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By Joe Valenti July 10, 2014

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Contents

Introduction and summary

Millions of Americans are financially vulnerable. Yet the credit options available to borrowers in some cases reduce their financial security even more.

The story of Susan Fronczak, a 60-year-old Arizona woman, demonstrates how expensive and risky consumer credit can be. She borrowed $2,000 from an auto title lender—a company that makes loans pledged by a car title and a spare set of keys—at a 182 percent annual interest rate, under an agreement that would cost her at least $3,860 to pay back the $2,000 loan.[1] Ultimately, she could not afford the monthly payments, and her car was repossessed. By the time she was able to get her car back, she had paid more than $5,000 to the lender.

Unfortunately, many Americans could easily end up in Fronczak's shoes. Twenty-seven percent of Americans report that they have no emergency savings at all.[2] Roughly two out of every five American families indicate that they would "probably not" or "certainly not" be able to come up with $2,000 in 30 days to deal with an emergency, according to the 2012 National Financial Capability Study.[3] For Latinos, African Americans, and young people ages 18 to 34, this rises to half of all families. Of families in the bottom third of the income distribution, 68 percent said they would be unable to come up with the money in an emergency.[4]

At the same time, deceptive advertising abounds for easy cash through loans with "no credit check needed" and "same day approval."[5] Perhaps not surprisingly, many people turn to these high-cost, short-term loans—such as payday and auto title loans—in response to financial setbacks. These loans are pledged against a future paycheck or the keys to one's car and are infamous for high fees and predatory practices.

These high-cost forms of lending have virtually disappeared from mainstream banks in recent years. Nudged by financial regulators such as the Federal Deposit Insurance Corporation, or FDIC, and the Office of the Comptroller of the Currency, banks that offer high-cost deposit-advance loans have largely left the market of making cash advances secured by a borrower's future income. These two bank regulators adopted new, common-sense guidance in November 2013 that requires banks to consider borrowers' ability to repay short-term, small-dollar loans based on their banking history over the past six months and to impose a "cooling off" period that would prevent consumers from getting trapped in a cycle of debt.[6] Even several banks that are not subject to actions by these two regulators announced in January that they would voluntarily end their deposit-advance programs as well.[7]

While banks' departure from this predatory market is a step forward, financially vulnerable consumers are still targets of predatory lenders that generally offer false promises of financial help to deal with financial emergencies. Storefront payday lenders that enable consumers to receive cash upfront in exchange for an agreement to repay principal, interest, and fees in the near future—sometimes as quickly as the next payday—remain legal in 36 states.[8] And in 21 states, auto title loans—or pledging a car's title and spare set of car keys in exchange for quick cash—are another option.[9] If the loan is not promptly repaid, the borrower's car can be repossessed. Internet lenders have also entered the marketplace, some of which are situated offshore or on Native American tribal lands in order to evade state and federal laws, even as states have sought to regulate them.[10]

Regulators and policymakers have increasingly paid attention to the needs of financially vulnerable borrowers and are taking action both by protecting consumers from bad products and by supporting lower-cost alternatives. The 2007 Military Lending Act greatly curbed predatory payday, car title, and refund anticipation loans to active-duty military service members by capping interest rates on loans made to military borrowers and their families.[11] The FDIC has led banks to experiment with affordable small-dollar-loan programs with some success, and some credit unions and nonprofit organizations offer affordable loans as well. Employers have also established financial fitness programs that include short-term credit options, though it is unclear whether these loans will ultimately be a help or a hindrance to consumers.

But regulators and policymakers need to go further to protect consumers:

- Congress should extend to all Americans the 36 percent annual interest rate cap that currently applies to military families, and the Consumer Financial Protection Bureau should ensure that small-dollar loans truly take into account the borrower's ability to repay.

- State governments should pass and enforce 36 percent annual interest rate caps inclusive of all fees, and local governments should use their zoning powers to restrict the growth of high-cost predatory lenders.

- State and federal agencies should continue to use various enforcement mechanisms to target illegal lending activity.

