H.R. 1214, THE PAYDAY LOAN REFORM ACT OF 2009

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

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H.R. 1214, THE PAYDAY LOAN REFORM ACT OF 2009

Thursday, April 2, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:30 p.m., in room 2128, Rayburn House Office Building, Hon. Luis V. Gutierrez [chairman of the subcommittee] presiding.

Members present: Representatives Gutierrez, Maloney, Watt, Sherman, Moore of Kansas, Waters, McCarthy of New York, Baca, Green, Clay, Miller of North Carolina, Scott, Cleaver, Ellison, Meeks, Perlmutter, Speier, Childers, Minnick; Hensarling, Castle, Royce, Capito, Garrett, Neugebauer, McHenry, Marchant, Lee, Paulsen, and Lance.

Chairman GUTIERREZ. This hearing of the Subcommittee on Financial Institutions and Consumer Credit will come to order.

Good afternoon, and thanks to all of the witnesses for agreeing to appear before the subcommittee today. Today's hearing is a legislative hearing that will examine H.R. 1214, the Payday Loan Reform Act of 2009.

We will be limiting opening statements to 10 minutes per side, but without objection, all members' opening statements will be made a part of the record.

I yield myself 5 minutes.

Over the last 2 decades, payday lending has become a very controversial source of credit in many of our communities. The payday loan industry is grown in size from roughly 300 offices in 1992 to over 24,000 last year. As our constituents are faced with even tougher economic conditions during this recession, they are more and more likely to turn to the services offered by the payday lending industry to pay for emergency car repairs, an unexpected doctor's bill, and even groceries for their families. Many of these families have been ignored or shut out of the mainstream financial services industry and have nowhere else to turn for credit.

The last hearing on payday lending in front of the House of Representatives was held in March of 2007, and much has changed in those 2 years. More States have enacted protections against abusive payday loan practices by enacting cap rates or by banning payday lending all together. A select few States like New York, North Carolina, Pennsylvania, and West Virginia have banned payday lending altogether and many States do not offer their citizens even a decent level of protection against abusive payday practices. And, seven States failed to have any cap on small loan rates.

Missouri, for example, has an APR cap as high as 1,955 percent. While I have and will continue to support consumer groups' tireless efforts to eliminate abusive practices, in the lending industry, they are fighting an uphill battle against better-funded lobbyists in States like Delaware, New Hampshire and Wisconsin, where there is no rate cap at all.

[chart]

Chairman GUTIERREZ. This chart separates States into three classes: those that have banned payday lending, first; those that kept interest rates for payday lenders at 15 percent or 391 percent APR; and, either those that have no cap at all or have a cap in place that exceeds 391, which is the largest number of 26 States there, the object of my bill is to move all 23 of the States in the far right column over to the middle column. Then the consumer groups will have a realistic opportunity to work their magic and move as many States as possible over to the far left column.

By the way, that column on the far right represents almost 113 million who would be helped by the bill. The current state of affairs for those consumers is unacceptable, and Congress would be derelict in its duty if we allowed them to remain unprotected from abusive and predatory lending. H.R. 1214, the Payday Loan Reform Act of 2009, creates significant protections from abusive payday practices by preventing rollovers and freeing consumers from the debt trap by mandating a cost-free 90-day repayment plan.

The bill lowers the effective APR of a payday loan to 48 percent of 15 cents for every dollar loan. This is a rate that is lower than the 23 current State rate caps, including California, Colorado, New Hampshire, and even my home State of Illinois. My legislation would also prohibit unfair mandatory arbitration clauses, provide increased disclosure, and honor all existing, stronger State protections by creating a Federal floor on which stronger laws can be built.

We may hear from the consumer groups today that a similar law that was passed in Illinois has been a failure, but according to the State Department of Financial Institutions, Illinois' 15.5 percent rate cap has already saved consumers in our State over $35 million since its enactment in December of 2006. My bill would move that rate cap even lower.

I recognize that my bill is not a cure-all for this issue. My intent with H.R. 1214 is to give the efforts to protect consumer rights a boost by creating a minimum level of protection that all consumers will enjoy. This legislation would lower the APR cap for nearly 113 million Americans immediately upon its enactment, despite complaints from the industry that the bill sets rate caps too low and assertions from consumers that the bill does not go far enough.

I think that improving protections for 113 million consumers is a significant step in the right direction. The status quo in the payday industry is unacceptable. The Payday Loan Reform Act says "no" to the status quo. It would protect millions of Americans from abusive lending practices in one fell swoop.

I look forward to hearing the testimony of our panelists and also look forward to a lively debate on this controversial issue.

I yield to the gentleman, Mr. Hensarling, 5 minutes for his opening statement.

Mr. HENSARLING. Thank you, Mr. Chairman.

Congress and the Financial Services Committee continue to enact legislation that retracts credit in the middle of a recession. There is the mortgage cramdown that made mortgage loans more expensive for some and inaccessible to others.

Now, just a few moment ago, the credit card bill, which will deny credit to some may get more expensive to others; now, we have the payday lending bill. The bill before us, I fear, essentially does two harmful things: Number one, it establishes price controls; and number two, it erodes risk-based pricing, which permits people, particularly low-income people who haven't had access to credit before, to finally have access to needed credit.

What will the outcome be if we pass this legislation? Again, consumers will lose. They will lose choices. They will lose credit. They will lose economic freedom. What will they gain? They will gain bounced checks. They will gain utility reconnect fees. They will gain eviction notices, and they will gain the opportunity to be forced into the underground economy.

Now, I continue to observe. Particularly, I have been involved in the budget debate on the Floor. And listening to my colleagues on the other side of the aisle here, how many talk about the benefits of the free enterprise system? Yet, we continue to have legislation after legislative initiative that appears to attack it and erode it daily.

I would remind my colleagues that just because you don't need or you don't appreciate a particular service doesn't mean that your neighbor doesn't. Now, I know we will hear a number of sad stories about people who are caught up in cycles of debt, and I assume they are all true, and my heart will go out to these people. But I wonder though, if this never-ending cycle of debt that we hear so often, is that a symptom? Or is that the cause? My belief is that it is probably the symptom, and, indeed, I have a quote from a recent Federal Reserve study that said:

"There is no evidence that loan rollovers and repeat borrowers affect store profits beyond their proportional contribution to total loan volume. In other words, the industry's profitability does not depend on the presence of repeat borrowers, per se."

So I believe we need to go to the root cause of the problem, not the symptom; the root cause of the economic turmoil that is affecting the lives of our citizens.

We need to pass policies in this Congress and in this committee that will help preserve our fellow citizens' jobs today and grow better job opportunities tomorrow, and prevent punitive taxes from shrinking their already-shrinking paycheck.

I have a suggestion. We could start this afternoon by rejecting the Democratic budget which establishes a national energy tax which CBO says could impact families at $1,600 a month—$300 billion of new taxes for small businesses with all the layoffs that would be associated with that.

Again, if we pass this legislation, I believe that consumers are going to be forced into many alternatives that they may find more harmful to them. The average telephone reconnect fee is $50, maybe many consumers would have preferred to pay the $15 market fee to borrow the hundred. The average cable reconnect fee can be as much as $100. Again, there are many consumers who would prefer to pay the $15 than the $100 reconnect fee.

A bounced check can average $28.23. Overdraft fees can be $56. Now, if we get focused on APR, which may or may not be the best way to judge these loans, a bounced check can have an APR of 755 percent, and you add the overdraft fees. All of a sudden on that same $100 loan, you are at 1,449 percent.

The Chairman of the FDIC has said, "when used on a recurring basis for small amounts, the APR for fee-based, bounced protection far exceeds the APRs associated with payday loans. And, given that these tend to be small, short loans to people who were credit risky without collateral, there are fixed costs associated with these loans. The default rates are high. Of course this APR is going to be large, but why take away the option of what the consumer wants to do?

Why replace his judgment or her judgment with ours?

The answer is economic growth, economic opportunity for our neighbors, a competitive market, and effective disclosure.

Mr. Chairman, thank you, and I yield back the balance of my time.

Chairman GUTIERREZ. The gentleman yields back the balance of his time.

Mr. Moore, you are recognized for 1 minute.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman, for holding this hearing and for your hard work in drafting H.R. 1214, the Payday Loan Reform Act. I am proud to be a co-sponsor of this balanced legislation, and whenever we have industry on one side saying the bill goes too far, and consumer groups saying it doesn't go far enough, we are probably striking close to a proper balance.

In Kansas, we already have laws on the books protecting consumers that are nearly identical to H.R. 1214. Our State law already limits a maximum fee of 15 cents per dollar advance in advance rollovers. Applying these kinds of consumer protections to all States would probably permit States with tougher payday lending laws to maintain those requirements. That, I believe, is the right approach.

Thank you, Mr. Chairman. I yield back.

Chairman GUTIERREZ. Thank you.

Mr. Paulsen is recognized for 2 minutes.

Mr. PAULSEN. Thank you, Mr. Chairman, for holding this hearing today.

At a time when the credit markets are frozen or certainly drying up, I think it is very important that we ensure that we bring as much liquidity into the market as possible, and we need to make sure that there are as many options as possible that are available for consumers. I found it interesting that a recent report by the Federal Reserve Bank of the State of New York noted that payday lenders fill a very valuable niche market where banks and credit unions have left a void.

The study found that people in those States that banned payday loans bounced more checks. They filed more complaints about lenders and debt collectors and they filed for bankruptcy at a higher rate. So, I want to make sure that any legislation that is pushed through by Congress does not exasperate those effects throughout the country. I certainly understand the goal of protecting consumers, but we must make sure that credit is available for those who need it.

I also have some concerns about the preemption portions of the legislation which we will have discussions on. There's a patchwork of legislation out there right now through all the different States, but I want to make sure that we don't mire down the payday lenders with overregulation. I look forward to the testimony today from our witnesses, and I yield back to the chairman.

Chairman GUTIERREZ. Congressman Baca, you are recognized for 3 minutes.

Mr. BACA. Thank you very much, Chairman Gutierrez and Ranking Member Hensarling, for your leadership on this important subject.

The issue of payday advanced lending reform is a critical one and I applaud Chairman Gutierrez for introducing the legislation on this subject, and, as some of you know I have introduced alternative legislation on this issue. I believe that my bill, H.R. 1846, the Consumer Lending Education and Reform Act or the CLEAR Act, reforms the payday loan industry, while also ensuring that borrowers have access to loans when they are needed.

In these difficult times students, police officers, teachers, and other working Americans sometimes need access to emergency credit. These people, like Tina Hall, who would not have been able to pay for her daughter's emergency dental care if it hadn't been for the payday loan she received; and, I received about 47 different letters just in my area, and I would like to just read one of them. It says, "Dear Congressman Baca: I come to (blank) for the payday loan." I'm not going to give advantage to that one. "I use the services during an emergency. This is a good service to have when you need some money real quick. I feel this is a good service. Please don't take it away."

Again, we must have access to credit open to borrowers like Tina and this person whose letter that I just read, who are doing the right thing. But we also must have a clean-up industry with tougher regulations and consumer protections and oversight. The CLEAR Act achieves these principles and will also impose a strict national fee structure on payment loans. My bill caps it at 15 cents per dollar plus allowance for a 5 percent original fees for loans borrowed over the Internet. This additional 5 percent fee for the Internet loan is due to higher consumer acquisition cost.

My bill limits borrowers to refining a loan no more than 2 times at a rate of 15 cents per dollar for the first refinancing, and 10 cents per dollar for the second refinancing. The CLEAR Act also requires lenders to obtain bonding to follow the Fair Debt Collection Practice Act and to advise borrowers of the availability of free credit counseling. These provisions will eliminate the fly-by-night lenders who take advantage of vulnerable individuals. It is my preempting existing State law, the CLEAR Act would create a national standard; and, I state, create a national standard for short-term loans. This will ensure residents of the 50 States have access to payday advance loans at affordable rates.

We must remember that for many of our customers, advance loans are more effective than other alternatives, as you can see by the chart that we have out here. If a customer with overdraft protection on his or her checking account writes a $100 check, but only has $75 in the account, the bank charges them approximately $38.

If a customer who does not have overdraft protection bounces the same $100 check, they will be charged $30.

If I could have an additional 30 seconds?

Chairman GUTIERREZ. There is no further time.

Mr. BACA. Can somebody yield to me?

Chairman GUTIERREZ. Well, we could try it.

I recognize Mr. McHenry for 3 minutes.

Mr. MCHENRY. I will yield to my colleague 30 seconds.

Mr. BACA. Thank you. Thank you very much.

Just to finish up, then, if a customer does not have the overdraft protection to bounced check for the same $100, they will be charged $30 for a bad check, which means both the bank and the merchants are giving them a total of $60. So they're actually paying more than going to a payday than what it would be otherwise.

The CLEAR Act provides national regulatory reform that contains consumer protection and oversight, while also ensuring working Americans have access to credit.

I thank the chairman for recognizing me, and I look forward to working with him and other members on this important issue. And thank you very much for yielding the time.

Mr. MCHENRY. I thank my colleague, and I thank you, Mr. Chairman. I thank the ranking member as well.

There is going to be a discussion about the North Carolina experience today. In North Carolina, we simply do not have payday lending recognized by the State. Now, the failure of State regulation means that there are no State-chartered institutions that are allowed to do payday lending.

However, payday lending still occurs, even though, illegally, in North Carolina. There are mechanisms to do that. We have individuals who drive over the State lines to do that. We have those who access other opportunities via the Internet. We have other individuals in the State who access credit through simply unregulated means. The North Carolina experience is not a good one in terms of access for low- and moderate-income individuals to opportunities for lending. So the North Carolina experience, we need to be clear about.

Mr. Chairman, I ask unanimous consent to submit a Federal Reserve of New York staff report on payday credit bans.

Chairman GUTIERREZ. Without objection, it is so ordered.

Mr. MCHENRY. Thank you, Mr. Chairman.

Beyond that, this is the worst time to further constrict credit. We see the recession with the impact on other traditional means of lending, the constriction within our credit markets. The access of credit has been severely limited right now. The impact on families is real and so we need to have regulated means of individuals being able to meet their demands, their worldly demands of paying their car payment and making their home payment, paying their rent, even feeding their kids. This is a very basic function.

I want to commend the chairman, though I have concerns about his legislation. I do appreciate the fact that he has approached this in a pragmatic way and I hope that we can have a realistic discussion on how we can properly allow for the function of the credit markets in many different ways in this country. And I am very grateful for the opportunity to have this discussion before this committee.

I think it is important, especially now in these tough economic times, that we have this discussion about the importance and the necessity of payday credit advances.

Thanks so much, and I yield back.

Chairman GUTIERREZ. The gentleman yields back the balance of his time.

We have Mr. Scott for a 1½ minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Let me just say very quickly, these are tough times. And with the tumultuous financial markets, bank bailouts, rising unemployment, and the continued downturn of our housing markets, many working and middle-class Americans indeed are finding it harder and harder to make ends meet, and some are turning to short-term loans to get them over certain hurdles. This is a market. These are consumers. These are our constituents out there who do need help.

I think what we are trying to do with this legislation, which I am a co-sponsor of, Mr. Chairman, as you know, we are asking and reaching for what I will refer to as a delicate balance. And that delicate balance is to make sure that those of our consumers, those of our constituents who need in an emergency situation to have access to safe, protected, and fair means of acquiring funds that they need to get them over in a tough time. But, yet, we must do it in a way that protects them from getting caught in long-term debt in a cycle of debt. This bill will not put payday lenders out of business, but what it will do is it will cause this industry to lose some profits; but, all of it at the expense of ensuring that those 23 States with weak or even no payday lending rules will receive increased protections from those that are less than honest lending practices.

The bill also will not preempt States that already have laws on their books that may be strong or even outlaw some of these practices. And there are those who say the bill does not go far enough. There are those who say the bill goes too far. But again, Mr. Chairman, what I feel we have here is a bill that does reach that delicate balance that is needed to give access to credit in these tough times to those folks who need it, while, at the same time, providing maximum protections for our consumers in this industry.

I yield back the balance of my time.

Chairman GUTIERREZ. The gentleman yields back the balance of his time. I ask unanimous consent to add an additional minute for opening statements on each side. Hearing no objections, it is so ordered.

Mr. Ellison, you have 45 seconds.

Mr. ELLISON. Thank you, Mr. Chairman.

Sadly, there are millions of hardworking Americans out there without checking and savings accounts. These are the unbanked. Until we change that, until we make much greater progress in areas of financial access, we will continue to have payday lending industry.

In the meantime, we have to make sure that all consumers using payday loan products are protected. For that reason, I want to commend you, Chairman Gutierrez, on your leadership in convening this important hearing on payday lending reform. In sum, I believe the legislation makes a lot of progress towards striking a balance between ensuring basic protections for consumers and not stifling their access to credit.

However, it's only a first step of many to provide affordable financial products to all Americans. To that end, I am especially interested to hear more about these efforts of regulated financial institutions like community banks, credit unions, and others, to bring millions of unbanked Americans into the fold of the mainstream financial services industry.

Thank you. I yield back.

Chairman GUTIERREZ. Thank you.

Mr. Hensarling, you are recognized for 1 additional minute.

Mr. HENSARLING. Thank you, Mr. Chairman.

Not unlike the gentleman from California, I have heard from a number of my constituents. I have heard from a lady named Theresa in Dallas where I live, a 43-year-old divorcee who recently survived stage 4 cancer. She wrote to me and said:

"Congressman, without these loans I would have been evicted from my apartment on two separates occasions. Please help to keep these loans from being banned. There are many of us out here with no other choice at all."

I also heard from Paul in Mesquite, Texas: "Working payday to payday in this economy we sometimes need a quick loan for food, gas, utilities, prescriptions. If payday loans are banned, our checks may have to bounce and then I have to pay the big banks overdraft charges. I won't name the name of the company. Payday lenders are helping working Americans stay afloat 'til payday."

Mr. Chairman, I hope we keep in mind Theresa of Dallas and Paul of Mesquite as we go through this debate.

And I yield back the balance of my time.

Chairman GUTIERREZ. We certainly will.

Mr. Meeks, you are recognized for 45 seconds.

Mr. MEEKS. Thank you, Mr. Chairman, and I just want to say, briefly, that I wasn't always a Member of Congress. In fact, I didn't always wear a suit like this.

I grew up in a neighborhood that was tough. My parents had no money. And what this is about is about options. It's about options that average, everyday people, good people can have, if, in fact, they find a hard time. In fact, it could save their credit. Because, if you, not only by paying a late fee, it ruins your credit and stops individuals who have aspirations to own a home one day.

Because when they want to go in that home, if they didn't pay that back to the bank because they paid late, then their credit rating goes down, and, they're not able to afford a house to even move themselves up. This is about options. We have some concerns. This bill addresses the concerns to protect consumers. You know, no rollovers or fee capped at 15 cents for every dollar. You know, default extended as far as repayment is concerned. So, among others, in my brief time, I just want to say that this is for everyday people and I don't have to give the testimony of what someone has given me.

I can tell you that I have lived through it and I have seen these results when someone doesn't have options. I have seen them to go to someone else who gives that option, and they don't pay back. Unfortunately, sometimes they come back without a limit, and we need to stop that.

I think this is a good bill and I support it.

Chairman GUTIERREZ. Thank you.

Okay. We have some great witnesses. We are going to hear from them now.

Testifying first before the subcommittee is Ms. Jean Ann Fox, who is the director of financial services for the Consumer Federation of America, but she is also testifying on behalf of Consumer Action, Consumer's Union, the National Association of Consumer Advocates, and the National Consumer Law Center as well as U.S. PIRG.

Please, Ms. Fox, you are recognized for 5 minutes.

STATEMENT OF JEAN ANN FOX, DIRECTOR OF FINANCIAL SERVICES, CONSUMER FEDERATION OF AMERICA

Ms. FOX. Thank you, Mr. Chairman, and Ranking Member Hensarling.

I appreciate the invitation to come and testify before you today. I am also representing the Woodstock Institute in Chicago.

We appreciate your interest in protecting consumers from the payday loan debt trap that results from these extremely expensive, balloon payment loans that are secured by direct access to consumers' checking accounts. Payday loans are harmful to borrowers. They undermine scarce family resources. They risk bank account ownership. They double the risk that you will end up in bankruptcy or seriously delinquent on a credit card payment.

When you study actual payday loan borrowers, you find that these products are harmful to the families who use them. We agree that payday lending and similar products should be reformed, but we respectfully disagree with the specific methods used in H.R. 1214. The bill authorizes single payment loans for as short as a day or two at a cost of 391 percent APR for a 2-week loan, or 782 percent for a 1-week loan.

The bill sets up an unaffordable repayment term. It has to be repaid in full out of your next paycheck that is deposited to your bank account, otherwise, you will end up paying bounced-check fees to the payday lender and to your own bank. A family making $35,000 a year, which is a typical payday loan income range for borrowers, would not be able to pay a typical $300 loan back out of their next paycheck, even if the loan were free. These are simply unaffordable, single-payment loan terms.

The bill also authorizes loans to be secured by unfunded checks. In other words, to get a payday loan, every borrower has to write a check when they have insufficient funds in the bank at the time they write it, or they sign over electronic control of their bank account to the payday lender. This bill authorizes lenders to turn a debit authorization into a paper check that takes money out of a consumer's bank account, depriving them of current protections they would have under the Electronic Fund Transfer Act.

The narrow definitions of a payday loan and of a creditor in this bill also mean that it's easy to evade application of the law. For example, the chairman mentioned the Illinois experience. Illinois defines a covered payday loan as 120 days, so most of the big payday lenders turned their product into 121-day or longer loans, and they are not subject to the rate cap or the other provisions in the Illinois payday loan law.

There are other loopholes in this bill. It doesn't cover open end credit. Most of the big payday lenders in Virginia turned their product into open end credit to get around changes to the law that took effect this year in Virginia. In Texas, almost all of the payday loan business is done under the credit services organization model, so it is doubtful whether this bill would apply to those payday lenders in Texas.

The chairman has mentioned that at least rates would go down in some of the States where rate caps are set higher than $15 per hundred; however, in 10 of those States, there's no rate cap for an installment loan, so there would be little barrier to the payday lenders just changing their product into a 91-day installment loan and continuing to charge even higher interest rates.

The protections against the payday loan debt trap in this bill are well-intentioned and we appreciate that, but they have been tried in other States and they don't stop payday lending from being a debt trap. The average customer has nine loans per year, even in States that limit you to one loan at a time, or that prohibit renewals or that have repayment plans. As long as you allow this product to be offered under the terms of a typical payday loan, you will have a payday loan debt trap.

Congressional approval for a bill that caps rates at this high rate will undermine the momentum in the States. For example, at the ballot box last fall, voters in Arizona rejected a ballot initiative that had the same rate cap, the same kind of repayment limits, as are included in this bill. Voters rejected 391 percent lending in Ohio and the trend in the States is away from legalizing payday lending, and the momentum is toward restoring conventional, smaller rate caps; and, I fear that passing this bill would undermine that momentum.

We urge you to ban loans secured by getting consumers to write unfunded checks and we urge you to support the rate cap in Representative Speier's H.R. 1608, which would provide real protection for all forms of credit to all consumers.

[The prepared statement of Ms. Fox can be found on page 47 of the appendix.]

Chairman GUTIERREZ. Thank you.

I tried to give the gentlelady a little more time, since she is against the bill, but we are going to show fairness here. But I hope we won't all continue, Mr. McCullen, as you are next, the president and chief executive officer for Finance America of Louisiana.

You are recognized for 5 minutes.

STATEMENT OF TROY McCULLEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FINANCE AMERICA OF LOUISIANA

Mr. MCCULLEN. Thank you, Mr. Chairman, and members of the subcommittee.

It is an honor to be here today. I own the largest small-loan company in Louisiana, and operate 30 locations. I am also president of the Louisiana Cash Advance Association, and, working closely with the Louisiana legislature and the Office of Financial Institutions, helped draft and implement the laws that we currently operate.

Our laws are working and I want to offer you information that will help you in your decisionmaking process. From the beginning we had two specific goals in mind: provide structure to a service that customers need and want; and implement tight consumer protections. All lenders are licensed, regulated, and extensively audited by the Office of Financial Institutions. And I believe we have one of the best consumer protection laws in the country.

If you want a national standard, and want to implement something that will work, implement Louisiana's law. As with any new industry, ours has certainly had its problems, and there have been bad operators just as in any industry. But, with lots of hard work, things are leveling out and in Louisiana, the number of lenders is actually dropping. This phenomenon happens in every new industry, and it's the way our country's free market system works. Businesses rise and fall based upon consumer demand.

I believe we will continue to see downward adjustments and consolidations in the future. Louisiana's law provides for full disclosure of all fees and terms on the promissory note including APR. It prohibits companies from accepting fees to rollover, flip, or renew a loan. This is one of my personal hot buttons, and our law keeps consumers from getting into a cycle of debt. Our law allows for the collection of reasonable attorneys fees and court costs, and mandates the posting of a fee schedule and the Office of Financial Institutions 800 number for complaints.

The maximum fee allowed on a cash advance in Louisiana is 16.75 percent of the face of the check. This means when someone borrows $100, the fee is $20. If they borrow $200, the fee is $40; no compounding; no excessive fees. There is a $45 fee cap; and, like other lenders, we are allowed a $5 documentation fee. There are very few complaints. In fact, Louisiana had over 4 million transactions in 2008, and regulators only received 24 complaints, of which only 2 pertained to excessive fees.

While we are an open book and disclose all fees in the promissory note, I believe we should be taken out from under the Truth in Lending. Ours is a fee-based business and APRs should not apply. Money is just like any other commodity and applying APR to our business skews reality and is illogical.

I compare our business to a Triple A rental store. You can buy a hedge clipper at Home Depot for $100 or you can rent it from Triple A for $20. Our customers rent the same way. It's just that our product is money, and they pay a fee for the convenience. If they do not need our service, they will not come in.

An example of how someone would use our services if they bounced three $50 checks, the total fees could exceed over $150. If the same person borrows $150 from one of our stores, the fee is around $30; $150 versus $30. It's that simple.

Defaults are a constant problem. If a $300 loan customer charges off, 7 other customers must pay in order for us to break even. Louisiana's law could be better by allowing us to reduce or control bad debt in a better way. Some States have implemented a database which allows for only one or two loans at a time.

I am not in favor of the database, but controlling consumer bad debt would be a benefit. We use Teletrack to track data, and if a customer has more than one loan, we will not loan to them. If they have charged-off somewhere else, we will not loan to them. The consumer groups want you to believe that we are trying to put people deeper into debt when in reality we want our customers to pay and not default. It's perception versus reality.

The consumer groups have done an excellent job of spreading this information, and I have realized that perception can become reality when repeated enough times. But the horror stories you see in the newspaper and on television are not reality in Louisiana; and, for the record, we are not predatory. We take no collateral, and there is nothing to take away.

Again, the consumer groups are spreading incorrect information and they know it. They have hijacked the word "predatory" and are incorrectly applying it to us. Predatory lending applies only to the mortgage business. It has nothing to do with rates or fees or APR. If it did, every NSF fee would be considered predatory.

According to the recently released FDIC study of bank overdraft programs, the average $66 check that bounces and is repaid in 2 weeks incurs an APR of over 1,000 percent. A $60 ATM overdraft that is repaid in 2 weeks incurs an APR of over 1,100 percent. ATM overdrafts and NSF overdrafts paid by the bank for their customers are extensions of credit.

I am not suggesting that you apply APR to these extensions of credit, but my point is that if you apply APR to us, then the same should be applied to them. I am comparing apples to apples. If you exempt them—

Chairman GUTIERREZ. The time of the gentleman has expired.

[The prepared statement of Mr. McCullen can be found on page 78 of the appendix.]

Chairman GUTIERREZ. Testifying third is Mr. Michael Flores. He is the chief executive officer of Bretton Woods, Incorporated, a management consulting firm. And, Mr. Flores, your chart that you brought is going to be to my left, your right. Sorry, we can't put it on the other side closer to you.

STATEMENT OF MICHAEL FLORES, CHIEF EXECUTIVE OFFICER, BRETTON WOODS, INC.

Mr. FLORES. Thank you, Chairman Gutierrez, Ranking Member Hensarling, and members of the subcommittee.

I am CEO of Bretton Woods, a management consulting firm. And my clients include banks, thrifts, credit unions, payday lending industry, and bank technology companies. I have more than 30 years experience and have taught at the graduate school of banking in Madison, Wisconsin, and the Pacific Coast Banking School of Seattle, Washington, and published several articles and studies on the financial services industry.

In essence, my business is helping banks improve profitability. Because this hearing is about payday lending, I am here today to put this in the context of the bigger picture: short-term, unsecured credit market. The short-term credit market is made up of products and services for people who need a small amount of cash for a short period of time. It is more than a $70-billion market that includes credit cared overlimit fees, overdrafts, NSF, and payday loans.

Additionally, the market includes tens of billions of dollars in late fees or reconnect fees, as has been mentioned earlier. All of these credit products are short-term and are all unsecured. Currently, banks and credit unions control the largest share of this market. That may come as a surprise to some people, because very few banks offer the unsecured short-term dollar products, typically considered to be a loan.

As the committee may know, only 30 banks have signed up for the FDIC small loan pilot program, which was designed to see if alternatives to payday lending could be offered profitably. The results are not in, but I am not encouraged that they will be profitable or encouraging. I have worked with banks over these years, and this legacy cost structure of banks inhibit their ability to offer these small-dollar, short-term credits in a profitable manner.

So what role do banks play in a short-term credit market? Well, primarily through insufficient funds known as bounced check fees and overdraft protection, these products are all part of a competitive marketplace and all are considered alternatives to payday loans.

[chart]

If you will refer to our first chart here, the pie chart, published research I conducted in November and December of 2008 and recently updated in early March of this year found that banks and credit unions earn $34.7 billion in combined NSF and overdraft fees. By comparison, the late and overlimit penalties on credit cards was $20 billion, and payday lenders earned $7.3 billion for 2008.

As had been mentioned earlier in your hearing 2 weeks ago on overdrafts and credit cards, these fees for banks are an increasingly significant source of revenue for these banks. As a matter of fact, if these fees were eliminated or reduced, many banks would be profitable in this country.

Now, from the consumer perspective, when a consumer doesn't have enough money to pay a bill in his or her checking account, then they have the option of either bouncing the check using overdraft protection, getting an advance on a credit card, or using a payday loan.

[chart]

If you will look at chart two, please, it has been mentioned earlier about the FDIC study, that the average cost of a bounced check was $66 or the average amount was $66. Before that transaction, the consumer would pay $27 in overdraft fees. If they did not have overdraft protection, the fee would be averaging almost $29 to return the check, plus a merchant fee of over $26, payable to the merchant to whom they wrote the check.

In comparison, a customer who took out a $66 payday advance, would pay approximately $10.56, based upon 16 cents per dollar advance. Just by looking at the household data, you can get a sense of what option is used most. This is one of the major points I want to make today, if you will bring up the next chart please.

[chart]

There are approximately 101 million households with checking accounts in this country. In States where payday loans are on a national average, these households pay approximately $343 in NSF and overdraft fees per year. In States where payday loans are available, the average household pays $239 per year. And, in States where these loans have been eliminated, the average household pays $496 a year in NSF and overdraft fees.

Now, I want to stress that I don't maintain there is a direct relationship, but I think this is a significant indicator and should justify an extensive and robust study considering all the variables to determine if there is indeed a direct correlation between availability of an option, such as a payday loan, and the impact on NSF and overdraft fees.

