AMERICAN BANKER

Colorado Is No Model for a National Payday Rule

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DEC 10, 2014 10:00am ET

As the Consumer Financial Protection Bureau considers rules to protect consumers who take out payday loans, some observers are pointing to changes that Colorado enacted in 2010 as a model. Colorado's cap on payday loan interest rates — limited to 45% per year — has indeed reduced costs for borrowers. But with origination and monthly fees included, annual percentage rates are still in the triple digits. Lenders also have no requirement, and little incentive, to assess borrowers' ability to repay. The data suggests that payday loans in Colorado remain dangerous and unaffordable for many borrowers.

In addition to capping rates and fees, Colorado encouraged longer-term loans with equal installment payments. In 2012, the last year for which complete information is available, the average payday loan borrower paid $341 per year in fees, down from $518 in 2010 before the law changed, according to data from the Colorado Attorney General. The average loan contract in 2012 carried a 188% APR, compared to 339% APR in 2010.

While these figures show some modest success, Colorado's borrowers continue to experience high default rates and to engage in repeat lending: two tell-tale signs of unaffordable lending.

Colorado's 2013 data shows that more than 38% of state payday borrowers defaulted on their loans — and that's probably an understatement, since it does not consider consumers who juggle loans from multiple lenders. That is a shockingly high and intolerable default rate by any measure, even if it is down from the 49% default rate before the reforms were enacted.

The defaults are especially high given that lenders have a coercive way of ensuring repayment of unaffordable loans: they hold the borrower's post-dated checks or electronic debit authorization. A borrower can default only if the check bounces not once but every time it is re-presented; if the borrower pays hefty stop-payment fees to stop all of the checks; or if the consumer goes so far as to close the bank account. All of those options carry serious repercussions and costs to the borrowers.

The 38% default rate is just the tip of the iceberg of Colorado borrowers' distress. Many consumers who do not default still incur extensive overdraft and insufficient funds fees from their banks, have trouble paying for other expenses or incur late fees on other bills. None of those measures are captured in the default rate.

In another sign of unaffordability, although the average loan contract in 2012 was six months, the typical borrower repaid early and then re-borrowed — not just once, but twice a year, remaining in debt for 11 months. More than one-third of loans (36%) and nearly 50% of larger loans were taken out the same day as the previous one was paid off. That is, as consumers pay down their loans, they appear to be re-borrowing in order to get cash to cover their payments. The amount of re-borrowing, the amount of time borrowers spend in debt, and the annual cost all appear to be steadily climbing since the new rules were enacted in 2010, as lenders gain experience in maximizing profits.

Monthly payments on Colorado loans do take up a smaller share of borrowers' income than lump-sum payday payments, the latter of which are completely out of reach for many people. A report by the Pew Charitable Trusts suggests that payments above 5% of monthly or biweekly gross income — about where the Colorado payments fall — are unaffordable. That may be reasonable as an upper limit.

But responsible underwriting requires looking at expenses as well as income. Many payday borrowers are not managing to meet their current expenses and cannot afford any more debt, no matter how small the payments. Those borrowers would be better off doing in the first place what they eventually do to get out of payday loans: do without, cut expenses, turn to friends and family, sell a possession, or go to a credit union or other lender that requires counseling or financial education before extending a loan. Those options are harder but safer than "fast cash."

Colorado's biggest success — bringing down the annual cost of loans for payday borrowers — is the result of capping interest rates and fees, which the CFPB cannot do because it does not have the authority to adopt a usury cap. While Colorado should be commended for taking that step, its rates are still way too high, permitting lenders to profit despite high levels of defaults.

The easiest and most effective way for Congress and states to stop the payday loan debt trap is to adopt a 36% rate cap for all payday loans. High rates enable improvident lending and make lenders insensitive to significant levels of borrower distress. A 36% cap reduces costs for borrowers while giving lenders an incentive to minimize defaults and do appropriate underwriting.

Meanwhile, the CFPB should keep in mind that moving payday lenders away from balloon payments to smaller installment payments will not, by itself, fix the problem. No matter how the loans are structured, the CFPB must stop unfair, deceptive and abusive practices by preventing lenders from making loans that borrowers cannot afford to repay. To reach that goal, the agency should require front-end underwriting that looks at borrowers' income and expenses and monitor back-end loan performance. This will ensure that consumers are able to repay the loans not just in theory but in practice.

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