- Congress and the financial regulators should encourage lenders to develop and market affordable alternatives for financially vulnerable consumers.

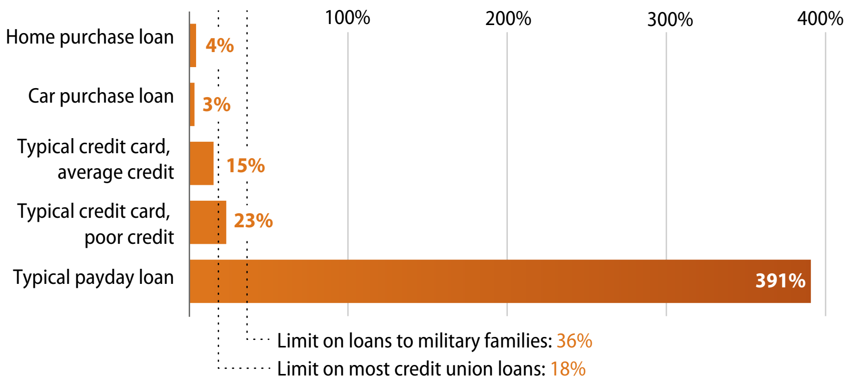
This report addresses why existing payday and auto title loan options are often harmful. It then outlines existing alternatives and the future steps that can be taken to better protect consumers.

The trouble with payday and auto title loans

Payday and auto title loans are extremely expensive for borrowers. A typical two-week loan charges $15 per $100 borrowed. While this may be marketed as a 15 percent loan, when calculated as an annual percentage rate, or APR, as required under the 1968 Truth in Lending Act, 15 percent interest over two weeks becomes 391 percent APR. Meanwhile, the average credit card currently has an annual rate of 15.6 percent, which would be a monthly rate of 1.3 percent or a two-week rate of slightly more than one-half of 1 percent.[12] Figure 1 illustrates the annual interest rates charged on a number of financial products and some of the interest rate limits imposed by law or regulation.

FIGURE 1

Annual percentage rates for various loan products relative to legal limits, spring 2014



Source: Home, auto, and credit card rates based on Bankrate.com; credit union loan limits according to the National Credit Union Administration; payday loan APR based on $15 per $100 borrowed for a two-week loan.

Even compared to a high-cost credit card that charges 23 percent APR[13]—currently a typical offer for a consumer with poor credit—a two-week payday loan at $15 per $100 is 17 times more expensive, and a 30-day loan is nearly eight times more expensive. And this interest rate does not always include all fees. In Virginia, for example, the payday loan itself charges interest at an annual rate of 36 percent, a level that, while quite high, is at the historical legal limit for reasonable small-dollar lending. But two additional flat fees increase the average annual rate for borrowers to 289 percent, and in some cases, the rate is as high as 819 percent.[14]

Yet the rates that borrowers ultimately pay are often even higher, leading to a debt trap. Financially strapped consumers who are unable to pay the loan off within the short time period generally have the option of paying interest and reborrowing or refinancing the loan as interest accumulates even more. Consumers typically do not take out a payday loan once, pay it back immediately, and never borrow again. Indeed, recent analysis by the federal Consumer Financial Protection Bureau, or CFPB, found that four out of five borrowers roll over a payday loan within 14 days.[15] The median payday loan borrower is typically in debt for more than half the year, with two-thirds of borrowers taking out seven or more loans in a given year, as shown in Figure 2.[16] These findings are fairly consistent among states in which regulators collect this information. In California, 43 percent of all borrowers took out seven or more loans in 2012, with 28 percent taking out 10 loans or more.[17] Seventy-eight percent of payday loan borrowers in Virginia took out more than one loan in 2013.[18] While payday loans may lead to a never-ending cycle of debt, delinquent auto title loan borrowers also run the risk of losing their cars. In Virginia, 17,000 cars were repossessed in 2013 when borrowers failed to pay back title loans on time,[19] and in Texas, 35,000 cars were repossessed in 2012 for unpaid title loans.[20]

