April 2, 2013

Via Facsimile and E-mail

The Honorable Lou Correa, Chair
Senate Banking and Finance Committee
State Capitol, Room 405
Sacramento, CA 95814

RE: SB 515 (Jackson) – Support

Dear Chairman Correa:

I am writing on behalf of the Center for Responsible Lending (CRL), one of the sponsors of SB 515 by Senator Hannah Beth Jackson, along with National Council of La Raza (NCLR), the California Reinvestment Coalition (CRC) and Public Interest Law Firm, a program of the Law Foundation of Silicon Valley (PILF). SB 515 would implement much needed reforms to payday lending that would bring the product in line with its advertised purpose and suitable use, *i.e.*, as a short-term source of funds for an occasional emergency. SB 515 targets the problem of the debt trap, to ensure that borrowers are able to take out and repay their loans without having to borrow again before their next payday.

SB 515 includes three principal reforms. First, SB 515 limits the number of loans that lenders can provide to any borrower at 4 per year. This loan cap would be enforced by the implementation of a real-time database to which all licensees would be required to report. Second, SB 515 extends the minimum term of a payday loan, so that borrowers will have more time to accumulate the amounts necessary to repay it. Finally, SB 515 proposes to require all lenders to apply standardized underwriting guidelines to ensure that borrowers have a reasonable ability to repay their loans without having to reborrow.

CRL is a national organization working to eliminate abusive lending practices. We have undertaken research and policy work on payday lending for 10 years, in states all over the country. We are also affiliated with Self-Help, one of the nation's largest national Community Development Financial Institution whose mission is to build wealth among lower income populations. Self Help Federal Credit Union launched its operations in California in 2008 with a mission to create ownership and economic opportunity for low-income communities and is now one of the largest CDFI's in the state. We have grown primarily by merging with local credit unions whose board members, in the face of a dire economic climate, were looking to join with a larger community development credit union in order to better serve their members over the long term.

Self-Help Federal Credit Union (SHFCU) has launched a pilot credit union concept, called Community Trust Prospera (formerly called "Micro Branch"), designed specifically around the needs of families that are living paycheck-to-paycheck. A hybrid of a check casher and a credit union branch, CT Prospera "meets unbanked customers where they are" providing check cashing, remittance and other services in a convenient and comfortable environment with extended hours. But unlike a check casher, its tellers are trained to deliver "in-line financial education" at the point of service, nudging customers toward mainstream financial products such as savings and checking accounts, and responsible loan products.

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www.responsiblelending.org

Through both its traditional full-service branches and the Prospera hybrid branches – SHFCU now provides responsible financial products and services to nearly 50,000 members and customers in the Central Valley, the greater Bay Area and Los Angeles.

Structural Features of Payday Loans Cause the Debt Trap

By design, the key features of a payday loan contribute to the payday debt trap.

First, the fact that a payday loan is a very high-cost loan coupled with an extremely short term of about two weeks makes it exceedingly difficult for borrowers to pay off the loan in full as required, without facing another financial shortfall before meeting all of their monthly expenses.

New Pew Trust research shows that the average borrowers can only afford to repay $50 after two weeks after covering other expenses, while the typical repayment required in California is $300.[1] The cost to reborrow in California is a seemingly more manageable $45 out-of-pocket, since they will still owe the full $300 on their next paycheck. As such, borrowers end up taking out new loans not because they have a new financial need, but because they cannot afford to repay the loan and cover basic expenses without taking a new loan. This reality turns payday loans into long term debt.

Second, state law does not require payday lenders to evaluate a borrower's likely ability to repay a payday loan from income based on the borrower's income and expenses, and without having to borrow again. Department of Corporations data show that, indeed, most borrowers cannot repay payday loans without borrowing again and that a very large proportion of loans go to borrowers who take out more six loans per year.