In conclusion, I am a proponent of competition and I am a proponent of options for the consumer. As long as there are options available, the consumers are smart. They will look for the best value at the lowest cost, and I would hope this legislation strikes a balance that encourages competition and not reduces competition.

Thank you.

[The prepared statement of Mr. Flores can be found on page 42 of the appendix.]

Chairman GUTIERREZ. Thank you very much.

And, now we have, last but not least, Ms. Gerri Guzman, a resident of Montebello, California, who is coming before us today to discuss her role as a payday lending consumer.

You are recognized for 5 minutes, Ms. Guzman.

STATEMENT OF GERRI GUZMAN, RESIDENT, MONTEBELLO, CALIFORNIA

Ms. GUZMAN. Thank you.

Good afternoon. My name is Gerri Guzman. I am a resident of Los Angeles County in California.

I currently serve on the Montebello Unified School District Board of Education, where I serve 33,000 kindergarten through 12th-grade students and their families, 78 percent of whom qualify for free or reduced lunch. I am also active in the following organizations: Optimists International; the Boys and Girls Club; and my local chapter of the American Red Cross.

I have also been a payday lending customer, and I am here today to talk about that experience. I am thankful for the opportunity to be here, as I think sometimes with issues like payday lending, the opinions of the people who actually use the service aren't often heard.

I also would like to add that when my City considered a moratorium on payday lending business licenses, I took the opportunity to meet with several community members to listen not only to their experience but to gain an understanding of why my community uses payday lenders.

Personally, I consider payday loans to be a necessary evil. If I had the choice, I would never have been in the situation where I needed a payday loan. I am sure this rings true for tens of millions of lending customers around the country. In a perfect world, we would all have the money set aside in a savings account to cover the expenses that are unexpected or unavoidable. But having much money in a savings account is not a reality for many working families, especially today.

I first became a payday lending customer when I decided to leave my job and become my mother's primary caretaker 14 months prior to her passing. I do not regret for a moment my decision; however, I would be lying if I told you it didn't create a temporary financial hardship. At the time, my options were to take out a payday loan or not to purchase a water heater.

I was aware of the cost of the payday loan and decided that it was the best option for me at the time. Thankfully, my financial circumstances have changed, and, although I am no longer a payday customer, I would like to know the option is available should I need to be again. I do wish that there were more choices and better choices for consumers, but in reality, there are not. There are more choices in tough financial times. People have the smarter decisions they can make and the better off they will be in the long run.

I, like most people in this day and age, am budget conscious and look for the best options available in all situations. I knew what a payday loan would cost, but the bottom line is the process was simple and quick. I am aware that payday lending customers often get themselves into trouble, and some people make poor choices and get caught in a debt spiral. But, certainly, this is not unique to only payday lenders, lending customers.

I do think that it is important that the government protect people from predatory lenders and abusive practices. I would like to see a mechanism in place to minimize a likelihood of payday lending customers getting trapped in a cycle of debt. I am sure that most people intend to pay off their loan when it is due, but often, unexpectedly again, the money is not available.

In these situations, it is important that a lender work with a borrower to make sure they aren't worse off than they were before. An adjusted pay plan would be very helpful to many consumers and certainly be more realistic. It would also be helpful to make it easier for customers to compare credit products.

Most of my neighbors are hard-working middle-class and lower-class families. Very minimal healthcare insurance often makes it a necessary situation to make a choice of making a payday loan or having bounced a check or doing without the necessary services. It would be helpful to make it easier for customers to compare those products. Companies need to be up-front and clear about how much the borrower will pay for the loan and exactly when it is due back.

However, I have found that even with the information to make an informed decision, emergency situations often create urgency and all too often the quickest, easiest solution wins out over reason.

I want to thank you today for your time. I appreciate the opportunity to represent the tens of millions of payday lending customers across the country, many of whom I represent. We each have our personal reasons for going to a payday lender, but I think that almost all of us would agree that while this is not a perfect option, and it's not right for everyone, we are very grateful that the option was available when we needed it.

Thank you.

[The prepared statement of Ms. Guzman can be found on page 76 of the appendix.]

Chairman GUTIERREZ. Thank you very much.

I appreciate the testimony of all of the witnesses.

First, let me take in terms of my 5 minutes, I think it is probably better to talk about a specific amount of money in relationship to $100 in terms of the service. Because when you do the APR, I'm not quite sure you can compare an apple to an apple and an orange to an orange.

That's just my point of view. People can continue to use the APR argument if they wish to do so.

I would like to share with Ms. Fox that I appreciate her testimony and I would like to have an opportunity—I addressed a group of consumer groups earlier today, this morning, so that we can begin the process of dialogue and open communication. Because it is clear, given her testimony, that you don't grasp the bill and what our goal is in the bill.

First of all, I want to make sure that everybody understands what our bill does. It allows you 6 payments, 13 days apart for 78 days, and including the 14 days, that's 92 days. But if you listen to the testimony that was given earlier, you would think that you could simply roll it over. Well, we have a ban on rollovers. We have a ban on non-sufficient funds and being able to submit a check for non-sufficient funds. And our APR is actually lower than Louisiana, which is at 521. We were just at the 391, because we specifically relate $15 to 100.

And then, of course, they said, well, they got around the bill. Ms. Fox says that and she is right. This is not an installment loan protection program. This is about the payday industry. We hope in the near future to be able to deal with installment loans, but that is not what we are talking about today.

If people change the nature of their relationship with those providing funds, those changes should not be attributed to this measure. This measure, as many of my colleagues who are supporting it understand, is a measure which will allow us to take 23 States and over 100 million people who do not have these protections today and be able to encourage them.

Ms. Fox, in your testimony you assert that H.R. 1214 would provide congressional approval for payday lending. I find the argument confusing. See, by not acting to curtail payday lending in over 18 years, it has gone from 300 store funds to 24,000. So has not Congress already provided its approval?

Nine million Americans participate in legal and authorized payday lending. Wouldn't Federal regulations on payday lending demonstrate that Congress is paying attention and ready to regulate the industry?

Is your argument that no Federal legislation on payday lending would send us a message that Congress disapproves of payday lending?

Ms. FOX. Thank you, Mr. Chairman.

The action that Congress has taken on payday lending to-date has been to ban this product for service members and their families. In 2006, you enacted a provision in a defense authorization bill to put payday lending off limits to service members at the request of the Department of Defense, because this product was viewed as being harmful to them.

Typically, small loan products are regulated at the State level where State laws authorized certain types of lending, like installment lending, pawn shops, or payday loans. Typically, Congress does not enact authorization bills for specific products. You have over-arching laws like Truth in Lending, which require all creditors to tell consumers what their loans cost.

Chairman GUTIERREZ. I guess I understand those things, and since even though I am the chairman, my time is still limited to 5 minutes.

Ms. FOX. Okay.

Chairman GUTIERREZ. The issue here is whether or not we wish to take 23 States and over 100 million consumers and offer them a protection they do not have today.

And so, I guess, would you like to see rollovers eliminated in 23 States, which this bill does? Just yes or no, because I know my time is waning.

Ms. FOX. This bill doesn't stop back-to-back lending.

Chairman GUTIERREZ. It does. It does do that.

We will have a continuing conversation about it because it does, and it specifically states it.

You know, if you wish to be against the bill because you wish us to do nothing other than eliminate payday lending, which in your statement anybody can read and extrapolate, Ms. Fox, you don't like the payday. I don't like the payday. You wish to eliminate it. You wish to ban it.

That's not possible. That's not possible. So what we're trying to do, many of us, is to reform that very system that many of us, and as I stated earlier, we would like to take the columns over. But that's just not possible. So as we look at those situations in this Congress, and I just would like to say to the lady also that, you know, I began the amendment process for the military servicemen here in this committee that got it down to 36 percent. We were successful in that venture.

I think I have a good gauge of what is and can or cannot be successful. But I will work with you, because the only bill that we have gotten after I introduced this bill is a bill that makes it harsher on consumers vis-a-vis the payday industry. I look forward to working with those who have the ability of doing better.

I yield to the gentleman, Mr. Hensarling, 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Okay, Ms. Fox, I guess I have to bite on this one. I think I heard the chairman say, and I'm not sure I completely heard you make this definitive statement, but is it the position of your organization that payday lending should be banned?

Ms. FOX. It is our position that consumers should be protected from triple-digit interest rates. They should not be exposed to writing checks without money in the bank as security for a loan, and they should have an affordable repayment schedule.

Mr. HENSARLING. Well, unfortunately, Ms. Fox, I have a short period of time.

You would do well in this institution as well. We're not particularly good about giving yes or no answers either.

[laughter]

Mr. HENSARLING. I am curious, and I'll throw this open to anybody on the panel. I believe that the best consumer protection is a competitive market. I have spent a number of years in the business world. I think I have history. I think I have evidence.

If I did my own homework properly, I have seen studies that tell me that there are over 22,300 payday stores in America. I saw one study from a particular State that said there were more payday locations than McDonald's, Burger Kings, and Wendy's combined. I had my staff pull the "Yellow Pages" out of Dallas. I'm a Dallas resident, and there were over 125 different payday locations: 46 locations of Ace Cash Express; 25 of Cliff's Check Cashing; 14 Advance America; 13 Check and Go; 10 Easy; 7 Check Into Cash; 6 Federal Cash Advance; 4 Speedy Cash; and too many Cash America locations to even count.

To me, it seems like a fairly competitive market, and I am fearful that the underlying legislation might make it less competitive.

Does anybody want to take the opposite view that there is a competitive marketplace?

Seeing none, let's talk about what might happen if we lack competition in that market.

The gentleman from North Carolina, who isn't here at the moment because I saw him speaking on the Floor out of the corner of my eye.

Mr. WATT. One of them is.

Mr. HENSARLING. The gentleman who agrees with me is not!

[laughter]

Mr. HENSARLING. The one who introduced the Federal Reserve study into the record, I would like to quote from that same Federal Reserve Study, which investigated how consumers fared after payday lending was essentially banned in Georgia and North Carolina.

I'm sure the gentleman from North Carolina will have an opportunity to speak to that, but the Federal Reserve study concluded:

"Compared with households and states where payday lending is permitted, households in Georgia have bounced more checks, complained more to the Federal Trade Commission about lenders and debt collectors, filed for Chapter 7 Bankruptcy protection at a higher rate. North Carolina households have fared about the same. This negative correlation reduced payday credit supply, increased credit problems, contradicts the debt trap critique of payday lending, but is consistent with the hypothesis of payday credit is preferable to substitutes such as the bounced check protection sold by credit unions and banks or loans from pawn shops."

That is from the Federal Reserve.

Does anybody on the panel wish to take issue with their conclusions?

Ms. FOX. Yes.

Mr. HENSARLING. Ms. Fox, we will give you a short amount of time.

Ms. FOX. Yes. When studies are done that look at actual payday loan borrowers, they find that they are better off without this product. For example, in a large Texas study, payday loan borrowers are twice as likely to end up in bankruptcy in the next 2 years, as people who applied for it and were turned down for the loan.

Mr. HENSARLING. Well, Ms. Fox, do you not believe the earlier testimony as far as various APRs? I think the gentleman from Louisiana talked about the average fee for bounced checks and reconnect fees.

Do you doubt that evidence?

Ms. FOX. Absolutely not, as we testified earlier in March. We think overdraft loans are the bank equivalent of payday lending, and this committee can deal with that by enacting Representative Maloney's H.R. 1456.

Mr. HENSARLING. Well, I cut into the remaining time I have. I'm going to try to get another question in here if at all possible. But I know we just had this debate on credit cards, and yes, credit card terms can be confusing. I have walked into a number of payday stores in Dallas, Texas. The fees are right there on a big board. It's not confusing to me. I talked to several customers. They seem to know exactly what they were doing and they were very happy to have that option versus a lot of other alternatives that were less so.

Mr. McCullen, in Louisiana, are these hard-to-understand transactions?

Mr. MCCULLEN. No, sir, they are not.

Chairman GUTIERREZ. 15 seconds, Mr. McCullen, to answer the question.

Mr. MCCULLEN. They are not. Everything is posted and listed on the promissory note and the customer understands exactly what the fees are. There are no hidden fees.

Ms. GUZMAN. Is there any time for one additional, brief comment?

Chairman GUTIERREZ. No, I'm sorry. A little later on, I'm sure we will come back to you Ms. Guzman.

We have about 11½ or 12 minutes. I am going to stay and listen to the gentleman from North Carolina as it has already been kind of prepped up. We don't want to take a break.

So the gentleman from North Carolina is recognized for 5 minutes, and then we are going to go vote and come right back.

Mr. WATT. Thank you, Mr. Chairman, because I might not be able to come back. And I appreciate you getting my questions in or comments in before I leave.

First of all, I want to start by inviting all of my colleagues who say they believe in States' rights to come on back and join the States' rights caucus that I have been trying to remind them they have deserted. I have no problem with helping these 23 States, but when the chairman says that we can't ban payday lenders, that's exactly what we have done in North Carolina.

Whether I agree with it or don't agree with it, we have a State legislature there. They have considered this issue. And I have been trying to decide, trying to review the bill to be clear on whether it does preempt State laws or whether it does not preempt State laws. To the extent that it preempts State laws, North Carolina's law, it may well be helping the 23 States that the chairman said that it helps, but it's overriding North Carolina's law which says you can't do this in North Carolina.

So unless we can write this bill in such a way that the provisions of it are a true floor as opposed to a preemption, I have serious problems with it and I don't read these provisions to do that.

Chairman GUTIERREZ. Will the gentleman enter into colloquy with me?

Mr. WATT. I'm happy to.

Chairman GUTIERREZ. That is the intent of the bill—not to preempt.

Mr. WATT. I have been told that.

Chairman GUTIERREZ. And I look forward to working with you, because I know you're really good at the law and drafting legislation so we can make it as explicit as possible to make sure that we reach that goal.

Mr. WATT. I just want to make clear that when you find all of these folks who are supporting this bill, when you make that clear, the room will get a lot more scarce than it is today. If this bill is a floor, and we are explicit that it is a floor, then I think we are moving the state of the law forward; but, if it is a preemption of State law, then in North Carolina, we haven't moved.

Chairman GUTIERREZ. Would the gentleman yield?

Mr. WATT. My legislators tell me they don't want payday lending in North Carolina.

Chairman GUTIERREZ. It will be a lot easier, my friend, because if that isn't accomplished—and I know that you and I can get that done explicitly in this legislature—then the room won't be empty or full, because I'll simply withdraw the legislation as a sponsor and ask my colleagues. It will cease to exist as a bill, if we are not, and I look forward to working with you because I know the clarity with which you can write that legislation.

Mr. WATT. I am glad to hear that from the Chair, and I hope everybody in the room heard it.

Mr. SCOTT. Will the gentleman yield for one second?

Mr. WATT. I am happy to yield to my gentleman friend from Georgia.

Mr. SCOTT. Thank you very much, the gentleman from North Carolina. Our case is very similar in Georgia where we also have outlawed payday lending. And as a co-sponsor of this bill, I can assure you that we will make, if it is not clear as is, we certainly will make sure that it is clear, and the chairman has spoken.

Mr. WATT. Well, I am reading the language on page 10, "Requirements of this subsection regarding extended repayment plan shall supersede any repayment plan requirements under any State law." I don't know what that means. Perhaps we will be able to clarify it. I am reading that we preserved the enforcement authority of the attorneys general. That is on page 16 of the bill.

But, I am also reading, "Scope of application: the provisions of the section apply to any person or entity that seeks to evade its applicability by any device, subterfuge, or pretense whatsoever."

North Carolina has done it openly, not by pretense, subterfuge or device. They have done it openly.

So, I mean, if your intent is that, and we can get there, I'll be right there with you.

Chairman GUTIERREZ. Thank you.

The time of the gentleman has expired.

I wanted you to have the opportunity, and Mr. Royce has a question. So we will try to get that in.

I would encourage people to go vote, and we will be right back.

Mr. ROYCE. Thank you very much, Mr. Chairman.

In light of the time, let me just ask this question of the witnesses. You know, some author referred to payday lending as predatory in nature, but on that topic, the New York Federal Reserve—and this was during the time that our current Treasury Secretary, Tim Geithner, was the bank's president—did a study entitled, "Defining and Detecting Predatory Lending." And in that study, they come to this issue of payday lending, and they note:

"Our findings seem mostly inconsistent with the hypothesis that payday lenders prey on lower, for example, lower the welfare of households with uncertain income, or households with less education. Those types of households who happen to live in the States that allow unlimited payday loans are less likely to report being turned down for credit, but are not likely by and large to report higher debt levels, contrary to the overpowering prediction of our model."

So I was going to ask Mr. McCullen: Do you agree with the New York Fed's assessment of payday loans?

Doesn't the presence of a robust short-term credit market in fact benefit some consumers by increasing the availability of credit to them: And I will also ask Ms. Flores that question.

Mr. MCCULLEN. Yes, sir, Mr. Royce.

People use us for all kinds of different reasons, and it's a lot of credit almost that people can use at any point.

Mr. ROYCE. And, Mr. Flores, your observations on that front?

Mr. FLORES. I am in full support of the fact that the availability of payday lending certainly assists those consumers.

Chairman GUTIERREZ. We have 5 minutes to get over and vote. We will make sure you get all your time when we get back.

Mr. ROYCE. Well, I'll just conclude then, Mr. Chairman, by saying, let's make sure in terms of that credit availability for people that try to access credit, let's make sure that they're allowed, you know, that we don't foreclose that option for them as we move forward.

And, again, Mr. Chairman, thank you.

Chairman GUTIERREZ. Yes. We are going to recess for the vote. I have an emergency meeting I need to go to. Mr. Ellison will be filling in for me when we get back.

[recess]

Mr. ELLISON. [presiding] The hearing will be called back to order and reconvened. The Chair will recognize himself at this time for 5 minutes.

Ms. Fox?

Ms. FOX. Yes, sir.

Mr. ELLISON. In your testimony, you asserted that H.R. 1214 could provide congressional approval for payday lending. I find this argument somewhat confusing. By not acting to curtail payday lending over the—oh, sorry.

Ms. Fox, it is clear from your testimony that you are very much opposed to H.R. 1214, and any attempts to regulate the payday industry that would stop short of banning the product. Part of what you do for a living is to count votes.

Is there legislation currently in the Congress that would ban payday lending that you believe has enough support to pass both Chambers, and be signed into law?

Ms. FOX. We believe that consumers need protection from all forms of extremely expensive credit. Senator Durbin's S. 500 and Representative Speier's H.R. 1608 would provide the traditional 36 percent small loan rate cap that would cover everything from bank overdraft loans to payday loans.

President Obama ran on a platform supporting a 36 percent rate cap, and voters in America support that by 70 percent—

Mr. ELLISON. Reclaiming my time, Ms. Fox, does that piece of legislation you just cited have enough votes to pass?

Ms. FOX. I am ever hopeful that Congress wants to support consumers caught up in a disastrous credit—

Mr. ELLISON. Thank you, Ms. Fox. Ms. Fox, you know, you have heard the testimony of Ms. Guzman. She did say that—believe her term was a necessary evil, something that people don't want, but—and I'll be the first to agree, that I tend to not have a lot of problems with payday lending.

But if you just simply foreclose the option outright, what happens to people like, say, Ms. Guzman? Does she now have to bounce a check to get that water heater she needed? What about the situation where you just need some money, you don't have anybody to go to, and your options are to bounce a check or just suffer, I guess. What about that?

Ms. FOX. We think consumers deserve better than payday lending, and in California—

Mr. ELLISON. Okay, Ms. Fox. Thank you. Thank you, Ms. Fox.

So Ms. Guzman, your situation—I mean, do you think that the bill that we're talking about now balances the equities in a reasonable way? As you already pointed out, you're no big fan of payday lending either, but if you have to do something, and you're really in a jam, do you think it balances the equities?

Ms. GUZMAN. I think it is offering a very realistic answer to payday lenders. It gives them the option and access, which is the American way. And at the same time, it protects the consumer, which is what we look traditionally from our government for, a minimal amount of protection, in this case from the situation getting out of control, or not having, you know, the certain protections you need to not continually live in this type of debt.

Mr. ELLISON. Thank you, Ms. Guzman.

Mr. Flores, how could the payday product be improved to make it more useful to the consumer, in other words, eliminate the debt trap, and to make the loan easier to repay? Do you have any views on this?

Mr. FLORES. Yes, sir, I do. I have read the legislation, and I agree with the—certainly the disclosures. I'm not necessarily for the Truth in Lending disclosure, because I think that's misleading. I like the 6-month payment plan. That certainly offers relief to the consumer. And so I think those would be the key issues.

One point I would like to make, though, on that legislation, is the $.15 per dollar cap. Philosophically, I'm against price caps or price controls, and not just from the business's profitability standpoint, but as businesses grow, and costs increase, be it salaries, overhead, whatever, there's no additional relief for that company to do something with pricing, short of trying to control expenses more.

And so I think that is an issue that I would take with this. Otherwise, I think the bill will strike the balance that you're looking for.

Mr. ELLISON. Mr. Flores, in your testimony you also indicate that, "the legacy cost structures of banks inhibit their ability to offer short-term low-dollar credits in a profitable manner."

Could you elaborate on what you mean by that?

Mr. FLORES. Banks have a huge investment in what we call brick and mortar, branch offices around the country that have huge operation centers, information technology centers, and personnel. And the way they are designed—the cost for them—and we looked at this many years ago, and a lot of banks, we said, you cannot make an individual loan under $5,000.

The resource it needs, the individual resource, the systems resources, the compliance costs, the documentation cost, to make a $5,000 loan, is the same that would make a $500 loan. And they cannot—and they just don't have the cost structure to efficiently offer that product.

Mr. ELLISON. The gentleman from Minnesota's time has expired, and the Chair will recognize Mr. McHenry from Texas.

Mr. MCHENRY. Thank you, Mr. Chairman.

Ms. Fox, a basic question for you: If payday loans were prohibited nationwide, let's say we did that legislatively, what do you think would replace it?

Ms. FOX. If payday loans were prohibited nationwide, consumers would save billions of dollars in repeat lending.

Mr. MCHENRY. Yes, but what would replace it?

Ms. FOX. Consumers would use traditional small loan companies. That's what happened in North Carolina, when payday lending was expelled—

Mr. MCHENRY. I'm from North Carolina, and that's not truly the case. They travel to South Carolina, they use other mechanisms. I mean, people need short-term lending, and what you're saying is, in essence, people just bounce a check.

Ms. FOX. Very few consumers deliberately write a check to bounce, whenever they don't have sufficient money. That tends to be something that catches you by surprise when your bank lets your debit card—

Mr. MCHENRY. Sure, unless—

Ms. FOX. —transaction go through. But there are—

Mr. MCHENRY. Reclaiming my time, let's reference the Federal Reserve report that is submitted for the record.

The Federal Reserve report expresses that in States like Georgia and North Carolina, there are—the example they use in the report—you have more complaints to the Federal Trade Commission about lenders and debt collectors, you have more bounced checks in that State, you have higher bankruptcy rates in that State, and they don't allow for payday lending.

So explain to me how this is a rational argument you're making. Because human nature—there is obviously a need for this type of short-term lending. Do you disagree that there is a need for it?

Ms. FOX. There is a need for small dollar lending. The short term is part of the problem. The Federal Reserve report you're referring to is one staff member's draft report. It's not an official report from the New York Federal Reserve Bank. They looked at aggregate data; they did not look at individual consumer experiences.

For example, during that period of time, there were more complaints from D.C. consumers about debt collection to the Federal Trade Commission than there were from Georgia, so the standards that he used to try to describe what was going on—

Mr. MCHENRY. So you just—

Ms. FOX. —are too—

Mr. MCHENRY. I'm trying to talk about—

Ms. FOX. —aggregate. They aren't a good description.

Mr. MCHENRY. Okay.

Ms. FOX. If you look at research done, looking at actual consumers who use payday lending, every one of them shows it is harmful.

Mr. MCHENRY. Okay, great. So you are saying that there is just simply—there is a demand for it, but you don't think it is good for consumers to have this option.

Ms. FOX. We think there's a demand for small dollar loans that are served by credit unions, by credit card cash advances, by traditional small loan companies that make installment loans to consumers. This market can be served and is being served—

Mr. MCHENRY. What if you don't have a credit card?

Ms. FOX. —and a third of the people live in a State where payday lending is not permitted, and they get small dollar loans.

Mr. MCHENRY. Sure, and you know what they do? They travel across State lines in North Carolina. I have seen the effects in North Carolina—

Ms. FOX. In New England—

Mr. MCHENRY. Pardon me?

Ms. FOX. In New England—

Mr. MCHENRY. Well, I'm not from New England. I'm giving you the North Carolina experience—

Ms. FOX. Yes.

Mr. MCHENRY. —and, you know, you have mentioned that basically, in North Carolina, we haven't suffered based on a prohibition of payday loans.

Ms. FOX. That's what the banking commissioner's survey of North Carolina consumers found, that they were—they didn't miss it. They were glad to see it go.

Mr. MCHENRY. Certainly, in terms of who they deal with, and the regulated—you are saying that one person's opinion is invalid from the Federal Reserve, which I think the American people know is pretty valid, and another person's is very valid, based on your political perspective.

Ms. FOX. Well, the North Carolina bank—

Mr. MCHENRY. Mr. Flores?

Ms. FOX. —had an—

Mr. MCHENRY. Let me actually go on to someone else, Ms. Fox. I don't have much time, and we obviously know your perspective on this, that you just—you understand the demand, but you don't think it's possible or necessary to fill that demand with regulated means.

Mr. Flores, you do a lot of work on this, and the question is, do you have an opinion on whether consumers are better off, or not better off, to have a regulated payday alternative?

Mr. FLORES. Sir, they're much better off. It's a $40 billion demand annually—

Mr. MCHENRY. Why are they better off?

Mr. FLORES. —for this type of credit. That $40 billion would have to be met with other vehicles. And right now, that other vehicle is basically an overdraft or a credit card advance.

A credit card advance is very expensive. You have an advance fee of 3 to 5 percent. And in these cases, you are going to have APRs well north of 20 percent. Most people will make minimum payments, and they will never get out from under it, versus a payday loan, which they fully plan to pay off in that 1-week or 2-week period.

Mr. MCHENRY. Well, thank you, Mr. Flores. And what I would say is you're missing a third option, which is the illegal option. And Mr. Chairman, if you will give me 15 additional seconds.

There is a third option, which is the illegal option, which—instead of charging a high interest rate, the experience I have had with individuals I knew and worked with in my family's business, that they could get lending, and it was dollar-for-dollar lending. If you wanted $20, you paid $20.

Mr. ELLISON. The gentleman's time has expired.

Mr. MCHENRY. And if you didn't pay, you got your legs broken.

Mr. ELLISON. The gentleman's time—

Mr. MCHENRY. That's the illegal option, and that's unfortunately what Ms. Fox is really trying to put people into.

Mr. ELLISON. The gentleman's time has expired.

The Chair will recognize the gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Let me begin by going over a little bit here. First, let me deal with the State's preemption issue. It certainly is the intent of this legislation not to interfere with those States who already have laws on the books of whatever nature they may be. And I think when we get to my colleague from New York, Mrs. McCarthy, she's going to go into a little more detail with this, because there are varying understandings of that.

But certainly this legislation is a targeted piece of legislation that targets 23 States that do not have any regulatory reform on payday lenders. It is also an effort by this body to get a bill passed that will provide some major protections for consumers and our constituents who want this service. Whether we may want it, or may use it or not, there is a niche and a market that is there that consumers want and need.

Let me just very briefly—Ms. Fox, are you aware that this legislation caps interest rates and fees for short-term loans at a combined 15 percent, and at the same time gives borrowers liberal, very liberal, repayment loans that are structured in a way that will not take them into this cycle of unending debt?

Ms. FOX. I'm glad you have asked about that, because there are some States that have tried using an extended repayment plan, and it hasn't worked to prevent payday loans from being a debt trap.

In those States, they have the same average number of loans for customers as the rest of the States that authorize payday lending. And that's because the payday lender whose profit is based on getting consumers to renew loans one after another, has no incentive to encourage people to use the repayment plan. You have to ask for it.

So in the States that have tried it, only 2 to 3 percent of the eligible loans end up going into the repayment plan. We have the same problem with the renewal ban. It prohibits renewals. Well, all but five of the States that permit payday lending prohibit renewals in one way or the other.

But consumers just come in on payday, pay off the loan, and now they don't have enough money to make it for the rest of the pay cycle. So they write a new check, they take out a new loan. It's not counted as a renewal, it's a back-to-back loan. And that's how people get trapped in the debt trap.

Mr. SCOTT. All right. But what I'm saying is you support the measure that we have in the bill, or do you not support in this legislation, our language that will regulate and will impose balanced criterion on these loans, which specifically address the cycle of debt and excessive interest rates that result from continually refinancing or rolling over these loans? That is the crucible of the issue—

Ms. FOX. Right.

Mr. SCOTT. —that this bill addresses and stops, which is the most egregious point in payday lending.

Ms. FOX. We think this bill authorizes egregious lending. It authorizes writing unfunded checks to get loans. It authorizes a payback term of as little as 2 days. It authorizes back-to-back loans, one right after the other.

Mr. SCOTT. All right.

Ms. FOX. And it does not serve as your intended consumer protection.

Mr. SCOTT. All right. Well do you believe, Ms. Fox, that for these 23 States that have nothing, this bill will offer some help, and a regulated form is needed?

Ms. FOX. It doesn't offer much of a reduction in the rates. For example, in California, payday loans cost—

Mr. SCOTT. But my question is—and I agree. We have to fashion measures to try to respond to constituents' needs, and measures that we can develop the coalitions and alliances of thought, that we can get through this body.

Ms. FOX. Well, we—

Mr. SCOTT. And so the point I'm saying is, would not these 23 States be better off with this effort of bringing some relief and some reform into regulatory reform? Just yes or no, that's all I wanted to—

Ms. FOX. No, they would not be better off, because of all the loopholes in the bill.

Mr. SCOTT. All right.

Ms. Guzman, let me ask you this, because I only have one question. I understand, I believe, you have used payday lending, is that correct?

Ms. GUZMAN. Yes, I have.

Mr. SCOTT. So I think that your comments will be very important. May I just ask—

Mr. ELLISON. The gentleman's time has expired.

Mr. SCOTT. All right.

Mr. ELLISON. Mr. Marchant from Texas.

Mr. MARCHANT. Thank you. First of all, my position on this, after serving 18 years in the State legislature, and dealing with this issue every single session for 18 years, is that this is an issue that very much deserves to be debated and decided in the State houses.

I do not believe this is a Federal issue. I'm with Mr. Watts on this issue. I do not believe that you can write legislation on this kind of a subject at the Federal level, and try to force it down on States who have clearly had the opportunity.

Probably every year they meet, these 23 States have had the opportunity to take this subject up. So that—I'm not for the legislation simply because of that.

As far as trying to set Federal lending limits and Federal—and actually have the Federal Government set rates on a private transaction, a legal private transaction, that also is something that I'm not interested in.

Perhaps there's some venue—because there is Federal insurance on the banks, there may be some case to be made for preemptive rights of the Federal Government to go down and talk—and pass ordinances and laws for banks.

In Texas, we were the last State in the Union to have branch banking, because we felt like it was a States' rights issue. We were the last State to pass home equity loans, because we felt like it was a States' rights issue.

So I'm very much a States' rights issue guy on this here. I do not believe that the Federal Government can effectively regulate this industry.