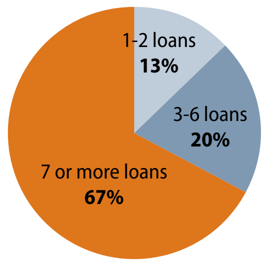
These storefront lenders are numerous; there are approximately 3,500 payday lenders in Texas alone, more than the state's number of grocery stores.[21] They are also often geographically situated in low-income communities. The roughly 600 auto title lenders in Arizona have largely clustered in lower-income and majority-minority neighborhoods, just as payday lenders did before voters opted to ban them statewide in 2008.[22] Perhaps not surprisingly, Phoenix is one of the more than 100 municipalities that have used zoning authority to limit where lenders can be located.[23] An analysis of payday lenders in Seattle found that their locations were associated with increased violent crime rates, possibly because payday loan recipients would be carrying large amounts of cash.[24]

Payday and auto title lenders assert that their loans help vulnerable consumers deal with financial shortfalls. Yet in many cases, the loans that consumers expect will help solve their financial problems may very well make these problems worse, as loans are refinanced or reborrowed, interest and fees accumulate, and future income and prospects are lost.

FIGURE 2

The vast majority of payday loan borrowers rely on multiple loans

Number of annual payday loans per borrower



Source: Consumer Financial Protection Bureau, "Payday Loans and Deposit Advance Products" (2013), available at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

The case for federal action

Historically, states have limited high-cost lending through usury caps. During the 19th century, many states set the maximum interest rate that could be charged on loans, often limiting it to between 6 percent and 12 percent interest annually.[25] A century ago, states began capping small-dollar, short-term loans at 36 percent interest annually as an exception to enable access to credit at rates above these state caps without reaching abusive levels.[26] Today, limiting small-dollar lending to rates of 36 percent annually—or in some states, even lower levels—generally drives the high-cost payday and auto title lenders out of the market. But these state actions are not airtight. Despite a 2008 statewide referendum in which Ohioans overwhelmingly voted to ban payday lending at triple-digit interest rates, lenders simply rechartered themselves under a loophole in state law designed for mortgage lending.[27] The Ohio Supreme Court recently unanimously upheld the use of this loophole.[28]

What was once a state issue has increasingly become a federal consumer protection issue. Moreover, the Supreme Court limited states' ability to regulate the interest rates of national banks beginning with the Court's *Marquette* decision in 1978.[29] But federal interest rate caps have long been under consideration by Congress as well. In 1991, the Senate approved a measure sponsored by then-Sen. Alfonse D'Amato (R-NY) to limit credit cards' annual interest rates to 14 percent. Through the bipartisan Military Lending Act, Congress enacted a national 36 percent annual cap on interest rates for active-duty military service members and their families, based on a Pentagon report that illustrated the devastating effects of high-cost lending on military readiness and performance.[30]

Federal agencies are also addressing the concerns posed by high-cost, small-dollar lending; such actions are not limited to banking regulators. This April, the Federal Trade Commission fined online payday lenders based on tribal lands for attempting to garnish borrowers' wages in violation of debt-collection laws.[31]

Existing alternatives

In the absence of high-cost payday and auto title loans, borrowers have a number of other options. A 2012 Pew Charitable Trusts survey found that most payday loan borrowers would take informal steps to deal with financial shortfalls, such as cutting back on expenses, delaying bill payments, or borrowing from family and friends if small-dollar loans were not available.[32]

But there are other credit options for borrowers. Notably, all of the following alternatives are a fraction of the cost of payday or auto title loans. All of these loans are paid back over a period of time—recognizing that a consumer who is unable to make ends meet likely is unable to pay back the loan in a single payment. All of these affordable, responsible small-dollar-loan alternatives are based on some assessment of a borrower's actual ability to repay the loan.

