CRL REVIEW OF *DEFINING AND DETECTING PREDATORY LENDING*, BY DONALD P. MORGAN, FEDERAL RESERVE BANK OF NEW YORK, JANUARY 2007

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In a recent working paper, Donald Morgan, a researcher from the Federal Reserve Bank of New York, attempts to determine whether payday lending is predatory by comparing the welfare of households in states where payday lending is unlimited versus states where payday lending is not authorized. After a comparative analysis, Morgan concludes that "unlimited" payday lending enhances welfare. However,

MORGAN'S FINDINGS ARE FLAWED FOR THREE KEY REASONS:

- The comparisons attempted between unlimited payday and non-authorizing states in 2001 are impossible because states did not have the tools to effectively regulate or restrict payday lending at that time. Example: Morgan considers North Carolina a non-authorizing state—however, it had at least 500 stores during the analysis period and was one of the most saturated states in the country.

- Key definitions utilized by the research are overly narrow or are contradicted by available data. Example: Morgan, in part, defines vulnerable households as those with unpredictable future income. However, an industry survey notes that households are nearly three times likely to borrower payday loans because of unexpected *expenses*.

- Morgan's finding that unlimited payday lending leads to lower prices is in conflict with other research. Example: Researchers from the FDIC, using a national, random sample, found that most payday companies charge the maximum rate permitted by state law.

We discuss these points more fully below.

RESEARCH SUMMARY

In order to determine if payday lending is predatory, Morgan compares the welfare of households in states where payday lending is "unlimited" versus states where payday is not authorized. Morgan measures "welfare" in two ways: (1) household non-mortgage debt levels and (2) delinquent bill payments. Specifically, the study assumes the greater the level of debt and incidence of delinquency, the lower the household's welfare. Morgan concentrates on "risky" households, which he defines as those who believe they will face income uncertainty in the future and those with less than a college degree. The main data sources used for this survey is the Federal Reserve's 1995 and 2001 Survey of Consumer Finance, which gathers information on a little over 4,000 households' financial status.

Morgan finds that households in states where payday lending is unlimited enjoy a greater level of welfare than those in states where payday is not authorized. Therefore, he concludes that payday lending is not predatory.

The author also hypothesizes that payday lender competition, measured by payday loan shops per capita, decreases the costs of loans. Morgan compares fees reported in a 2001 survey with more recent state shop data and concludes that payday loans in states with higher payday stores per capita carry modestly lower costs.

The rationale and findings of this paper are flawed for the following reasons:

1. COMPARISONS BETWEEN "UNLIMITED" PAYDAY AND NON-AUTHORIZING STATES NOT POSSIBLE IN 2001 BECAUSE OF BANK AGENCY MODEL.

The crux of Morgan's findings rest on the comparison of states that had unlimited payday lending in 2001 to those that did not specifically authorize the product. Unfortunately, because of some mis-identifications of non-authorizing states and the "bank agency" model of payday lending prevalent across the country in 2001, this study—and its findings—are fundamentally flawed.

Morgan identifies 18 states that he determines not to allow payday. Indeed, some of these states expressly did not permit payday lending. Others had active payday stores operating and did not address these loans specifically in law. In all of these states, however, payday lending stores could still operate under a "bank agency" (sometimes called rent-a-bank or rent-a-charter) model, in which a payday lender partners with a federally-insured bank in order to export favorable lending laws from the bank's home state to consumers in states where lending is more restrictive.[1] These arrangements were commonplace in 2001 – one payday lending company alone had 431 shops in so-called non-authorizing states.[2] As a result, comparisons between unlimited payday lending states and those which did not specifically authorize payday (but in fact they were saturated with payday lending shops) are not possible. Notable examples are detailed in the Appendix.

2. QUESTIONABLE DEFINITIONS OF PREDATORY LENDING, RISKY HOUSEHOLDS, AND WELFARE.

Morgan's definition of predatory lending as a welfare-reducing event with negative impacts for families is certainly a reasonable approach for capturing this problem. Families preyed on by unscrupulous lenders could be said to have less overall welfare than families utilizing responsible credit products. However, his measurement of welfare is quite narrow, only taking into account a family's overall debt level and timeliness of bill payments. A more inclusive definition of predatory lending such as "the lack of a fair exchange of value or loan pricing that reaches beyond the risk that a borrower represents or other customary standards" as proposed by the FDIC could be part of a more suitable definition upon which to judge whether payday lending is predatory.[3]

Morgan also creates a "risky" household profile as a proxy for payday borrowers by using two variables: households who feel their future income may be uncertain and those without a college degree. While these households may indeed be more "at risk" than those with more income security and education, these proxies do not necessarily lead to a greater propensity to use payday loans. In fact, payday industry data shows that payday borrowers have similar education attainment levels as the overall population.[4] In addition, it is uncertainty of expenses (not income), which has been found to primarily drive payday consumption.[5] We posit that payday borrowers have relatively stable incomes, since the requirements for a payday loan include a bank account and a regular paycheck or other source of income.