SB 515 Would Align Payday Loans With Their Intended Purpose As Short-Term Loans

Payday loans are small, short-term loans that are sold as a quick, easy way to tide borrowers over until their next payday. In California, a consumer can borrow up to $255. For a $255 loan, the borrower writes a $300 check ($255 loan plus $45 interest) that will be due typically about 2 weeks later, amounting to an annual interest rate of 459%. Payday loans are marketed and publicly rationalized as short-term loans for an occasional, unexpected expense, and inappropriate for long-term use. The Community Financial Services Association of America, a national payday trade association states as much on its website.[2]

> *[A] payday advance is inappropriate when used as a long-term credit solution for ongoing budget management. . . . A payday advance should be used responsibly and for* ***only the purpose for which it is intended: To solve temporary cash-flow problems*** *by bridging the gap between paydays. A payday advance is designed to provide short-term financial assistance.* ***It is not meant to be a long-term solution.***
>
> *-Community Financial Services Association of America*
> *(payday trade association) (emphases added)*

Despite these types of notices and warnings in public statements, payday lenders admit in private and research supports that the business model is designed to keep borrowers coming back for more and more payday loans.[3]

CRL research confirms the success of this business model, showing that three-quarters of payday lending volume is generated by churning.[4] The unique structure of a high-cost loan with a balloon payment due in only two weeks inherently sets borrowers up to need a new loan to fill the financial gap that results after paying off the first loan in full. The Department of Corporations noted a similar finding in its 2007 report: "This data indicates that [California customers who took consecutive payday loans] are able to pay off the payday transactions on the due dates, but not meet their expenses without engaging in another deferred deposit transaction."[5] A Recent Pew report found that a mere 14 percent of payday borrowers were able to afford to repay a typical payday loan from their monthly budgets.[6]

By prohibiting lenders from making more than 4 loans to any borrower in a twelve month period and providing a mandatory payment plan for borrowers who cannot repay a loan, SB 515 would align the structure of payday loans with their stated purpose by keeping payday loans available for true emergencies, and by making it easier for borrowers to repay them without the need to re-borrow in order to do so. This would maintain payday loans as short-term solutions, while preventing borrowers from falling into long term payday debt. In 2005, the FDIC issued guidelines recommending that borrowers should be restricted from having payday loans outstanding from any payday lender for more than three months in any 12-month period, finding that longer term use is not appropriate.[7]

Similarly, after evaluating whether payday loans are the appropriate source of credit for California consumers, the Department of Corporations concluded in its 2007 report on payday lending:

> "In terms of overall costs to consumers, the payday loan product may be appropriate for those customers who limit their use to one deferred deposit transaction and for those customers who engage in two to five payday transactions spread throughout the year. A longer-term, less costly installment loan product may be more appropriate for a substantial category of customers whose use appears more perpetual rather than occasional."[8]

SB 515 would implement reforms consistent with this conclusion.

In Washington State, an annual 8-loan loan cap that became effective on January 1, 2010 has proven effective in dramatically reducing the long-term debt trap that payday lending typically becomes, while keeping payday loans available to Washington consumers. Data from Washington's database provides strong evidence that the 8-loan limit has put a brake on the worst of the long-term payday lending debt in that state.[9]

- **Washington's payday loan volume decreased by 75% between 2009 and 2011.**[10] This reduction eliminated loans that were going to borrowers who were constantly churning their payday loans and taking out more than 8 loans per year. In 2009, more than 90,000 Washington borrowers (more than one in five) took out more than 12 loans – or more than one every month, accounting for 52 percent of all payday loans issued in Washington in 2009.[11]

- **More borrowers able to use payday for truly occasional borrowing**. The 8 loan limit has meant that more Washington borrowers are using payday loans as they are advertised – as an occasional loan. In 2011, 71 percent of all borrowers took 1 to 4 loans with 28 percent taking only one loan.[12]

By contrast, in 2009, only 44 percent of all borrowers took 1 to 4 loans with just 18 percent taking only one loan.[13]