I represent a district that—throughout my career, I always felt like the payday lending industry was an industry that I would see in districts where there were a lot of working class people, or a lot of people who live from paycheck-to-paycheck.

But my district is a suburban district near Dallas. And if you walk into one of the payday lenders in my district, you're going to find housewives, you're going to find school teachers, you're going to find factory workers, you're going to find people who work for the city, and you're going to find people that I don't think that we have given enough credit to.

These are people who can add and subtract and multiply. They know that bouncing the check at the bank is not a good thing. They know that it is costlier to go to the bank and bounce a check, than it is to go to the payday lender. They know that it could hurt their credit rating if they make a credit card payment late. They know that the credit card late payment is probably going to be more expensive than the payday lending rate.

So I, like the testimony the gentleman from Louisiana—we think that our system in Texas is working very well. I would like to give the other 23 States that have decided to not do anything about it, or still haven't decided what kind of laws they want to make, to continue to have that—those rights, and to continue with that.

For that reason, I am going to be against the bill, and thank you, Mr. Chairman.

Mr. ELLISON. The gentleman yields back. The Chair will recognize the gentlelady from New York, Mrs. McCarthy.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman, I appreciate it, and I appreciate this hearing.

First let me say, and join my colleagues from North Carolina and Georgia—that, you know, in the State of New York, we do not have payday lending, but we do. It's just a different form of what you're talking about. What is defined and regulated by the State as a payday loan, they have operations that offer similar products, but don't meet all the principles of a payday loan, so they're unregulated, and that is a grave concern.

And I think that's what, you know, we're trying to get at. Now I know CFSA has best practices for the payday advance industry. A lot of that has been put into this bill. The only difference will be that within this bill, there will be teeth, where we can actually—do regulate that, if that's what is going to come down on the road.

So to say that, you know, some of the States don't have any form of payday, I find not true. But the other thing is too, in my area where we have "payday lenders," we don't have any banks.

So where are those people who live in those particular areas—there is no banking. The other thing is, in almost all the banks I know, you have to have an account to go in and cash a check.

So again, we're finding problems with that. You know, if it's a paycheck from a—whatever the job is, and they have an account there, maybe the bank will cash that check, but otherwise, you can't cash a check there.

So I guess my feeling is that—I guess I want to go to Mrs. Fox. It's my understanding that the Consumer Financial Services Association of America has a list of best practices that their members must follow, and that the legislation reforming payday loans, H.R. 1214, puts a cap on interest rates that is lower than the fees allowed, again, in 23 States that allow payday lending.

Could you explain how a payday loan could be worse than the consequences of not being able to obtain a short-term loan from a financial institute, forcing an individual to bounce a check, as we have heard from many of my colleagues? And I think that's something that we have to take into consideration.

There is no one here—Republican or Democrat—who wants to condone anyone who is ripping off any of our constituents, nobody does. But the fact of life is that we need to have people—when they want to cash their check, or have a short-term loan, they need to have a place to go.

To me, it's almost like an ATM machine. Here are your prices. If you want to borrow or take money out with your credit card, you're going to pay an upfront fee. And if we can do that with some sort of regulation, I think that it's better than what it is today.

Ms. FOX. In New York, your 25 percent criminal usury cap prohibits payday lending, and although you have check cashing outlets where people pay a fee to turn a paper check into cash, that's not a credit transaction. I know you do have refund anticipation loans that are expensive in New York, because those are offered by banks, and New York can't regulate those interest rates.

But there are other options. Everybody who gets a payday loan is a bank customer. You have to have a checking account open in order to write a check. You can apply to your bank for real overdraft protection at a lower cost. A lot of credit unions offer low-cost, small loans to their members. And in Pennsylvania, the treasurer of the State puts deposits into credit unions to encourage them to make very-low-cost loans available in Pennsylvania. There are other options.

Mrs. MCCARTHY OF NEW YORK. I agree with you on that. But I'm saying to you, I know in certain districts—part of my district, they don't have a credit union. They don't have a bank. Where are they supposed to go? They also probably don't have a car. So where do they go?

Ms. FOX. Most people, when they have a $100 or $200 shortfall, turn to their family and friends. They deal with whatever the credit emergency is. They call the utility company and ask for extended payments. They ask the landlord for more time.

Mrs. MCCARTHY OF NEW YORK. Ms. Fox, I'm not trying to give you—

Ms. FOX. Paying 400 percent interest doesn't help.

Mrs. MCCARTHY OF NEW YORK. Ms. Fox, I'm not trying to give you a hard time, but we're talking about people who are probably on the very lower end of income. And most likely their family members are not going to have money.

But with that—I saw that—Mr. Flores, you wanted to say something?

Mr. FLORES. Yes, I would like to respond to that. When you go to the bank to apply for a traditional overdraft line of credit, which would be akin to a credit card, many banks that I have dealt with, who have actually formalized these overdraft programs, have limited or eliminated offering the traditional overdraft line of credit because there is very little revenue associated with that product. The revenue is all in this overdraft protection program.

So I think it's very difficult to say that people have the option to go in and get this. Because banks have looked at the profitability of all these products, and given the interest margin squeeze they are all facing right now, they are looking for the most profitable products they can offer.

Mrs. MCCARTHY OF NEW YORK. Thank you. With that, I yield back my time.

Chairman GUTIERREZ. Thank you. We're going to go to him, I just want to alert the members that when we begin these hearings, there are 10 minutes per side, by unanimous consent, for opening statements. And if people want time, they will be allotted that time on the basis of their seniority in the committee, so that everybody has ample time to be able—the gentleman on my right takes care of that side, and sometimes people don't get to speak.

I assure you when I was here 17 years ago, and I was way down there on the fourth row, I would have hoped these kinds of rules would have been in place.

Mr. Cleaver, you are recognized for 5 minutes.

Mr. CLEAVER. Mr. Chairman, this is one of those times—I know people assume that we come here with all—with the positions already in concrete, which is not true for me, certainly not today. Most of the assumptions I came in here with have dramatically changed, although I am not a fan of payday lending, not at all.

But I am concerned about—and I'm not sure anyone has addressed, a way in which we can provide necessary services to the unbanked. And it is—the unbanked represents an untapped market, and I'm not—I'm a federalist, so I'm not interested in supplanting Federal legislation—of supplanting State legislation with Federal legislation.

And so I'm really struggling with exactly where I am. The only thing I know for sure is that I don't like payday lending, because I think some of the practices, frankly—when you have fees of 300 percent, as happens in some places, that can't possibly be good. But on the other hand, what do we do to provide service to the unbanked? Can anybody—yes, sir, Mr. Flores?

Mr. FLORES. Mr. Cleaver, I have worked with clients in the past who have tried to address the unbanked situation. And the key to the unbanked is that the first product they need is the checking account.

And one of the strategies that has been employed is what is called a checkless checking account, where direct deposit is made to eliminate any potential fraud on the deposit side, or returned items on the deposit side. And no checks are permitted, only the debit card for ATM withdrawals and point-of-sale transactions, which would eliminate any potential for overdrawing this type of account. Once somebody establishes that, and over a period of time has a track record, then they go that next step in developing the appropriate credit—

Mr. CLEAVER. Well, the problem is—thank you. I hate to cut you off, except my time is running out.

And the problem with that is, when you go into the urban core, there is no gradualization, because there is no bank. You know—I mean, you can ride around in the urban core for miles and miles, and not come across a bank, or a grocery store, for that matter. But so—Ms. Guzman?

Ms. GUZMAN. Congressman, let me say that going back to my statement of an evil, but a necessary evil. When we deal with evil, we try to minimize the impact. And I think this legislation, and legislation like it that permits payday lending establishments, however regulates or caps the fees to protect the consumer, is the only answer.

Addressing Mrs. Fox, many of my neighbors do not have family members they can turn to for a payday lender situation. We have a transient population right now with the economy, where people move from community to community, State to State to find jobs. Many of them are first generation Americans, native born Americans. They do not have a family support base or safety net here.

So as I stated, payday lenders, there is a market for them. There is a need for them, and I would just be very grateful if we—

Mr. CLEAVER. Yes, but the—where I'm trying to go—thank you. Where I'm trying to go is, and maybe I'm inarticulate—

Ms. GUZMAN. What is the answer?

Mr. CLEAVER. What happens to the people who live in areas where there are no banks?

Ms. FOX. There are—may I?

Mr. CLEAVER. Ms. Fox?

Ms. FOX. There is a program that has been launched in a lot of large cities. It is called "Bank On," where the mayors and local civic leaders are working with banks to encourage them to provide the basic entry level banking services that the communities that you're describing need.

My organization, Consumer Federation of America, is working on America Saves campaigns across the country, to try to help low- and moderate-income consumers become savers. We have new data out from the Federal Reserve that compares people who use payday loans with people who don't. And the folks who don't use them are twice as likely to be savers than the folks who end up at a payday loan outlet.

So there are creative programs being worked on to bank the unbanked. The problem is, once you get these consumers banked, now they are the prime market for payday lenders, since having a checking account is a prerequisite, but they don't have enough money to be able to pay the loan back all at one time on their next payday.

Chairman GUTIERREZ. Yes. Thank you very much. Your time has expired.

Mr. CLEAVER. Thank you, Mr. Chairman.

Chairman GUTIERREZ. Ten seconds to go out of order. Unanimous consent—I would like to ask Mr. McCullen a question before we go any further. Hearing no objection, it is so ordered.

I have your statement here, the last paragraph:

"I respectfully request that you defeat this bill in its current form, or alter it to mirror the Louisiana law, which allows $20—which allows $.20 and a dollar—a dollar plus"—per dollar, sorry—"and a documentation fee."

So you're against the bill in its current form, is that correct?

Mr. MCCULLEN. Yes, sir.

Chairman GUTIERREZ. Thank you.

The gentlelady, Ms. Speier, is recognized for 5 minutes.

Ms. SPEIER. Thank you, Mr. Chairman.

Ms. Guzman, I have a question for you. If you could get a payday loan for 36 percent instead of 300 percent, would you like that?

So would you support a bill that had an interest cap of 36 percent, instead of 300 percent?

Ms. GUZMAN. I would support any loan that would—

Ms. SPEIER. Would you put your microphone on, please?

Ms. GUZMAN. I apologize. I would support anything that would minimize the negative impact to consumers or my neighbors.

Ms. SPEIER. So there—yes, Mr. Flores?

Mr. FLORES. I would like to—

Ms. SPEIER. Would you support that?

Mr. FLORES. Well, it sounds good. But the issue is, when you do a 36 percent annual percentage rate, that means it boils down to a $1.38 fee for a $100.00 advance. And no one can—there's not a business model that will allow anyone to even cover their costs and offer that product.

So while yes, it sounds good, and it is—36 percent on a traditional installment loan makes sense, for this type of fee product, it does not make sense, because no one—you would put the industry out of business, and you have—

Ms. SPEIER. Well, maybe—maybe some of us think that the industry has overstayed its welcome.

Mr. FLORES. Well, yes, ma'am, but—

Ms. SPEIER. That's—Mr. Flores, that's all I have to ask for you.

It appears that the payday lending industry is losing some of its momentum. In fact, there hasn't been an initiative that they brought before a State since 2005, that has actually passed. Because the people in our communities recognize that 300 percent interest rate is not a good interest rate. And in D.C., as I understand it, it has been prohibited—payday loans are now prohibited, as is they are in New York and other places.

And I have to believe, that in huge communities like that, where there are a high percentage of low-income people, they are finding other ways to get credit when they need it.

The question I have for you, Ms. Fox, is the following: What are the loopholes in this bill?

Ms. FOX. The bill defines a covered payday loan as only closed end, so it leaves out all the payday lenders who have turned their product into an open-end product. For example, in Virginia, Advance America makes open-end loans—same cost structure, same term for the loan. It's just they called it open end. It would not be subject to this bill.

Any loan that was for longer than the 90-day definition, would not be covered by this bill. And payday lenders have already changed the term of their loans, in order to get around that kind of definition as well.

We are also concerned that the credit services organization model, which is used widely in Texas—Texas has never passed a payday loan industry bill to allow payday lending. The Texas Finance Commission rules would permit it under their regular small loan law, but most lenders in Texas call themselves credit services organizations, and charge a high fee for arranging a loan with some third party lender. It's not clear to me that they would be subject.

So we have a bill that would leave out almost all the payday lending in Illinois, probably all of it in Texas, a big chunk of it in Virginia, and it would be very easy for lenders in 10 of the 23 States that permit higher than the 390 percent cap in this bill, to just change their product into an installment product, because there's no rate cap on installment lending.

So it would be very easy to get around the definitions in this bill, and keep right on charging 500, 600 percent, without violating this bill.

Ms. SPEIER. So what would improve the bill?

Ms. FOX. It would improve the bill to prohibit holding personal checks as security for the loan, to make these loans on the basis of a contract.

Ms. SPEIER. Let me ask you a question on that. It seems to me almost illegal, because you're not supposed to provide a check if you don't have sufficient funds.

Ms. FOX. You would think so, wouldn't you?

Ms. SPEIER. So you are basically—they are basically asking the person to conduct themselves in an illegal manner by offering up that check, that they don't have sufficient funds to use.

Ms. FOX. That's true. And in some States, the payday loan law has to exempt these customers from being subject to the criminal bad check law, because otherwise they would be.

But the lender knows you don't have money in the bank when they take the check. But they hold it, and that adds costs for consumers. In Virginia, people paid, in 2007, about $5 million to their own banks in bounced check fees, because their payday loan checks were returned.

Ms. SPEIER. Okay, so that would improve the bill. What else would improve the bill?

Ms. FOX. A longer loan repayment term. If you gave people 5 months to repay your payday loan as structured here, at $15 per hundred. That gets it down to 36 percent APR. We know from the chart I included in my testimony, that the typical family making $35,000 a year cannot pay all of this back out of one paycheck.

Chairman GUTIERREZ. The time of the gentlelady has expired.

Ms. SPEIER. Thank you.

Chairman GUTIERREZ. Congresswoman Maxine Waters from California.

Ms. WATERS. Thank you very much. I'm going to yield to the gentlelady from California. I just came in. Her line of questioning is exactly what I looked forward to doing, so Ms. Speier, would you continue your line of questioning, please?

Ms. SPEIER. Thank you.

So we had so far established that if you would not require them to hold a blank check, that would be an improvement to the bill. If you could provide within this bill a longer repayment period, that would improve the bill.

What else would you—

Ms. FOX. And a reasonable small loan rate cap. Competition does not drive down the cost of payday lending. You may have a payday lender on every corner, but they are all typically charging the legal rate. It takes a rate cap to bring down the costs of loans to consumers who have little power in the market.

And the traditional small loan rate cap of 36 percent is a reform that consumers say they want to have. In polling that was released just this last week, 70 percent of Americans want a rate cap of 36 percent or less to protect consumers from rate gouging. And that's the rate cap that was upheld in voting at the polls in both Ohio and Arizona last fall.

Consumers don't think that creditors should be allowed to charge 400 percent.

Ms. SPEIER. Ms. Fox, just to point out to you, when I introduced the bill that would create a usury rate of 36 percent, I had people in my district calling me saying, "That's too high," so they would find this particular conversation particularly interesting, I think. I yield back.

Chairman GUTIERREZ. The gentlelady yields back.

Mr. Paulsen?

Ms. WATERS. The gentlelady is yielding back her time to me. Let me just say, Mr. Chairman, that the payday lending has always been a real concern of mine. And you're right, I happen to have a portion of my district where we have a lot of lenders, and the argument is made that, you know, people depend on this kind of lending. But I just think that 300 or 400 percent is way too high.

Let me tell you what I began to think about payday lending. We have been dealing with subprime loans, and we refer to many of the deals as exotic lending, where we had Alt-A loans, that they didn't do verification on employment.

We had adjustable rate loans that were just outrageous in the amount of money that it costs the taxpayer when they reset with these high margins, and on and on and on. And we're calling for regulation, and we want tighter regulation.

The same thing is going on here. We have products that are injurious to our consumers, and we need to crack down on this. Just as we're looking at the subprime loans, and the mess that was created, we have a problem here with people making very little money, who will never be able to get out from under this kind of debt, unless we do something to crack down. Now this has been going on for a long time.

And so, Mr. Chairman, just let me say that no matter what the intent is, the fact of the matter is we have to resist any attempt to make it look as if we are cracking down, when in fact we are opening the door for more abuse.

And I will yield back the balance of my time.

Chairman GUTIERREZ. The gentlelady yields back her time.

Mr. Paulsen, you are recognized for 5 minutes.

Mr. PAULSEN. Thank you, Mr. Chairman. And I know a lot of the questions I had have already been asked. But I wanted to ask Mr. McCullen first, perhaps, how would the legislation, H.R. 1214, really impact your business? If you could just describe how the legislation would impact what you do.

Mr. MCCULLEN. The legislation that's being discussed here today, if it had been in place in Louisiana last year, I would have ended in the negative. That's why I'm here not to support this bill.

I ask in my testimony that you implement the Louisiana bill, because I am listening to all these different things being said here. We don't have these problems in Louisiana, because it's against the law. We had 24 complaints last year, and we have over 4 million transactions.

We have a very tight, succinct bill that we're able to operate under, and it protects the consumers. So that is why I was against this bill.

Mr. PAULSEN. I'm just curious, Mr. McCullen, then, I mean, who would really benefit from this law if that's the case? Is there another product that's similar to yours that you offer, and I had mentioned this in my opening statement, but, you know, on a widespread basis, is there any other product that's offered that really substantially is available at a lower cost for people?

Mr. MCCULLEN. Not to my knowledge, no.

Mr. PAULSEN. And coming from Minnesota, Mr. Chairman, it is the case where I have talked to people in this industry, too, that their average interest rate that they'll charge is only 9½ percent, and so a very reasonable level. Ms. Fox had mentioned earlier her concern about triple digit APRs. And I'm just curious, what do you think of a 99 percent APR, Ms. Fox?

Ms. FOX. It's still high. It sure beats 520 percent, which is what they can charge in Louisiana for a single payment loan. We think that the traditional small loan rate cap in States has been around 36 percent. It provides for loans to consumers who don't have a perfect credit rating under an affordable repayment schedule. And we think that would be more beneficial than what's being proposed here.

Mr. PAULSEN. Well, and I think it's also important to point out that it would be very beneficial for consumers down the road to not necessarily rely on the description of an APR. I don't think consumers understand what APR means, necessarily, and just regulating not having that triple digit APR, that is going to be much more easier for consumers if they understand what real fees are. We have seen that in the credit card industry.

Mr. McCullen, do you have a comment on that?

Mr. MCCULLEN. I appreciate that comment, because I wanted to bring that to the table. Most Americans do not understand APR. I have lots of friends of mine who are personal friends of mine, they do not understand what we do, and how we do it. When I explain it to them, they understand that this is a flat fee.

And I also want to make a comment about APR. The American Banking Association testimony that was before the subcommittee on March 19th, said with regard to applying APR to overdraft fees, and other short-term credit product, "Any time an annual percentage rate is calculated for a term of less than a year, the inclusion of a fixed fee, even a modest one, will distort and overstate the APR. The shorter the repayment period, the greater the APR will appear in instances where there is a fixed fee. This means that the sooner the consumer repays, the greater the calculated APR, a difficult concept to explain to consumers, as it appears they are paying—that paying earlier actually increased the cost of credit."

Mr. PAULSEN. Well, and Mr. Chairman, it just points out, I think there are some States that have done some good things, and have some good models. And Minnesota and Louisiana might be another case too, and I hope we consider that as the legislation moves forward. Thank you. I yield back.

Chairman GUTIERREZ. Thank you.

Mr. Sherman, you are recognized for 5 minutes.

Mr. SHERMAN. Thank you. I'm a bit confused about using APR as a way to determine the fairness of the fee.

Ms. Fox, I was once at my bank an hour before it opened. Usually I would go inside to get a couple hundred bucks out of my account, but I wanted the money an hour sooner than I could get because, like, they were closed. And so I went to the machine. I paid—my bank was good. They only charged me a $1 fee to get my $200 an hour early, $1 to get my $200 an hour early.

Now that's 186,000 percent APR. Am I an idiot for paying 186,000 percent APR to pay that $1 fee just for an hour?

Ms. FOX. Was the $1 fee to borrow the money, or just a fee for accessing it through the ATM rather than in person?

Mr. SHERMAN. It's a time value of money. I was going to get the same money sooner, whether it constituted a loan for the hour, which was then repaid to the bank without further cost or otherwise. I mean, it's—I got my money an hour early, time value of money, 1 hour, $200, it is 186,000 percent APR.

Ms. FOX. Well, I would never say that a Member of Congress was an idiot, so—

Mr. SHERMAN. Everyone else does.

Ms. FOX. Well, I would never say that.

Mr. SHERMAN. Okay.

Ms. FOX. But I would say—

Mr. SHERMAN. Should that transaction be banned because it's 186,000 percent APR?

Ms. FOX. Well, that's not the product we're talking about today.

Mr. SHERMAN. I'm asking you a question.

Ms. FOX. Okay.

Mr. SHERMAN. You don't get to confine your responses just to what we're talking about today.

Ms. FOX. Truth in Lending has been the law of America for 4 decades. It requires that credit be quoted with a comparable price, so you can compare a 1-month pawn transaction, a 2-week payday loan, a 6-month installment loan, and a cash advance on a credit card, and that's the price tag.

Mr. SHERMAN. But when you are doing things for a short period of time, I mean—

Ms. FOX. That's right.

Mr. SHERMAN. —if one payday lender charges $30 to use the money for 2 weeks, and another one charges $40 to use the money for 3 weeks, you don't necessarily say that the higher fee is the better deal. Time value of money is something I understand, I'm a CPA.

Ms. FOX. Yes.

Mr. SHERMAN. I also understand it just doesn't make any sense to evaluate a fee like transaction.

Ms. FOX. Well, we disagree.

Mr. SHERMAN. Okay. The other point I'll make is, I deal with my constituents. They know I'm a CPA. They ask me all kinds—the only financial transaction they do understand is they payday loan.

Ms. FOX. Well—

Mr. SHERMAN. None of them understand just about anything else, but you say, okay, you use your credit card, and you pay most of it off, and then you use it some more. How much is that going to cost you? They have no idea. You use your overdraft protection. How much is that going to cost? Nobody knows.

Ms. FOX. Well, if this subcommittee would enact Representative Maloney's overdraft bill, consumers would get Truth in Lending cost disclosures for those loans as well, and we think that would have a great benefit on the banks.

Mr. SHERMAN. Well, what I'm questioning is whether Truth in Lending makes any sense at all for loans of less than a month or 2 months. What you think of as great information, to my constituents is gobbledy-gook or misleading.

Ms. FOX. Well, requiring loans to be repaid in less than several months also doesn't make very good sense for consumers in the income bracket who use payday loans.

Mr. SHERMAN. Some people only want to—I see my home girl from the San Gabriel valley, where I grew up, Aztecs—

Ms. GUZMAN. Yay.

Mr. SHERMAN. —and I mean, were there occasions where you needed the money for only a month, or did you always have a need for the money for 3 months or 4 months, or longer?

Ms. GUZMAN. No, on that particular occasion that I discussed earlier, I did only need it actually for 30 days. What I did was I paid it back, because I'm not allowed to rollover, and literally borrowed it back at that moment, again, paying another fee, because I couldn't pay it back for 30 days. But, you know, I was able to pay it back.

Mr. SHERMAN. But you only held the money for a grand total of 30 days?

Ms. GUZMAN. Yes.

Mr. SHERMAN. Okay. So if we forced you to take the money for 60 days, but we charged you just a little bit more, would that help you?

Ms. GUZMAN. Well, it would at least give me the option of not having to pay it back in 2 weeks. I'm just saying in my—Congressman, in my experience, everyone's situation is different. I do have very well-intended neighbors who would need the loan—

Chairman GUTIERREZ. The gentleman's time has expired.

Ms. GUZMAN. Oh, I'm sorry.

Mr. SHERMAN. Okay. I just ask the witness not to tell anybody in the San Fernando Valley that I actually grew up in the San Gabriel Valley. I yield back.

Ms. GUZMAN. My lips are sealed.

Chairman GUTIERREZ. Yes. We ban rollovers in this particular bill, and we give you 90 days to pay the money back, so you wouldn't have had to pay the fee again.

Mr. Childers is recognized for 5 minutes.

Mr. CHILDERS. Thank you, Mr. Chairman, and I have been following between votes, and the earlier part of the panel, I want to thank you all for being here from my office. And I think this has really been touched on today, but I really wanted to address the issue, Mr. Chairman, of regulating by the States. And I just want to go ahead and say this.

I am from Mississippi. Mississippi is no different from all the other States. We have varying degrees of people in need of various amounts of loans and sizes. I come from a State, quite frankly, that does a good job of regulating. They do a good job of regulating banks, they do a good job of regulating consumer loans, and they do a good job of regulating payday loans, if that's what it is to be called.

Now at my age, I have survived many errors, let me just say that. And there are times that I needed a little bit of money, and there were times that I needed a lot of money. And I'm not so sure that this is really the avenue for us to take on this. And I will say this. I'll use my own State as an example there.

It is my belief that customer John Doe will go to the place where he can borrow money—or Jane Doe—will go to the place they can borrow money, for the least amount. I believe that. I have done that in my life.

There are times that my own hometown banker probably charged me more than my neighbor, but there were a lot of factors. Maybe my credit wasn't as good as that time. Maybe he thought I already owed too much money. I just—I wanted to make that just as a statement really and—to the panel. And I understand each of your interests, and I appreciate that. I read what you delivered to us and I have listened to you while in my office, in between these votes today.

But my State does a good job, and I really have nothing but compliments for my own State. And in my State, the payday loan companies seem to be the target, if you will, of maybe this discussion today. The people there—and don't get me wrong, I'm certain that there have been instances where people have been aggrieved. It is like any industry. There are always some who have been wronged, or believe to have been wronged.

By the same token, I saw this industry in my State, and regardless of what I personally think about the industry, I will say this. They stepped up and worked with the State of Mississippi to regulate themselves to a degree, or to accept regulation, so they could stay in business.

I'm anxious—you know, I welcome any comment from the panel back, but I just wanted to speak, I guess, on behalf of State regulation.

Mr. FLORES. Congressman, I was just looking at my study, and for the State of Mississippi, since you do allow payday lending—

Chairman GUTIERREZ. Mr. Flores, could you put your microphone on?

Mr. FLORES. I'm sorry. The State of Mississippi, the average consumer who has a checking account, pays $163 in overdraft in NSF charges, compared to the national average of over $300. So again, according to my opening statement, is there a direct correlation? I don't think there's enough data yet, but there's certainly an indication that we ought to look at it in more detail.

And so the consumers in your State are paying less in overdraft charges than consumers in many other States.

Mr. CHILDERS. I would agree there probably isn't enough data to say that is it, but it is—if it's a fact, it just is what it is.

Thank you, Mr. Chairman.

Chairman GUTIERREZ. You're welcome.

A couple of quick questions to Ms. Fox. You said—is it your testimony that competition will not drive down the price of payday loans?

Ms. FOX. It has not, no.

Chairman GUTIERREZ. Okay. So supply and demand works everywhere else except the payday industry.

Ms. FOX. That's right.

Chairman GUTIERREZ. I just wanted to make sure that was your testimony. I can tell where you're at. And then your testimony is that the bill would force payday lenders to change their product.

Ms. FOX. It would give them an incentive to change their product.

Chairman GUTIERREZ. So while it has nothing to do with the driving down the price, it will change their behavior in terms of changing their product to installment loans.

Ms. FOX. From past experience, that is likely to happen.

Chairman GUTIERREZ. From past experience. So it does have on one, but not on the other.

Everyone has had an opportunity.

I would ask unanimous consent that a letter supporting the goals of this legislation from the National Association of Federal Credit Unions be entered into the record. Hearing no objection, it is so ordered.

I want to thank the witnesses and the members for their participation in this hearing. The Chair notes that some members may have additional questions for the witnesses, which they may wish to submit in writing. Therefore, without objection, the hearing record will remain open for 30 days for members to submit written questions to the witnesses, and to place their responses in the record.

This subcommittee hearing is now adjourned.

[Whereupon, at 4:56 p.m., the hearing was adjourned.]

A P P E N D I X

April 2, 2009

Testimony of Michael Flores
House Financial Institutions and Consumer Credit Subcommittee
April 2, 2009

Thank you, Mr. Chairman, members of the Committee. I'm Michael Flores, CEO of Bretton Woods, Inc. a management consulting firm. My clients include commercial banks, thrifts, credit unions and the payday lending industry. I have more than 30 years experience and have taught at the Graduate School of Banking in Madison, Wisconsin and the Pacific Coast Banking School in Seattle, Washington and have published several articles and studies on the financial services industry. My expertise is on how financial institutions make money.

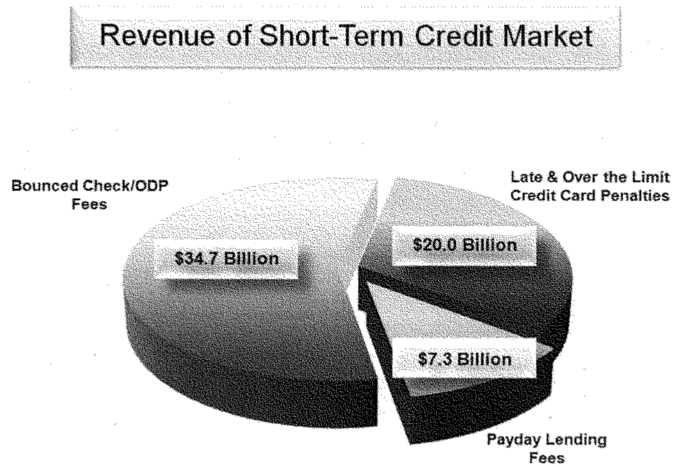
Because this hearing is about payday lending legislation, I am here today to put payday lending in the context of the bigger picture: the short-term, unsecured credit market.

The short-term credit market is made up of products and services for people who need a small amount of cash for a short period of time. It is a more than $70 billion dollar market that includes credit card over-the-limit fees, bounced-check/non-sufficient funds fees, overdraft protection and payday loans. Additionally, the market includes tens of billions of immeasurable dollars in late fees paid annually by consumers. All of these credit products are short-term, all unsecured.

Currently, banks and credit unions control the largest share of this market. That may surprise some people because very few banks offer the unsecured, short-term, small-dollar products that you would typically consider to be a loan. As the Committee may know, only 30 banks have signed up for the FDIC's small loan pilot program which was designed to see if alternatives to payday lending could be offered profitably. The results, to date, are not promising. The legacy cost structures of banks inhibit their ability to offer short term, low dollar credits in a profitable manner.

So what role do banks play in the short-term credit market? Primarily through non-sufficient funds fees (NSF) more commonly known as "bounced check fees," and overdraft protection, which the FDIC itself recently categorized as a short-term credit product. These products are all part of a competitive marketplace and are all considered alternatives to payday loans.

The banks are in this marketplace in a huge way. I published research I conducted in November and December of 2008 and updated in early March this year finding that bounced-check and overdraft protection fees accounted for $34.7 billion in revenue for banks and credit unions in 2008. By comparison, late and over-the-limit penalties on credit cards account for $20 billion in revenues, and payday lenders generated $7.3 billion in revenues.



