

# MISALIGNED INCENTIVES

WHY HIGH-RATE INSTALLMENT LENDERS  
WANT BORROWERS WHO WILL DEFAULT



July 2016

**NCLC**<sup>®</sup>  
NATIONAL  
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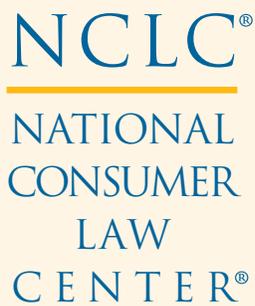
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## ACKNOWLEDGEMENTS

The authors would like to thank Diane Standaert, director of state policy at Center for Responsible Lending, for consultation; NCLC colleagues Shirlyon Williams for research and Jan Kruse for communications and editing; and Julie Gallagher for graphic design.



## ABOUT THE NATIONAL CONSUMER LAW CENTER

Since 1969, the nonprofit National Consumer Law Center<sup>®</sup> (NCLC<sup>®</sup>) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness.



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## EXECUTIVE SUMMARY

Lenders normally want borrowers who will pay back their loans in full. This seems obvious—otherwise, won't the lender lose money?

Yet in the high-rate installment loan market, the normal incentive to make affordable loans does not work. When loans have high interest rates, lenders may seek out and can profit from borrowers who will default in significant numbers. The gap between lender and borrower success can encourage business models that harm numerous consumers.

This report analyzes the inherently dysfunctional and harmful dynamics of high-rate installment loans. In a responsible loan market, the lenders' profits are closely aligned to the successful repayment of the credit. Borrowers and lenders have parallel incentives and share the same goals of successful repayment. But high-rate lending can lead to asymmetrical incentives:

- **As long as the borrower pays long enough before defaulting, a high-rate installment loan will be profitable.** If the borrower makes even half the payments on a longer-term high-rate installment loan, the lender may receive sufficient cash flow to recover the amount loaned and another 50% or more, likely more than enough to turn a profit.
- **A borrower who defaults later can be a more profitable customer than one who pre-pays the loan in full too early.** Tighter underwriting can lead to borrowers who are able to repay early, generating less revenue than a consumer who struggles for months or years to make payments and then ultimately defaults.
- **While the lender may have a successful experience, default causes a cascade of devastating consequences that are likely to plague the consumer for a lifetime.**

It is not our purpose to evaluate whether high-rate lenders have excessive profits. High rates tend to encourage inefficient operations. Thus, high-rate lenders may or may not be highly profitable.

Instead, our goal is to show that loans that default can be a desirable component of a high-rate lender's portfolio and part of its business plan despite the harms those loans cause to consumers. **The problem is a business model that is callous about defaults and the devastating impacts they have on consumers.**

This report first illustrates a dysfunctional loan through an analysis of a \$2,600, 42-month loan with 96% annual interest. **After 20 months of payments, less than half-way through the loan, the consumer has paid over \$4,331 yet reduced the loan balance by only \$391.** If the consumer defaults at this point, the lender will have recovered its principal and another \$1,731, likely enough to cover expenses and generate a profit. The yawning gap between lender success at 20 months and borrower success at 42 months creates enormous peril for consumers.

A smaller, \$500 loan with a 2-year term and 231% interest can be equally dysfunctional. A borrower could make \$45 biweekly payments for a year—the same amount they would pay to roll over a traditional balloon payment payday loan—with similar results: over \$1,000 in payments with the loan amount reduced by less than \$50. The lender can easily turn a profit even if the consumer does not make it into the second year.

We then show that large potential gaps between lender and borrower success characterize several high-rate installment loans on the market today. Even assuming that these lenders have extremely high expenses amounting to 50% of the loan amount, each of these loans has a large gap between the lender's likely profit point and the borrower's successful repayment of the loan:

- CashCall starts making a profit after only about 14 monthly payments on its 47-month, 135%, \$2,600 loan in California. CashCall targets a 35% to 40% default rate.
- On Elevate's Rise \$2,250 loan at 274% in Alabama, lender success could require only 14 of 26 biweekly payments.
- Cash Central (a subsidiary of Community Choice Financial) could begin turning profits after 10 months of payments on a 2-year loan of \$2,000 at 185% in Missouri.
- Advance America recovers 150% of the amount loaned after only 16 of 26 biweekly payments on its \$2,550, 196% loan in California.

These loans have the potential for misaligned incentives leading to profits for lenders and great harm for many borrowers.

Skewed incentives are most pronounced in larger, longer-term loans. But a misalignment of lender and borrower success can also occur with smaller or shorter loans, especially those with high rates, disproportionately long terms, or a pattern of refinancing:

- On shorter 6-month loans, triple-digit lenders can often recover the amount loaned if the borrower makes only half of the payments.
- A Speedy Cash \$300 loan at 430% in Missouri requires 18 months of \$50 biweekly payments, but the lender might profit if the borrower defaults after little more than 4 months of payments.
- If a Cash Store loan in Texas is refinanced three times with \$81 cash out each time, the consumer must make \$2,210 in additional payments. The time to repay the 6-month loan stretches to nearly 10 months, but the lender might make a profit after less than 4 months of payments.
- With loans from ACE Cash Express, Advance America, Elevate (Rise), and CashNetUSA (a subsidiary of Enova), a refinancing that gives the consumer barely enough cash to cover one payment can add three, four, or even six payments to the time in debt, increasing the possibility that the consumer will default before reaching the end.

**Not surprisingly, high default rates are common among high-rate installment lenders.** The Consumer Financial Protection Bureau found a 24% per-loan default rate for payday installment loans, with high defaults even when payments are limited to only 5% of the borrower's monthly income. Data collected by California reveal default rates from 20% to 40% or even higher among high-rate installment lenders, compared to default rates of 2% to 9% for companies that make lower interest rate loans to California consumers with subprime credit scores. The charge-off rates for high-rate lenders in California are 1,000% to 2,000% higher than national credit card charge-off rates.

Defaults are just the tip of the iceberg of borrower pain caused by unaffordable lending. When delinquencies are added to defaults, the "struggling index" for some lenders in California rises to 30% or even 80% or higher. Even loans that do not default can be a destructive experience for struggling borrowers.