Banks

Seven out of eight banks surveyed by the Federal Deposit Insurance Corporation report that they offer unsecured personal loans—generally for 90 days or more—with interest and fees that are less than 36 percent annually.[33] To test solutions for expanding these efforts, the FDIC launched a two-year affordable small-dollar-loan pilot program in 2008 at 28 participating banks, with loans conforming to the 36 percent annual interest rate limit.[34] More than 34,000 loans were made, each lasting from 2 months to 24 months, at default rates comparable to other bank loan products. During the pilot, banks expressed concerns about short-term profitability but recognized that these loans were a valuable complement to other products.[35]

Credit unions

Many credit unions also offer small-dollar loans with interest rates that are limited by law and regulation. Currently, credit unions may not charge more than 18 percent interest annually for most loans, or 28 percent interest for some smaller loans that meet certain requirements.[36] In some cases, savings features may also accompany loans. For example, the North Carolina State Employees' Credit Union—the nation's second-largest credit union by membership—offers a "Salary Advance" loan of up to $500 at 12 percent interest annually, and loan repayments are accompanied by a mandatory contribution to a savings account to prevent future financial distress.[37] One particularly innovative approach is San Francisco's Payday Plus SF initiative, in which city residents with regular income from a job can be connected with participating credit unions that make affordable short-term loans alongside financial counseling and the potential to build a positive credit history.[38]

Mission-driven lenders

California-based Progreso Financiero is an example of a mission-driven lender committed to affordably and responsibly reaching underserved communities. It offers the vast majority of its installment loans at or below 36 percent interest annually, targeted to Latinos in California, Texas, and Illinois through locations inside Latino supermarkets as well as some standalone locations.* Since its founding nearly a decade ago, it has made more than $1 billion in loans to more than 370,000 borrowers and estimates having saved consumers $170 million in fees.[39]

Employers

If done right, the workplace can be another opportunity to provide affordable loans as an employee benefit. In some cases, employers have reformed how they pay their workers—through direct deposits into low-cost bank accounts or through safe and affordable prepaid cards—to enable them to get the maximum value for each paycheck and to provide them better financial options.[40] Offering affordable credit may be a natural extension of this role if employers do so responsibly. In some cases, employer loans can be reasonably priced. Emerge Financial Wellness, a firm that about 175 companies retain to offer financial counseling, lends to employees at participating companies at annual interest rates of between 9.9 percent and 24 percent.[41] Yet lending by employers can be just as dangerous as traditional payday loans, depending on the terms of the loan. When including all fees, some loans to employees may have triple-digit annual interest rates, just as payday and auto title loans do.[42]

The way forward

Banks' departure from the payday loan market based on new guidance from federal regulators is a major development, but future steps can be taken to protect consumers from high-cost payday lending from nonbanks and to encourage more innovative forms of small-dollar lending.

Extend the interest rate cap and ensure affordability to borrowers

Congress should extend the 36 percent annual interest rate cap beyond military families to include all Americans. States that ban high-cost payday and auto title loans typically enforce this interest rate limit already, or enforce a rate similar to it.

Sen. Dick Durbin (D-IL) has introduced legislation along with four co-sponsors to extend this 36 percent annual rate, including all fees, to the vast majority of loans, including payday loans. This step would create a sound national standard and encourage innovation.[43] A consumer survey in North Carolina following enforcement of the state's usury cap in 2006 found that most former payday loan customers were able to manage their money in other ways, including those in the Charlotte metro area who could have driven to South Carolina where these loans remained legal.[44] Legal limits designed to protect service members from financial harm are appropriate for all Americans.[45]

In the absence of congressional action, the Consumer Financial Protection Bureau cannot issue a rate cap, but it can take other steps to protect consumers. One of these steps is to ensure that these loans are affordable and take into account the borrower's income and expenses—the hallmark of responsible lending.

Develop short-term loan alternatives

Financial regulators should encourage the development of affordable short-term loan alternatives and public banking options. Regulators have already expressed interest in alternatives to payday loans. The CFPB's Project Catalyst enables financial innovators to meet with regulators to discuss new products under development and determine if these products comply with existing law—or if waivers are an option.[46] Through its pilot program, the Federal Deposit Insurance Corporation found that the typical affordable bank loan under the 36 percent annual limit was feasible and had reasonable repayment rates. But Congress and banking regulators can and should do more to support alternatives.