In summary, while Morgan's attempts to define these murky topics are certainly commendable, the narrow interpretations of family welfare and likely payday borrowers make it impossible to draw broad conclusions regarding the impact of payday lending on the welfare of "risky" households. The author concedes this point in the Conclusion, in which he states, "…perhaps payday loans help risky households better manage their finances? It will take more data to confirm that particular conjecture…"[6]

3. PURPORTED LINK BETWEEN PAYDAY STORE SATURATION AND LOWER COSTS IN CONFLICT WITH REGULATOR DATA AND OTHER RESEARCH.

Morgan's finding that "payday loan rates and fees decline significantly as the number of payday lenders…increase" is contradicted by a number of other studies that strongly suggest state rate caps determine the typical payday loan fee. For example:

- In 2005 researchers affiliated with the Federal Deposit Insurance Corporation (FDIC) analyzed a random, national sample of 600 payday stores and found that payday lenders charged an effective annual percentage rate (APR) near the state statutory limit. These researchers concluded that "competition does not appear to affect fees charged in the way [one] normally thinks that competition will affect loan market interest rates."[7]

- Similarly, researchers at the University of North Carolina while reviewing regulator-collected data on NC-based payday firms noted in 2003 that a payday loan's APR is mostly a function of loan term because "most companies charge the maximum fees permitted by law."[8]

- In a 2004 analysis of Colorado payday lending data, Chessin found that a borrower's payday lending costs appear to be inelastic with 89.27 percent of all loans charging the state's maximum permissible rate. In fact, Chessin noted that despite an increase from 212 locations in 2000 to 616 locations at the end of 2004 (i.e. more stores per capita), the frequency of loans charged at the state limit *increased* albeit modestly from 89.27 percent in 2002 to 92.75 percent in 2004.[9]

One other issue with Morgan's analysis is his comparison of reported fees from 2001 with stores per capita from 2005. Given that the industry's regulatory landscape has changed rather dramatically since 2001 (as previously noted) and the total national number of payday loan shops has increased from some 10,000 in the beginning of 2001 to 23,000 shops thru 2005,[10] any comparison between fees charged in 2001 and storefront saturation in 2005 would likely be strained.

Appendix

Morgan identifies many states as not allowing payday lending in 2001 that were among the most payday saturated during that period. Each of the states listed below was categorized in *Defining and Detecting Predatory Lending* as a non-authorizing state.

- North Carolina was one of the most payday-saturated states in the nation at the time, with over 500 storefronts.[11] Even when the law authorizing payday lending expired at the end of August 2001, payday lending continued in the state unabated due to rent-a-bank charters. In 2005, an estimated 385 payday loan stores continued to operate in the state.[12] Not until a March 2006 Attorney General settlement agreement did payday lending effectively end in North Carolina.[13]

- Indiana was found to have a thriving $510 million a year payday loan industry operating within its borders in this time period, with an estimated 500 payday store locations throughout the state.[14]

- Arkansas passed a law authorizing payday lending in 1999. Despite a court challenge in 2001 because of the law's conflict with a state constitutional interest limitation of seventeen percent per annum, payday licenses were still granted and businesses continued to operate. In 2004, 275 payday stores were operating in Arkansas and these loans continue to be made in that state to this day.[15]

- Michigan's Attorney General reported about 650 payday lending storefronts in 2001.[16]

- In New York, the state regulator found thirty-two Internet payday lenders making payday loans to New Yorkers in 2000, many of which were partnered with County Bank, a Delaware state-chartered bank.[17] Attorney General Spitzer later sued and successfully shut down these arrangements along with the FDIC actions to halt these abuses of a bank charter.

- A 2001 survey found that payday loans were made by storefronts in Georgia and Virginia at triple-digit APRs through partnership with banks primarily located in Delaware.[18]

- In Pennsylvania, the Attorney General in 1999 stated his approval of payday stores operating there through the bank agency model despite being in excess of usury limits.[19]

- In West Virginia, First American Cash Advance opened it first stores in 2001 and quickly grew to 11 payday shops. Not until 2006 did the company suspend its operations in West Virginia.[20]

- Finally, legal challenges and regulatory interpretations enabled payday lending to continue in Alabama throughout 2001 despite loans exceeding the state's small loan interest rate cap.[21]

One of the largest payday lenders in the country—Advance America—has released its number of storefronts on a state-by-state basis for several consecutive years as part of its annual report. While this only documents one lender's market presence by state in 2001, it plainly demonstrates how states identified by Morgan as having not authorizing payday lending in fact had significant numbers of payday shops in operation during this time period.