Legislators, regulators and enforcement authorities should take action to change these misaligned incentives and narrow the gap between lender and borrower success:

- **The easiest and most effective way to align the interests of lenders and borrowers and to minimize defaults is to cap interest rates (including fees) at 36% (lower for larger loans, such as those over \$1,000).** At lower interest rates, the lender and borrower together will benefit from a successful loan and feel pain from an unsuccessful one. Rate caps should apply to all consumer and small business loans regardless of size.
- **Lenders should be prohibited from making loans that borrowers cannot afford to repay on the loan's original terms while meeting other expenses without reborrowing.**
- **Regulators should monitor and collect data on default rates and other indicators of unaffordable lending.** Data should be collected on default rates on a per-consumer and loan-cohort basis, as well as on rates of refinancing, late fees, delinquencies, and bounced or missed payments.
- **Default rates above 10% (or lower for auto title, payroll deduction, and other loans with strongly coercive repayment mechanisms) should face scrutiny.** The lender's interest rates, as well as the leniency or aggressiveness of its collection practices, should factor into what level of defaults reflects unfair, deceptive or abusive practices.
- **Lenders with high default rates should be found to be in violation of rules prohibiting unfair, deceptive, or abusive practices.**

Lenders should not be allowed to profit from a business model that imposes harm on a significant number of borrowers. Instead, interest rate caps and front-end underwriting requirements will steer the market towards loans that borrowers can afford to repay. Keeping an eye on how loans perform in practice is also critical to ensuring responsible lending that not only turns a profit for lenders but also is a positive experience for the vast majority of borrowers.

TABLE 1  
Loans Analyzed

LENDER	STATE	LOAN*	INTEREST RATE**	NO. OF PAYMENTS	PAYMENT AMOUNT	TERM IN MONTHS	CHARTS
Hypothetical loan		\$2,600	96%	42	\$216.55 monthly	42.0	1-5
Hypothetical loan		\$2,600	24%	24	\$137.46 monthly	24.0	4
Hypothetical loan		\$500	231%	52	\$45.00 biweekly	24.0	6
ACE Cash Express	NM	\$200	398%	13	\$36.32 biweekly	6.0	13
ACE Cash Express	CA	\$2,600	209%	20	\$267.31 biweekly	9.2	16
Advance America	SD	\$500	349%	12	\$86.11 biweekly	5.5	13, 16
Advance America	CA	\$2,550	196%	26	\$227.95 biweekly	12.0	11
Cash Central (Community Choice Financial)	MO	\$2,000*	185%	52	\$146.43 biweekly	24.0	11
Cash Store	TX	\$1,000	582%	12	\$245.51 biweekly	5.5	17, 18
CashCall	CA	\$2,600*	96% + \$75 fee	42	\$216.55 monthly	42.0	7, 8, 9
CashCall	CA	\$2,600*	135% + \$75	47	\$294.46 monthly	47.0	7, 9
CashNetUSA (Enova)	OH	\$800	459%	12	\$164.25 biweekly	5.5	13
CashNetUSA (Enova)	OH	\$1,200	379%	15	\$200.57 biweekly	6.9	16
Check 'n Go	CA	\$3,000	219%	26	\$294.41 biweekly	12.0	11
Elevate (Rise)	TX	\$800	350%	10	\$150.15 biweekly	4.6	16
Elevate (Rise)	AL	\$2,250	274%	26	\$256.21 biweekly	12.0	11
Insikt	CA	\$2,500*	34% + \$90	48	\$73.00 biweekly	22.1	12
Oportun	CA	\$1,600*	35% + \$90	34	\$64.00 biweekly	15.6	12
Shoreside	CA	\$2,600*	180% + \$75	52	\$190.00 biweekly	24.0	11
Speedy Cash	MO	\$300	430%	39	\$49.61 biweekly	18.0	14, 15
Speedy Cash	IL	\$400	372%	12	\$71.68 biweekly	5.5	13
Speedy Cash	MO	\$1,500	199%	39	\$121.38 biweekly	18.0	11

\*Fees may reduce the amount the consumer receives or may be added to the amount financed. It is possible other lenders have fees beyond those listed.

\*\*Rates are rounded. Rates are generally as stated by lenders and may not be accurate APRs.

## I. HIGH-RATE INSTALLMENT LOANS AND DYSFUNCTIONAL DYNAMICS

### A. Introduction: Dysfunctional Credit Markets and the Rise of High-Rate Installment Loans

In a well-functioning loan market, the interests of lenders and borrowers are aligned. Lenders have an incentive to lend only to borrowers who are able to make the payments as scheduled. If the payments prove unaffordable, both the lender and the borrower lose. Credit that benefits both borrowers and lenders is healthy—affording borrowers the opportunity to obtain goods and services to which they would not otherwise have access and providing lenders a steady and honorable business opportunity.

Yet in some credit markets, the interests of lenders and the borrowers diverge. Predatory lending happens when lenders benefit from, or are callous about, the borrower's *inability* to afford the loan. The incentives in predatory lending programs are not parallel: the lenders' interests are at cross-purposes from those of the borrowers.

Recent history has provided several examples of dysfunctional markets where incentives have been misaligned, causing serious pain for consumers:

- Before the 2009 reforms, credit card companies pushed consumers into a “sweat box,” making substantial profits from late and over-the-limit fees and hair-trigger interest rate increases.
- The business model of payday lenders is based on repeat lending to borrowers who cannot afford to repay balloon payment loans and are forced to roll them over again and again. The Consumer Financial Protection Bureau has found that one-in-five payday loan sequences ends in default.<sup>1</sup>
- The foreclosure crisis revealed that profits based on originating and securitizing mortgages rather than the repayment of those mortgages over time led to a push to increase loan volume at the expense of solid underwriting and affordable loans.

This report illustrates how the high-rate installment loan market provides similarly misplaced incentives and causes great harm to consumers.

Payday lenders are increasingly moving into dangerous high-rate installment loans in response to restrictions on balloon-payment loans. State-licensed payday lenders now make payday installment loans in about 19 states.<sup>2</sup> Other companies are also offering high-rate installment loans, especially for loans over \$2,500, where many states do not have interest rate caps.<sup>3</sup> But even these larger loans may be aimed at borrowers who actually sought smaller loans.<sup>4</sup>

State-licensed payday lenders now make payday installment loans in about 19 states.

We start with a \$2,600, 42-month loan at 96% interest.<sup>5</sup> The problems described are exacerbated if the lender charges a higher interest rate, as many do. (See Section II.) We then show similar dynamics for a \$500, 2-year loan at 231%. We assume that all of the loans in this report have equal payments that reduce principal, and no up-front fees or credit

insurance. The dichotomy between lender success and borrower failure will be exacerbated if the loans has additional predatory features such as interest-only payments, large up-front fees, credit insurance, late fees, or additional interest on late payments, especially when combined with loan flipping.

Following the analysis of the two sample loans, we examine several high-rate installment loans on the market today that may produce profitable defaults. (The loans are summarized in Table 1.) We also show how loan flipping can exacerbate the gap between lender and borrower success. We then summarize some data providing evidence of significant default rates in the high-rate installment loan market and lenders who are callous about defaults and the struggles of consumers.