- **Washington consumers have saved millions of dollars in fees.** The shrinking number of payday loans has saved consumers $136 million in fees. This money can instead be put back into the state economy rather than in the pockets of payday lenders based in Texas, South Carolina, Ohio and elsewhere.[14]

- **The 8-loan cap effectively reduces but does not eliminate the payday debt trap.** Nearly one in four payday borrowers in Washington, 24 percent, reached the 8-loan limit (in 2011).[15] These borrowers were still in payday loan debt for nearly eight months of the year (with average loan terms of 28.7 days), longer than the FDIC-recommended limit of three months.[16]

The 4-loan limit proposed by SB 515 would even more effectively address long-term lending, while continuing to keep payday loans available for truly occasional borrowing and short-term use.

Payday Loans Become Long-Term Debt That Cause Serious Financial Hardship

Under existing law, payday borrowers typically get trapped in a cycle of long term debt that does more harm than good.

Payday Loans Trap Californians in Long-Term Debt

The most recent annual data from the California Department of Corporations (DoC) show that in 2011, Californians took out more than 12.43 million payday loans.[17] In the raw, the 2011 numbers (12.43 million loans taken by 1.74 million borrowers) suggest that the average California borrower takes out slightly more than 7 loans per year, but these numbers do not account for payday borrowers who borrow from multiple stores or where multiple people from the same household take out payday loans.[18] A detailed 2007 report and study on payday by the DoC take these factors into account and reveal an even greater pattern of repeat lending.

- *Most Borrowers Are Regular Users*: The average number of loans for the one million borrower households was nearly 10, exceeding the national average of 9 per year.[19]
- *Most Loans Go to Borrowers Caught in a Debt Trap*: Nearly 450,000 borrowers had back-to-back spells of 6 loans or more, conservatively accounting for more than 50% of all loans.[20]
- *For Many Borrowers, There is No Way Out*: 57,147 borrowers had more than 19 consecutive transactions during 2006. These borrowers accounted for only 4% of borrowers, but a startling 25% of the 10 million loans taken out in 2006.[21]
- *Very Few Borrowers Take Just One Loan*: Less than 4% of loans went to one time borrowers.[22]

These figures show that significant numbers of California borrowers are finding themselves caught in the payday loan debt trap for long periods of time. As the California Department of Corporations (DoC) has acknowledged, "[W]hen payday loans are used for a long period of time, the fees charged can rapidly exceed the amount borrowed and can create a serious financial hardship for the borrower."[23] Adopting a loan limit would help borrowers avoid utilizing payday loans as a long-term source of credit.[24]

Payday Loans Do Not Solve A Financial Emergency. They Leave Borrowers Worse Off

Economists studying payday lending have found that it leads to significant economic harms even beyond the debt trap for borrowers who are generally living paycheck-to-paycheck with little financial cushion.

- *High Incidence of Defaults on Payday Loans.* Although default rates on individual loans are very low, half of all payday borrowers end their cycle of repeat loans by default.[25]
- *More Frequent Credit Card Delinquencies.* Payday borrowers are more likely to become seriously delinquent on their credit cards than similarly-situated people who do not use payday loans.[26]
- *Other Financial Harms:* Households with access to payday loans are more likely to pay the mortgage rent or other bills late, and delay medical care and prescription drug purchases.[27] No evidence that payday loan access mitigates financial distress.[28]
- *More Overdrafts and Loss of Bank Accounts:* Use of payday lending actually *increases* overdraft fees and many borrowers lose their bank accounts due to excessive overdrafts.[29]
- *Bankruptcy*. Borrowers who are approved for a payday loan, as opposed to those who are *denied* a payday loan, are almost 90% more likely to file for bankruptcy.[30]

SB 515 Will Reduce Borrowers' Need for Additional Loans And Otherwise Alleviate the Harms of Payday Loans