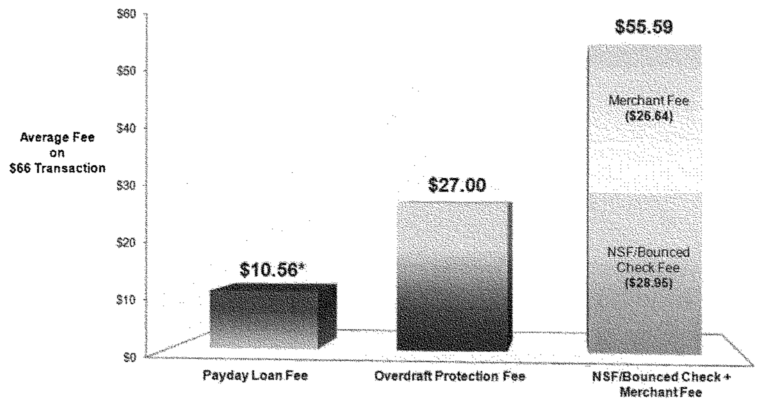
Revenue from bounced check and overdraft protection fees has become so significant to banks that they implement strategies to maximize income on these fees. For example, it is common practice for a check that has already bounced to be re-deposited. Banks also process larger denomination checks first before lower dollar items. In fact, the FDIC found that 53.7 percent of large banks batched processed overdraft transactions by size, from largest to smallest.

But let's look at this from the consumers' perspective. When a consumer does not have enough money in his or her checking account to pay a bill, they have the option of bouncing a check, using overdraft protection, getting a payday loan, paying the bill late or borrowing from another institution, primarily credit card advances, all of which come at a price.

The FDIC reports that the average amount of a check written to overdraw a bank account is $66. For that $66 check transaction, a customer would pay an average fee of $27 in overdraft protection fees. Customers without overdraft protection would pay a non-sufficient funds/bounced check fee averaging $28.95, plus a merchant fee averaging $26.64, to whom they wrote the bad check. In comparison, a customer who took out a $66 payday advance to cover the cost of the check would pay a fee of $10.56, based on a fee structure of $16 per $100 borrowed.

Cost Comparisons on $66 Transaction

$66 = Average check amount written to overdraw bank account



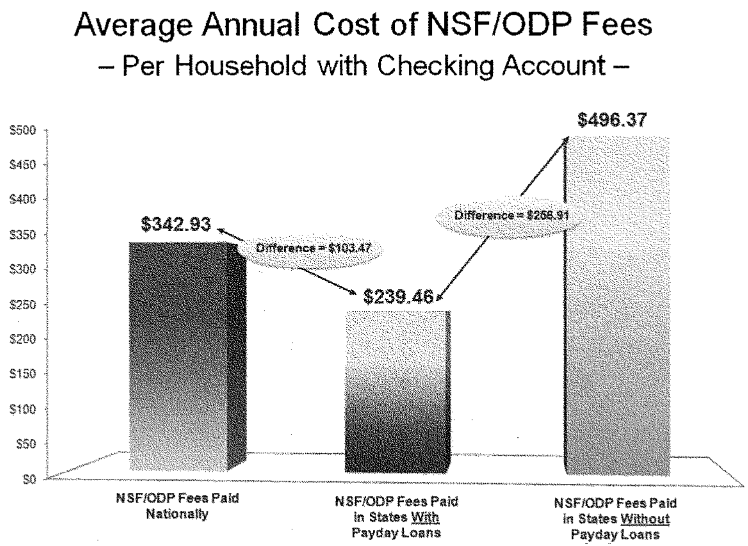
* Based on fee structure of $16 per $100 borrowed

Just by looking at the household data you can get a sense of which option is used the most. And this is the major point that I want to make today.

The national average household with a checking account paid approximately $342.93 in fees in 2008. The active households with bank or credit union accounts (20.2 million households) each paid $1,374 in annual NSF/ODP fees.

In states where payday loans are available, the average consumer pays $239.46 per year in ODP and NSF fees--$103.47 less than the national average. On the other hand, in states where payday loans have been eliminated, checking account holders pay, on average, $496.37 each year—that's $256.91 more than their counterparts who live in states with payday loans.

Comparative Data- ***2008 Average NSF/ODP per Banked Household***



I do not represent that these statistics definitively prove that payday loan availability reduces NSF/OD fees; I do maintain this it is a significant indicator and that an extensive and robust analysis should be conducted to determine any correlation between availability of payday loans to NSF/OD fees.

That said, the benefit to consumers of competition between banks and payday lenders for the short-term credit market is dramatic and indisputable. I am not here today to tell the Committee that one product is better than the other, as that depends on the personal financial situation of the individual.

It is my opinion, that bank services such as overdraft protection provide a useful service for customers. And that they are a direct competitor of payday loans. Like payday loans, they should not be used as a recurring method of obtaining credit, as they are intended for short-term use.

Likewise, I believe that there is a significant market for payday loans and that, if the industry is appropriately regulated by state and federal laws, like the one we are discussing today, then these loans responsibly meet the short-term, low dollar credit needs of many consumers. And among overdraft protection, payday loans and other short-term credit options, consumers will be in a position to choose the best lending option for them.

To sum up, I believe there is a need for all options to be made available in a regulated environment in order to satisfy the short-term credit market, a multi-billion, important market. I hope this Committee will find a legislative balance that increases, not diminishes competition in this market.

Consumer Federation of America

Consumer Action
Education and Advocacy Since 1971

Consumers Union
Nonprofit Publisher of Consumer Reports

National Consumer Law Center

NACA

U.S. PIRG
Federation of State PIRGs

Testimony Of
Jean Ann Fox
Director of Financial Services
Consumer Federation of America

On Behalf Of
Consumer Action
Consumers Union
National Association of Consumer Advocates
National Consumer Law Center
(On behalf of its low income clients)
US PIRG

Before
The Subcommittee on Financial Institutions and Consumer Credit

Regarding
H.R. 1214, the Payday Loan Reform Act of 2009

April 2, 2009

Chairman Gutierrez, Ranking Member Hensarling, and members of the Subcommittee, I appreciate the opportunity to offer our comments on payday lending and on H.R. 1214, the Payday Loan Reform Act of 2009. I am testifying today on behalf of the Consumer Federation of America,[1] as well as Consumer Action,[2] Consumers Union,[3] National Association of Consumer Advocates,[4] National Consumer Law Center (on behalf of its low-income clients),[5] and USPIRG.[6]

We appreciate your interest in protecting consumers from predatory payday lending and the debt trap that results from offering small loans at extremely high rates secured by direct access to the borrower's bank account. American consumers are paying billions in usurious rates for loans that undermine scarce family resources, risk bank account ownership, and compound cash-strapped consumers' financial problems. We agree that payday lending and other similar products should be reformed. However we respectfully disagree with the methods used in H.R. 1214.

We oppose enacting legislation to sanction a predatory credit product that traps cash-strapped American families in a debt cycle of repeat borrowing. Congress outlawed these loans for Service members and their families in 2006 and should extend the same protections to all Americans. As American families struggle to make ends meet, protections against extremely expensive loans, unaffordable repayment terms, and loss of control of bank accounts are more important than ever. H.R. 1214 does not provide the protections that American consumers need or want.

H.R. 1214 authorizes single payment loans at 391 percent annual percentage rate (APR) or higher for shorter term loans. H.R. 1214 provides Congressional approval to the hazards of lending based on soliciting consumers to write unfunded checks held for future deposit or requiring consumers to sign over electronic access to their bank accounts. While the rate cap authorized by this bill does not preempt lower state caps, Congressional approval of triple-digit lending will undercut reform efforts in the states. The protections against the payday loan debt

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[1] The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, founded in 1968 to advance consumers' interests through advocacy and education.

[2] **Consumer Action**, founded in 1971, is a San Francisco based nonprofit education and advocacy organization with offices in Los Angeles and Washington, DC.

[3] **Consumers Union** is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers.

[4] The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

[5] The **National Consumer Law Center (NCLC)** is a non-profit corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country.

[6] The **U.S. Public Interest Research Group (USPIRG)** serves as the federation of and federal advocacy office for the state PIRGs, which are non-profit, non-partisan public interest advocacy groups that take on powerful interests on behalf of their members.

trap provided by this bill have proven ineffective in states that have tried them. The H.R. 1214 definition of payday loan creditors and payday loan products is so narrowly drafted that its provisions will be easily evaded. For example, most payday lending in Illinois will not be impacted by this legislation.

This legislation authorizes a predatory loan model that is the norm for state payday loan regimes and fails to provide substantial new protections in the states where payday lenders now operate under safe harbor carve-outs from state usury or small loan laws. Arizona voters rejected this same rate cap and repayment plan when they voted overwhelmingly to reject Prop 200 at the polls in November, despite the payday loan industry's expenditure of about $15 million. They understood that this is "no reform at all."

Enacting H.R. 1214 will slow the wave of reform at the state level which has been picking up momentum following Congressional action to protect Service members and their families from predatory payday lending. Key states, such as Ohio, have rejected 391 percent APR loans in favor of the state's traditional small loan cap. Congressional approval of balloon payment loans secured by unfunded checks at triple digit rates will undermine state reform efforts.

Instead of authorizing payday loans at 391 percent APR, we urge this Subcommittee to support Representative Jackie Speier's H.R. 1608 to cap the total cost of all forms of credit at 36 percent FAIR rate and to substitute the provisions of Representative Gutierrez' 2007 legislation, H.R. 2871, to provide real protections against unsafe banking practices fostered by payday lending.

Introduction to Payday Loans

Origins of Payday Lending

Payday lending has its roots in the long-illegal practice of "wage lending" or "salary buying," in the late 1800s. In those days, wage lenders would lend money in exchange for borrowers relinquishing their right to collect a certain portion of their future wages. A typical borrower might receive $5 on a Monday in return for promising to pay the lender back $6 on Friday.[7] This 20 percent fee on a one-week loan translated to triple-digit annual interest rates well in excess of states' interest rate caps on small loans.

Wage buyers argued that they were not subject to these caps because they were purchasing future wages at a discount in return for the immediate "sale" of the borrower's next paycheck – in other words, charging a fee for a service as opposed to originating a loan. Similar to today's payday borrowers, workers assigning their future wages often could not pay back the entire loan amount when due, and instead had to roll over their debt repeatedly.

States put an end to these lending practices in the early and mid 1900s by enacting strong regulations for small loans with annual interest rate caps ranging from 24 to 42 percent. These usury caps largely remain in place for consumer lending, with a median rate of 36 percent among

[7] Christopher Peterson, *Taming the Sharks: Towards a Cure for the High Cost Credit Market*. University of Akron Press (2004).

all states.[8] Payday lending reemerged in the 1990's as lenders sought and won safe harbor legislation in some states.[9]

Payday Loan Product and Industry

Payday loans are short-term cash loans based on personal checks held for future deposit or on electronic access to the borrower's bank account, depending on the terms of state laws. Borrowers write a personal check for the amount borrowed plus the finance charge and receive cash. Lenders hold checks until the next payday when loans and the finance charge must be paid in one lump sum, with a single paycheck. To pay a loan, borrowers can redeem the check for cash, allow the check to be deposited, or pay the finance charge to roll the loan over for another pay period.

Payday loans range from $100 to $1,000, depending on state legal maximums. The typical loan term is about two-weeks. The finance charge for a payday loan ranges from around $15 per $100 borrowed to $30, resulting in annual interest rates from 391 percent to 782 percent for a two-week extension of credit. Payday loans are subject to Truth in Lending requirements, per court decisions and a Federal Reserve Board ruling in 2000.[10]

In order to obtain a payday loan, a borrower merely has to have an open bank account, a source of income from a job or public benefits such as Social Security, and a valid form of identification. Lenders do not determine if a borrower can afford to repay the loan. Lenders do not use conventional credit checks, but use specialized credit reporting services that track the subprime market. While failing to repay is typically reported to mainstream credit reporting services, successful repayment of a payday loan does not improve a consumer's credit score.

Payday loans are made by payday loan stores, check cashers, pawn shops and some rent-to-own outlets. They are also marketed via toll-free telephone numbers and over the Internet. By the end of 2007, industry analysts reported about 23,600 payday loan outlets plus a growing online loan market in the United States. Stephens Inc. reported combined store and online annual loan volume of $50.7 billion, with $8.6 billion in loan fees paid by consumers.[11] The Center for Responsible Lending estimates that 19 million borrowers take out payday loans during a year.[12]

Payday lending at triple-digit rates is authorized by state laws or regulations in thirty-four states and is permitted for licensed lenders with no rate cap in Wisconsin. Fifteen states and the District of Columbia do not authorize these extremely expensive or single pay period loans

[8] For a comprehensive discussion on the history of usury laws in the United States and their impact on small loans, see Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, Minnesota Law Review (forthcoming Winter 2008) and Lynn Drysdale & Kathleen Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today's Society* (2000).

[9] Jean Ann Fox, "The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry," Consumer Federation of America, November 1998.

[10] Federal Reserve Board, Official Staff Commentary § 226.2(a)(14)-2, issued March 24, 2000.

[11] Stephens Inc., Payday Loan Industry Report, April 17, 2008, page 34.

[12] Center for Responsible Lending, "Quick Reform Could Plug $5 Billion Hole in Worker Wallets," Issue Brief, January 2009.

secured by personal checks. Twenty-nine payday loan states set rate caps, albeit very high caps, while six do not. (See Appendix A.)

Payday Loans Disproportionately Target Vulnerable Consumers

The Federal Reserve Board's Survey of Consumer Finances (SCF) conducted in 2007 and released earlier this year provides a portrait of families who acknowledged using a payday loan in the prior year compared to families who did not use these loans. The findings, issued as a report by the Center for American Progress, are consistent with earlier research.[13] Payday loan users tend to have less income, lower wealth, fewer assets, and less debt than families without payday loans. They are more likely to be minorities, single female head of household, and younger than non-payday loan users. These borrowers have less education than consumers who do not use payday loans and are much less likely to own their own homes. While nearly half of families who did not use payday loans described themselves as "savers," only one-quarter of payday loan users say they are savers.[14]

These findings confirm earlier research and regulator data which demonstrate that minorities, lower-income, and otherwise vulnerable families are the consumers most likely to be paying triple digit interest rates for single payment loans based on unfunded checks held by a payday lender. (For more demographic information on payday borrowers, see Appendix B.)

The Problem with Payday Lending

While payday loans are advertised as a way to deal with an occasional financial emergency, most borrowers find themselves in long-term, high-cost debt traps. This is because the predatory structure[15] of the payday lending business model sets these borrowers up for failure.

The fundamental problems with the payday loan product which result in borrowers being trapped in long-term debt include: (1) the high annual percentage rate on these loans; (2) the short time period in which a borrower has to repay the debt in one balloon payment; (3) the holding of a check or access the borrower's bank account as collateral; and (4) a lack of consideration of the borrower's true ability to repay. These are discussed in greater detail below.

[13] Amanda Logan and Christian E. Weller, "EZ Payday Loans: Who Borrows From Payday Lenders? An Analysis of Newly Available Data," Center for American Progress, March 2009, summary of findings at page 1.
[14] This is consistent with research from CFA which finds that a family earning $25,000 per year and no savings is eight times as likely to take out a payday loan in a year than the same income family with at least $500 in emergency savings.
[15] FDIC's Office of the Inspector General (OIG), Challenges and FDIC Efforts Related to Predatory Lending, Audit Report No. 06-011, June 2006. "Characteristics potentially associated with predatory lending include, but are not limited to, (1) abusive collection practices, (2) balloon payments with unrealistic repayment terms, (3) equity stripping associated with repeated refinancing and excessive fees, and (4) excessive interest rates that may involve steering a borrower to a higher-cost loan." Payday lending is listed as an example. "Payday Loans are small-dollar, unsecured, short-term advances that have high fees relative to the size of the loan. When used frequently or for long periods, the total costs can rapidly exceed the amount borrowed."

1. High Annual Percentage Rate (APR)

APR is a function of (1) the fee or interest charged on a loan and (2) the time a borrower has to repay their debt. Since payday loans have a relatively high fee and must be paid back within a short period of time, the APR on the typical two-week loan is about 400 percent.

2. Short Loan Term

When a borrower takes a payday loan, they must pay back the entire amount, plus a fee, on their next payday. The vast majority of borrowers will pay back their loan when due because it is the first thing they pay with their paycheck. Borrowers also want to avoid a "bounced" check and the resulting fees. The problem is that this does not leave them enough money to pay for rent, food, or other bills if they do not immediately get another payday loan.

The table below illustrates how a payday borrower earning $35,000 a year would be hard pressed to pay back the typical $300 loan, plus its $45 fee, in just one pay period. Even if the payday loan came with *no* finance charge, a borrower earning $35,000 a year cannot afford to repay the typical payday loan in a single payment on his or her next payday.

The payday lending two-week loan term traps borrowers in a repeat borrowing cycle, no matter what fee is charged.

	Cost of Two-Week Payday Loan		
	$0 per $100 (free loan)	$15 per $100 (391% APR)	$20 per $100 (521% APR)
Income and Taxes			
Income per half-month pay period	$ 1,458.33	$ 1,458.33	$ 1,458.33
Taxes	$ 17.79	$ 17.79	$ 17.79
Social Security	$ 96.33	$ 96.33	$ 96.33
Income after tax	**$ 1,344.21**	**$ 1,344.21**	**$ 1,344.21**
Payday loan payment due on $300 loan	**$300**	**$345**	**$360**
Paycheck remaining after paying back payday loan	**$ 1044.21**	**$ 999.21**	**$ 984.21**
Household Expenditures per 2 week period			
Food	$ 193.54	$ 193.54	$ 193.54
Housing	$ 516.21	$ 516.21	$ 516.21
Utilities	$ 128.00	$ 128.00	$ 128.00
Transportation	$ 165.42	$ 165.42	$ 165.42
Healthcare	$ 103.88	$ 103.88	$ 103.88
Total Essential Expenditures	**$ 1,107.04**	**$ 1,107.04**	**$ 1,107.04**
Money from paycheck remaining (deficit)	**$ (62.83)**	**$ (107.83)**	**$ (122.83)**

Source: 2007 Consumer Expenditure Survey, Bureau of Labor Statistics, households earning $30,000-39,999 annually

This example is of a borrower earning $35,000 a year, and excludes other costs such as childcare, clothing, etc. which are likely applicable to many payday borrowers.

3. Check Holding or Account Access
For most store-front lending, consumers are required to write a personal check for the amount of the loan plus the finance charge payable to the lender on the borrower's next payday. At the time the check is written, borrowers do not have sufficient funds on deposit to cover the check, but hope that on payday they will be able to cover the check.

Check holding makes the lender the first priority for payment out of the borrower's next paycheck. Failure to repay results in bounced check fees from the payday lender and the borrower's bank. It also results in a negative report to credit reporting services used by banks and retailers in deciding whether to accept payment by check or to open an account. Consumers can lose their check-writing privileges at retailers or become black-listed on ChexSystems, unable to open a new bank account due to bounced checks triggered by payday lending.

Check holding also fosters coercive collection tactics when lenders threaten criminal sanctions for failure to "make good" on the check used to secure the loan.[16]

Payday lenders who use debit authorization as security for a loan and as the payment method for a loan get direct access to the borrower's bank account when pay or benefits are deposited on payday. As soon as funds are deposited, the payday lender can withdraw payment. Repeat presentment of the check or debit for payment can trigger multiple NSF fees for consumers with low balances.

Loans based on writing unfunded checks have an adverse effect on consumers' bank account ownership. Recent research by Harvard Business School found that access to payday loans is associated with higher numbers of involuntary account closures where a bank closes a customer's account because it has been repeatedly overdrawn.[17]

4. No Consideration of Ability to Repay
Payday lenders do not consider any of a borrower's outstanding debt payments or other obligations.

Adverse Impacts for Payday Borrowers

These predatory elements of payday loans cause borrowers to take out one loan after another, without being able to fully retire their debt. The average payday borrower takes out nine loans a year and these loans tend to be taken on a consecutive basis, with more than one transaction per month.

Getting stuck in a pattern of repeat borrowing, where a person takes out a loan each pay period, can adversely impact their finances in myriad ways. In most cases, a payday borrower is worse off than if they had never taken that first payday loan. Independent academic research has shown that payday lending increases a borrower's chances of filing for bankruptcy, becoming

[16] CFA Testimony, Federal Trade Commission Workshop on Fair Debt Collection Practices Act, June 20, 2007.
[17] Dennis Campbell, Asis Martinez Jerez, and Peter Tufano (Harvard Business School). *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures*. June 6, 2008. Available at: http://www.bos.frb.org/economic/eprg/conferences/payments2008/campbell_jerez_tufano.pdf

delinquent on a credit card, having a hard time paying other bills, delaying medical care and prescription drug purchases, and losing their bank account. (For summaries of this research, see Appendix C.)

H.R. 1214 Does Not Protect Consumers from the Payday Lending Debt Trap

Alarmed at the number of payday borrowers trapped in long-term debt, many states have tried to curb payday lending abuses while allowing the industry to continue to charge triple-digit APRs. Some of the provisions adopted include renewal bans, cooling-off periods, and extended payment plans. While these measures sound promising, lenders have found ways to evade the intent of these provisions and continue to trap borrowers in long-term debt.

<u>Fee Cap of Fifteen Cents Per Dollar Authorizes Triple-Digit Debt</u>

For the typical two-week payday loan term, the fee authorized by H.R. 1214 translates to *391 percent APR.* For a one-week loan, loans would be authorized at *782 percent APR.* The news release announcing the bill states that consumers are currently subject to payday loans at interest rates from 261 percent to 913 percent annually, but fails to mention that H.R. 1214 will permit APRs of above 261 percent. Describing the costs allowed by the bill as pennies per dollar and not mentioning the very short loan period for payday loans can mislead people into believing that the bill sets a 15 percent annual interest rate cap.

H.R. 1214 has been characterized as providing stronger protection than twenty-three states now provide. Existing payday loan laws in 35 states result in loans that range from 235 percent to 1,955 percent or have no cap for a two week $250 loan. For a $250 two-week sample loan, twenty-three states permit loans at higher rates than H.R. 1214 permits, but, in most cases, not much higher. For example, H.R. 1214 permits 391 percent APR versus 396 percent in OK, 409 percent in NM, 460 percent in SC, 456 percent in AL, and 521 percent in CO.[18] In addition, ten of these twenty-three states set no rate cap on installment loans, making it very likely that lenders would reformat their loans slightly to continue charging the same higher rates they charge now.

Competition does not drive down the cost of payday lending. Any cap becomes the standard price for this product. As a spokesman for a large publicly traded payday loan operation told investors, "Now I know part of the creep up in losses is probably – *although there's no price competition, there is probably an increased demand to get that first customer.* And I think maybe some of the companies – and we're part of that – have eased up our underwriting to get that first customer."[19] (Emphasis added.) CFA surveys of payday loan outlets over the years have documented that most lenders charge the maximum rate permitted in the state.[20] By capping payday loans at 391 percent for a two-week loan, H.R. 1214 locks in extremely expensive rates for borrowers.

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[18] Consumers Union, National Consumer Law Center, and Consumer Federation of America, "50 State Small Loan Scorecard," August 2008, http://www.consumerfed.org/pdfs/small_loan_scorecard_08.pdf

[19] Q2 2007 Advance America, Cash Advance Centers Inc. Earnings Conference Call, July 26, 2007, quoting John Hill.

[20] CFA surveys posted at www.paydayloaninfo.org in Research and Reports section.

Narrow Definition of a Payday Loan Allows Lenders to Avoid Regulation Entirely

In addition to these problems, legislation targeting solely the payday loan product is entirely circumvented by payday lenders if they can tweak their product so that it does not meet the definition of a payday loan. HR 1214 includes numerous requirements that must be met in order for a payday loan to fall under its purview. For example, the payday loan must be offered as closed-end credit, it must be for no more than 91 days, must be secured by a personal check or account access, and the credit must be extended by the payday lender or their affiliate. Payday lenders can slightly alter their product to ensure that they do not fall under this definition of a "payday loan" in many states.

For example, a payday lender could offer an open-ended loan as has been attempted by payday and car title lenders in Kansas, Virginia, and Pennsylvania; offer a higher-priced installment loan as is currently done in Illinois[21] and New Mexico; or partner with an independent entity that provides the payday loan, as is done in Texas. In addition, at least one major payday lender[22] offers their product securing it through means other than a personal check, which would exempt them from H.R. 1214's regulations.

While some states have traditional small loan laws with an underlying rate cap, ten payday loan states[23] do not. It is unlikely that payday lending in any state lacking an underlying small loan rate cap would be subject to this legislation as currently drafted. Also if a state's law does not forbid lenders to broker loans through independent third parties, the legislation will also not have much impact. Definitional problems are discussed in more detail below.

Definitions of "Creditor" and "Payday Loan" Open Loopholes Exploited by Lenders

H.R. 1214 Section (f)(2) defines a covered creditor as "a person who makes or offers payday loans and includes any affiliate of a creditor that offers or makes a payday loan, buys a whole or partial interest in a payday loan, arranges a payday loan for a third party, or acts as an agent for a third party in making a payday loan, regardless of whether approval, acceptance, or ratification by the third party is necessary to create a legal obligation for the third party; and any other person or entity that is engaged in a transaction that is in substance a disguised payday loan or a subterfuge for the purpose of avoiding the requirements of this section."

Key features (italics) in the definition of covered payday loans in (f)(3) of the bill, include:

- a *closed-end* credit transaction, *unsecured* by personal property;
- *excludes* credit card transactions under *open end* credit plan;
- a term of *91 days* or less, *$2,000* loan or less;

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[21] In Illinois, payday lenders skirt the state's payday loan regulations by making five month installment loans. A $500 loan carries a $775 fee, equating to a 403% APR. Example on file with CFA.

[22] Rent-A-Center Financial Services offers signature loans which mimic a payday loan's cost and term in 17 states. Instead of securing these loans with a personal check, applicants must provide five personal references and mortgage servicer or landlord contact information.

[23] States without small loan rate caps include Delaware, Idaho, Illinois, Missouri, Montana, New Hampshire, New Mexico, South Dakota, Utah, and Wisconsin.

- finance charge exceeding *36 percent APR*, in which the consumer gets funds from and incurs interest or a fee payable to the creditor; and
- the borrower provides a *check* or other payment instrument to the creditor who agrees not to deposit or present the check for payment for more than *one day* or authorizes the creditor to initiate a *debit* or *debits* to the borrower's bank account by electronic fund transfer or *remotely created check* after 1 or more days.

The following forms of payday lending would not be subject to this law due to the definition of a creditor and/or a payday loan in H.R. 1214.

Open end payday loans, such as those used by major companies in Virginia,[24] by payday lenders attempting to circumvent a similar definition in the Military Lending Act,[25] and by companies that attempted to circumvent laws in Pennsylvania[26] and New Hampshire.[27] In states that permit open end credit to be offered by non-bank lenders, payday lenders would be likely to use this definitional loophole to avoid the provisions of H.R. 1214.

Payday loans made by *credit services organizations*, including almost all payday lending in Texas, would be likely to fall outside the bill's definition of a covered creditor. By operating as credit services organizations (CSO), payday lenders claim to be independent third-parties that, for a high fee charged to the borrower, arrange and guarantee loans between borrowers and unaffiliated lenders. H.R. 1214 defines "creditor" as the person who "makes or offers a payday loan" or "an affiliate of a creditor" that "offers or makes a payday loan...arranges a payday loan, or acts as an agent for a third party." Under the current CSO scheme in Texas, payday companies operating as credit services organizations may not meet the definition of a creditor as defined in this act because they purport to be an independent third-party, not an affiliate of the lender actually making the loan. It is also questionable whether the products offered by a CSO would fall within the definition of a payday loan in this bill. In Texas, there is no maximum loan amount, and publicly traded CSOs report that the lenders allow loans up to $3,000. While CSOs include their unregulated fees for purposes of disclosing a finance charge under Truth in Lending, we would expect CSOs to find creative ways to continue avoiding Texas law and to avoid any rate cap in this legislation if enacted.

[24] Example: An Advance America "Revolving Credit Agreement" for credit extended December 3, 2008 in Richmond, VA disclosed a 365 percent APR for loans with ACH Authorization and 456 percent without ACH Authorization for payment. Under the heading "Security Interest," the contract states: "Any ACH Authorization you may have signed in connection with this Revolving Credit Agreement is collateral for this loan." Contract on file with CFA.

[25] A Military Financial, Inc. "Rapid Cash" loan made just prior to the start of MLA rules to a Mayport, FL sailor cost 713.89% APR for a $971 loan with $698.32 in finance charges over four installment payments of $417.33 each. As of October 1, 2007 Military Financial advertised a "Rapid Cash Line of Credit" for up to 40% of monthly take home pay with no credit check and 99% approval.(Ad in *Navy Times*, p. 41, 12/24/07) Its FAQ web page states: "It is illegal to charge more than 36% for a closed end loan consumer loan (payday loans, title loans, etc.) A Rapid Line of Credit is not a closed end loan. It is a revolving line of credit that allows you to access the available funds in your account at any time." See www.militaryfinancial.com/Faq.aspx, visited 1/10/08.

[26] PA COURT DECISION ON OPEN END AEA LOANS

[27] NH BANKING COMMISSIONER RULING ON AEA OPEN END LOANS

"Installment" payday loans for longer than 91 days in duration would not come under H.R. 1214's definition of a payday loan. Most payday lenders in Illinois have morphed their single payment product into longer term loans (essentially building in loan flipping) to evade state limits on short term loans. Consumer advocates in Illinois report that 95 percent of "payday lending" is now structured as installment loans covered by the Illinois Consumer Installment Loan Act, which has no rate cap. Illinois "installment" payday loans still cost over 400 percent APR. The Governor of Illinois wrote to members of the Department of Defense Authorization Conference Committee in 2006, describing the "aggressive battle" waged by payday lenders in Illinois to circumvent consumer protections. "As soon as we instituted new payday loan restrictions that limit interest rates and apply to loans with terms of up to 120 days, the industry began offering loans with terms of 121 days so they could resume charging interest rates of 500 percent or more."[28]

Consumers in states that do not have an installment small loan rate cap would not be "protected" by H.R. 1214's 391 percent APR cap on two week loans. Lenders in these states could simply convert their loans to longer term transactions to evade the 91 day definition of a covered loan. (States include DE, ID, IL, MO, MT, NH, NM, SD, UT, and WI.)[29]

Loan Security/Payment by Check Holding, Debit Authorization and Demand Drafts Unsafe

a) Loans based on unfunded checks held for future deposit.

Payday lenders require borrowers to write personal checks for the amount of the loan plus the finance charge as both security for the loan and as the payment device, encouraging unsafe use of bank accounts. Checks are part of the payment system, a substitute for cash, not an asset that should collateralize a loan. Severe laws meant to prevent check bouncing should not apply to people who simply fail to pay their debts. Borrowers do not have funds on deposit to cover the checks at the time they are written, a fact well known by lenders. This keeps these checks from being fraudulent "hot checks," but sets up a cascade of consequences when the borrower can't cover the check in full out of the next paycheck.