The report concludes with recommendations for essential steps to realign lender and borrower success and eliminate lending practices that inevitably lead to high default rates and other manifestations of borrower pain.

### *B. At High Rates, Payments on Longer-Term Loans are Nearly Interest-Only for Many Months, so the Payments Exceed the Loan Amount Early in the Loan Term*

When longer-term loans have high interest rates, payments barely cover the interest for a long period of time. This is the case even with regular amortization and no up-front fees.<sup>6</sup>

A consumer who borrows \$2,600 at 96% on a 42-month loan will have \$216.55 monthly payments. The consumer will pay almost \$2,600 in the first 12 months—even if all payments are made exactly when due (see Chart 1). Yet only \$162 of those payments will be applied to reduce the principal.<sup>7</sup> The consumer still owes \$2,438 and has 30 more monthly payments to make.<sup>8</sup> (See Appendix 1.)

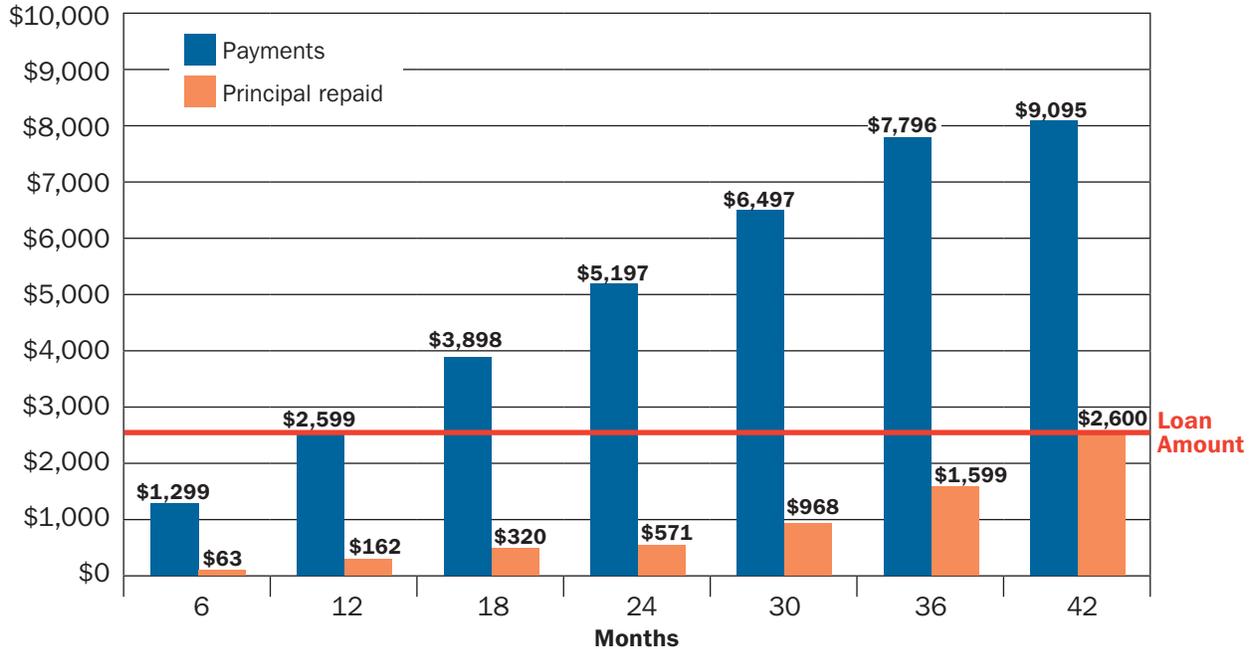
The consumer's payments barely cover interest—not only in the first few months, but well beyond. **After paying for two years on the loan, only \$571 of the \$5,197 in payments is applied to reduce the loan balance.** The consumer still owes more than \$2,000 of the \$2,600 loan.

The reason that the consumer still owes so much is because high rates and long terms distort the amortization of the loan. On a loan with a high rate or a long term, the bulk of the initial payments go to pay the interest that has accrued and only a small amount reduces the principal. As the principal balance is reduced, the amount of interest owed with each payment goes down, leaving more of the payment to be applied to the loan balance. This process is repeated with each payment. But when the interest charges are high, the principal reduction happens very slowly. Thus, with high-rate loans, there is a long period of time when almost no part of any payment reduces the loan balance.

### *C. High-Rate Lenders May Profit on Loans that Default*

While high-rate lenders recover the original loan amount long before the end of the term, to make a profit, they need to recover enough payments to cover not only the loan

CHART 1  
**Payments Toward Principal**  
**\$2,600, 96%, 42-Month Loan**



but also their expenses. But even when expenses are included, the payments on longer-term high-rate loans may cross the profit point long before the end of the term.

The exact profit point for a particular lender depends on the loan’s interest rate, term and size, along with the lender’s expenses. Expenses include origination costs, cost of funds (which will be higher for lenders with reputations for engaging in predatory lending), servicing costs, collection costs (higher for lenders who do not underwrite well for ability to pay), and other overhead, among other factors. Many of these expenses are the same regardless of the size and duration of the loan, and some are higher for larger or longer loans.

There is no standard expense ratio considered appropriate in the small dollar loan market. Indeed, high interest rates can support—and even encourage—inefficient operations with higher expenses. For example, payday lenders usually charge the highest rate permitted by state law, with higher overhead and less efficient operations in states with higher interest rates.<sup>9</sup> High interest rates also support shoddy underwriting practices that drive up expenses on the back end.

Expenses can run anywhere from 2% to 60% or more of the loan amount. In the prime lending market, financial institutions tend to have operating expenses of around 5% to 7% of outstanding loan balances, whereas newer marketplace lenders could have expenses as low as 2%.<sup>10</sup>

Outside of the prime lending market, Insikt, a small California-based lender that makes loans at about 36% plus an origination fee, has indicated that its expenses, not including losses,<sup>11</sup> run about \$138 for its \$1,000 12-month loan—or 13.8% of the loan amount.<sup>12</sup> Insikt would likely have an even lower expense ratio for a \$2,600 loan, as the origination costs would be a smaller percentage of a larger loan.