Virtually all Western states have taken policy action in the last few years that target the debt trap feature of payday loans. Arizona and Montana enacted rate caps by ballot initiative.[31] Oregon legislated longer terms and rate caps.[32] Colorado mandated longer term installment loans (of no less than six months).[33] Washington State established an annual cap on the number of loans per borrower.[34]

While other states have acted, California has reached a political stalemate in recent years. **It is time for California to act.** SB 515 offers real reforms to payday loans that will help end the debt trap while keeping payday loans available to Californians in times of true emergencies. The bill would accomplish the following:

Keep Payday Loans for Short Term Emergencies, Not Long-Term Debt: Place an Annual Loan Limit on Payday Loans. The payday lending industry asserts that its product is intended for occasional, short-term use. SB 515 would prohibit lenders from making more than 4 loans to any consumer in a 12 month period. Capping the number of loans that payday lenders can make to a borrower each year would, therefore, be consistent with the industry's definition of responsible use, and would prevent payday loans from becoming long-term debt.[35] This reform would maintain the current cost of a payday loan at $15 per $100, while ensuring that its use is truly short term. SB 515 would also implement a database to facilitate and enforce the loan limit, as well as a required repayment plan so that borrowers can affordably pay off the 4th loan without reborrowing, or otherwise pay off the loan over time when they are unable to repay the loan by its due date.

The creation of the database also provides the Department of Corporations with a powerful new tool to collect and analyze the utilization of payday loans, leaving the Department well-positioned to produce much more informative annual data reports. SB 515 also specifies additional data elements which are to be included in the annual report. This data will serve an important public purpose: to better inform all stakeholders about how payday loans are used going forward.

Give Families More Time to Repay a Payday Loan Without the Need to Borrow Again: Extend the Minimum Loan Term. The extremely short term of a payday loan is one of the key features that serves to trap borrowers in long term debt. SB 515 would provide for terms of 30 days per $100, or 30, 60 and 90 day terms depending upon the amount of the check. These terms are in line with Pew research finding that they typical payday borrower can only afford to pay $100 per month after other expenses.[36] Extending the term would give borrowers more time to repay the loan, making it more likely that the borrower will be able to accumulate the funds to pay off the loan without taking out another one.[37]

Ensure That Families Can Afford to Repay a Payday Loan: Require Robust Underwriting. Families fall into a cycle of repeat lending with payday loans because they cannot afford to repay the loan after two weeks and still meet their basic expenses. SB 515 requires payday lenders to evaluate each borrower's ability to repay the loan, modeled on underwriting provisions of the small-dollar loan pilot program.[38] This reform may also help borrowers repay their loans without the need to borrow again.

A fundamental lesson of the subprime mortgage crisis is that responsible lending requires that lenders evaluate a borrower's reasonable ability to repay the loan out of income without having to reborrow again. California has begun to implement this standard in the small dollar loan pilot program, and should apply it to all loans covered by the California Finance Lenders Law. It is critical however, to establish meaningful underwriting standards for payday loans and all other consumer finance loans. Without some consistent standards, lenders who do not use underwriting will attract the most-vulnerable borrowers with the least ability to pay to their products. By definition, these borrowers will be most likely to default, and thereby drive up the price of lending to cover higher level of defaults. This kind of high-cost, high-default model is undesirable.

For these reasons, CRL strongly supports SB 515 and urges your support when the bill comes up for a vote. Should you have any questions, please do not hesitate to contact me, or my Legislative Associate Lara Flynn, at 916/444-3509.

Sincerely,

Paul Leonard
Director, California Office

cc: Senator Hannah-Beth Jackson
Honorable Members, Senate Banking & Finance Committee
Eileen Newhall, Staff Director, Senate Banking & Finance Committee

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[1] *Payday Lending in America: Report 2; How Borrowers Choose and Repay Payday Loans* at 13-15 (The Pew Charitable Trusts Feb. 2013) [hereinafter *Pew Report 2*], available at http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Safe_Small_Dollar_Loans/Pew_Choosing_Borrowing_Payday_Feb2013.pdf.