Loans based on check-holding create incentives for loan flipping and additional costs for borrowers. If the lender deposits the borrower's check on the due date and the borrower does not have sufficient funds to cover the debt, she will incur insufficient funds fees imposed by both the payday lender and the consumer's bank. When payday lending was legal in North Carolina, borrowers paid over $2 million in NSF fees to payday lenders, in addition to any charges owed to their bank.[30] Virginia regulators reported that 54,403 checks returned unpaid triggered $228,718

[28] Press Release, Governor Rod Blagojevich, Illinois, "Governor Blagojevich calls on Congress to pass federal payday lending protections for Military Personnel," September 7, 2006.
[29] Consumers Union, National Consumer Law Center, Consumer Federation of America, "50-State Small Dollar Loan Scorecard," August 2008, available at http://www.consumerfed.org/pdfs/small_loan?scorecard_08.pdf.
[30] As reported in the 2000 Annual Report of the North Carolina Commissioner of Banks, the total amount of NSF fees collected by payday lenders was $2,000,844. This was the last year payday lenders were authorized to operate in North Carolina. The report is available at www.nccob.org/NR/rdonlyres/5F7F31CF-2645-4CD2-8EE1-EE349F9F6AE8/0/cccon00.pdf.

in insufficient funds fees paid to payday lenders in 2007.[31] Consumers are strongly encouraged to renew loans to avoid double fees for a returned check.

Checks as security for loans give an advantage to the payday lender for debt collection. By holding the borrower's check, lenders get the ability to call the consumer's bank to check "funds availability." As soon as the bank tells the lender funds are available to cover the check, the lender goes to the bank to collect on the payday loan. Consumers who are juggling bill payment decisions lose all control over the timing for repaying a payday loan, since the lender can deposit the loan check at any time after the due date, precipitating NSF fees for other checks written. For example, the payday lender's decision about when to put through the check may cause the rent or mortgage check to bounce. Some lenders require multiple checks for a single loan, maximizing the number of NSF fees that will be charged if the loan is not repaid in full on the borrower's next payday.

Payday loans, because they tap funds from deposit of the borrower's next paycheck, are a modern form of wage assignment, a disreputable credit practice which, when done directly, is prohibited by the Federal Trade Commission's Credit Practices Rule. Instead of authorizing loans secured by unfunded personal checks, we supported the sponsor's H.R. 2871, introduced in 2007, to ban such practices in lending.

b) Loans secured by debit/s authorization undermines protections in the Electronic Fund Transfer Act.

Consumers lose control of their checking accounts when lenders condition the extension of credit on direct electronic access. While a borrower can stop payment on a paper check, the same right does not apply by law for a single debit. Consumers may ask their bank to revoke authorization for lenders to electronically withdraw funds, but savvy lenders can easily evade those efforts. A lender can too easily avoid a stop order on an electronic payment simply by breaking an electronic withdrawal into smaller segments or altering the amount by a few pennies to evade the description of the transaction in the stop order. As a result, consumers are confronted with multiple NSF fees when the payday lender makes multiple attempts to electronically withdraw funds from the consumer's checking account.

- For example, an Indiana consumer had insufficient funds to repay a $300 payday loan plus $35 finance charge on its due date. The lender's first electronic funds draft was returned for insufficient funds. The lender then broke the debt into three parts and submitted three electronic drafts for $167.50, $167.50 and $20, respectively. The borrower's bank charged a $26 "bounce protection" charge for each item which overdrew his account.[32]

Securing a payday loan or any other type of small loan with debit access to a bank account also exposes low-balance borrowers to multiple attempts to collect the debt, each triggering the bank's insufficient funds fees.

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[31] Virginia State Corporation Commission, Bureau of Financial Institutions, 2007 Payday Loan Annual Report, page 7.
[32] On file with CFA.

- A Sailor based in Florida was charged $200 for ten returned check fees as a result of repeated attempts to debit his account to collect on one payday loan. His credit union charged $20 per returned debit as did the payday lender. The original $300 loan cost a $45 finance charge and 342.19% APR and listed the personal check presented electronically as "security" for the loan.[33]

Authorizing payday lending based on electronic access to borrowers' bank accounts also exposes borrowers to unsafe treatment of personal financial information because the practice requires that the payday lender collect and retain information about the borrower's bank account.

- A major payday loan chain was cited by state regulators in Washington and Idaho for obtaining borrowers' checking account PIN numbers during the loan application process without the borrower's knowledge. Washington regulators noted that obtaining and storing personal identification numbers of customers without their consent or knowledge was a prohibited practice that exposed consumers to the potential theft of funds and possibility of identity theft.[34] According to the Idaho Department of Finance, "examiners learned of instances where borrowers were asked to input PIN numbers into the lender's telephone key pad during the loan process. Check 'n Go would then electronically retrieve those PIN numbers and store them in its computer system for account balance verification purposes."[35]

Payday loans using repeat debit authorizations facilitate loan renewals (which lead to repeated payment of a high loan fee directly from the consumer's checking account) much more easily than loans based on presenting paper checks for payment. Online payday loans, all of which use debit authorization, frequently set loans up to automatically renew every payday with just payment of the finance charge withdrawn from the borrower's account by electronic funds transfer.

For example, for an initial loan of $200, the consumer would authorize a debit of $260 from her account two weeks from the date of the loan. Unless the consumer faxes a request three days in advance of the due date, two weeks after the initial loan the lender will deduct the $60 finance charge and renew the $200 loan for another pay cycle. Two weeks later, an additional $60 is debited and the $200 plus another $60 fee is still due two weeks after that. This cycle can continue for many weeks. The consumer has $120 withdrawn from his or her checking account in every four week period without reducing the loan balance of $200.[36]

H.R. 1214's explicit authorization of payday loans secured by single or repeated debit transactions undermines the protections of the Electronic Fund Transfer Act, which prohibits basing the extension of credit with periodic payments on a requirement to repay the loan

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[33] Loan and credit union documents on file with Consumer Federation of America.

[34] Press Release, "State Files Largest Case Against Payday Lender," Washington State Department of Financial Institutions, August 16, 2006.

[35] News Release, "The Idaho Department of Finance Obtains Assurance of Discontinuance from Check 'n Go of Idaho, Inc.," Idaho Department of Finance, January 25, 2005.

[36] Jean Ann Fox, " Internet Payday Lending," Consumer Federation of America, November 2004, http://www.consumerfed.org/pdfs/Internet_Payday_Lending113004.pdf

electronically.[37] Since EFTA was enacted before single-payment payday loans became widely available, it is unclear whether single payment payday loans that permit renewals are "periodic," triggering the ban on requiring the borrower to sign an agreement to electronically access the account. By defining a covered payday loan as one based on "debit or debits," H.R. 1214 may be construed as over-ruling the long-standing protections of the Electronic Fund Transfer Act against requirements to pay debt electronically for periodic payments. The bill fails to close a gap in EFTA that should extend this protection to single debit payments.

Payday loans secured by debit access to the borrower's bank account which cannot be cancelled also functions as the modern banking equivalent of a wage assignment – a practice which is prohibited when done directly. The payday lender has first claim on the direct deposit of the borrower's next paycheck or exempt federal funds, such as Social Security, SSI, or Veterans Benefit payments. Consumers need control of their accounts to decide which bills get paid first and to manage scarce family resources. By authorizing payday lenders to have the first priority for funds in the bank account, H.R. 1214 will worsen the financial plight of consumers.

c) Demand Drafts Authorized

The definition of a payday loan in H.R. 1214 specifically authorizes a financial product - "remotely created check" - that is prone to fraud and has largely been discredited. These are "demand drafts," in which a creditor creates a paper check that withdraws funds from a consumer's bank account without the consumer seeing or signing the instrument. The legal theory is that the consumer has authorized the creation of a check, perhaps even orally, without ever signing a check. This method is highly prone to abuse and should be eliminated.[38] Every application for a payday loan requires consumers to provide their bank account routing number and other information necessary to create a demand draft as well as boiler plate contract language to authorize the device. The account information is initially used by online lenders to deliver the proceeds of the loan into the borrower's bank account using the ACH system. Once the lender has the checking account information, however, it can use it to collect loan payments via remotely created checks even after the consumer revokes authorization for the lender to electronically withdraw payments.

The use of remotely created checks is common in online payday loan contracts.

- ZipCash LLC "Promise to Pay" section of a contract included the disclosure that the borrower may revoke authorization to electronically access the bank account as provided by the Electronic Fund Transfer Act. However, revoking that authorization will not stop the lender from unilaterally withdrawing funds from the borrower's bank account. The contract authorizes creation of a demand draft which cannot be terminated. "While you may revoke the authorization to effect ACH debit entries at any time up to 3 business

[37] Reg E, 12 C.F.R. § 205.10(e). 15 U.S.C. § 1693k states that "no person" may condition extension of credit to a consumer on the consumer's repayment by means of a preauthorized electronic fund transfer.

[38] The Federal Trade Commission settled four cases for $16 million that involved telemarketers and Wachovia Bank which involved the use of demand drafts to withdraw unauthorized funds from consumers' accounts. The complaint alleged that the defendants had illegally purchased leads containing consumers' unencrypted bank account numbers for use in telemarketing. (FTC Press Release, January 13, 2009).

> days prior to the due date, *you may not revoke the authorization to prepare and submit checks on your behalf until such time as the loan is paid in full.* " (Emphasis added.)[39]

Remotely created checks are subject to fraud and are often used by those who cannot obtain an ACH merchant account. In 2007 the *New York Times* reported on fraudulent demand draft use by telemarketers at Wachovia.[40] The National Association of Attorneys General urged the Federal Reserve Board to ban demand drafts outright in a 2005 proceeding.[41] In 2007, CFA and other organizations urged the Board to either prohibit the use of demand drafts or extend EFTA protections to these transactions.

Use of a demand draft to secure a payday loan and to collect payment on a payday loan undermines existing consumer protections in the payment system. Consumers have the right under EFTA to revoke the authorization to pay the loan through electronic withdrawals from their bank accounts. However, consumers who exercise that right will still have no control, other than closing their account, over continued withdrawals using remotely created checks authorized by H.R. 1214.

To the best of our knowledge, no state payday loan authorization law permits lenders to use a demand draft to secure or collect payment on a loan. In fact, some states specifically prohibit payday loans to be made via the Internet where demand draft use is common. Permitting a lender to write a check to withdraw funds from the consumer's bank account exposes borrowers to fraud, deprives consumers of dispute rights for unauthorized debit transactions under EFTA, leaving a victim on her own to sort out the charges and resulting insufficient funds and overdraft fees from other payments that are returned unpaid due to presentment of the demand draft. While the Federal Reserve enacted a requirement in 2005 that changed the warranty for demand drafts from the consumer's bank to the financial institution that accepted the demand draft for deposit. While this was a positive action, it provides little consumer protection.

<u>Roll-Over Provisions Do Not Stop Repeat Lending</u>

H.R. 1214 prohibits making more than one loan at the same time to a consumer, presumably at one loan outlet or with one lender. The prohibition does not extend to all loans offered by all lenders.

H.R. 1214 prohibits new loans from being made to borrowers in a repayment plan by the same lender or for at least 13 days after a repayment plan is completed, but it does not prohibit loans from being made by any other lender to a consumer who has already pledged her next paycheck to cover a loan.

The bill prohibits knowingly accepting payment in whole or in part for a repayment plan payment with money from another payday loan by the same lender, but does not apply to using the proceeds of a second loan to repay a loan not in the repayment plan, limiting this provision's

[39] Loan Supplement (ZipCash LLC) Form #2B, on file with CFA.
[40] Charles Duhigg, "Bilking the Elderly, With a Corporate Assist," *New York Times,* May 20, 2007
[41] National Association of Attorneys General, Comments to Federal Reserve Board, Docket No. R-1226 (Proposed Amendments to Regulation CC/Remotely Created Checks), May 3, 2005.

usefulness at preventing borrowers from having more than one loan at a time. This provision makes H.R. 1214's limits on multiple loans less effective than they first appear. It prohibits rolling over a loan and defines a prohibited "rollover" as a transaction where the borrower pays a finance charge only and extends the loan plus a new finance charge for another pay cycle.

The bill does not ban multiple loans from all lenders. It does not include any enforcement method, such as a database, to prevent multiple outstanding loans. There is no way to prevent a borrower in an extended payment plan from getting a loan from another lender. While the bill prohibits using the proceeds of one loan to make a plan payment, a lender cannot identify the source of cash used to make a payment. The limitations in this bill are simply not enforceable.

The bill's rollover ban also does not prevent the most common form of repeat lending, in which borrowers on payday bring in cash and "buy back" the original payday loan check. Lenders immediately will "re-loan" the loan principal, write up a new contract, take a fresh check as security for the loan, and obligate the borrower to repay the same finance charge next payday. While this is technically not a roll-over, it has the same impact on the borrower's budget and indebtedness. It is the pattern of back-to-back lending that characterizes transactions in states that sought to curb "roll-overs." For example, Florida and Oklahoma[42] both employ fee caps, renewal bans, payment plans, cooling off periods, and loan tracking databases.

- About half (49 percent) of all subsequent loans are taken out within 24 hours of the previous loan being paid off.
- Nearly 90 percent of all subsequent loans are taken out within the same two-week pay period of the previous loan being paid off.
- 94 percent of all subsequent loans are taken out within the same month of the previous loan being paid off.
- The average borrower has 1.5 transactions every month.

Contract Requirements and Collection Provisions Do Not Make H.R. 1214 Beneficial

H.R. 1214 includes these protections against contract terms and abusive collection methods. The bill bans:

- Threatening or seeking to have consumers prosecuted in criminal court to collect the loan;

- Taking or attempting to take an interest in personal property to secure a loan;

- Filing or initiating a legal proceeding (lawsuit or arbitration) when a loan is in an extended payment plan. The loan is not in default if the borrower keeps up with extended payment plan terms;

- Taking any power of attorney;

[42] See "Oklahoma Trends in Deferred Deposit Lending," Veritec Solutions LLC (June 2008) and "Florida Trends in Deferred Presentment," Veritec Solutions LLC (July 2008). Subsequent loan data is from a public records request and is on file with CRL.

- Several onerous contract provisions, including a confession of judgment clause, a waiver of right to a jury trial unless the waiver is included in an arbitration clause allowed by this bill; and a mandatory arbitration clause that is oppressive, unfair, unconscionable, or substantially in derogation of the rights of consumers.

The bill also prohibits contracts that waive the rights of consumers under the law or any claim or defense arising out of the loan contract, as well as lenders who attempt to collect or charge attorney's fees, court costs, or arbitration costs incurred in connection to a loan.

These provisions do not add meaningful new protections or limit the abusive terms of the loan product itself. It is already an unfair practice to threaten criminal prosecution for failure to repay a payday loan, to take a confession of judgment, or to include contract terms that are oppressive, unfair, or unconscionable under the Federal Trade Commission Act, the FTC's credit practices rule, the Fair Debt Collection Practices Act, state common law, and/or many state laws that apply to payday lenders.

Coercive collection tactics made possible by the design of payday loans is a particular problem. Despite state prohibitions on threatening or using criminal prosecution to collect on a payday loan in almost all circumstances, payday lenders and their debt collection agencies have been charged with collection abuses by state enforcement officials and in private litigation.[43] For example, Florida's Attorney General won final default judgment in 2007 against debt collection firm Ellis Crosby & Associates, Inc., and Ted Ellis Crosby individually, for illegally collecting payday loan debts from thousands of consumers across the country. The charges are summed up as follows:

"Defendant ECA and Defendant CROSBY illegally contacted consumers at work, engaged in harassing, oppressive and abusive conduct, failed to identify themselves as collections agents, falsely represented themselves as law enforcement officers or attorneys, falsely threatened legal action, falsely threatened criminal arrest, threatened violence, misrepresented that the consumer had committed a crime, falsely represented the amount due, falsely implied they were government investigators, falsely stated their office is in a federal building, falsely claimed that an Order of Homeland Security prevented disclosure of their address, falsely threatened to seize computers, falsely stated that non payment would result in arrest, and falsely stated that the sum owed could only be paid in full."[44]

It would be much more effective protection to prohibit lenders from soliciting unfunded checks than to attempt to prevent lenders from threatening consumers with criminal sanctions for failure to make good on the check used to obtain the loan.

[43] See, CFA Testimony, FTC Workshop on Fair Debt Collection Practices Act.

[44] State of Florida v. Ellis Crosby & Associates, Inc., Complaint for Declaratory Relief, August 24, 2005 at 2.

Small Loan Interest Rate Caps: A Proven Way to Protect Consumers and Ensure Access to Responsible Credit

Fifteen states and the District of Columbia employ comprehensive rate caps on all small loan products at or around 36% APR.[45] In some of these states, payday lending at triple-digit rates has never been legal; in others, state policymakers reined in payday and other high-cost lenders with a rate cap after seeing how the destructive effect of these loans on family finances.

Similarly, due to concerns that members of the military were becoming heavily indebted to payday lenders, Congress approved a 36% APR rate cap to protect active-duty service members and their families from these high-cost loans. As a result, over a third of the U.S. population is not subject to the payday lending debt trap. This approach is affirmed by a recent national survey, where over 70 percent of respondents supported an interest rate cap of 36% APR or less.[46]

North Carolina is one of these states that once had payday lenders, but no longer does. A study of low- and moderate-income households in the state shows that North Carolinians with financial emergencies do not miss payday loans, but instead use a variety of other, often better, alternatives. For example, credit products such as overdraft lines of credit, consumer finance installment loans, and credit card cash advances are used by households facing financial shortfalls in that state. A progress report from the Department of Defense concluded that affordable loan options to the military increased after the cap and that military debt relief societies were able to reduce assistance given to indebted members of the military because of the reduction in payday loan usage.[47]

Programs at the state and federal level have been instituted to provide a wide range of affordable small loan products. The FDIC is actively encouraging banks under its purview to craft and market small loan products at 36 percent or less to the general population. The FDIC Guidelines for Responsible Small Dollar Lending call for rates of no more than 36 percent annual interest, affordable and amortizing payment schedules, and sound underwriting to determine the borrower's ability to repay the loan.[48] The FDIC is currently conducting a pilot project with over thirty banks to evaluate the optimal features for responsible small dollar lending.

Similarly, the Pennsylvania State Treasurer has taken an active role in spurring responsible small loans offered by credit unions by keeping state funds on deposit at these institutions. Seventy-nine credit unions with 211 locations now offer the Better Choice loan, launched in 2006. Since the program began, credit unions have made nearly 15,000 loans totaling $6.8 million dollars in

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[45] These fifteen states include Arkansas, Connecticut, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Vermont, and West Virginia.
[46] Congress Should Cap Interest Rates: Survey Confirms Public Support for Cracking Down on High-Cost Lending, Center for Responsible Lending (March 2009).
[47] Department of Defense, Report on Implementation of Limitations on Terms of Consumer Credit Extended to Service Members and Dependents, July 22, 2008.
[48] FDIC, Affordable Small-Dollar Loan Guidelines, Press Release updated November 4, 2006.

volume, saving nearly $5 million in interest and fees that would have been charged by traditional payday lenders.[49]

Affordable credit products are not the only strategy needed to help households more effectively deal with a financial shortfall. Borrower surveys reveal that many households are not taking out a payday loan because of a single financial emergency, but instead have expenses that regularly exceed their income. For these households who may not be able to financially handle additional debt burdens at any interest rate, non-credit strategies may be more appropriate. These may include budget and financial counseling; getting help from friends, family, or an employer; negotiating with a creditor; setting up different bill payment dates that better align with the person's pay cycle; and putting off a purchase for a few days.

To this end, efforts to help low- and moderate-income families build emergency savings should also be supported. There is some evidence that a lack of savings may make it more likely that households seek out payday loans. For example, the Consumer Federation of America found that families earning $25,000 per year with no emergency savings were eight times as likely to use payday loans as families in the same income bracket that had more than $500 in emergency savings. Policies and programs that encourage and facilitate emergency savings among low- and moderate-income households would help alleviate the need for small loans, allowing households facing financial shortfalls to rely on their own savings rather than taking on additional debt.

Better Policy Options than Enacting H.R. 1214

We urge the Subcommittee to replace the language in H.R. 1214 with the provisions in H.R. 2871, sponsored by the Chairman in 2007. That bill extends the Military Lending Act ban on basing loans on unfunded checks or electronic take-over of consumers' bank accounts to all Americans.

We support Representative Jackie Speier's H.R. 1608 to cap rates for all forms of consumer credit at 36 percent annually including interest, fees, and other costs. A blanket usury cap provides the only effective protection for consumers against extremely expensive credit and avoids the loopholes and definitional problems that plague bills targeted at a specific product. For example H.R. 1608 would apply the same rate cap to the bank equivalent to payday lending which H.R. 1214 does not. H.R. 1608 puts all consumer lenders on the same basis, is widely supported by voters, and won approval at the ballot box in two key states last fall.

We urge no action on H.R. 1214 as currently written. Thank you for the opportunity to testify before the subcommittee today.

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[49] "Pennsylvania Treasurer McCord to Pennsylvanians: You Have A Better Choice for Short-Term Loans," March 12, 2009, http://www.centredaily.com/pr_news_wire/storey/1168139.html, viewed March 15, 2009.

Appendix A: State Legal Status of Payday Lending

States combat high cost credit through several legal strategies. In Georgia, payday lending is explicitly prohibited and a RICO violation. New York and New Jersey prohibit payday lending through their criminal usury statutes, limiting loans to 25 percent and 30 percent annual interest, respectively. The Arkansas constitutional usury cap prohibits payday loans.

Payday lending is not specifically authorized and is de facto prohibited by several state small loan rate caps. These states include Connecticut, District of Columbia, Maryland, Massachusetts, North Carolina, Pennsylvania, Vermont, and West Virginia.

Four states permit loans based on checks held for deposit under traditional small loan laws or at a much lower rate than typical payday lending. The Maine Uniform Consumer Credit Code caps interest at 30 percent for small loan companies but permits tiered fees that result in 261 percent APR for a two-week $250 loan. Oregon permits a one-month minimum term payday loan at 36 percent interest plus a $10 per $100 initial loan fee. As a result a $250 one-month loan costs 154 percent APR for the initial loan, and 36 percent APR for any subsequent loans. New Hampshire capped payday loan rates at 36 percent APR, effective in 2009. The lowest cost payday loan law was enacted by Ohio last year, capping rates at 24 percent APR.

Recent Legislative Actions in States

As the adverse impact of payday lending has become apparent, state efforts to prohibit payday lending or to apply meaningful restrictions on its most abusive features have been growing significantly. No state has legalized payday lending since Michigan enacted its law in 2005 and four states that previously allowed it have either banned or strictly regulated it. North Carolina permitted its payday loan law to sunset. Ohio enacted a 28 percent annual rate cap for payday lenders last year, which was unsuccessfully challenged by the industry in a ballot initiative.

Last fall, voters in Arizona rejected by a wide margin a ballot initiative promoted by the payday lending industry that was very similar to the provisions of H.R. 1214. In the only two instances where voters were asked whether they wanted payday lenders to charge 391 percent APR for quick and easy credit, voters overwhelmingly supported a rate cap of 36 percent or less. Even though the Arizona Prop 200 offered consumer-friendly sounding "reforms" such as a repayment plan, voters rejected the industry-funded ballot initiative whose key purpose was to preserve the right to charge almost 400 percent APR for loans forever.

In recent years, Oregon and New Hampshire enacted 36 percent annual rate caps, with Oregon requiring that payday loans must be offered for a term of at least one month. While the Oregon law permits a $10 per $100 loan fee for the first one-month loan, lenders can only charge 36 percent interest for any renewals or subsequent loans, bringing the annual percentage rate to about 154 percent for the first one-month loan and 36 percent subsequently.

The District of Columbia repealed its law allowing payday lending, while the Arkansas Supreme Court ruled that payday loan fees violated the state's constitutional usury cap. Legislation to curb payday lending or cut the cost of loans has received high-profile support in a number of other states, including Virginia, South Carolina, Washington, Kentucky, and Colorado. The Governor of Kentucky announced this month that he will support a 36 percent rate cap on payday lending at next year's legislative session. In addition, the New Hampshire Senate voted in March, 2009 to cap rates on consumer loans of $10,000 or less at the same 36 percent cap applied this year to payday and car title loans.

Appendix B: Payday Borrower Demographics

Lenders claim that their customers are middle class and middle income.[50] The most reliable data on borrowers comes from customer applications collected by regulators as licensees are inspected, not from industry-funded telephone surveys drawn from customer lists provided by lenders. This summary of studies supports the latest findings from the Federal Reserve Survey of Consumer Finances as reported by the Center for American Progress.

Payday Loan Borrowers Are Low to Moderate Income
The Colorado Attorney General's office supervises licensed payday lenders and collected a sample of customer records over five years of inspections. Borrower demographics of over 21,955 separate applications collected during 1,446 compliance examinations show that the typical payday loan customer is a thirty-six year old single woman, making $2,219 per month. Consumers earning $2,500 or less per month ($30,000 per year) make up nearly two-thirds of all borrowers. The majority (62.8 percent) of all Colorado borrowers is in the lowest three income occupations of laborer, office worker, or benefit recipient.[51]

Payday Loan Borrowers are Disproportionately Minorities
The Center for Responsible Lending found that payday lending locations cluster in African American and Latino neighborhoods in California. Even when controlling for factors such as income, educational attainment, and the presence of retail space, payday lenders are 2.4 times as concentrated in neighborhoods with the highest levels of African Americans and Latinos, as compared with largely white neighborhoods. The resulting drain of $247 million in fees from these neighborhoods threatens to make families more financially insecure and exacerbates already present wealth disparities.[52]

An academic 2001 survey of low-income families in Charlotte, North Carolina's largest city, found that African Americans were about twice as likely to have borrowed from a payday lender in a two-year period as whites and that African Americans were five times more likely than whites to take out multiple payday loans, controlling for many socioeconomic characteristics. The same study found that payday lenders clustered in working-class neighborhoods and disproportionately favored high-minority neighborhoods.[53]

Texas payday loan borrowers are typically African American and Hispanic, according to an academic study based on analysis of a database of 145,000 payday loan applicants during 2000-2004 from a "large payday and pawn lender" in Texas. While only 11 percent of Texas adults are Black, 43 percent of payday loan borrowers were. Despite lower bank account ownership by Hispanic families (24 percent nationally are unbanked compared to ten percent for the population

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[50] Community Financial Services Association, "Payday Advance Customer Profile," at www.cfsa.net/govrelat/pdf/Payday_Advance_Customer_Profile.pdf

[51] Colorado Uniform Consumer Credit Code Administrator, "Payday Lending Demographic and Statistical Information: July 2000 through December 2007, February 4, 2008.

[52] Wei Li, Leslie Parrish, Keith Ernst, and Delvin Davis. Predatory Profiling: The Role of Race and Ethnicity in the Location of Payday Lenders in California. Center for Responsible Lending (March 26, 2009).

[53] Michael A. Stegman, "Payday Lending," *Journal of Economic Perspectives, Vol. 21, Number 1, Winter 2007,* at 174.

as a whole, according to the Federal Reserve's Survey of Consumer Finances),[54] 34 percent of payday loan borrowers were Hispanic, compared to 29 percent of Texas adults. The Skiba/Tobacman study also found that 62 percent of borrowers were female and that the median annual pay was $18,540, compared to Census data for Texas of $19,617. Only 34 percent of borrowers own their own home.[55]

Payday Loan Borrowers Are Benefit Recipients

A California Department of Corporations-commissioned survey found that 10.6 percent of payday loan users are public benefit recipients, plus 4.9 percent listed disability and 2.9 percent listed retirement as their regular source of income.[56] Consumer Federation of America testified before the House Subcommittee on Social Security in 2008 that Social Security and Supplemental Security Income, and other public benefit recipients are paying $860 million per year in payday loan finance charges, with exempt funds direct deposited to bank accounts as security for these high cost loans.[57] This proportion is echoed by the Colorado Uniform Consumer Credit Code data identifying ten percent of borrowers list "benefits" as their source of income.

[54] Maude Toussaint-Comeau, "Changing Hispanic demographics: Opportunities and constraints in the financial market," Chicago Fed Letter, No. 192, August 2003, at 3.

[55] Paige Marta Skiba and Jeremy Tobacman, Table 1.

[56] California Department of Corporations study of payday lending, reported by California Budget Project, "Payday Loans: Taking the Pay Out of Payday," September 2008, available at www.cbp.org. Telephone survey conducted in 2007.

[57] Jean Ann Fox, Consumer Federation of America, Testimony on Protecting Social Security Beneficiaries from Predatory Lending and Other Harmful Financial Institution Practices, Subcommittee on Social Security, Committee on Ways & Means, June 24, 2008.

Appendix C: Research on the Adverse Impact of Payday Loans on Borrowers

Payday loan borrowers are worse off than consumers who have no access to payday loans. Colby College researchers simulated families trying to pay bills in spite of budgetary constraints over a 30 month period. "Borrowers" who used the typical volume of payday loans per customer per year for this industry were found to be worse off financially than those without access to payday loans.[58]

Using payday loans causes financial hardship for families. A University of Chicago Business School doctoral student compared households in states with and without access to payday loans over a five year period and found that access to payday loans increases the chances a family will face hardship, have difficulty paying bills, and have to delay medical care, dental care, and prescription drug purchases.[59] These finding are bolstered by findings in the Detroit Area Study (DAS), conducted by a University of Michigan law professor. Comparing payday loan users with similar low to moderate-income households in Detroit who did not use payday loans, the DAS found almost three times the rate of bankruptcy, double the rate of evictions and phone cut-off, and almost three times the rate of having utilities shut off.[60]

Using payday loans increases the chance of losing a bank account. Harvard Business School researchers examined involuntary bank account closures in states where payday loans are available and states where these loans are prohibited to determine the impact of loan availability on account closure. Advocates argue that using payday loans leads consumers to overdraw accounts while lenders claim that the ability to get payday loans saves consumers from otherwise overdrawing their accounts. The study found that an increase in the number of payday loan outlets in a county is associated with an eleven percent increase in involuntary bank account closures, even when other variables such as income and poverty rate are taken into account. To test the theory, researchers looked at Georgia, a state that bans payday loans but is surrounded by states that permit the product. Counties at least 60 miles from the border with payday loan states had a 15.6 percent decline in account closures when Georgia expelled payday lending.[61]

Payday loan users who also have credit cards are twice as likely to become delinquent on the card. Researchers at the Chicago Federal Reserve Bank, Vanderbilt University, and the University of Pennsylvania examined a large sample of payday loan users who also had a credit card from a major issuer. They found that taking out a payday loan makes a borrower almost twice as likely as other credit card customers to become seriously delinquent on their credit card

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[58] Bart J. Wilson, David W. Findlay, James W. Meehan, Jr., Charissa P. Wellford, and Karl Schurter, "An Experimental Analysis of the Demand for Payday Loans," April 1, 2008
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1083796

[59] Brian T. Melzer, "The Real Costs of Credit Access: Evidence from the Payday Lending Market," November 15, 2007
http://home.uchicago.edu/%7Ebmelzer/RealCosts_Melzer.pdf

[60] Michael S. Barr, "Financial Services, Savings, & Borrowing Among LMI Households in the Mainstream Banking & Alternative Financial Services Sectors," Federal Trade Commission, October 30, 2008.

[61] Dennis Campbell, Asis Martinez Jerez, and Peter Tufano, "Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures," June 6, 2008
www.box.frb.org/economic/eprg/conferences/payments2008/campbell_jerez_tufano.pdf

during the next year. For all credit card users, the seriously delinquent rate is 6 percent while for payday loan borrowers in this sample, the rate is around 11 percent.[62]

Payday loans have a fifty-fifty chance of causing defaults in the first year of use. Researchers at Vanderbilt and the University of Pennsylvania examined a large sample of payday loan files at a Texas payday lender and found that over half (54 percent) of borrowers defaulted on loans during the first year. By the time loans are written off by the lender, borrowers have repaid fees equaling about 90 percent of their initial loan principal but are counted as defaults for the full amount of the loan.[63]

Using payday loans causes borrowers to file for bankruptcy. In a large Texas study, researchers found that payday borrowers were about twice as likely to file for bankruptcy in the next two years. They filed for bankruptcy at higher rates than similarly situated payday loan applicants who were turned down for payday loans. And, the bankruptcy impact was strongest on women, blacks and homeowners.[64] When they filed for bankruptcy, their payday loans accounted for about 11 percent of their total annual interest burden.