State identified as "non-authorizing" in 2001 by Morgan	Advance America locations in 2001
Alabama	53
Arkansas	27
Georgia	67
Indiana	77
Michigan	27
North Carolina	124
Virginia	56

Just these seven "non-authorizing" states make up over a quarter of Advance America's total 1,558 locations in 2001.

[1] Further discussions of the bank agency model of payday lending can be found in *Rent-a-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections* (at http://www.consumerfed.org/pdfs/paydayreport.pdf) and, more recently, in *Georgia's Payday Loan Law: A Model for Preventing Payday Lending* (at http://www.responsiblelending.org/issues/payday/policy/page.jsp?itemID=29472890).
[2] Appendix table from Advance America's annual reports. On file with author.
[3] FDIC Financial Institution Letter. Supervisory Policy on Predatory Lending, January 22, 2007. Available at http://www.fdic.gov/news/news/financial/2007/fil07006.html.
[4] The Community Financial Services Association released an *Analysis of the Payday Advance Industry* in 2001, which found that 27% of payday borrowers had at least some college and 11% held a college degree. In comparison, they report that 28% of the total adult population had at least some college and 13% held a college degree. A 2002 IO Data survey of 2,600 payday borrowers found that 34% had at least some college and 21% held at least a college degree.
[5] See findings from a 2002 IO Data survey of 2,600 payday borrowers commissioned by the Community Financial Services Association of America (CFSA), which found that 52% of borrowers took out a payday loan because of an unexpected expense and 10% because of an expected expense, compared to 18% that had a temporary reduction in income.
[6] *Defining and Detecting Predatory Lending*, page 22.
[7] From *Payday Lending: Do the Costs Justify the Price*, Mark Flannery and Katherine Samolyk, pg 9-10. June 2005
[8] From *Payday Lending: A Business Model that Encourages Chronic Borrowing*. Michael Stegman and Robert Faris, pg 23. Economic Development Quarterly, March 2003

[9] From *Borrowing Peter to Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act*, 400; 408-409. Denver University Law Review, Vol. 83, Iss. 2

[10] Stephens Inc. *Presentation at CFSA Conference*, March 2, 2006; Stephens Inc. *Update on the Payday Loan Industry: Observations on Recent Industry Developments*, September 26, 2003.

[11] From *Rent-a-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections*, Consumer Federation of America and the U.S. Public Interest Research Group, November 2001. Available at http://www.consumerfed.org/pdfs/paydayreport.pdf.

[12] From *Race Matters: The Concentration of Payday Lenders in African-American Neighborhoods in North Carolina*, Center for Responsible Lending, March 2005. Available at http://www.responsiblelending.org/issues/payday/reports/page.jsp?itemID=28012448.

[13] *Payday Lending on the way out in NC,* press release by North Carolina Attorney General, March 1, 2006. Available at http://www.ncdoj.com/DocumentStreamerClient?directory=PressReleases/&file=paydaylenders3.06.pdf

[14] From *Race Matters: The Concentration of Payday Lenders in African-American Neighborhoods in North Carolina*, Center for Responsible Lending, March 2005. Available at http://www.responsiblelending.org/issues/payday/reports/page.jsp?itemID=28012448.

[15] Payday Lenders in Arkansas: The Regulated and the Unregulated, Arkansans Against Abusive Payday Lending, February 2006. Available at http://www.stoppaydaypredators.org/pdfs/news%20articles/06_0200_Payday_U_Study.pdf.

[16] Gregg Krupa, *The Detroit News*, "Payday Loans Trap Borrowers," August 19, 2001.

[17] From *Internet Payday Lending : How High-Priced Lenders Use the Internet to Mire Borrowers in Debt and Evade State Consumer Protections*, Consumer Federation of America, November 2004. Available at http://www.consumerfed.org/pdfs/Internet_Payday_Lending113004.pdf.

[18] From *Rent-a-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections*, Consumer Federation of America and the U.S. Public Interest Research Group, November 2001. Available at http://www.consumerfed.org/pdfs/paydayreport.pdf.

[19] From *Show Me the Money! A Survey of Payday Lenders and Review of Payday Lender Lobbying in State Legislatures*, Consumer Federation of American and the U.S. Public Interest Research Group, February 2000. http://www.uspirg.org/uploads/0J/JI/0JJIxjolTQlIpsOOhaP_dg/showmethemoneyfinal.PDF.

[20] Greg Hohmann, *Charleston Daily Mail*, "State's only payday lender leaves the area," October 27, 2006 at http://www.pliwatch.org/news_article_061027A.html

[21] From *Show Me the Money! A Survey of Payday Lenders and Review of Payday Lender Lobbying in State Legislatures*, Consumer Federation of American and the U.S. Public Interest Research Group, February 2000.