[2] *See* http://cfsaa.com/what-is-a-payday-advance/is-a-payday-advance-appropriate-for-you.aspx.

[3] In addition to the data itself, industry pronouncements make this clear. For example, Dan Feehan, CEO of Cash America remarked at the 2007 Jefferies Financial Services Conference: "And the theory in the business is 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." *See id.* at 1. Others in the industry have a similar analysis: "The financial success of payday lenders depends on their ability to convert occasional users into chronic borrowers," "This industry could not survive if the goal was for the customer to be 'one and done'. Their survival is based on the ability to create the need to return, and the only way to do that is to take the choice of leaving away." *See id.* at 10-11.

[4] Leslie Parrish & Uriah King, *Phantom Demand: Short-Term Due Date Generates Needs for Repeat Payday Loans, Accounting for 76% of Total Volume* (Center for Responsible Lending July 9, 2009), available at http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf.

[5] *California Deferred Deposit Transaction Law, Report to the Governor and the Legislature as Required by Financial Code Section 23057* at 15 (Dec. 2007), hereinafter "DOC Report," available at http://www.corp.ca.gov/Laws/Payday_Lenders/Archives/pdfs/CDDTL07_Report.pdf. Note, however, that the DoC defined

"consecutive" transactions as one taken out within 4 business days of paying off a prior loan, *id.* at 14, underestimating the number of borrowers who were unable to get to their next payday after repaying a payday loan.

[6] *Pew Report 2* at 6.

[7] Federal Deposit Insurance Corporation, *Payday Lending Programs Revised Examination Guidance* (Mar. 1, 2005), available at http://www.fdic.gov/news/news/financial/2005/fil1405a.html.

[8] 2007 DoC Report at 14.

[9] Washington State Department of Financial Institutions, *2011 Payday Lending Report* (2012) [hereinafter *2011 WA Report*], available at http://www.dfi.wa.gov/cs/pdf/2011-payday-lending-report.pdf.

[10] *Id.* at 5.

[11] Calculations based on Washington loan frequency data. *See* Washington State Department of Financial Institutions, *2009 Payday Lending Report* at 4-5 (2010) [hereinafter *2009 WA Report*], available at http://www.dfi.wa.gov/cs/pdf/2009-payday-lending-report.pdf.

[12] *2011 WA Report* at 10-11.

[13] *2009 WA Report* at 6-7.

[14] The California economy would similarly benefit from fee savings by California consumers. None of the top 5 payday lenders (by number of locations) in California are California companies, and only 1 of the top 10 lenders is based in California. The money saved by consumers would be spent in California, rather than sent to companies out-of-state (or even out of country, in the case of Advance America, the top payday lender in California).

[15] *2011 WA Report* at 7.

[16] Federal Deposit Insurance Corporation, *Payday Lending Programs Revised Examination Guidance* (Mar. 1, 2005), available at http://www.fdic.gov/news/news/financial/2005/fil1405a.html.

[17] Department of Corporations, *2011 Annual Report: Operation of Deferred Deposit Originators Licensed Under the California Deferred Deposit Transaction Law* at 4 (Oct. 31, 2012), available at http://www.corp.ca.gov/Laws/Payday_Lenders/pdfs/CDDTL2011ARC.pdf. The number of payday loans taken by Californians has been steadily growing since 2006, with the total 2011 volume nearly 25% higher than the 2006 volume. *Id.*

[18] *Id.*

[19] The number of loans in 2006 was 10,048,422. DoC Report at 6, Table 1-1. The total number of borrower families was 1.01 million. *See 2007 Department of Corporations Payday Loan* Study at ix (Applied Management & Planning Group Dec. 2007; Updated June 2008), available at http://www.corp.ca.gov/Laws/Payday_Lenders/Archives/pdfs/PDLStudy07.pdf.

