loans.pdf*
also,
Brandon Coleman and Delvin Davis, *Perfect Storm: Payday Lenders Harm Florida Consumers Despite State Law,* Center for Responsible Lending, March 2016, available at http://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl_perfect_storm_florida_mar2016_0.pdf

[6] CFPB, *Payday Loans and Deposit Advance Products*, April 2013, available at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf

[7] Ibid, *Supplemental Findings on Payday, Payday Installment, and Vehicle Title Loans, and Deposit Advance Products,* June 2016, available at http://www.consumerfinance.gov/data-research/research-reports/supplemental-findings-payday-payday-installment-and-vehicle-title-loans-and-deposit-advance-products/

[8] Dan Feehan, former CEO of Cash America, remarks at Jeffries Financial Services Conference, 06/20/07.

[9] excerpt from email dated 2/14/2011 from Hilary B. Miller, chairman of the pro-payday lender group, Consumer Credit Research Foundation, available (see Exhibit D) at http://campaignforaccountability.org/cfa-report-reveals-payday-lenders-paid-for-at-least-one-favorable-academic-study/

[10] The Pew Charitable Trusts, *Who Borrows, Where they Borrow and Why*, July 2012, available at http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf, also FDIC, *Alternative Financial Services and Prepaid Cards Findings*, National Survey of Unbanked and Underbanked Households, 2011, available at https://www.economicinclusion.gov/surveys/2011household/afs-and-prepaid-cards-findings/

[11] CFPB, *CFPB Data Point: Payday Lending*, March 2014, available at http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf

[12] Ibid, *Payday Loans and Deposit Advance Products*, April 2013, available at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf

[13] NonPrime101, *A Balanced View of Storefront Payday Borrowing Patterns, Report 7c,* March 2016, available at https://www.nonprime101.com/data-findings/

[14] Jonathan Zinman, *Consumer Credit: Too Much or Too Little (or Just Right)?* , February 2014, available at http://www.dartmouth.edu/~jzinman/Papers/CreditSupply_Zinman_JLS_2014.pdf

[15] Dennis Campbell, F. Asis Martinez-Jerez, and Peter Tufano, *Bouncing out of the Banking System: an Empirical Analysis of Involuntary Bank Account Closures,* Journal of Banking & Finance 36, no. 4 (April 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335873, also
Paige Marta Skiba and Jeremy Tobacman, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default*, Vanderbilt Law and Economics Research Paper No. 08-333, August 21, 2008, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319751, also
Brian Meltzer, *The Real Cost of Credit Access: Evidence from the Payday Lending Market,* The Quarterly Journal of Economics 126,, no. 1 (2011), available at http://web.law.columbia.edu/sites/default/files/microsites/transactional-studies/files/13PDL_realcosts_melzer_qje_pub_0.pdf

[16] Susanna Montezemolo and Sarah Wolff, *Payday Mayday: Visible and Invisible Payday Lending Defaults,* The Center for Responsible Lending, March 2015, available at http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf

[17] CFPB, *Online Payday Loan Payments,* April 2016, available at http://files.consumerfinance.gov/f/201604_cfpb_online-payday-loan-payments.pdf

[18] Brian Meltzer, *The Real Cost of Credit Access: Evidence from the Payday Lending Market,* The Quarterly Journal of Economics 126,, no. 1 (2011), available at http://web.law.columbia.edu/sites/default/files/microsites/transactional-studies/files/13PDL_realcosts_melzer_qje_pub_0.pdf, also
Scott Carell and Jonathan Zinman, *In Harm's Way? Payday Loan Access and Military Personnel Performance,* Review of Financial Studies, 27, no. 9 (2014), 2805-2840, available at http://rfs.oxfordjournals.org/content/early/2014/06/19/rfs.hhu034.abstract , also
Paige Marta Skiba and Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy*?, Vanderbilt Law and Economics Research Paper (2009, Paper No. 11-13) *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266215*
Dennis Campbell, F. Asis Martinez-Jerez, and Peter Tufano, *Bouncing out of the Banking System: an Empirical Analysis of Involuntary Bank Account Closures, Journal of Banking & Finance 36, no. 4 (April 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335873*

[19] Diane Standaert and Delvin Davis, *Payday and Car Title Lenders Drain $8 Billion in Fees Every Year,* The Center for Responsible Lending, May 2016, available at http://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl_statebystate_fee_drain_may2016_0.pdf