A 2011 report by the North Carolina Office of the Commissioner of Banks indicates that expenses of the lenders it surveyed amount to under 22% of a \$2,000 loan.<sup>13</sup> The report is based on an extensive survey of the expenses and profit margins of lenders operating under the state's Consumer Finance Act. The report noted that the average FICO score of consumer finance company borrowers was 578.<sup>14</sup> For all lenders, the average interest rate was 24%; state law caps rates at 36% for smaller loans and 18% for larger loans.<sup>15</sup>

The California lender CashCall, which concentrates on high-rate installment loans of \$2,600 loans with several year terms, has reported expenses that ranged from 37% prior to 2008 to 58% or higher after its cost of funds increased.<sup>16</sup>

High expenses can themselves be a sign of problematic practices and do not necessarily justify high rates. But setting aside concerns about the appropriateness of high expenses, we will generously assume that a lender needs to recover 50% more than the loan principal in order to cover expenses and begin making a profit. It is also important to remember that even if the lender does not receive enough payments to cover all of its expenses, any loss on the loan may not be a significant pain point. As long as the lender finds consumers who pay for a period of time, any losses may be easily offset by the profits on other loans, leading the lender to be insensitive to the pain of defaults.

For our sample 42-month, \$2,600, 96% loan, the payments will more than exceed the principal of the loan plus another 50% for expenses after the 19<sup>th</sup> payment (see Chart 2). In 19 months, the lender will have received \$4,114 in payments, returning the \$2,600 loan principal and \$1,514 more for expenses.

That is, even if the lender has a high 50% expense ratio, the lender will make a profit as long as its borrowers pay for an average of 19 months or more. Even if expenses are as high as 60% of the loan, the lender needs only to receive payments for an average of 20 months. The profit point goes down to 16 months if expenses are 30% of the loan amount and to 15 months if expenses are kept to 24%.

After a lender recovers the loan principal and its expenses, the loan becomes a successful experience for the lender, even if the consumer eventually defaults. Additional payments produce more profits, but the critical point for the lender is finding consumers who will cross the profit point, *not* ones who can repay their entire loan.

But the impact on the consumer is quite different. If the consumer defaults after making 20 payments on our \$2,600 loan, the lender has collected \$4,331. Even with a 50% expense ratio (that is, \$1,300 in expenses), the lender will have a \$431 profit. Yet the consumer's \$4,331 in payments will reduce the loan by only \$391, leaving the consumer with a \$2,209 debt and the collectors at the door (see Chart 3).

CHART 2

**Profit Point**

**\$2,000, 96%, 42-Month Loan**

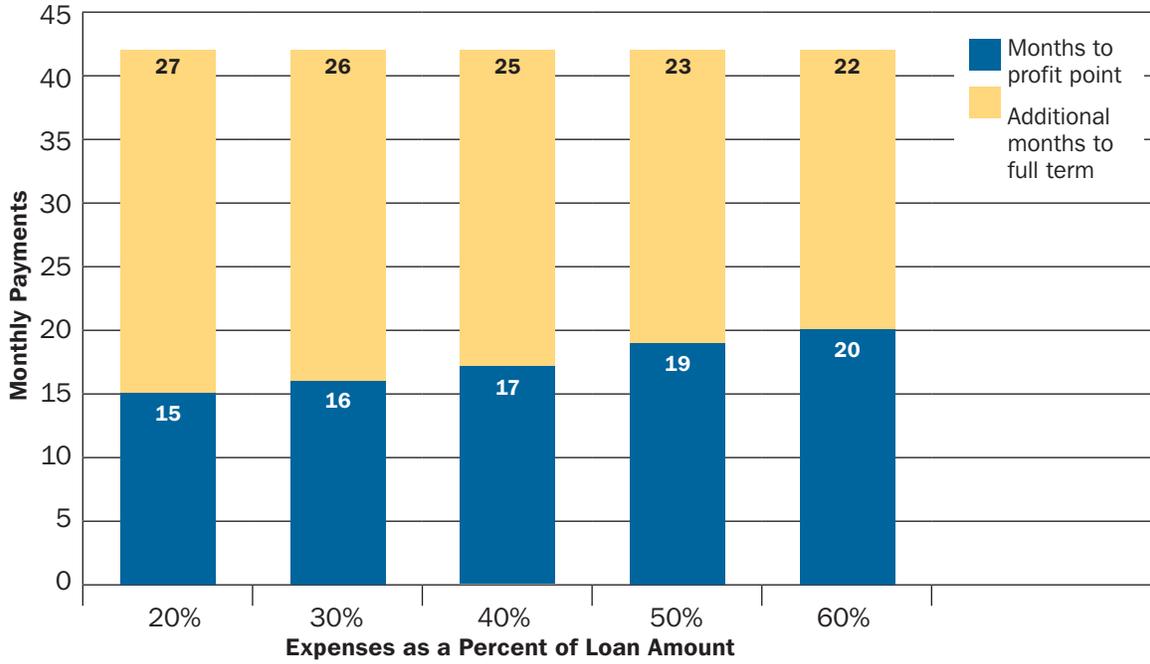
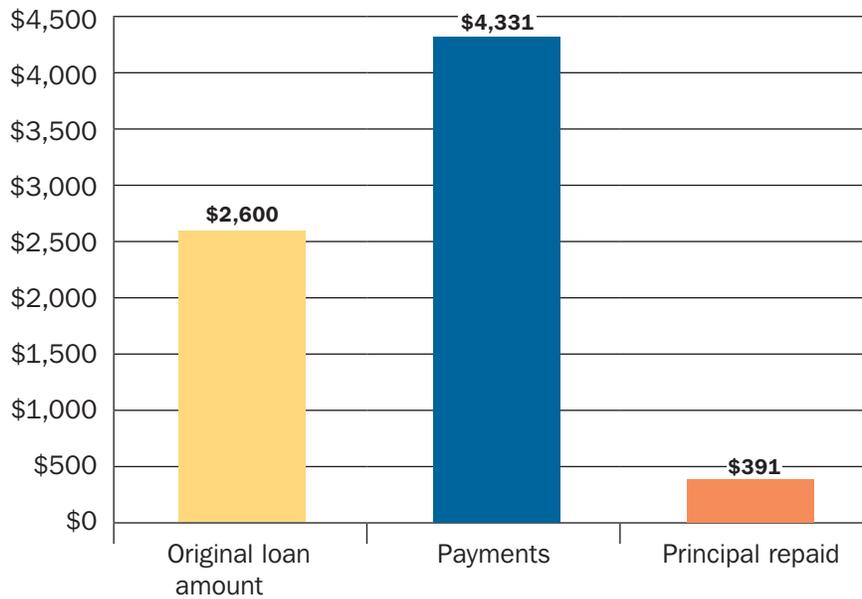


CHART 3

**Default After 20 Months: Payments Made & Principal Repaid**

**\$2,600, 96%, 42-Month Loan**



Of course, not every loan that defaults pays long enough to get to the profit point. But the lender only needs its loans to go beyond the profit point *on average*. The losses from early defaulters are significantly reduced by the gains from the other borrowers who pay long past the break-even point. As long as the average length of time that borrowers repay their loans exceeds the break-even point, the lender will have a profitable portfolio.