[62] Agarwal, Sumit, Skiba, Paige Marta and Tobacman, Jeremy Bruce. Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles? (January 13, 2009)
http://ssrn.com/abstract=1327125
[63] Paige Marta Skiba and Jeremy Tobacman, "Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default," August 21, 2008.
http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=1636
[64] Paige Marta Skiba and Jeremy Tobacman, "Do Payday Loans Cause Bankruptcy?" October 10, 2008
http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=2221

Appendix D: H.R. 1214 Does Not Protect Consumers from the Payday Lending Debt Trap

Alarmed at the number of payday borrowers trapped in long-term debt, many states have tried to curb payday lending abuses while allowing the industry to continue to charge triple-digit APRs. Some of the provisions adopted include renewal bans, cooling-off periods, and extended payment plans. While these measures sound promising, lenders have found ways to evade the intent of these provisions and continue to trap borrowers in long-term debt.

H.R. 1214, the Payday Loan Reform Act of 2009, contains a number of provisions which try to temper the worst elements of the product, while not addressing the high APR, short loan term, or other practices that make these loans predatory. Some of these provisions include: (1) a cap on fees of fifteen cents per dollar borrowed; (2) a ban on renewals; (3) a limit of one loan at a time; and (4) the opportunity to use an extended payment plan up to twice a year. In addition, because these regulations apply solely to payday loans as narrowly defined in the legislation, lenders could alter their product slightly to avoid these provisions entirely. The following section addresses each of these provisions in turn and how lenders render them ineffective at stopping the debt trap.

Fee Cap of Fifteen Cents per Dollar Borrowed

HR 1214 seeks to set a ceiling on payday loan fees of fifteen cents for every hundred borrowed. While this would be a reduction in some states which currently allow higher fees, it would still allow payday lenders to charge about 400 percent APR on the typical two-week loan. As detailed in a previous section, even if a lender provided a free loan to a borrower (as many advertise for an initial loan), the borrower would have trouble paying back just the principal on a single paycheck.

Competition does not drive down the cost of payday lending. Any cap becomes the standard price for this product. As a spokesman for a large publicly traded payday loan operation told investors, "Now I know part of the creep up in losses is probably – *although there's no price competition, there is probably an increased demand to get that first customer.* And I think maybe some of the companies – and we're part of that – have eased up our underwriting to get that first customer."[65] (Emphasis added.) CFA surveys of payday loan outlets over the years have documented that most lenders charge the maximum rate permitted in the state. By capping payday loans at 391 percent for a two-week loan, H.R. 1214 locks in extremely expensive rates for borrowers.

Renewal Bans

Almost every state allowing payday lending has some sort of restriction on the renewal of payday loans. Only five states—Kansas, Nevada, Texas, Utah, and Wisconsin—allow unlimited

[65] Q2 2007 Advance America, Cash Advance Centers Inc. Earnings Conference Call, July 26, 2007, quoting John Hill.

renewals. Many policymakers enact renewal bans to address concerns that these ostensibly short-term loans are repeatedly rolled over into long-term debt.

Payday lenders routinely circumvent the intent of renewal bans by having borrowers pay off their loan and immediately take out another; this process is termed a "back-to-back" transaction. Because these types of transactions technically do involve paying off the loan—if only for a moment before a new loan is originated—they are not considered renewals.

Regulator data from Florida and Oklahoma show their lack of effectiveness. Nearly half (45 percent) of repeat payday transactions in Florida occur as soon as the 24-hour cooling-off period expires, and 88 percent of these are originated before the typical borrower receives their next paycheck.[66] Data from Oklahoma reveals a similar trend with 87 percent of loans taken out during the same pay period that a previous loan is paid off.[67] So, while a brief pause in lending does occur, the borrower is still flipped into another loan and continues to be in long-term debt. The experiences in Florida and Oklahoma are similar to data from the nation's largest lender, Advance America, which shows 46.5 percent of transactions were originated on the same date as a previous loan was paid off.[68]

<u>Limiting Borrowers to One Loan at a Time</u>

Several states restrict the number of payday loans a borrower can have outstanding or employ limits on the total indebtedness a borrower can have at any given time. Loopholes in these types of provisions are rampant, with many states merely requiring that the borrower sign a statement that they have no other loans outstanding. Since this limitation is applied to an individual borrower, another member of the household can simply visit the payday lender to take out an additional payday loan for the family. Even if effectively enforced, these types of provisions still allow a borrower to take out 24 consecutive two-week loans per year—thus remaining indebted to a payday lender the entire time.

<u>Extended Payment Plan</u>

H.R. 1214 establishes a repayment plan to be provided once every six months to borrowers who request it within seven days of a loan's due date. Borrowers are not eligible for the plan until six months after fully paying off the prior plan. Under the design of this plan, consumers cannot be charged additional finance charges or interest fees for using the plan.

While a repayment plan is in effect, the same lender cannot extend a new payday loan to a borrower. In addition, the borrower must wait another 13 days after completing the plan before being eligible to get a new loan. While this feature of the bill might appear to help consumers

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[66] Response to public records request of Florida data collected by Veritec, provided by the Florida Office of Financial Institutions and Securities Regulation on June 16, 2003, on file with CRL.

[67] Response to public records request of Oklahoma data collected by Veritec, provided by the Oklahoma Department of Consumer Credit on August 29, 2007, on file with CRL.

[68] Advance America Prospectus. December 17, 2004, pg 37-38. 42.3 percent of transactions were consecutive transactions defined as loans entered into on the same day as a previous payday loan was paid and 4.2 percent were direct renewals, defined as simple extensions of an outstanding payday loan by paying only the applicable finance charge.

trapped in repeat borrowing, experience from the states that have tried repayment plans shows it is not an effective remedial reform.

The availability of an extended payment plan does not make payday lending safe or affordable for borrowers. Regulator data from the states that have attempted this program demonstrates that less than two percent of eligible transactions employ a repayment plan. Payday lenders discourage repayment plan use among borrowers by playing up the fact that a borrower cannot take out another payday loan while they are in a payment plan, nor during the cooling-off period which follows. The table below summarizes payment plan take-up rates in states that have already incorporated this provision into their payday lending regulations.

	% of Eligible Transactions Employing Payment Plan/Grace Period	**Payment Plans as % of Total Transactions**
Florida[69]	0.42%	0.42%
Michigan[70]	2.42%	1.33%
Oklahoma[71]	1.84%	1.14%
Washington State[72]	Not Available	1.20%

Lenders have little incentive to cast these plans in a positive light to borrowers, because they make less money if the borrower enters a payment plan, rather than continuing to take a new loan each pay period. Specifically, one state regulator reports that lenders have tweaked their product

[69] *Florida Trends in Deferred Presentment*, Prepared by Veritec Solutions LLC for the Florida Department of Banking and Finance. (August 2007). Available at http://www.veritecs.com/FL_trends_aug_2007.pdf. Payday borrowers in Florida may request a 60 day grace period the day before their loan is due and must make an appointment with a credit counselor within 7 days.

[70] *Michigan Trends in Deferred Presentment*, Prepared by Veritec Solutions LLC for the Michigan Office of Financial and Insurance Services (July 31, 2007). Available at http://www.michigan.gov/documents/cis/OFIS_DPST_REPORT_204749_7.pdf. Payday borrowers are eligible for a payment plan in Michigan after eight transactions over a 12 month period. The lender may charge a $15 set up fee. The borrower can then pay back their debt over three installments.

[71] *Oklahoma Trends in Deferred Deposit Lending*, Prepared by Veritec Solutions LLC for the Oklahoma Department of Consumer Credit. (May 2007). Available at http://www.veritecs.com/OK_Trends_05_2007.pdf.. Payday borrowers may request a payment plan in Oklahoma prior to the due date of their 3rd, 4th, or 5th consecutive loans. The lender may charge a fee of 10% or $15, whichever is less. The borrower then pays back their debt over the next four paydays in equal installments and must wait 15 days after paying the loan off before taking out a new payday loan.

[72] Data is based on reporting from 92% of the industry. See *2006 Payday Lending Report*. Washington State Department of Financial Institutions (2007). Available at http://www.dfi.wa.gov/cs/pdf/2006_payday_report.pdf. Payday borrowers in Washington State are eligible for a payment plan after taking out four successive loans and before the default of the last loan. Lenders may charge a one-time fee of up to 15 percent of the first $500 of principal owed and 10% of the remaining principal balance. Borrowers are given at least 60 days to pay back their debt in three or more installment payments.

slightly after implementation of a payment plan measure so that borrowers do not become eligible for the plan.[73]

[73] For example, borrowers are eligible for Colorado's payment plan after taking out four consecutive loans (defined as loans taken within five days after a previous loan is repaid). The state regulator office reports that lenders have made their borrowers ineligible for payment plans in the following ways: (1) requiring at least a six day cooling off period after the third consecutive loan, (2) offering an interest free loan after the third consecutive loan (loans without finance charges do not count towards payment plan eligibility under the law), and (3) refusing origination of a 4th consecutive loan, which would presumably drive borrowers to another payday lender. See *Springing the Debt Trap* by the Center for Responsible Lending for more details.

- My name is Gerri Guzman. I am a resident of Los Angeles County, CA and currently serve on the Montebello Unified School District Board of Education. Our District serves 33,000 Kindergarten thru 12 grade students and their families, 78% of whom qualify for free or reduced lunch. I am also active in the following organizations: Soroptimist International, the Boys and Girls Club, and my local Chapter of the American Red Cross.

- I have also been a payday lending customer and am here today to talk about my experience. I am thankful for the opportunity to be here, as I think sometimes with issues like payday lending that the opinions of the people who actually use the product are never listened to.

  I also would like to add that when my City considered a moratorium on granting business licenses to Pay Day Lenders, I meet with several community members to listen not only to their experiences but to gain an understanding of why a pay day loan appeared to be the best choice.

- Personally, I consider payday loans to be a necessary evil. If I had the choice, I would never have been in a situation where I needed a payday loan. I'm sure this rings true for the tens of millions of other payday lending customers around the country. In a perfect world, we would all have money set aside in savings to deal with expenses as they come up. Unexpected, but unavoidable expenses, such as a broken down car, a medical bill or a child's college application form.

- But having much money in savings is not the reality for many families, especially with the economy the way it is today.

- I first became a payday lending customer when I decided to leave my job to become my Mother's primary caretaker for the 14 months prior to her passing. I do not regret for a moment my decision but I would be lying if I said it didn't create a temporary financial hardship.

- At the time, my options were to take out a payday loan or not to replace a water heater.

- I was aware of the cost of the payday loan and decided that it was the best option for me at the time. No, they are not cheap, but they can be the least expensive, or only choice.

- Thankfully, my financial circumstances have changed. And although I am no longer a payday lending customer, I would like to know that I have the option to do so again, if I choose.

- I do wish that there were more choices and better choices for consumers. But there are not. The more choices people in tough financial situations have, the smarter decisions they can make and the better off they are.

- I was not tricked into using a payday loan. I, like most people in this day and age, are budget conscious and look for the best options available in any situation. I knew what a payday loan would cost, but the process was simple and quick.

- There are payday lending customers who get themselves into trouble. And some people make poor choices and get caught in a debt spiral. But this is not unique to payday lending customers. I don't think the government should focus on helping those few at the expense of the rest of us.

- But, I do think that it is important that the government protect people from predatory lenders and abusive practices.
- I would like to see a mechanism in place to minimize the likelihood of payday lending customers don't get trapped in a cycle of debt. I'm sure most people intend to pay the loan back when it's due, but sometimes the money does not become available. In these situations, it's important that the lender work with the borrower to make sure they aren't worse off than they were before. An adjusted payment plan would be helpful.
- It would also be helpful to make it easy for customers to compare credit products. Companies need to be upfront and clear about how much the borrower will pay for the loan and when it will be due back. However, I have found that even with the information to make an informed decision, emergency situations create a sense of urgency. All too often the quickest, easiest solution wins out over reason.
- Thank you for your time today. I appreciate the opportunity to represent the tens of millions of payday lending customers across the country. We each have our own personal reasons for going to a payday lender, but I think almost all of us would agree that payday lending is not a perfect option and it's not right for everyone. And we were glad the option was available.

Testimony of Troy McCullen
House Financial Institutions and Consumer Credit Subcommittee
April 2, 2009

Good afternoon, Mr. Chairman and members of the Committee. My name is Troy McCullen and I own the largest small loan company in Louisiana and operate 30 locations. I am also president of the Louisiana Cash Advance Association and working closely with the Louisiana Legislature and the Office of Financial Institutions helped draft and pass the laws under which we operate. Our laws are working, and I want to offer you information that will help you in your decision-making process.

From the beginning, we had two specific goals in mind – provide structure to a service that customers need and want, and implement tight consumer protections. All lenders are licensed, regulated and extensively audited by the Office of Financial Institutions, and I believe we have one of the best consumer protection laws in the country. If you want a national standard and want to implement something that will work, implement Louisiana's law.

As with any new industry, ours has certainly had its problems, and there are bad operators in every industry. But with lots of hard work things are leveling out, and in Louisiana the number of lenders is actual dropping. This phenomenon happens in every new industry, and is the way our country's free market system works. Businesses rise and fall based on consumer demand. I believe we will continue to see downward adjustments and consolidations in the future.

Louisiana Law:

- Provides for full disclosure of all fees and terms on the promissory note including APR,
- Prohibits companies from accepting fees to rollover, flip or renew a loan. This is one of my hot buttons, and our law keeps consumers from getting into a cycle of debt,
- Allows for the collection of reasonable attorney's fees and court costs, and
- Mandates the posting of a fee schedule and OFI's 800 number.

The maximum fee allowed on a cash advance in Louisiana is 16.75% of the face of the check. This means when someone borrows $100.00, the fee is $20.00. If they borrow $200.00, the fee is $40.00. No compounding, no excessive fees. There is a $45.00 fee cap, and like other lenders we are allowed a $5.00 documentation fee.

If a customer defaults, we are allowed to charge 36% for the first year and 18% thereafter. There are VERY few complaints. In fact, Louisiana had over 4.1 million transactions in 2008 and regulators received only 24 complaints which is statistically non-existent. Of those 24 complaints, only two pertained to excessive fees.

While we are an open book and disclose all fees in the promissory note, I believe we should be taken out from under the Truth in Lending requirements. Ours is a fee based business, and APR should not apply. Money is just like any other commodity, and applying APR to our business skews reality and is illogical. I compare our business to an AAA Rental store. You can buy a hedge clipper at Home Depot for $100.00 or you can rent it from AAA for $20.00. Our customers rent the same way. It's just our product is money, and they pay a fee for the convenience. If they do not need our service, they will not come in. An example of how someone would use our service is if they bounce three $50.00 checks, the total fees can exceed $150.00. If the same person borrows $150.00 from one of our stores, the fee is around $30.00. $150.00 vs. $30.00.

Defaults are a constant problem. If a $300.00 loan customer charges off, seven other customers must pay in order for us to break even. Louisiana's law could be better by allowing us to reduce or control bad debt in a better way. Some states have implemented a database which allows only one or two loans per customer at a time. I am not in favor of the database, but controlling consumer bad debt is a benefit. We use TeleTrack to track negative data, and if a customer has more than one loan, we will not loan to them. If they have charged off somewhere else, we will not loan to them. The consumer groups want you to believe that we are trying to put people deeper into debt, when in actuality we want our customers to pay and not default.

Perception vs. Reality. The consumer groups have done an excellent job of spreading misinformation, and I've realized that perception can become reality when repeated enough times. But the horror stories you see in the newspapers and on television are not reality in Louisiana. And for the record we are not predatory as there is nothing to take away. Again, the consumer groups are spreading incorrect information, and they know it. Predatory lending applies only to the mortgage business. It has nothing to do with rates or fees or APR. If it did, every NSF fee would be considered predatory.

According to the recently released FDIC Study of Bank Overdraft Programs an average $66.00 check that bounces and is repaid in two weeks incurs an APR of over 1,000%. A $60.00 ATM overdraft that is repaid in two weeks incurs an APR of over 1,100%. ATM overdrafts and NSF overdrafts paid by the bank for their customers are extensions of credit. I'm not suggesting that you apply APR to these extensions of credit, but my point is if you apply APR to us, then the same should be applied to them. If you exempt them, we should also be exempt because we too offer a fee based service.

While the rate appears not to be a big deal, it will have a detrimental effect on our industry. I believe this bill could put many of the lenders in my state out of business. If that occurs, you will not only swell the unemployment lines, but the availability of credit will be restricted and ultimately you will hurt those you are trying to help. We should be expanding credit these days, not restricting it.

I respectfully request that you defeat this bill in its current form or alter it to mirror the Louisiana law, which allows for $ .20 per $1.00 plus a documentation fee. Thank you.

Federal Reserve Bank of New York
Staff Reports

Payday Holiday: How Households Fare after Payday Credit Bans

Donald P. Morgan
Michael R. Strain

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Abstract

Payday loans are widely condemned as a "predatory debt trap." We test that claim by researching how households in Georgia and North Carolina have fared since those states banned payday loans in May 2004 and December 2005. Compared with households in states where payday lending is permitted, households in Georgia have bounced more checks, complained more to the Federal Trade Commission about lenders and debt collectors, and filed for Chapter 7 bankruptcy protection at a higher rate. North Carolina households have fared about the same. This negative correlation—reduced payday credit supply, increased credit problems—contradicts the debt trap critique of payday lending, but is consistent with the hypothesis that payday credit is preferable to substitutes such as the bounced-check "protection" sold by credit unions and banks or loans from pawnshops.

Key words: payday credit, consumer welfare, bounced check protection, informal bankruptcy

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The payday loan industry depicts itself as a financial crutch propping up struggling borrowers until their next paycheck. In truth, the loans are financial straitjackets that squeeze the working poor into a spiral of mounting debt (Atlanta (GA) Journal-Constitutional Editorial, 12/8/2003)

I. Introduction

In 1933 President Roosevelt closed all banks in the U.S. The "bank holiday" was a desperate effort to calm bank depositors and halt the runs that were draining money and credit from circulation.

In 2004 and 2005 the governments of Georgia and North Carolina permanently closed all the payday lenders operating in their state. Payday lenders are "fringe banks" (Caskey 1994): small, street-level stores selling $300 loans for two weeks at a time to millions of mostly lower middle income urban households and members of the military. The credit is popular with customers, but despised by critics, hence the bans in Georgia and North Carolina. This paper investigates whether those "payday holidays" helped households in those states. Why might less credit help? Because payday loans, unlike loans from mainstream lenders, are considered "debt traps" (Center for Responsible Lending 2003).[1]

The debt trap critique against payday lenders seems based on three facts: payday loans are expensive ("usurious"), payday lenders locate near their customers ("targeting"), and most payday customers are repeat ("trapped") borrowers. After documenting that the typical customer borrows 8 to 12 times per year, the CRL (Center for Responsible Lending) concluded:

> ...borrowers are forced to pay high fees every two weeks just to keep an existing loan outstanding that they cannot afford to pay off. This ..."debt trap" locks borrowers into revolving high-priced short-term credit instead of ...reasonably priced longer-term credit (Ernst, Farris, and King 2003, p. 2)

[1] Jane Bryant Quinn (financial columnist in *Newsweek*) recently warned that "payday loans can be a debt trap" (October 8, 2007).

The CRL study went on to estimate that 5 million trapped American families were paying $3.4 billion annually to "predatory" payday lenders.[2]

The debt trap critique has influenced lawmakers at every level to restrict payday credit or ban it outright. Oakland and San Francisco limit the number and location of payday stores. Oregon and Pennsylvania recently joined Georgia and North Carolina in banning payday loans. New York, New Jersey, and most New England states have never granted entry.[3] By contrast, some western states (Washington, Idaho, Utah, and until recently New Mexico) have maintained relatively laissez-faire policies toward payday lending. That patchwork regulation means that millions of people use payday credit repeatedly in some states, while their counterparts in other states go without. However one sees payday credit—as helpful or harmful—the uneven regulations means millions of households are potentially being wronged.

We test the debt trap hypothesis by investigating whether Georgia and North Carolina households had fewer financial problems, relative to households in other states, after payday credit was banned. The study we depart from is Stegman and Faris (2003). They find that "pre-existing" debt problems-- bounced checks or contact by debt collectors--were the most significant predictors of payday credit demand by lower income households in North Carolina.[4] We follow up by researching whether problems

[2] The CRL study did not distinguish repeat borrowing from *serial* borrowing (rolling the same loan over and over). The relative extent of serial and repeat borrowing is still not entirely clear.
[3] At the federal level, the Military Personnel Financial Services Protection Act of 2006 effectively prohibits payday loans to soldiers and other military personnel.
[4] Stegman and Farris (2001) conclude that payday lending encourages "chronic" borrowing, but stop short of recommending bans of payday lending lest borrowers resort to more expensive, "underground" credit. They relate a telling anecdote: in states that prohibit payday loans, loan "sharks" have been observed at check cashing stores, waiting to collect from borrowers who have just cashed their work paychecks. The

go down when payday credit gets banned. Is payday credit part of the problem, or part of the solution?

We study patterns of returned (bounced) checks at Federal Reserve check processing centers, complaints against lenders and debt collectors filed by households with the FTC (Federal Trade Commission), and federal bankruptcy filings. The monthly complaints data are new to this study; we obtained them from the FTC under the Freedom of Information Act. We use changes in complaints within a state to identify changes in household welfare (well-being), a distinct advantage compared to the ambiguous measures (interest rates and repeat borrowing) emphasized by critics of payday lending. How do we know when credit is *so* expensive or burdensome that households are better off without it? The real test is whether household welfare is higher with or without payday credit, and complaints are a measure of welfare.

Most of our findings contradict the debt trap hypothesis. Relative to other states, households in Georgia bounced more checks after the ban, complained more about lenders and debt collectors, and were more likely to file for bankruptcy under Chapter 7. The changes are substantial. On average, the Federal Reserve check processing center in Atlanta returned 1.2 million more checks per year after the ban. At $30 per item, depositors paid an extra $36 million per year in bounced check fees after the ban. Complaints against debt collectors by Georgians, the state with the highest rate of complaints to begin with, rose 64 percent compared to before the ban, relative to other states. Preliminary results for North Carolina are very similar. Ancillary tests suggest that the extra problems associated with payday credit bans are not just temporary

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source of the anecdote noted that two week rate of interest charged by the shark outside his store was 20 percent. The typical rate for payday credit is 15 percent.

"withdrawal" effects; Hawaiians' debt problems declined, and become less chronic, after Hawaii doubled the maximum legal "dose" of payday credit in 2003.

Our findings will come as no surprise to observers who have noticed that payday credit, as expensive as it is, is still cheaper than a close substitute: bounced check "protection" sold by credit unions and banks (Stegman 2007). Bounce protection spares check writers the embarrassment of having a check returned from a merchant, and any associated merchant fees, but the protection can be quite expensive. The Woodstock Institute survey of overdraft protection plans at eight large Chicago banks estimated the (implicit) APR for bounced check "protection" averaged 2400 percent (Westrich and Bush 2004).[5] Sheila Bair (2005), now head of the Federal Deposit Insurance Corp., observed that the "enormous" fees earned on bounced protection programs discouraged credit unions and banks from offering payday loans. She warned that customers were "catching on" and turning to payday credit for their "cheaper product."[6]

Our findings reinforce and extend other recent research on the consumer benefits payday credit. Morgan (2007) finds that households with risky income (and hence, high demand for credit) are less likely to miss debt payments if their state allows unlimited payday loans. That study looked at variation in credit supply between states; this study

[5] The average fee in the Woodstock survey was $29 per overdraft. Bouncing one $150 check for two weeks (1/26 of a year) implies an APR = (29/150)x26 = 503 percent. Bounced checks like company: the APR for bouncing two $75 checks = (58/150)x26 = 1006 percent. The APRs Woodstock calculated were higher (but probably more realistic) because they (1) factored in the daily overage fees levied by some banks and credit unions and (2) assumed five $40 overage of $200 over 14 days. Lehman (2005) calculates overdraft APRs of the same order using data from Washington Department of Financial Institutions.
[6]Bair, Sheila, Presentation at the Federal Reserve Bank of Chicago Bank Structure Conference, 2005, http://www.chicagofed.org/cedric/files/2005_pres_session1_bair.pdf, accessed June 9, 2007. Appelbaum (2006) reported that North Carolina banks began advertising their overdraft services more actively after payday lending was banned. Interestingly, payday lending boomed about the same time that bank consultants began marketing bounce check "protection" to credit unions and banks as revenue enhancers (Consumer Federation of America).

looks within states.[7] Morse (2006) finds that California households weather floods, fires and other natural disasters with less suffering (foreclosures, illness, and death) if they happen to live closer to the types of places where payday lenders tend to congregate. Her findings show that payday credit can be profoundly beneficial, even lifesaving, in extraordinary events.[8] Our findings show it helps avoid more quotidian disasters, like bouncing a mess of checks, or getting hassled at work by debt collectors.

Our findings may not be consistent with Skiba and Tobacman (2006). Using data from a single large payday lender in Texas, they find "suggestive but inconclusive evidence" (p. 1) that payday loan applicants who are denied loans are less likely than applicants granted loans to file for rescheduling of their debts under Chapter 13 of the bankruptcy Act. By contrast, filings under Chapter 7 were not affected. We too find lower Chapter 13 filings after payday loans are banned (denial at the state level) but we find higher Chapter 7 filings. Now recall that rescheduling under Chapter 13 is for filers with substantial assets to protect, while Chapter 7 ("no assets") is for everyone else, including, as seems likely, most payday borrowers. Combined with our findings of more bounced checks and more problems with debt collectors, we take our results as evidence of a slipping down in the lives of would-be payday borrowers: fewer bother to

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[7] The CRL argues that Morgan (2007) mistakenly classified some states with active payday lending markets as non-payday states (e.g. North Carolina).
http://www.responsiblelending.org/issues/payday/briefs/page.jsp?itemID=31489963
They make a fair point. However, the forthcoming revised version of Morgan (2007) shows that his main results and conclusions are largely unchanged if those disputed states are omitted from the analysis. That invariance is not surprising as the identification in that study came by comparing states that allowed *unlimited* payday loans to states with limited (or no) payday credit. The disputed states did not allow unlimited payday loans, and in fact, many did not allow it at all.

[8] Karlan and Zinman's (2006) powerful credit experiment, set in South Africa, shows that marginal credit applicants that are granted (expensive) loans are less likely to go unemployed, poor, or hungry than are denied applicants.

reschedule debts under Chapter 13, more file for Chapter 7, and more simply default without filing for bankruptcy.[9]

Section II describes the payday credit market and the debt trap critique that led Georgia and North Carolina to close the market in those states. Section III illustrates how higher interest rates might push households from a sustainable debt path to an unsustainable path with accumulating debt and problems. Section IV introduces the debt problems we study and documents how national events have influenced their trends. Section V presents the main results: most problems increased in Georgia and North Carolina, relative to the national average, after those states banned payday credit. Ancillary tests show that Hawaiians' debt problems (complaints) declined and became less chronic after the payday loan limit was doubled. Section VI concludes.

II. Payday Credit and its Critics

Here we describe the payday credit market — the loan, the people who demand payday loans, and the firms that supply them — and critics' objection to the market.

The loan. The typical payday loan is $300 for two weeks (Stegman 2007). The typical price is about $45 ($15/$100), implying an annual percentage rate (APR) of 390 percent. Payday lenders require proof of employment (pay stubs) and a bank statement. Some lenders require only that, others may also check Equifax to see if the borrower has defaulted on previous payday loans. If approved, the borrower gives the lender a post-dated check for the loan amount plus interest, say $345. Two weeks later the lenders

[9] Credit constrained borrowers may also resort to selling assets, thus obviating filing for Chapter 13. Increased asset sales after the ban were reported to us by a large (one of the big five) payday lender that also operates pawnshops, and we also found lower auto repossession rates after Hawaii doubled the payday loan limit (repossession rates are not available for North Carolina and Georgia). Those results are available upon request. "A Slipping-Down Life," Anne Tyler's novel (1969, Random House) about diminished prospects, is set in North Carolina.

deposits the check and the credit is extinguished. If borrowers wish to roll over (extend) the loan, they pay the $45 interest charge and write a new, post-dated check for $345. The initial check is returned (uncashed) to the borrower.

Payday lending evolved from check cashing in the early 1990s (Caskey 1994). Once a customer had cashed a paycheck (or assistance check) repeatedly, lending against future checks was a natural step.[10] Payday lenders are 2nd generation check cashers that learned to lend. That evolution suggests payday credit was not contrived specifically to trap borrowers, though it may have devolved.

Demand. At least ten million households borrow from a payday store every year (Skiba and Tobacman 2006). All payday borrowers, by definition, have jobs and bank accounts.[11] From a large survey of payday customers commissioned by the payday trade association we know the typical customer is about 40 years old and earns between $30,000 and $40,000 per year (Ellihausen and Lawrence 2001). Only 20 percent have a college diploma, compared to 35 percent of all adults Customers tend to be disproportionately female, and Black or Hispanic (Skiba and Tobacman 2006). Active-duty military personnel demand more payday credit than their civilian counterparts (Stegman 2007).

Payday customers are risky. The rate of bankruptcy among the customers Skiba and Tobacman (2006) studied was an "order of magnitude" (ten times) higher than the

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[10] Modern payday lending resembles "salary buying" of a century ago, where lenders buy someone's next paycheck at discount (see Chessin citation in Stegman 2007). This may be gratuitous, but *all* credit is payday credit in the sense that repayment comes from future income (or profits).

[11] Second generation banked households studied by Stegman and Farris (2003) were less likely to demand payday credit than 1st generation banked households, suggesting borrowers graduate to more mainstream credit.

national average. Sixty percent of the customers surveyed by Elliehausen and Lawrence (2001) reported they had "maxed out" (borrowed to the limit on) their credit cards.

Most payday borrowers are repeat customers; if they borrow once, they are likely to borrow 8 to 12 times per year (Center of Responsible Lending (2003) and Skiba and Tobacman (2006)). The extent of *serial* borrowing (rolling the same loan over and over) versus repeat borrowing is not entirely clear.

Supply. The number of payday credit stores has grown from essentially zero in the mid-1990s to over 20,000 today. As with mainstream banks, the distribution of payday lending firms is bimodal: a handful of very large corporate firms operate thousands of payday stores in virtually every state that allows it, while hundreds of small firms operate just a few stores within a single city, state, or region. Several of the multi-state firms have publicly traded stock. Stegman (2007) documents the phenomenal expansion in the number of payday stores in states that permit them. In just five years, store numbers in Ohio and Oregon doubled, and in Arizona they tripled. Nationally, payday lenders are said to outnumber McDonald's restaurants (Stegman 2007).[12]

While rapid entry suggests low entry costs and/or high expected returns, recent profitability studies find relatively normal returns. After analyzing firm level data provided by two large payday lending corporations, Flannery and Samolyk (2005) conclude that payday lending prices seem roughly commensurate with costs. Huckstep (2007) concludes similarly after examining costs and returns of publicly traded payday lending firms. Normal returns suggest entry and competition work to limit payday loan

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[12] For relative numbers of payday lenders and McDonalds in each state see http://www.csun.edu/~sg4002/research/mcdonalds_by_state.htm

prices and profits. Using "found data" Morgan (2007) finds lower payday loan prices in cities with more payday stores per capita, consistent with the competition hypothesis.[13]

Against payday lending. Payday lenders' many critics include consumer advocates, journalists, competitors, and increasingly, the government at all levels.[14] Their main objections, again, are "targeting" (women, minorities, and soldiers), high prices, and repeat borrowing. Payday lenders are said to locate near their prey, then hook them on expensive credit they cannot payoff. Repeat borrowing is seen as proving the debt trap hypothesis: borrowers are tempted into borrowing $300 for two weeks expecting to pay $45, but wind up paying many times that amount as they borrow repeatedly.