[20] DoC Report at 13, Table 2-1. 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 10.048 million, the total number of loans.

[21] *Id.*

[22] *Id.* This was calculated by assuming 387,338 loans were made to single loan borrowers, and dividing by 10.048 million, the total number of loans.

[23] DOC Report at 44.

[24] *Id.*

[25] Researchers from Vanderbilt and Oxford found that over half (54%) of all payday borrowers will default in the first twelve months based on an analysis with two million observations. Paige M. Skiba, & Jeremy Tobacman, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default* (Aug. 21, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319751. CRL later found that 44 percent of borrowers will experience a "return event" or default in which borrowers cannot service their payday loan debt in a timely manner. Uriah King & Leslie Parrish, *Payday Loans, Inc. Short on Credit, Long on Debt* (Mar. 31, 2011), available at http://www.responsiblelending.org/payday-lending/research-analysis/payday-loan-inc.pdf.

[26] Using a database of Texas borrowers, the authors find that taking out a payday loan makes a borrower 92 percent more likely to become seriously delinquent (i.e., 90 days or more late) on their credit card during the year. *See* Sumit Agarwal, et al., *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?* (NBER Working Paper No. 14659) (Jan. 13, 2009), available at http://www.nber.org/papers/w14659.

[27] *See* Brian T. Melzer, "The Real Costs of Credit Access: Evidence from the Payday Lending Market," *Quarterly Journal of Economics* (2011), available at http://qje.oxfordjournals.org/content/126/1/517.full.pdf.

[28] *Id.*

[29] An increase in payday lending locations in a particular county is associated with an 11 percent increase in involuntary bank account closures (generally due to the account being excessively overdrawn), even after accounting for county per capita income, poverty rate, educational attainment, and a host of other variables. *See generally* Dennis Campbell, et al., Harvard Business School, *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures* (Dec. 3, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335873. For a more general discussion, see Center for Responsible Lending, *Payday Puts Families in the Red*, available at http://www.responsiblelending.org/payday-lending/research-analysis/payday-puts-families-in-the-red-final.pdf.

[30] *See* Paige M. Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* (Nov. 9, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266215.

[31] In 2010, Montana voters passed I-164, which capped annual interest rates on payday loans at 36%, by a vote of approximately 72% to 28%. *See* http://ballotpedia.org/wiki/index.php/Montana_Loan_Interest_Rate_Limit,_I-164_(2010). *See also* MT Code Ann. §§ 31-1-701 *et seq.* Arizona Proposition 200 in 2008 would have eliminated the sunset on payday lending authorization in Arizona, but it was defeated by a vote of approximately 60% to 40%. *See* http://ballotpedia.org/wiki/index.php/Arizona_Payday_Loan_Reform,_Proposition_200_(2008).

[32] Or. Stat. Ch. 725.

[33] Co. Rev. Stat. §§ 5-3.1-101, *et seq.*

[34] Wash. Rev. Code §§ 31.45.010, *et seq.*

[35] The FDIC Guidelines provide that a borrower should be restricted from having payday loans outstanding from any payday lender for more than three months in any 12-month period. Federal Deposit Insurance Corporation, *Payday Lending Programs Revised Examination Guidance* (Mar. 1, 2005), available at http://www.fdic.gov/news/news/financial/2005/fil1405a.html.

[36] *Pew Report 2* at 13-15.

[37] In 2010, Colorado amended its payday statute to make the minimum loan term 6 months. *See* Colorado House Bill 10-1351 (Approved May 2010), available at http://www.state.co.us/gov_dir/leg_dir/olls/sl2010a/sl_267.htm. Additionally, in 2007 Congress restricted payday lending to the military, and among other things provided for a minimum 91 day term. See John Warner National Defense Authorization Act for Fiscal Year 2007 Section 987, available at http://www.govtrack.us/congress/bills/109/hr5122.

[38] Cal. Finance Code § 22352(g)(3).