As long as the average length of time that borrowers repay their loans exceeds the break-even point, the lender will have a profitable portfolio.

Of course, the largest profits come from borrowers who pay for the full term of the loan—neither defaulting nor paying the loan off early. A borrower who makes all 42 payments on time on the \$2,600 loan will repay a total of \$9,095. But payments well short of that are enough to make the loan profitable.

In contrast, when interest rates are lower, defaults are much more painful to the lender. It takes the lender much longer to recover the loan principal, not to mention expenses. The borrower must make payments deep into the loan term for the lender to make a profit. While it is possible that the lender will turn a profit if the consumer defaults just a few payments shy of full term, in general, the lender must strive for borrowers who are able to repay their loans in full.

For example, more reasonable terms for a \$2,600 loan would be 24% annual interest and a 24-month term. (Loans can be dangerous not only if the rate is high but also if the term is disproportionately long.<sup>17</sup>) For that loan, a default at the 20-month mark would likely be unprofitable for the lender. The lender needs 19 monthly payments (of \$137.46) to exceed the \$2,600 loan amount, and the lender has a strong incentive to find borrowers who are likely able to repay the entire loan (see Chart 4).<sup>18</sup> Consequently, when interest rates are reasonable, lenders and borrowers rise and fall together.

The incentives are very different for a high-rate lender. While a high-rate installment lender has an incentive to minimize loans that default immediately, the lender may not care nearly as much about borrowers who default later. A high-rate lender will be profitable if its underwriting and payment collection processes achieve a portfolio of borrowers who, on average, make enough payments per loan to cover costs plus some profit. For high-rate lenders, minimizing defaults does not need to be a priority.

#### *D. Defaulted Loans Can Be More Profitable Than Ones Repaid Early*

A high-rate longer-term loan that defaults can actually be *more* profitable for the lender than one that is repaid in full through a prepayment early in the loan term.

If a borrower prepays a loan too early, the lender will recover the principal, but the interest may not be sufficient to cover expenses. It all depends on how many payments the borrower makes before prepaying.

As shown in Chart 5, with a 42-month loan of \$2,600 at 96% interest, the lender recovers \$904 *more* revenue from a borrower who defaults after 20 payments than one who prepays the loan after 4 payments. Moreover, a borrower who prepays has no further

CHART 4  
**Months for Payments to Equal Loan Amount**  
**\$2,600 Loan at 24% and 96%**

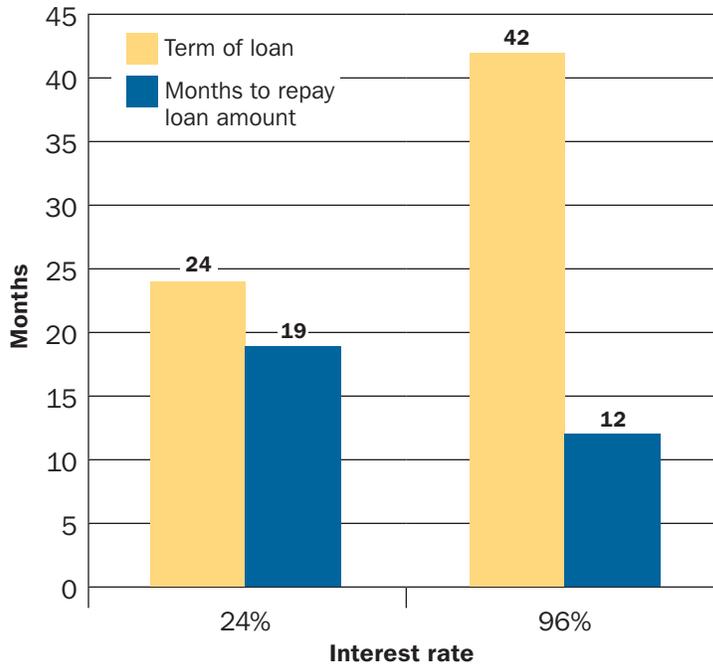
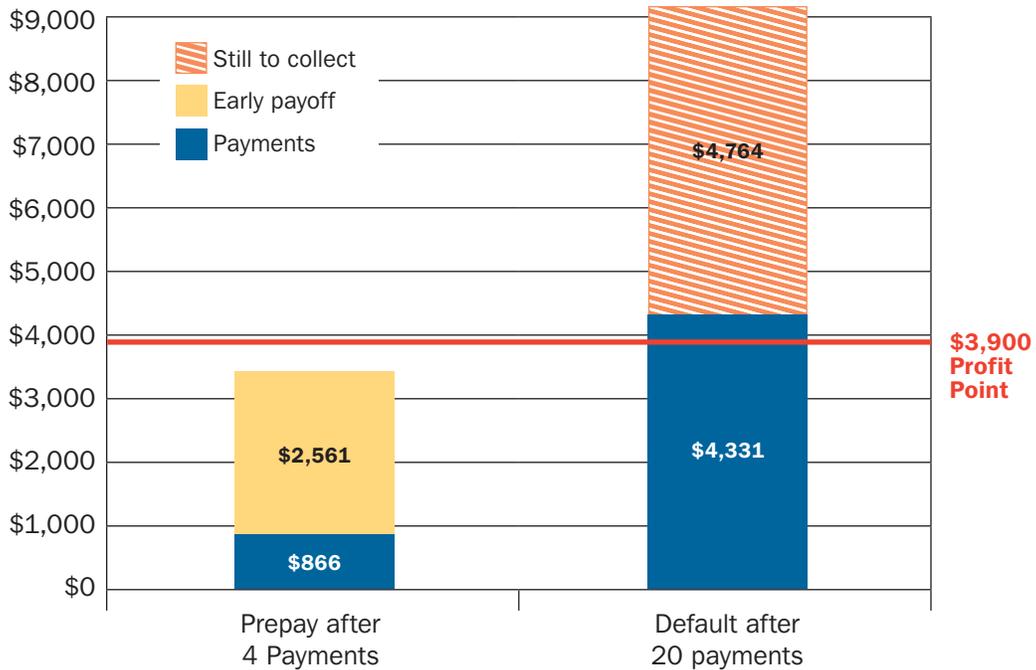


CHART 5  
**Lender's Revenue: Prepay v. Default**  
**\$2,600, 96%, 42-Month Loan**



obligation to the lender, while a borrower who defaults still owes much of the principal, some of which the lender may eventually collect. But even assuming the lender does not collect a penny more, the defaulted loan turns a profit whereas the one that prepaid too early does not.