The CRL (Center for Responsible Lending), a non-profit, non-partisan research institute headquartered in North Carolina, has been an especially influential of payday lending in particular and predatory lending in general. The CRL is affiliated with Self Help credit union.[15] After finding the typical payday customer borrows 8 to 13 times per year, the CRL estimated that payday lenders extracted $3.4 billion per year from "trapped" households (that borrowed more than 5 times per year). Those findings were cited by the Chairman of the NAACP (National Association for the Advancement of Colored People) in an editorial published by the Atlanta Journal Constitutional while the Georgia legislature was debating whether to ban payday lending:

[13] In a study of Colorado payday lenders, DeYoung and Phillips (2006) also find lower prices in markets with more lenders per capita. On the other hand, they also find evidence that government price ceilings provide a focal point that enables collusion, and thus, inhibits competition.

[14] Googling "Credit Unions Payday Lenders" produces many hits where credit union executives and consultants lament the harm done to their customers by payday lenders, *and* the loss of customers. For example: http://www.npr.org/templates/story/story.php?storyId=15276522

[15] http://www.responsiblelending.org/about/index.html.

> "the dirty secret of payday lending is that its business model is utterly dependent on extracting huge fees from those borrowers unable to pay the loan back." (Atlanta Journal Constitutional 3/4/2004, p.A14)

A follow-up study by the CRL projected that banning payday lending would save Georgia and North Carolina households $147 million and $153 million, respectively (King, Parrish, and Tanik 2006, table 5).

Georgia made payday lending a felony subject to class-action lawsuits and prosecution under racketeering in May 2004. Store counts provided to us by five large multi-state payday lending firms confirm that the ban caused payday credit supply to contract as intended (Chart 1): shortly after the felonizing, stores operated by the "big five" in Georgia fell from 125 to 0.[16]

North Carolina has gone back and forth with payday lenders (Hefner 2007). In 1997 the NC legislature exempted payday lenders from the state's usury limits for a three year trial. Critics prevailed on the legislature to let the law expire in 2001. Many small stores closed, but the largest firms circumvented the usury limits by affiliating with a national or state chartered bank (the bank agency or "rent-a-charter" model). A cat-and-mouse game followed, with bank regulators trying to limit charter-renting and payday lenders trying to evade the limits. In December 2005, the NC Commissioner of Banks ruled that the bank agency model violated NC law, "...effectively end(ing) payday

[16] Payday lenders defended themselves, of course, along with the occassional customer willing to testify on their behalf: "During her lunch hour Friday, (payday customer Audrey Richardson) went to Ruff's (payday) business for $300 to cover her car insurance bill until payday a week off, but she was turned away. "This could be devastating for people like me... this has bailed me out numerous times." (Quoted by Rhonda Cook in "Payday Lenders Cry 'Mayday' as Laws Tighten," Atlanta (GA) Journal-Constitution, March 6, 2004, E1). The Georgia House of Representatives passed the law against payday lending the same day they outlawed "bullying behavior" in schools.
http://www.legis.state.ga.us/legis/2003_04/house/house%20information/daily%20wraps/daily%2016.htm

lending in North Carolina" (Hefner 2007). The big five promptly closed 250 stores (Chart 1).[17]

Before we investigate whether those payday credit bans improved households' financial health, we contemplate the debt trap critique that prompted the ban.

III. Debt Trap Concepts

> "Trap: 1) A contrivance for catching and holding animals...
> 2) A stratagem for catching or tricking an unwary person..."[18]

Debt traps and predatory lending are not features of standard economic models of household borrowing. In standard models, households demand credit to sustain their consumption when their income temporarily falls or expenses temporarily rise. If credit is costly, households demand smaller quantities. Elastic demand ensures that households' debt burden does not exceed their debt capacity. Absent shocks or subterfuge, rational households keep themselves free of debt traps and predators' clutches.

Recent research departs the standard model by imagining lenders who trick households into borrowing at inimical terms. Della Vigna and Malmendier (2004) show how credit card lenders can get the better of procrastinating borrowers by using "teaser" rates or other price manipulation. Morgan (2007) imagines predators who can, at some cost, exaggerate the income prospects of gullible households, thereby driving up their loan demand. Especially gullible households may borrow up to the brink of default. It could be said that the prey in those models get trapped — they certainly get tricked.

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[17] Payday lenders agree to stop making new loans, to collect only the principal on existing loans, and to pay $700,000 to non-profit organizations for relief.
http://www.ncdoj.com/DocumentStreamerClient?directory=PressReleases/&file=paydaylenders3.06.pdf

[18] American Heritage Dictionary, 3rd ed. 1992, Houghton and Mifflin Co. Boston and New York.

Bond et al. (2006) show how even fully rational households can get trapped by better informed lenders.[19]

The stratagems in those theories seem more complicated than the debt trap critique levied against payday lenders.[20] Critics maintain that payday credit is prohibitively expensive, meaning repayment of the full $345 required for the typical two week loan is beyond borrowers' reach; the best borrowers can do is extend the loan indefinitely.

That debt trap concept seems closer to the "poverty trap" model in Sachs (1983). His model shows how a nation gets mired in poverty if its debt burden becomes too great. Debt servicing slows capital accumulation, which slow income growth and reduces saving. Reduced saving feeds back to reduce capital still further, so a downward spiral ensues. Debt *relief*, a reduction in borrower costs (or debt amnesty) can reverse the spiral. A simpler *debt* trap version of that model illustrates the basic arithmetic of a debt trap, and show how a rise in the cost of credit (the advent of payday lending?) might push households that *were* in a sustainable financial condition into an unsustainable path with accumulating debt and compounding problems.[21]

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[19] While those predatory lending models vary, two principles are the same: (1) collateral excites predators' instincts (because it reduces the hazard of bankruptcy), and (2) competition limits the harm predators can inflict (since competitors can profit by undoing the harm). Morgan (2007) finds lower payday loan prices in cities with more payday loans per capita, consistent with the competition hypothesis.

[20] To our knowledge, not even critics of payday lending allege that payday lenders are opaque about their borrowing terms. By contrast, bounce protection providers have been criticized for (1) providing protection by default, (2) encouraging overdrafts, and (3) not converting fees to equivalent annual rates (Bush and Westrich 2004). Skiba and Tobacman (2006) discuss a more sophisticated debt trap hypothesis that has payday lenders preying on hyperbolic discounters (procrastinators) who cannot commit themselves to repay the credit. As far as we know, there is no evidence for that hypothesis.

[21] Incorporating more flexible household behavior into our (admittedly) mechanical model would complicate the dynamics, without altering the basic result. Following Sachs (1982), we could allow debt problems (e.g., repossession of the borrowers' car) to lower productivity and slow income growth. Slower income growth reduces d* further, so *d* accelerates. Allowing feedback between debt problems and income growth makes the debt trap easier to fall into and harder to escape.

Imagine a household whose income *Y* grows exponentially over time (*t*) at rate *n:* $Y(t) = Y_0e^{nt}$. Households save a fixed fraction σ of their income: $S(t) = \sigma Y(t)$. The household owes $D(t)$. The stock of debt increases whenever interest on the debt exceeds savings: $\delta D(t)/\delta t = rD - \sigma Y(t)$. How much can the household afford to borrow? Because income is growing, sustainable debt should be defined relative to income: $D/Y \equiv d$. Steady state debt-income ratio (d^*) is where debt and income grow apace: $\delta D/\delta t = \delta Y/\delta t \Rightarrow rD(t) - S(t) = nY(t) \Rightarrow d^* = (\sigma + n)/r$. The sustainable debt-income is increasing in income growth (n) and decreasing in the interest rate r; the more debt cost, the less the household can afford. An exogenous increase in r will push households that *were* in sustainable financial condition onto a path of unsustainable debt accumulation and compounding problems. Critics may see advent of expensive payday credit as just such an interest rate shock.

The model tells us that the variable we would like to identify is the marginal cost of credit after payday credit gets banned. Short of knowing whether the alternatives offered by banks and credit unions are preferable, our strategy is to test whether households debt problems subside after the ban.[22] If the substitutes are cheaper, or less entrapping, households should look financially better off after the ban.

IV. Financial Problems

We study three financial problems that seem endemic to payday borrowers: (1) returned checks, (2) complaints against lenders and debt collectors, and (3) bankruptcy. We think of bounced checks as a small setback that might cascade into problems with debt collectors, or even bankruptcy.

Returned Checks. Checks are returned (bounced) if the check amount exceeds funds in the payer's account. To the uninitiated, bouncing a check is embarrassing, expensive, and potentially criminal.[23] Check bouncing may be especially problematic for payday borrowers as they are prone to bounce checks (Stegman and Faris 2003).

We study the quarterly rate of returned checks at Federal Reserve check processing centers (cpc) from 1997:q1 to 2007:q1 (Chart 2).[24] The returned check rate is calculated two ways: 1) the number of returned checks per 100 checks processed, or 2) the dollar value of returned checks per $100 worth of checks processed. The rate in number terms seems more relevant to (small dollar) payday credit users.

The rebound in returned check rates in 2004, after years of declines, reflects Check 21 (Check Clearing Act for the 21st Century), a new federal law that took effect October of that year. Check 21 lets depository institutions debit payers' accounts more quickly (using electronic presentment) without crediting payees' account more promptly.[25] Less "float" for check writers means more bounced checks.

More bounced checks means more demand for payday credit and/or "bounce protection" as ways to avoid bounced check.[26] Of course, households in Georgia and

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[22] The model also says our test should control for state economic conditions, because the impact of a change in interest rates (*r*) on steady state debt income (*d**) depends on income growth (*n*).
[23] For a comparison of states' criminal penalties for writing bad checks see http://www.ckfraud.org/penalties.html.
[24] The Federal Reserve processes (clears) checks for banks and a variety of other depository institutions, including credit unions. The 2004 Federal Reserve Payment Study estimates 36.7 billion checks were written in 2003 (http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf.) The Federal Reserve processed 14 billion checks in 2003, about 38 percent of the total (Federal Reserve 2005 Check Restructuring Factsheet:
http://www.federalreserve.gov/boarddocs/press/other/2004/20040802/attachment2.pdf. .
[25] The maximum time banks can wait to credit payees' accounts is governed by the Expedited Funds Availability Act. That law requires the Federal Reserve Board to reduce maximum hold times in step with reductions in actual check-processing times.
http://www.federalreserve.gov/paymentsystems/truncation/default.htm
[26] See http://www.federalreserve.gov/pubs/bounce/ for a comparison of "courtesy overdraft protection" plans offered by banks and credit unions.

North Carolina had only one choice once payday credit was banned. If we observe higher bounced check rates afterwards, it tells us payday credit was the preferred choice (else depositors would protect themselves completely with bounce protection). Unlike with payday credit, fees under bounce protection can quickly accumulate as unwitting depositors get charged for *every* ATM withdrawal.[27] Thus, a rash of bounced checks might be the initial setback that leads to more severe problems.

Complaints against Lenders and Debt Collectors (Informal Bankruptcy). Borrowers who default (quit paying debt) without officially filing for bankruptcy protection are subject to debt collection efforts by lenders and debt collectors, including wage garnishment, foreclosure, and asset repossession. Dawsey and Ausubel (2004) call default without bankruptcy protection "informal bankruptcy." Our 2nd measure of debt problems--complaints against lenders and debt collectors — makes a good measure of informal bankruptcy.

The complaints are collected by the FTC (Federal Trade Commission), the agency charged with enforcing the Fair Debt Collection Practices Act of 1978, the federal law intended to civilize third party debt collectors. Among other things, the law prohibits abusive, deceptive, and unfair collection practices by debt collectors. The FTC maintains a toll free number (877—FTC-- HELP) for households to call and complain about debt collectors. Households can also complain online, or by mail.[28]

Consumers filed 66,000 complaints against debt collectors in 2005. That is a small number *per capita*, but the FTC considers it a "small percentage" of all household

[27] If depositors refuse to pay overage fees, they may become unbanked. Chexsystems lets banks and credit unions track depositors' willingness to pay overdraft fees. http://www.chexsystemssolutions.com/

[28] "Lenders" comprises banks, credit unions, finance companies, mortgage lenders, installment lending, health care provider lending, and other lenders. Separate tallies are not available.

that experienced problems with debt collectors (Commission 2006, p4). Here is the litany of complaints (percent of total complaints received in 2005):

- Exaggerating amount or legal status of debts (43%)
- Calling continuously, before 8 am, or after 9 pm (24.6%)
- Repeatedly calling family, friends, and neighbors (11%)
- Obscene language (12%)
- False threats of dire consequences (9.6%)
- Impermissible calls to employer (6.3%)
- Revealing debt to 3rd parties (4.5%)
- Threatened violence (0.4%).

We consider complaints the most revealing of the three debt problems we study, for several reasons. First, complaints measure *welfare*—households are sufficiently bothered to appeal to the government for protection.[29] Second, the data are monthly. Third, they are intuitive. Recalling the model above, suppose a sudden rise in interest rates causes a household to default. Dunning by lenders and third party collectors follow. Until the defaulter files for bankruptcy, collection efforts escalate: wages get garnished, assets get repossessed. The most aggrieved defaulters will complain, and the tally of their complaints will register the financial shock like a simple seismograph. We maintain that variations in per capita complaints *within* a state reflect changes in household problems, rather than changes in debt collectors' practices. Collectors may become more or less aggressive over the business cycle, but that can be controlled for using state unemployment rates.[30]

[29] "Abusive collection practices … are known to cause substantial consumer injury" (Commission 2006, p.1).

[30] The level of complaints may not be a good indicator of the extent of problems, as noted above, but the change in complaints should reliably indicate whether household debt burdens have gotten heavier.

We acquired separate series on complaints against lenders and debt collectors between July 1997 and April 2007 for $200. Both series are expressed per 100,000 persons (Chart 3). Complaints against debt collectors are several times higher than complaints against lenders, suggesting lenders outsource the rough trade to third party collectors. The widening gap between the series after 2002 probably reflects rising identify theft (Commission 2006).[31] Across states, average complaints *per capita* were higher in Georgia than in any other state. Only Washington D.C. had more complaints per capita. Complaints in North Carolina were about average.

Bankruptcy. If bounced checks are the beginning of a financial crisis, and informal bankruptcy the middle, bankruptcy is the end, and like many unhappy endings, bankruptcy has multiple versions. Under Chapter 13 (rescheduling), filers keep all their assets and agree to repay debts out of future income according to a revised schedule. Under Chapter 7 (liquidation), filers hand over any non-exempt assets and keep their future income free and clear.[32] Naturally, Chapter 7 is preferred by households with few assets or who live in states with high exemptions. Until the bankruptcy reform in 2005, roughly two-thirds of filings were under Chapter 7, and most of those were "no asset" cases.[33] Given their lower income status, we suspect payday customers who wind up bankrupt are more likely to file under Chapter 7 than under Chapter 13.

[31] Credit card thieves charge up debts that rightful card owners are loath to pay, so dunning ensues. We control for the national trend in complaints (due to ID theft or other aggregate factors) using fixed year effects.

[32] Exemptions are the opposite of collateral—they are dollar amounts of assets (home equity, autos, tools of trade, jewelry, etc.) that creditors cannot claim.

[33] "Most chapter 7 cases are 'no-asset' cases" http://bankruptcy.lawyers.com/Chapter-7-Bankruptcy-Basics.html

We study quarterly, state consumer bankruptcy filings per 10,000 persons by chapter between 1998:q2 and 2007:q1 (Chart 4).[34] The rise and fall in Chapter 7 filings in 2005 and 2006:q1 reflects the new bankruptcy law: Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. BAPCPA restricts the "supply" of bankruptcy protection, for one, by requiring a means test to qualify for Chapter 7, so households rushed to file before the law took effect on October 17, 2005.[35] BAPCPA happened just two months before North Carolina banned payday loans.

Changes in Problems after Payday Credit Bans

Before we calculate precisely how each problem changed, we look at some pictures showing the trends in problems in each state *relative* to all other states. Returned check rates at the Atlanta and Charlotte check procession centers, particularly the rate per check, surged about the time Georgia and North Carolina banned payday loans (Chart 5a).[36] Were it not for the fluke drop at the Charlotte cpc shortly before the NC ban, returned checks there would be off the scale.[37] Complaints against lenders and debt collectors (informal bankruptcy) obviously increased in Georgia (Chart 5b). Complaints in North Carolina veered upward somewhat before the ban, but complaints appear

[34] The data before 2000 are from Dick and Lehnert (2007). The rest are from the American Bankruptcy Institute.
[35] Ashcraft, Dick, and Morgan (2007) analyze the impact of BAPCPA on borrowers and lenders.
[36] In 2004, the Atlanta cpc also processed checks for institutions Chattanooga, Tennessee. In personal correspondence, a project manager at the Atlanta cpc estimated that about 2/3 of checks processed at the Atlanta cpc in 2004 were drawn on financial institutions in Georgia. To the extent the Atlanta cpc processes checks drawn on financial institutions outside of Georgia, the impact of the payday ban in Georgia will be attenuated, e.g., the ban would have no effect on returned checks at the Boston cpc.
[37] The decline in returned checks rates at the Charlotte NC cpc in 2004 reflects that operations were transferred there from the Columbia SC cpc as part of the Federal Reserve's consolidation effort. http://www.federalreserve.gov/boarddocs/Press/other/2003/20030206/default.htm In personal correspondence, a project manager at the Charlotte cpc estimated that about 50 percent of checks processed at that cpc were drawn on NC institutions. To the extent the Charlotte cpc processes checks from outside North Carolina, the effect of the North Carolina payday ban on returned checks at the Charlotte cpc will be attenuated.

consistently higher afterwards. Chapter 7 bankruptcy filing rates rose in Georgia and North Carolina after the ban while Chapter 13 filing rates fell (Chart 5c-5d).

Differences-in-Differences (diffs-in-diffs)

Table 1 reports how each problem in Georgia differed after the ban (diff 1). For comparison, we also report how debt problems in other states differed after same date (diff 2). The difference-in-difference (diff 1 – diff2) indicates whether problems in Georgia declined more than they did problems in other states. In experimental terms, Georgia is the subject, other states are the control, and the treatment is the withdrawal of payday credit.

Note that the control group comprises states that allow payday lending and states (approximately ten) that do not.[38] Since the treatment is the *withdrawal* of payday credit, the sign of the difference-in-difference does not depend on the status of payday lending in other states. To see that, consider two extreme cases. First suppose that all other states prohibited payday loans. Assuming the debt trap hypothesis to be true and all else to be equal, problems for Georgians and North Carolinians would be higher than average before the ban, but lower than average after. Now suppose all other states allow payday lending. Then problems for Georgians and North Carolinians would be average before the ban, but lower than average after. In either case, if the debt trap hypothesis is correct, the withdrawal of payday credit should show up as negative difference-in-difference.[39]

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[38] Although the set of states that allow payday lending makes a more obvious control, identifying those states is problematic because payday lenders may operate without enabling legislation (*via* the bank agency model).

[39] If the difference in problems per capita per period between permitting and prohibiting states is constant, the sign and the size of the difference-in-difference is invariant to definition of the control group. Denote the mean in Georgia before ban and after by M_{GB} and M_{GA}. Denote the mean for other states before that

Returned checks per 100 checks processed at the Atlanta cpc increased by 0.02 percent after the ban (diff1). Returned checks per 100 at all other cpc declined by 0.14 (diff2). The difference-in-difference (diff1 – diff2) is positive and significant at the 1 percent level. The diff-in-diff estimate of 0.16 implies a 13 percent increase in the returned check rate at the Atlanta cpc compared to before the ban. What does that mean in dollar terms? The Atlanta cpc processed 188 million checks per quarter on average before the ban. The diff-in-diff of 0.16 per 100 checks processed implies 300,800 (0.16x1.88 million) more bounced checks each quarter. If each returned check cost depositors $30, depositors paid an extra $9 million per quarter ($36 million per year) in returned check fees after the ban.

Georgians had a lot more problems with lenders and debt collectors after the ban. The difference-in-difference for complaints against debt collectors was 0.7 per 100,000, a 64 percent increase compared to the pre-ban average. Complaints against lenders also went up, but not so much.[40]

Bankruptcy filings went in opposite directions by Chapter. Chapter 7 filing rates increased. The diff-in-diff of 0.7 per 10000 persons represents an 8.5 percent increase in Chapter 7 filings relative to average before the ban. By contrast, Chapter 13 fell. The decline in Chapter 13 filings more than offset higher filings under Chapter 13, implying total filings fell. As noted, Chapter 13 is for filers with substantial assets to protect, and

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date and after by M_{OB} and M_{OA}. The difference-in-difference is $M_{GA} - M_{GB} - [M_{OA} - M_{OB}]$. If the fraction of other states that permit payday lending is *f*, the difference for other state equals the weighted average of the means for states that *per*mit payday lending and the mean for states that *pro*hibit it:

$$M_{OA} - M_{OB} = fM_{O\_perA} + (1-f)M_{O\_proA} - \{f\, M_{O\_perB} + (1-f)M_{O\_proB}\}$$

Now suppose $M_{O\_perA} = M_{O\_proA} + P$ and $M_{O\_perB} = M_{O\_proB} + P$, where $P > 0$ as implied by the debt trap hypothesis. Substituting into the equation above implies

$M_{OA} - M_{OB} = fM_{O\_perA} + (1-f)(M_{O\_perA} - P) - \{fM_{O\_perB} + (1-f)(M_{O\_perB} - P\} = M_{O\_perA} - M_{O\_perB}$

[40] Which lenders were the object of complaints by Georgians is something we can only wonder about (we do not have that information); presumably it was whichever lenders replaced payday lenders.

that does not seem to fit the profile of payday borrowers. We would expect bankrupt payday borrowers to wind up in "no asset" Chapter 7 bankruptcy.

In sum, what we saw in Georgia after the ban was more bounced checks, more problems with lenders debt collectors (informal bankruptcy), more bankruptcy under chapter 7, but lower bankruptcy under chapter 13. Here is how we interpret those facts. The contraction in payday credit supply caused former borrowers to bounce more checks, thus aggravating their already marginal circumstances. To stave off bankruptcy, distressed borrowers pawned or sold assets.[41] For those who ultimately succumbed to their financial problems, the loss of assets made chapter 7 the natural choice. Others slipped into informal bankruptcy (defaulted without filing). Though sad to say, that slipping down, with less rescheduling of debts, but more "deadbeats" and "no asset" bankruptcies, seems to fit the picture a marginal payday customer pushed over the edge.

North Carolina banned payday credit in December 2005. With so few quarters elapsed, and a potentially confounding event (bankruptcy reform), we advise treating our North Carolina results as preliminary.[42] That said, the difference-in-differences for North Carolina tell the same story (Table 2). Bounced check rates at the Charlotte (NC) processing center rose relative to other processing centers after the ban, although the increases were not significant. Total complaints against lenders and debt collectors rose by over a third relative to other states. Chapter 7 filing rates were higher in NC, relative to other states, while Chapter 13 filing rates were lower. The rise in Chapter 7 filings

[41] In fact, increased asset sales after the ban were reported to us by a large (one of the big five) payday lender that also operates pawnshops. Thus, we interpret the "suggestive but inconclusive" increase in chapter 13 filing risk after receipt of payday loans found by Skiba and Tobacman (2006) as evidence that the extra credit obviated asset sales but not, alas, bankruptcy.

[42] The bankruptcy reform would have to have a more pronounced effect in North Carolina to explain the relative increases in chapter 7 filing rates. Ashcraft, Dick, and Morgan (2007) find the rush to file before

exceeded the decline in Chapter 13 filings (unlike in Georgia), so total filings were higher after the ban in North Carolina. Overall, the results for North Carolina are mostly consistent with the results for Georgia, and mostly inconsistent with the debt trap hypothesis.

Regression Analysis

We confirmed the results above using multivariate regression equations that control for unemployment and other differences between states:

$$DEP\ VAR = a + a_s + a_t + bUR + cGA + dNC + ePOST\text{-}BAN_{GA} + fPOST\text{-}BAN_{NC} + gGAxPOST\text{-}BAN_{GA} + nNCxPOST\text{-}BAN_{NC} + \varepsilon_{st}.$$

DEP VAR (dependent variable) equals some debt problem in state *s* at time *t* (subscripts omitted). The *a* measures the mean of DEP VAR over all *s* and *t*. The a_s measures any fixed (mean) differences between states, in case DEP VAR is always higher (or lower) in some states. Likewise, a_t allows for fixed differences between time period (year and quarter or month) due to national or seasonal effects. Including fixed state and time effects (standard with panel data) amounts to "demeaning" the data, i.e., subtracting off the state and time period means from all the other variables in the regression. *UR* denotes the unemployment rate in state *s* at *t*. The ε (error) represents all the other forces that influence DEP VAR. All the other variables are indicator (0 or 1) variables.[43] The *c* and *d* coefficients measure the difference between the mean of DEP VAR for Georgia and all other states and the difference between the mean for all states

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the new law was higher in high exemption states and lower average credit scores. North Carolina has a relatively low ($10,000) exemption, suggesting a less pronounced effect.

[43] For example, GA equals one if *s* = Georgia, zero otherwise. POST_BAN_GA equals one after May 2005, zero before.

before and after the ban. Likewise for *e* and *f*. We do not report those coefficients to keep the focus on *g* and *n:* those measure the difference-in-difference in problems between GA or NC and other states before the ban and after. The debt trap implies $g < 0$ and $n < 0$.

The results (Table 3) show that bankruptcy rates were positively related to unemployment, not surprisingly, but complaints against lenders and debt collectors (informal bankruptcy) were negatively related to unemployment. There could be two reasons for that negative correlation. Unemployed workers do not need protection from wage garnishment, for one. And perhaps debt collectors are less persistent with unemployed defaulters (whom they reach at home) because they believe unemployed defaulters who claim penury.

The other results confirm the diffs-in-diffs above. The Atlanta and Charlotte cpc returned more checks after the ban, though the latter was insignificant. Total complaints (against lenders and debt collectors) rose significantly after the ban. Chapter 7 filing rates were higher in Georgia after the ban, but Chapter 13 filings rates (and total filings) were lower. Chapter 7 *and* Chapter 13 filing rates rose in North Carolina.

More payday Credit, More Problems? Not in Hawaii

How do we know the problems associated with payday credit bans are not merely temporary "withdrawal" symptoms preceding a healthier, financial life lived without payday credit? For one, the extra problems were not temporary (Chart 5). As further evidence against the withdrawal/addiction hypothesis, we show that problems subside when larger "doses" of payday credit are allowed

In July 2003, Hawaii doubled the legal limit on payday loans to $600 under law HB595.[44] Though not as dramatic as a ban, a higher loan limit gives predatory payday lenders another hook: in addition to overcharging, they can also overlend. If the increased problems following a payday credit ban are just withdrawal symptoms, injections of payday credit should eventually lead to greater problems, once the rush ends.

Regressions results indicate just the opposite (Table 4).[45] Total complaints against lenders and debt collectors rose after Hawaii doubled the loan limit.[46] The diff-in-diff in total complaints (0.3) represents a 50 percent decline compared to average before the limit doubled. Bankruptcy filings under chapter 13 rose, but filings under Chapter 7 fell by more, so total filings fells. The diff-in-diff for total filings (2.6) represents a decline of 27 percent relative to average before the limit was raised.

Does Payday Credit Prolong Problems?

The results thus far suggest household credit problems go opposite the supply of payday credit: higher supply, lower problems. Here we test whether problems are more persistent when payday credit is more plentiful, as the debt trap hypothesis would suggest. The results are negative: problems appear less persistent when larger payday loans are available.

A simple dynamic model motivates the persistence tests. Suppose payday credit demand (*PCD)* this month depends on debt problems (*DP*) the month before*:* $PCD = aDP_1 + s$, where s stands for all other factors affecting payday credit demand. We

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[44] Source: National Council of State Legislatures, Enacted payday lending legislation http://www.ncsl.org/programs/banking/PaydayLend_2003.htm.

[45] Hawaii does not have a Federal Reserve check processing center.

maintain $a > 0$ based on the finding in Stegman and Faris (2003) that payday credit demand is positively related to past debt problems. Debt problems, in turn, depend on past debt problems and past payday credit usage: $DP = bDP_1 + cPCD_1 + e$. Eliminating PCD from those two equations gives $DP = bDP_1 + caDP_2 + cs + e$. If $c = 0$, payday credit is irrelevant and problems are short-lived. If $c>0$, payday credit prolongs problems. If c is sufficiently large ($> 1- b^2/a$), temporary problems become permanent disasters: the use of payday credit compounds problems until they overwhelm the borrower.[47] That seems close to the notion of a debt trap. By contrast, if $c < 0$, debt problems trail off sooner if payday credit is available; payday credit is part of the solution, not part of the problem.

We implement the test by regressing total complaints against lenders and debt collectors in Hawaii on six lags of itself, then comparing the implied dynamics before and after the doubling.[48] That strategy entails splitting the sample then estimating seven numbers (six coefficients and a constant) over each sub-sample, so our degrees of freedom are limited. We study only the monthly series (complaints) and only in Hawaii, where we have sufficient post-event data. This ancillary test is limited: were Hawaiians' problems more chronic once they had access to larger payday loans?

The results suggest just the opposite (Chart 6). Before the payday loan limit doubled, problems with (complaints against) debt collectors lasted about 7 months. After the doubling, such problems were over within the month.

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[46] Complaints against lenders in Hawaii rose. We cannot say whether the extra complaints were against payday lenders but it is possible; once the loan limit doubled, payday lenders had more skin in the game.
[47] If $-b^2 < ac < 1-b^2$, problems are chronic, but not explosive. Those conditions on c follow from (1) calculating steady state problems where p* is constant over time and (2) inspecting how p – p* evolves.
[48] Simply estimating an AR(2) (2[nd] order auto-regression) and examining the DP_2 coefficient takes the particular model above too literally. In a model with more lags, c would be distributed elsewhere.

VI. Conclusion

Georgians and North Carolinians do not seem better off since their states outlawed payday credit: they have bounced more checks, complained more about lenders and debt collectors, and have filed for Chapter 7 ("no asset") bankruptcy at a higher rate. The increase in bounced checks represents a potentially huge transfer from depositors to banks and credit unions. Banning payday loans did not save Georgian households $154 million per year, as the CRL projected, it *cost* them millions per year in returned check fees.

The increased problems are not just "withdrawal" symptoms preceding a healthier financial life without payday credit. The problems do not appear temporary, for one, plus we find that Hawaiians had fewer and less chronic problems after the maximum legal "dose" of payday credit was doubled.

While our findings contradict the debt trap/addiction hypothesis against payday lending, they are consistent with alternative hypothesis that payday credit is cheaper than the bounce "protection" that earns millions for credit unions and banks.[49] Forcing households to replace costly credit with even costlier credit is bound to make them worse off.