Congress could encourage such innovation by appropriating funds for small-loan demonstration projects by Community Development Financial Institutions, or CDFIs—lenders that specialize in serving distressed communities—as authorized, but never funded, by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[47] Congress could also encourage banks' development of affordable consumer lending products by providing additional incentives to financial institutions under the Community Reinvestment Act of 1977, which empowers federal regulators to assess how well banks serve low- and moderate-income people and communities. Strengthening public banking options may be another way to create better outcomes and improve market competition. As the U.S. Postal Service Office of Inspector General noted in January, postal installment loans could reach financially vulnerable borrowers at a fraction of the cost charged by payday lenders.[48] This is an approach that merits further consideration.

Ban high-cost payday and auto title lending at the state and local levels

State governments should ban high-cost payday and auto title lending. In the absence of a ban, state and local governments should improve data collection and use zoning authority to limit lenders' scope. While payday loans remain legal in Virginia and Texas, for example, recent state laws require the collection of data from licensed lenders to generate an annual report. These reports show that thousands of high-cost loans were made at triple-digit interest rates, with many borrowers ultimately rolling over their loans. They also demonstrate how these loans lead to a debt trap for many borrowers. Municipalities across the country have also used zoning to restrict where and how many lenders can operate, just as they would regulate liquor or adult video stores. While zoning is sometimes associated with anti-competitive behavior, competition has not brought payday loan prices down—indeed, most lenders charge at or near the state cap.[49]

Enhance enforcement tools

Federal and state banking regulators should enhance enforcement tools to target illegal lending activity. As payday lending has shifted from storefronts to online and offshore lending, regulators' responses have shifted to protect consumers. Last year, state officials of both political parties in several states—including New York State's Superintendent of Financial Services Benjamin M. Lawsky and Georgia Attorney General Sam Olens—issued cease-and-desist orders to Internet lenders that were violating state law.[50] The FDIC and the U.S. Department of Justice have cracked down on bank processing of illegal payday loan transactions through the Financial Fraud Enforcement Task Force.[51] These enforcement efforts should continue in order to protect borrowers and ensure that state bans on high-cost lending that are designed to protect consumers remain effective.

Conclusion

Millions of cash-strapped borrowers take out payday or auto title loans each year in an attempt to make ends meet, but in many cases, they find themselves only deeper in debt. Four out of five payday loan borrowers are unable to pay back the initial loan, according to a March 2014 report by the Consumer Financial Protection Bureau,[52] and thousands of auto title loan borrowers lose their cars each year because they are unable to keep up with the payments.

Despite action by some states to rein in these high-cost lenders, as well as efforts by the federal government to limit their ability to target military service members, these predatory lending practices continue to distress families and communities. Financially vulnerable Americans deserve both stronger laws and enforcement actions at all levels of government to remove bad actors from the financial marketplace. Americans also deserve the development of more affordable and responsible lending options to meet their credit needs without trapping them in a cycle of debt.

By expanding sound credit alternatives and limiting the presence of high-cost credit, policymakers and regulators can create better outcomes for these consumers and expand their economic security.

About the author

Joe Valenti is the Director of Asset Building at the Center for American Progress. His work focuses on improving the ability of low- and moderate-income consumers to participate in the financial sector and to make the most of their resources. Prior to joining CAP, he was a Hamilton Fellow at the U.S. Department of the Treasury, where he served as a research analyst working with the Community Development Financial Institutions and New Markets Tax Credit programs. He previously served as a senior analyst at the New York City Office of Financial Empowerment, the first local government initiative geared toward educating, empowering, and protecting low-income consumers, and as an associate at the Aspen Institute Initiative on Financial Security. He also interned for the U.S. Senate Committee on Banking, Housing, and Urban Affairs under Chairman Christopher J. Dodd (D-CT).

***Correction, July 14, 2014:** This report has been updated to reflect that most, not all, Progreso Financiero loan rates are below 36 percent.*

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