While the ideal borrower is one who manages to make every payment for the full term of the loan, a borrower with the ability to make all the payments may also have the ability to prepay the loan too early. **The interest that a high-rate lender makes while a borrower is struggling to make payments is so significant that it may provide the lender the incentive to prefer borrowers who will default part-way through the loan over those who will be financially able to prepay early.** A profitable loan program for a high-rate lender relies on finding the right mix of borrowers—minimizing those who either default or prepay too early, and maximizing those who default or prepay after the profit point or pay to full term.

### *E. Smaller or Shorter Loans Can Also Have Misaligned Incentives*

Although smaller and shorter loans are less likely to lead to profitable defaults, misaligned incentives and callousness toward defaults can happen even with a shorter loan.

First, the high interest charges collected when consumers make payments reduce the importance of any losses and desensitize shorter-term lenders to defaults.

Second, loan terms that are disproportionately long for a small loan exacerbate the potential for profitable defaults and misaligned incentives. A long term on a high-rate loan makes it more likely that the borrower will default after the lender has recovered substantial payments.

The longer the loan term, the greater the possibility that the consumer will struggle to repay the loan in full, even if the payment is relatively small.

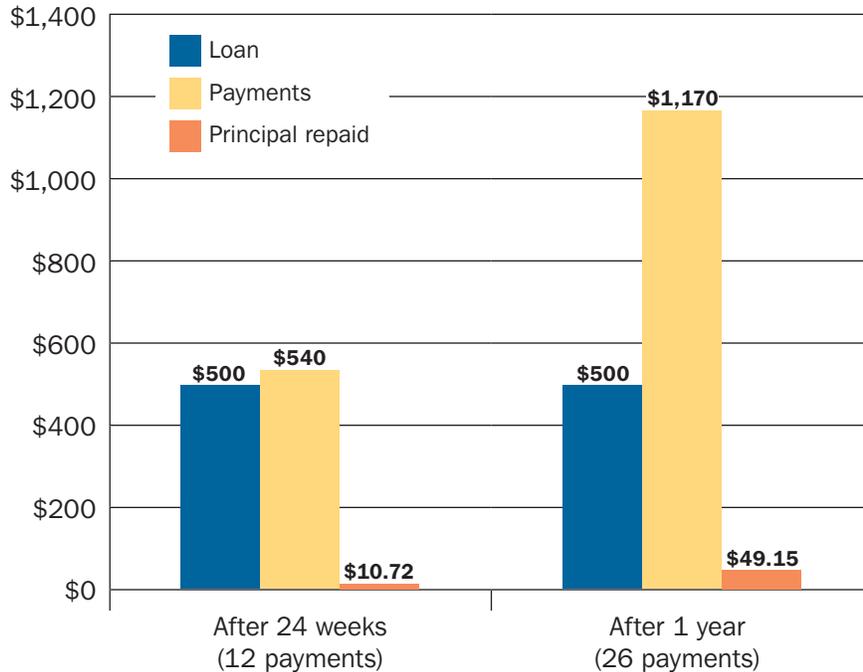
The longer the loan term, the greater the possibility that the consumer will struggle to repay the loan in full, even if the payment is relatively small. The burden of making the payment month in and month out takes a toll. The longer term also makes it more likely that the borrower will be hit with the income and expense fluctuations that are inevitable in the life of many low- and moderate-income consumers. After making payments for months with little progress in reducing the loan balance, the borrower may give up when faced with difficulty paying. Yet the payments may be enough to turn the lender a profit.

Small high-rate loans with excessively long terms may become more common as the Consumer Financial Protection Bureau cracks down on balloon-payment payday loans and adopts underwriting requirements that push lenders toward smaller installment payments.<sup>19</sup> For example, instead of a \$300 two-week payday loan with \$45 biweekly rollover payments, payday lenders could design a \$500, 2-year loan with \$45 biweekly payments and 231% interest. It would take only 12 of the 52 biweekly payments (about 6 months on a 2-year loan) for the lender to recover the \$500 loaned (see Chart 6). After a

CHART 6

**Payments Toward Principal**

**\$500, 231%, 2-Year Loan, \$45 Biweekly Payments**



year of payments totaling \$1,170, the lender would recover more than twice the original loan, but the consumer’s balance will not even be reduced by \$50.

A long, small installment loan is really just a payday loan with the rollovers built in—a payday loan on steroids. The payments in the first year are nearly interest-only—the equivalent to 26 back-to-back payday loans, far longer than the typical balloon payday loan debt trap.

Consumers who are stuck in such a long debt trap to pay off such a small loan are likely to run into other income and expense shocks before the loan is paid off. It seems highly likely that many borrowers will not be able to keep up payments when other difficulties arise over the course of two years. But with the lender easily recovering the amount loaned and enough to make a profit, borrowers may still be desirable despite their ultimate inability to repay the loan in full.

Thus, smaller loans are not immune from dangerously misaligned incentives.

A long, small installment loan is really just a payday loan with the rollovers built in—a payday loan on steroids.

## II. DANGEROUS LONGER-TERM LOANS ON THE MARKET TODAY

The repayment structures of many loans on the market today have the dangerous features previously explained: a high rate and a relatively long term. Together, these features produce payments that reduce the balance slowly and enable the lender to recover its principal—and far more—long before the loan is repaid. While larger and longer loans are more prone to profitable defaults, shorter or smaller loans can be problematic as well, as discussed in the next section.

### A. CashCall

CashCall is a California-based lender that makes high-rate installment loans to subprime borrowers. Class action litigation challenging the legality of CashCall's loans made between 2005 and 2011 revealed a wealth of details about its business model.<sup>20</sup>

During the class period, CashCall primarily made loans of \$2,600.<sup>21</sup> California law limits loans under \$2,500 to 25% interest, so CashCall did not make loans in that amount. In fact, California sued CashCall for improperly evading state interest rate caps by requiring borrowers to borrow more money than they wanted in order to avoid the state law interest rate cap.<sup>22</sup>

From 2005 until 2009, Cash Call's loans had an interest rate of 96% and a term of 42 months.<sup>23</sup> Starting in 2009, CashCall began charging an interest rate of 135% with a 47-month term.<sup>24</sup>

CashCall's expenses averaged 58% of its typical \$2,600 loan.<sup>25</sup> This meant that CashCall needed to collect payments exceeding 158% of the loan amount in order to recover the loan principal and its expenses and make a profit.