[49] Consider this pitch by for bounce protection in creditunion.com: "Today's economy has compelled many credit unions to pursue creative non-interest income solutions to address ailing bottom lines -- and overdraft payment services fit that need. For many credit unions, the situation has become critical" William Strunk, "Addressing Net Interest Income Erosion: A Matter of Survival." http://www.creditunions.com/home/articles/template.asp?article_id=2282

Our findings raise obvious policy questions. Oregon and Pennsylvania recently banned payday credit. New York, New Jersey, and most New England states never let payday lenders enter. Should they reconsider? Progressives may call for something better than either payday credit and bounce protection. We are all for that, but banning payday loans is not the way to motivate competitors to lower prices or invent new products.

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Table 1: Household Financial Problems in Georgia and Other States, Pre-Ban and Post-Ban

Reported is mean (number of observations) before ban (5/2004) and after ban for Georgia and for all other states
The final column (diff1- diff2) indicates whether the change in the mean in Georgia was larger or smaller than the change in the mean for other states, and whether the diff-in-diff was statistically significant.

	Georgia			Other states			
Bankrutpcy per 10000	Pre	Post	diff1	Pre	Post	diff2	diff1-diff2
Chapter 7	8.16	8.02	-0.14	9.14	8.32	-0.83	0.69 ***
	(25)	(11)		(1250)	(550)		
Chapter 13	11.90	8.57	-3.33	3.02	2.50	-0.52	-2.81 ***
	(25)	(11)		(1250)	(550)		
Ch.7 + Ch.13	20.05	16.58	-3.47	12.17	10.82	-1.35	-2.12 ***
	(25)	(11)		(1250)	(550)		
Complaints per 100000							
Against lenders	0.28	0.39	0.11	0.21	0.28	0.07	0.05 ***
	(79)	(35)		(3179)	(1610)		
Against debt collectors	1.11	2.91	1.80	0.54	1.61	1.07	0.73 ***
	(81)	(35)		(3783)	(1715)		
Total Complaints	1.13	2.91	1.79	0.59	1.64	1.05	0.74 ***
	(79)	(35)		(3179)	(1610)		
Returned checks §							
Per 100 checks	1.13	1.14	0.02	1.33	1.19	-0.14	0.16 ***
	(57)	(13)		(2561)	(359)		
Per $100	0.91	0.77	-0.14	1.30	1.01	-0.29	0.15 ***
	(53)	(13)		(2373)	(359)		

*** Significant at 1 percent

§ Returned checks at Atlanta, GA check processing center versus all other check processing centers

Authors' calculations. Data sources: Bankruptcy filings from American Bankruptcy Institute (2000-2007) and Dick and Lehnert (1998-2000). Bankruptcy filings scaled by Census population. Complaints from Federal Trade Commission. Returned Checks from Federal Reserve System

Table 2: Household Financial Problems in N. Carolina and Other States, Pre-Ban and Post-Ban

Reported is mean (number of observations) before ban (12/2005) and after ban for North Carolina and for all other states The final column (diff1- diff2) indicates whether the change in the mean in N. Carolina was larger or smaller than the change in the mean for other states, and whether the diff-in-diff was statistically significant.

	North Carolina			*Other states*			
Bankrutpcy per 10000	Pre	Post	diff1	Pre	Post	diff2	diff1-diff2
Chapter 7	4.84	2.17	-2.66	9.89	3.19	-6.70	4.04 ***
	(31)	(5)		(1550)	(250)		
Chapter 13	5.11	2.69	-2.42	3.16	1.92	-1.23	-1.19 ***
	(31)	(5)		(1550)	(250)		
Ch.7 + Ch.13	9.94	4.86	-5.08	13.05	5.12	-7.94	2.85 ***
	(31)	(5)		(1550)	(250)		
Complaints per 100000							
Against lenders	0.19	0.23	0.04	0.23	0.28	0.05	-0.02 *
	(97)	(16)		(4051)	(739)		
Against debt collectors	0.73	1.92	1.20	0.76	1.71	0.96	0.24 ***
	(99)	(16)		(4715)	(784)		
Total Complaints	0.74	1.92	1.18	0.82	1.75	0.92	0.26 ***
	(97)	(16)		(4051)	(739)		
Returned checks [§]							
Per 100 checks	1.32	1.40	0.08	1.31	1.28	-0.02	0.10
	(64)	(6)		(2789)	(131)		
Per $100	0.75	0.61	-0.14	1.27	1.09	-0.18	0.04
	(60)	(6)		(2601)	(131)		

*** Significant at 1 percent. * Significant at 10 percent

[§] Returned checks at Charlotte, NC check processing center versus all other check processing centers

Authors' calculations. Data sources: Bankruptcy filings from American Bankruptcy Institute (2000-2007) and Dick and Lehnert (1998-2000). Bankruptcy filings scaled by Census population. Complaints from Federal Trade Commission. Returned Checks from Federal Reserve System.

Table 3: Do Payday Loan Bans Reduce Household Debt Problems?

Reported are regression coefficients (st. errors). GA = 1 for GA (zero for other state). POST-BAN_GA equals 1 after GA banned payday loans (May, 2005) (zero if not) Coefficient on GAxPOST-BAN_GA measures difference-in-difference in Dependent Variable after the ban relative to all other states. NCxPOST-BAN_NC interpreted equivalently. Standard errors are adjusted for clustering at state or check processing center level. Regressions include all dummy variables, and state, year, and quarterly or month fixed effects.

	Dependent variable:							
	Complaints per 100,000 against			Returned checks per		Bankruptcy filings per 1,000		
	Lenders	Debt collectors	Total	100 checks	100 dollars	Ch. 7	Ch. 13	Total
GAxPOST-BAN_GA	0.02	0.74	0.70	0.18	0.19	0.44	-3.00	-2.56
	(0.00)**	(0.05)***	(0.05)***	(0.08)**	(0.08)**	(0.23)**	(0.11)***	(0.30)***
NCxPOST_BAN_NC	-0.03	0.23	0.20	0.14	0..09	4.03	-1.25	2.78
	(0.00)**	(0.05)***	(0.05)***	(0.10)	(0.09)	(0.29)***	(0.17)***	(0.36)***
Unemployment Rate	0.00	-0.05	-0.06	0.02	0.04	0.43	0.28	0.71
	(0.00)	(0.03)*	(0.03)**	(0.03)	(0.04)	(0.23)*	(0.08)***	(0.25)***
Observations	4903	5614	4903	2991	2799	1836	1836	1836
R-squared	0.58	0.82	0.83	0.49	0.5	0.8	0.95	0.85

*** significant at 1%. ** significant at 5%. *significant at 10%

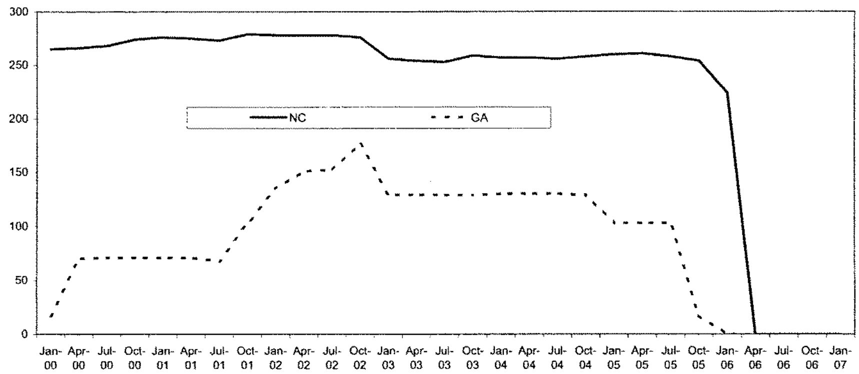
Table 4: Do Payday Loan Bans Reduce Household Debt Problems?

Reported are regression coefficient (standard errors). Coefficient on HIxPOST-DOUBLE measures difference-in-difference in Dependent Variable after Hawaii doubled payday loan limit in June, 2007. Regressions include all dummy variables and state, year, and quarter fixed effects. Standard errors adjusted for clustering at state level.

	Dependent variable:					
	Complaints per 100,000 against			Bankruptcy filings per 1,000		
	Lenders	Debt collectors	Total	Ch. 7	Ch. 13	Total
HIxPOST-DOUBLE	0.06	-0.22	-0.30	-3.09	0.46	-2.63
	(0.02)***	(0.09)**	(0.09)***	(0.42)***	(0.21)**	(0.54)***
GAxPOST-BAN_GA	0.02	0.74	0.70	0.46	-3.00	-2.55
	(0.01)***	(0.05)***	(0.05)***	(0.23)**	(0.11)***	(0.30)***
NCxPOST-BAN_NC	-0.03	0.23	0.20	3.99	-1.24	2.75
	(0.01)***	(0.05)***	(0.05)***	(0.30)***	(0.17)***	(0.37)***
Unemployment Rate	0.00	-0.05	-0.07 •	0.33	0.29	0.62
	(0.01)	(0.03)	(0.03)**	(0.20)*	(0.08)***	(0.24)**
Observations	4903	5614	4903	1836	1836	1836
R-squared	0.58	0.83	0.84	0.8	0.95	0.85

*** significant at 1%. ** significant at 5%. *significant at 10%

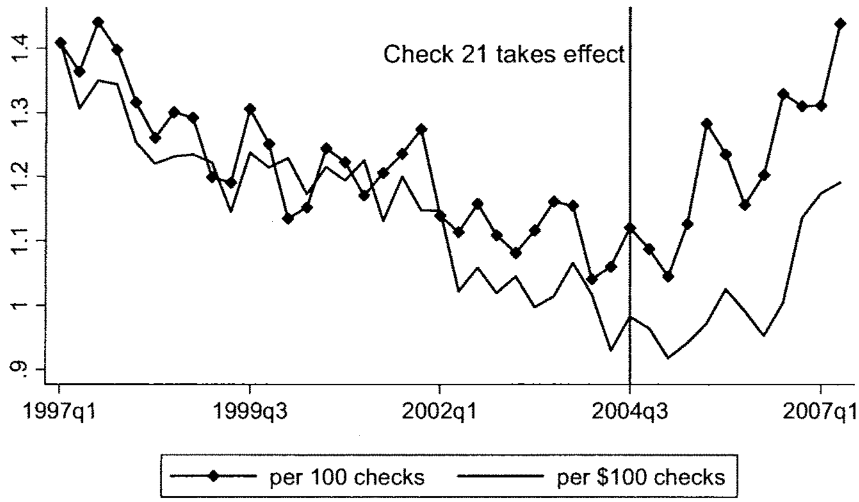
Chart 1
Number of stores operated by five big payday lenders in Georgia and North Carolina



Store counts provided to authors by five large, multistate payday firms.

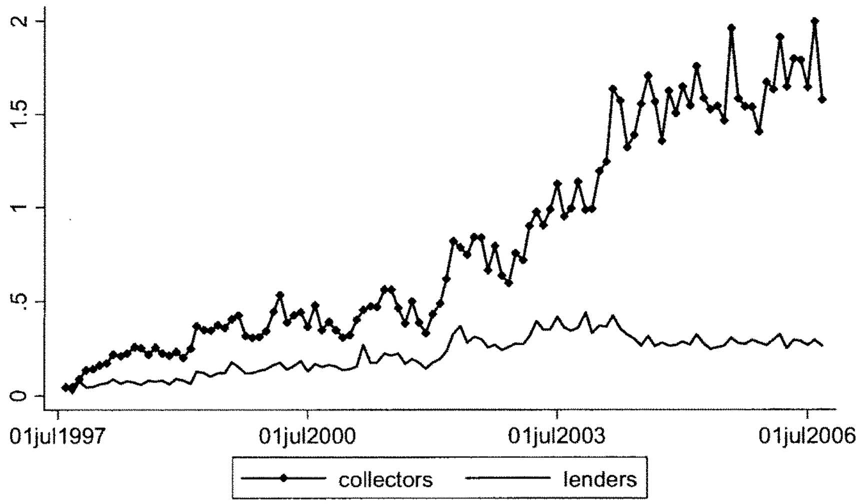
Chart 2

Returned Checks at Federal Reserve Processing Centers



Authors' calculation.

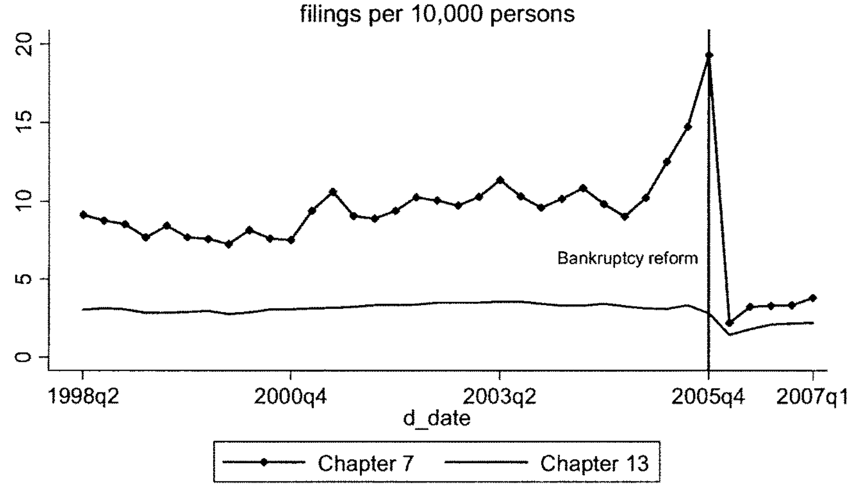
Chart 3 Complaints against lenders and debt collectors
complaints per 100,000 persons, average for all states



Source: Authors' calculation. Data from Federal Trade Commission

Chart 4: National Bankruptcy Filing Rate, by Chapter

filings per 10,000 persons



Sources: pre-2000 (Dick and Lehnert 2007); post-2000 (American Bankruptcy Ins.)

Chart 5a: Returned Checks and Payday Credit Bans

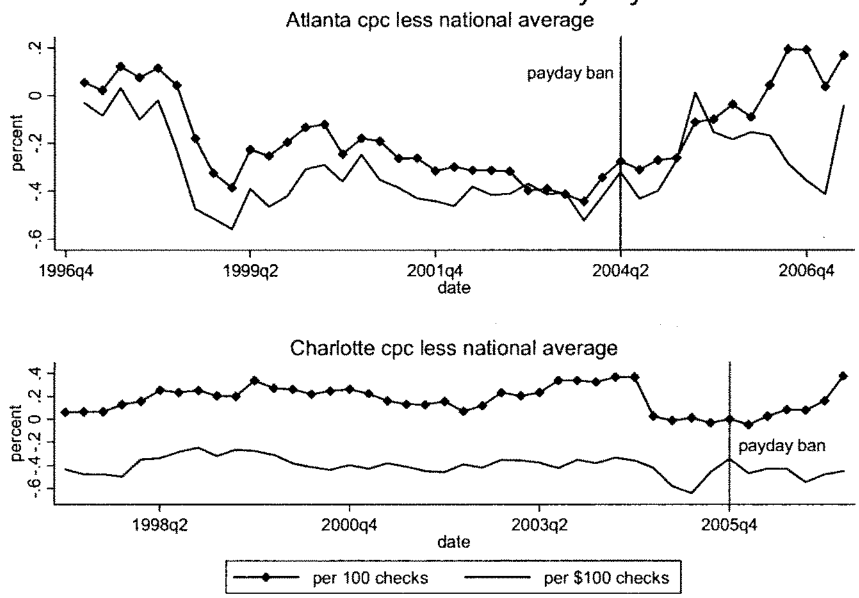
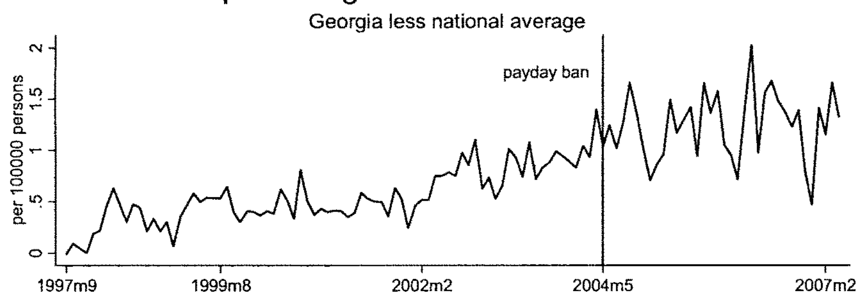


Chart 5b: Complaints against Lenders and Debt Collectors



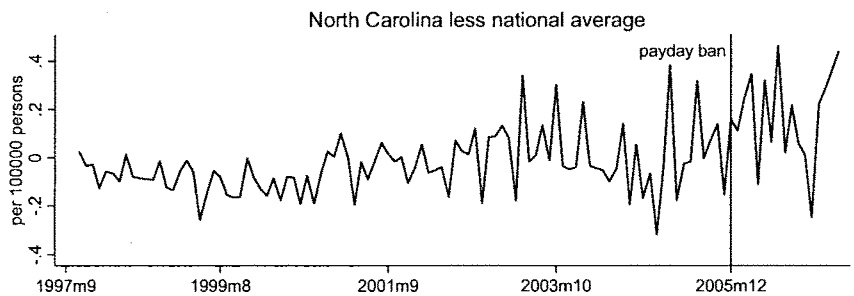


Chart 5c: Georgia Bankruptcy Filings less National Mean

filings per 10,000 persons, by chapter

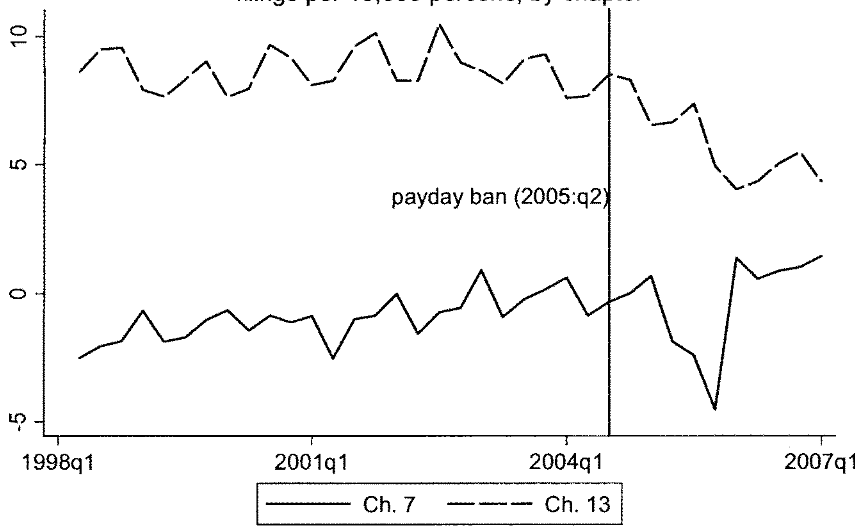


Chart 5d: N. Carolina Bankrutpcy Filing less National Mean

filings per 10,000 persons, by chapter

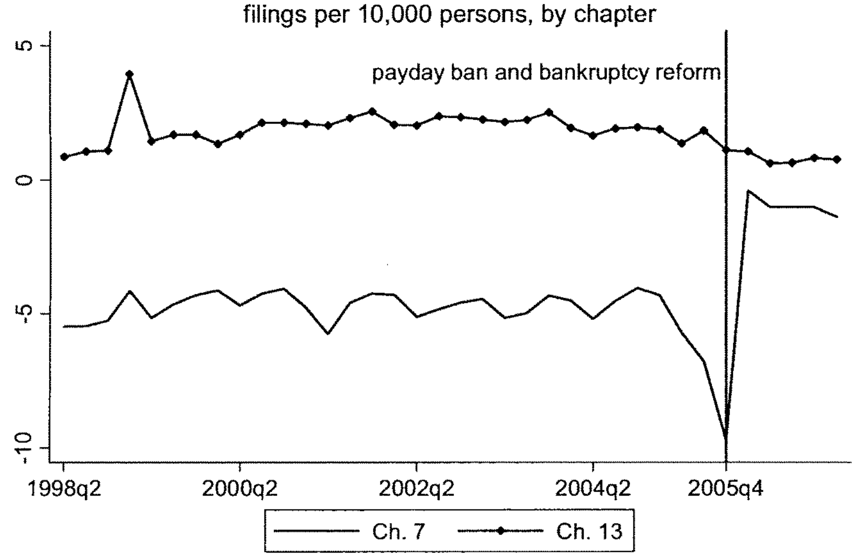
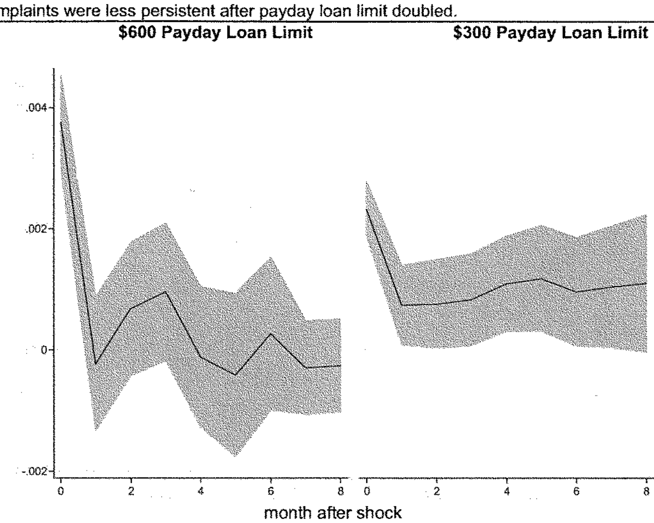


Chart 6: Were Hawaiians' Problems More Chronic After Payday Limit Doubled?

Plotted is response of complaints against debt collectors to random (standard deviation) change in complaints at time zero and 95 percent confidence band. Response derived from regressions of complaints on six lags of complaints over two sub-periods: 7/1997-6/2003 ($300 limit) and 7/2003-4/2007 ($600 limit) Complaints were less persistent after payday loan limit doubled.



Reply to comments by the CRL (Center for Responsible Lending) on "Payday Holiday: How Households Fare after Payday Loan Bans."

Donald P. Morgan and Michael R. Strain[1] December 13, 2007

We thank the Center for Responsible Lending for their comments on our paper (http://www.responsiblelending.org/pdfs/crl-morgan-critique-12-10.pdf.). Working papers are intended to stimulate discussion, and our working paper has accomplished that. We respectfully reply to their key comments below.

CRL:

1. Overall, when the authors compare the "credit problems" for households in Georgia and North Carolina to the national average for households in the United States, they fail to note that the national averages include, during the time period reviewed, at least ten states (with one-quarter of the U.S. population) that—like North Carolina and Georgia—do not authorize payday lending. This confusion of "payday versus non-payday" states was also exhibited in previous research by Morgan.[1]

REPLY: Because the treatment we study is the *withdrawal* of payday credit, the sign (positive or negative) of the difference-in-differences that we estimate (that is, the change in problems in NC or GA minus the change in other states) does not depend on the status of payday lending in other states.[2] To see that, consider two extreme cases. First suppose all other states prohibit payday loans. Assuming the debt trap hypothesis to be true and all else equal, problems in GA and NC would be above average for other states before the ban, but below average after. Now suppose all other states permit payday lending. Then problems in GA and NC would be average before the ban, but below average after. In either case, if the debt trap hypothesis is correct, the withdrawal of payday credit should show up as a decline in problems in GA or NC compared to other states, that is, a negative difference-in-difference.[3] We found just the opposite.

[1] Our views do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System or Cornell University. [2] As a practical matter, identifying the states with payday lending from states without is problematic because payday lenders have operated in states without explicit authorizing legislation (*via* the bank agency model). The CRL made that point clear in their discussion of Morgan (2007). Morgan and Strain (2007) used all other states as the control group precisely because we were *not* confused. [3] If the difference in problems per capita per period between permitting and prohibiting states is constant, the sign and the *size* of the difference-in-difference are invariant to the definition of the control group. We prove that here. Denote the mean of some problems in Georgia before and after the ban by M_{GB} and M_{GA}. Denote the mean for other states before after the date of the ban by M_{OB} and M_{OA}. The difference-indifference in problem (the change in the mean in Georgia minus the change in the mean in other states) is

$$M_{GA} - M_{GB} - [M_{OA} - M_{OB}].$$

If the fraction of other states that permit payday lending is f, the difference for other states equals the weighted average of the means for states that *per*mit payday lending and the mean for states that *pro*hibit it:

$$M_{OA} - M_{OB} = fM_{O\_perA} + (1-f)M_{O\_proA} - \{fM_{O\_perB} + (1-f)M_{O\_proB}\}$$

CRL:

2. In analyzing returned checks, the authors use data from the Federal Reserve's *regional* check processing centers (CPCs) as proxies for *state* credit markets. However, the regional CPC's in Atlanta and Charlotte handle checks for other states besides Georgia or North Carolina, including states that allow payday lending. For example, more than half of the checks processed at the Charlotte center come from states which allow payday loans. Similarly, during the aftermath of Hurricane Katrina, checks from households in Louisiana (which also allows payday lending) began to be processed in the Atlanta center. Because the CPC data includes returned checks for states that authorize payday lending, it is incorrect to use this data as representative of "non-authorizing" states like Georgia and North Carolina.

REPLY: Morgan and Strain (2007) acknowledged that the Atlanta CPC handles checks from Tennessee and that the Charlotte CPC handles checks from Columbia. Indeed, we were the source of the "more than half" figure the CRL mentions above. As we explained, the larger the fraction of checks drawn on institutions outside of NC (say), the smaller the estimated impact of the payday ban on returned checks at the Charlotte CPC. To take an absurd example, how much would we expect the payday ban in NC to affect the returned check rate at the San Francisco check processing center? Having to use "regional" CPC data makes our estimates of the impact of the bans on returned checks in Georgia and North Carolina less precise (i.e., increases the standard errors of the estimates). Indeed, the fact that the out-of-state fraction is larger at the Charlotte CPC (than at the Atlanta CPC) may explain why the large effect we found in Charlotte was not statistically significant.[4]

If the difference in problems per capita per period between permitting and prohibiting states is some constant $P > 0$, then $M_{O\_perA} = M_{O\_proA} + P$ and $M_{O\_perB} = M_{O\_proB} + P$. Substituting those equations into the equation above and collecting like terms implies

$$M_{OA} - M_{OB} = fM_{O\_perA} + (1-f)(M_{O\_perA} - P) - \{fM_{O\_perB} + (1-f)(M_{O\_perB} - P\}$$
$$= M_{O\_perA} - M_{O\_perB}.$$

Thus, as claimed, the difference-difference between GA and all other states equals the difference-indifference between GA and only others states that permit payday lending

$$M_{GA} - M_{GB} - [M_{OA} - M_{OB}] = M_{GA} - M_{GB} - [M_{O\_perA} - M_{O\_perB}].$$

If the debt problems caused by payday lending (under the debt trap hypothesis) compound over time, the sign of the difference-in-difference will probably depend on whether the control group comprises sets of states. We have not sorted out.

About 2/3 of checks processed at the Atlanta CPC are estimated (by Atlanta CPC staff) to be drawn on Georgia financial institutions.

CRL:

> Finally, the authors erroneously assume that bounced checks are the *only* substitute for a payday loan: "Of course, households in Georgia and North Carolina had only one choice once payday credit was banned. If we observe higher bounced checks afterwards, it tells us payday credit was the preferred choice..." But a recent study by the University of North Carolina Center for Community Capital found that former payday borrowers use a host of options to cover financial shortfalls, such as working out delayed payments with creditors; borrowing from family, friends, or employers; dipping into savings; or delaying a purchase for a short period of time.[2]

REPLY: It is reassuring to know that former payday borrowers can count on the kindness of creditors, friends, family, and employers, or just dip into savings (then why are they borrowing?), or postpone purchases. However, the question is whether those options are preferable to payday credit. If they were, then why didn't borrowers use them before the ban? More to the point, if the other options were as good or better than payday credit, bounced checks rates, complaint rates, and bankruptcy rates would have been unchanged or lower (relative to other states) after the ban. Instead, those problems increased.

CRL:

> Moreover, the authors admit that the rate of FTC complaints from households in North Carolina is *not* higher than complaint rates in other states.

REPLY: We show that per capita complaints in NC rose (relative to other states) after the ban; complaints by North Carolinians (to the FTC) about debt collectors were below average before the ban, but above average after.

CRL:

> the jurisdiction with the highest complaint rate was the District of Columbia. Yet during the time period for this research, the District of Columbia had some of the loosest restrictions on payday loans of any state. This appears to refute the authors' attempt to develop a cause-effect relationship between the absence of payday lending and FTC complaints.

REPLY: The high complaint rate in D.C. does not contradict our argument. *Demand* for payday credit is driven by "pre-existing" debt problems, namely bounced checks and contact by debt collectors (Stegman and Faris 2003).[5] Morgan and Strain (2007)

[5] Stegman and Faris, "Payday Lending: A Business Model that Encourages Chronic Borrowing," *Economic Development Quarterly,* 17 (1), 8-32.

investigates whether reducing the *supply* of payday credit (by banning it) cause problems to go down. We find the opposite.[6]

CRL:

> The data does show a steady *national* increase in FTC complaints for some time but especially since 2001. Many experts have attributed this to rise of identity theft; this is confirmed by the FTC as over 40 percent of all complaints involve challenging the actual validity of the debt. We are not aware of even a potentially plausible relationship between payday lending and ID theft.

REPLY: Morgan and Strain (2007) noted that ID theft was the most likely reason behind the national upward trend in complaints against debt collectors. We did not suggest that ID theft was related to payday lending, nor do any of our findings require a relationship between them.

CRL:

> 4. In analyzing variances in bankruptcy rates among states, the authors fail to account for several factors which greatly influence a person's chances of filing for bankruptcy protection. These factors include health insurance coverage, mortgage foreclosures, divorce rates, demographic factors such as income, and broader economic factors. Yet the *only* factor which the authors control for is unemployment rates.

REPLY: We agree that unemployment is not the only cause of bankruptcy, but the question is whether omitting income or some other variable cause us to overestimate the impact of the ban on bankruptcy rates in Georgia and North. We doubt it.[7] We allowed average bankruptcy rates for each state to vary due to fixed differences in, say, insurance coverage or divorce rates. Thus, the omitted variable, call it Z, would have to vary *just* so to unravel the negative link we found between payday credit supply and bankruptcy (and other problems): *Z* would need to change in Georgia relative to other states in May 2004,

[6] Failure to distinguish between supply and demand often leads to fallacious conclusions, e.g., sick people are found at (demand) hospitals, so doctors must supply sickness instead of cures.

Omitted variable bias is a perennial concern when the data under study were produced on the street, so to say, instead of in a laboratory setting with perfectly controlled conditions. The experiments run by Professors Dean Karlan (Yale) and Jonathon Zinman (Dartmouth) approximate laboratory conditions, and their results support our findings: access to credit, even expensive credit, does not make poor people worse off, it makes them better less likely to go hungry or unemployed. See http://www.dartmouth.edu/~jzinman/Papers/Karlan&Zinman_ExpandingCreditAccess_nov07.pdf The forthcoming revised version of Morgan and Stain (2007) controls for state income along with unemployment rates. Bankruptcy rates do fall when income rises, as CRL predicted in their comment, but our main results do not change if we hold income constant (actually, some results get stronger). The revised version includes new findings: bankruptcy rates and bounced check rates at the Boston check processing center decreased, in relative terms, after New Hampshire and Rhode Island liberalized their laws against payday lending.

then it would have to change in North Carolina relative to other states in December 2005, then it would have to change again in Hawaii relative to other states relative in July 2001. *Z* would truly have to zigzag to undo our findings.

O