CashCall crossed that profit point on the 96% loan after 19 on-time payments on a 42-month loan (or potentially sooner if the consumer made a number of late payments<sup>26</sup>) (see Chart 7). Even if many consumers defaulted and paid nothing more, CashCall's loan program was profitable as long as its average loan paid for at least 19 months.<sup>27</sup> (See Appendix 2.) In fact, CashCall's average loan duration for its 42-month loans was 20 months.<sup>28</sup>

In 2009, CashCall increased the interest rate for its \$2,600 loan from 96% to 135%.<sup>29</sup> The monthly payment increased from \$216.55 to \$294.46.<sup>30</sup> CashCall also experimented with the term and ended up increasing it from 42 to 47 months.<sup>31</sup> Stretching out the loan term from 42 months to 47 months did not benefit the borrower—it brought the payment down only \$1.40 from the \$295.86 that it would have been with a 42-month term. But the five more months of potential payments could yield over \$1,400 in additional revenue for CashCall.

CashCall increased its interest rates despite knowing that doing so had historically led to higher default rates. CashCall had originally made loans at interest rates as low as 24%, but then steadily increased the interest rates.<sup>32</sup> CashCall's experience showed rising charge-off rates as its interest rates skyrocketed. When its interest rates were 59%, CashCall had a 21% charge-off rate, but charge-offs doubled to 44% with the 96% loans. CashCall's own loan data confirmed the correlation between interest rate and default rates (see Chart 8).<sup>33</sup>

CHART 7

**CashCall's Profitable Defaults**

Months to Profit Point on 96% and 135%, \$2,600 Loans

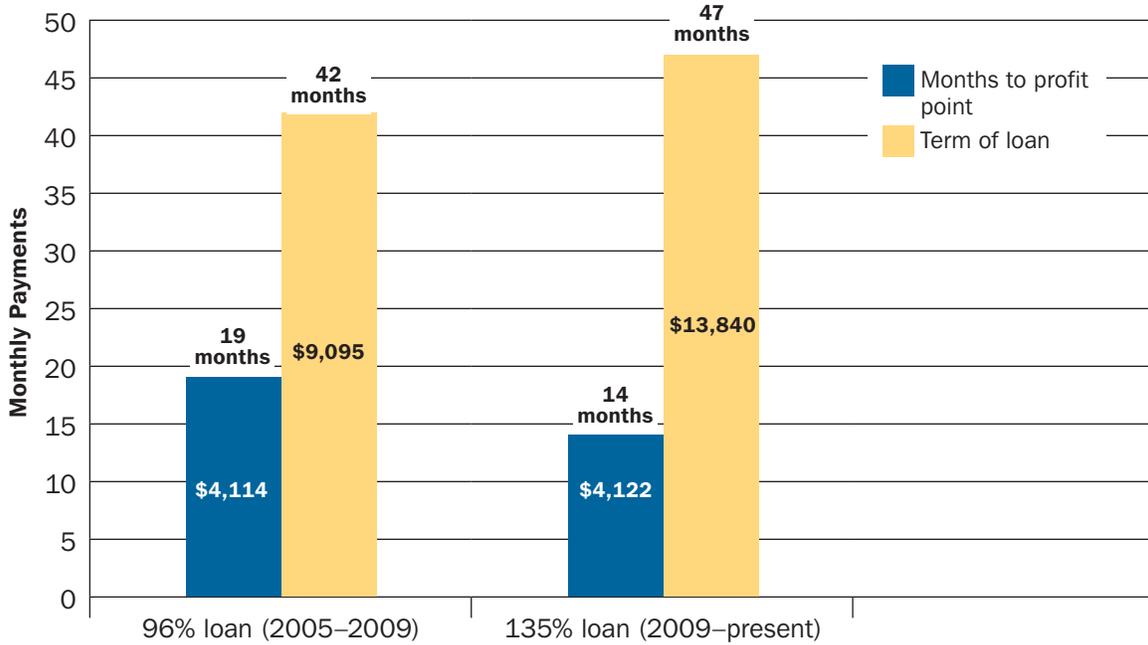
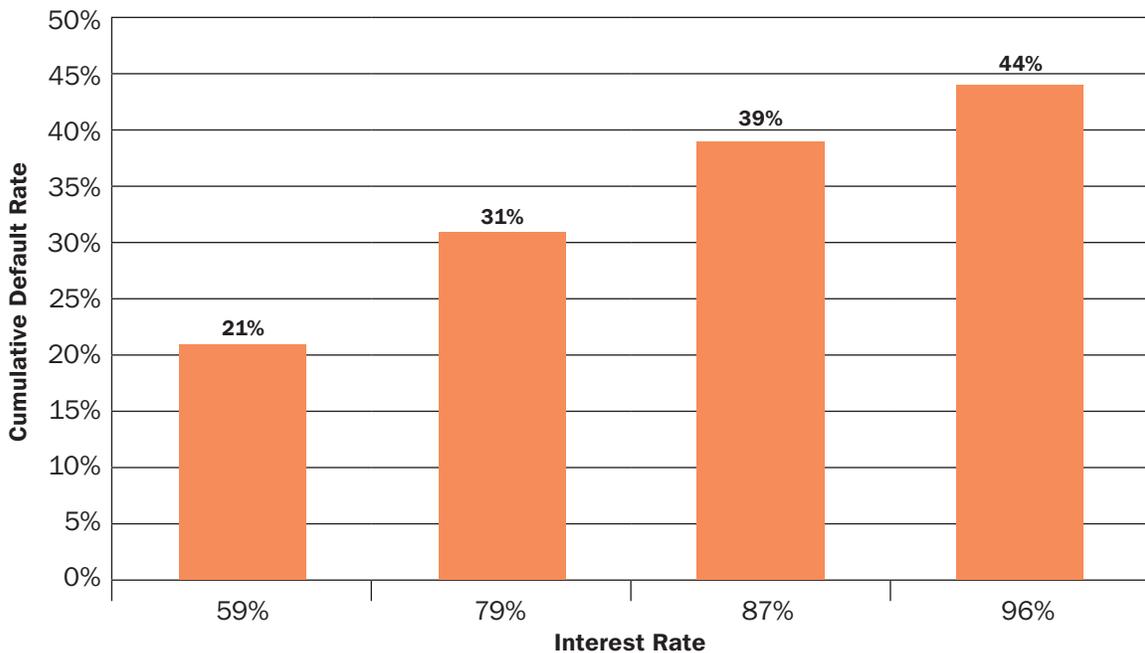


CHART 8

**CashCall's Cumulative Default Rates by Interest Rate for \$2,600 Loans**

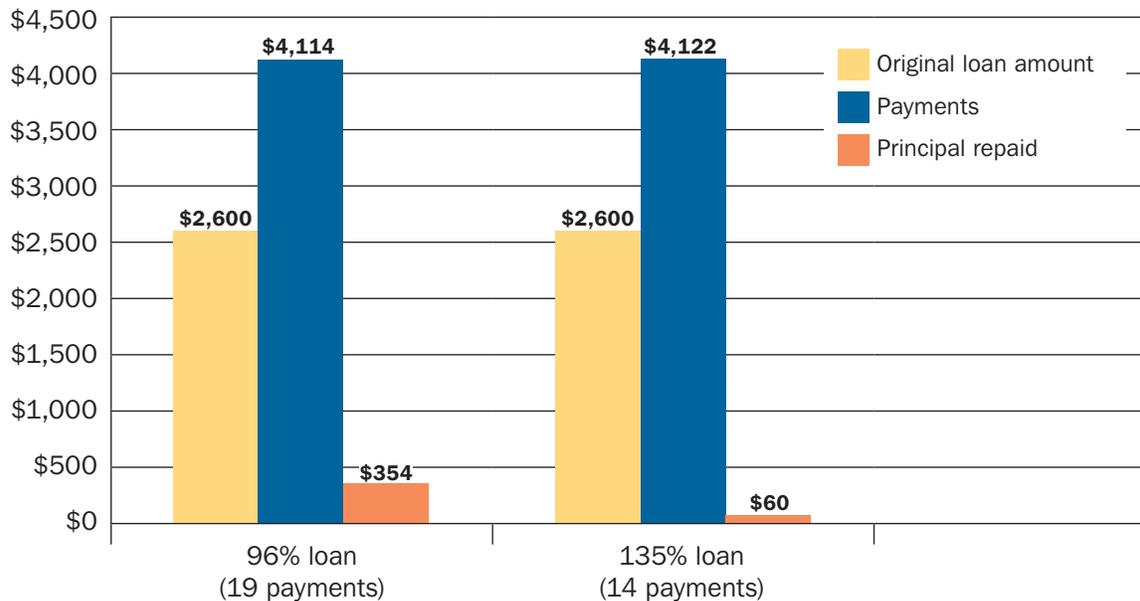


Source: Expert Report of Bruce McFarlane, De la Torre v. CashCall.

At the higher 135% interest rate, CashCall could turn a profit even earlier in the loan, despite an eventual default. Increasing the interest rate from 96% to 135% shortened the point at which CashCall recovered the loan amount plus its out-of-pocket expenses from 19 months to 14 months. That change widened the gap between CashCall’s 14-month profit point and the 47 months that the consumer must pay to be successful (see Chart 9).<sup>34</sup>

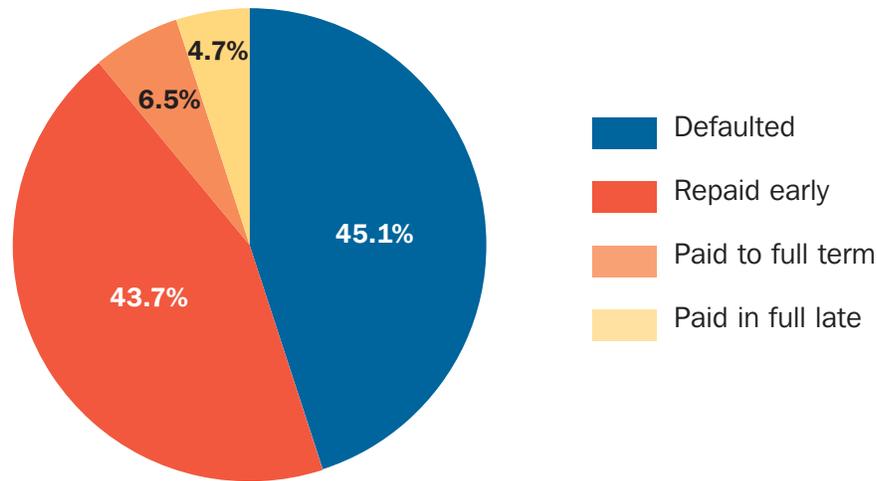
With CashCall’s current 135% loan, a consumer who makes 14 months of payments totaling \$4,122—enough to cover the \$2,600 loan and \$1,500 in overhead—reduces the loan balance by only \$60 (see Chart 9). In fact, since CashCall deducts a \$75 origination fee from the loan proceeds, the borrower actually receives only \$2,525. After \$4,122 in payments to CashCall, a consumer still owes *more* than the loan amount she received. Even when the interest rate was 96%, after making 19 payments totaling \$4,114 the consumer still owed \$2,246 and had reduced the loan balance by only \$354.

CHART 9  
**CashCall’s Misaligned Incentives:  
 Principal Repaid at Profit Point**  
**\$2,600 Loan at 96% (42 Months) v. 135% (47 Months)**



CashCall planned for very few of its loans to pay to full term. As noted, as a result of both defaults and early repayments, the average actual life of CashCall’s loans during the class period was only 20 months. Less than 7% of CashCall’s loans over the period covered by the litigation paid to full term; 45% defaulted, 44% paid early, and the remainder presumably paid in full beyond the original term (see Chart 10).<sup>35</sup>

CHART 10  
**CashCall Loan Performance  
 2005–2011**



Source: De la Torre v. CashCall.

CashCall borrowers struggled with their loans but almost always made some payments. Two-thirds of borrowers were late by 30 days or more at some point.<sup>36</sup> But only 4% of the defaults occurred without any payment of principal.<sup>37</sup>

CashCall’s high default rates did not occur by accident; CashCall targeted a 35% to 40% default rate in its profitability model.<sup>38</sup> That model balanced defaults against prepayments, because when prepayments went up, interest income went down.<sup>39</sup> If default rates went up, normally prepayment rates went down.<sup>40</sup>

CashCall’s high default rates did not occur by accident; CashCall targeted a 35% to 40% default rate in its profitability model.

CashCall monitored its profitability model to ensure that it had the right mix of defaults and prepayments to achieve its target return on investment.<sup>41</sup> Daily and weekly loan performance reports were reviewed at the highest levels of the company.<sup>42</sup> Although CashCall rejected 72% of borrowers,<sup>43</sup> high, planned defaults were a key element of CashCall’s business model.

### *B. Other High-Rate Installment Lenders*

Other high-rate lenders also have installment loan programs that may produce profitable defaults.

Advance America, Cash Central (a subsidiary of Community Choice Financial), Check ‘n Go, Elevate (through its Rise brand), Shoreside, and Speedy Cash offer installment loans of \$1,500 to \$3,000 at triple-digit rates. We do not know whether the profit point is the same for these loans as for the CashCall loans. Data are not available on these lenders’

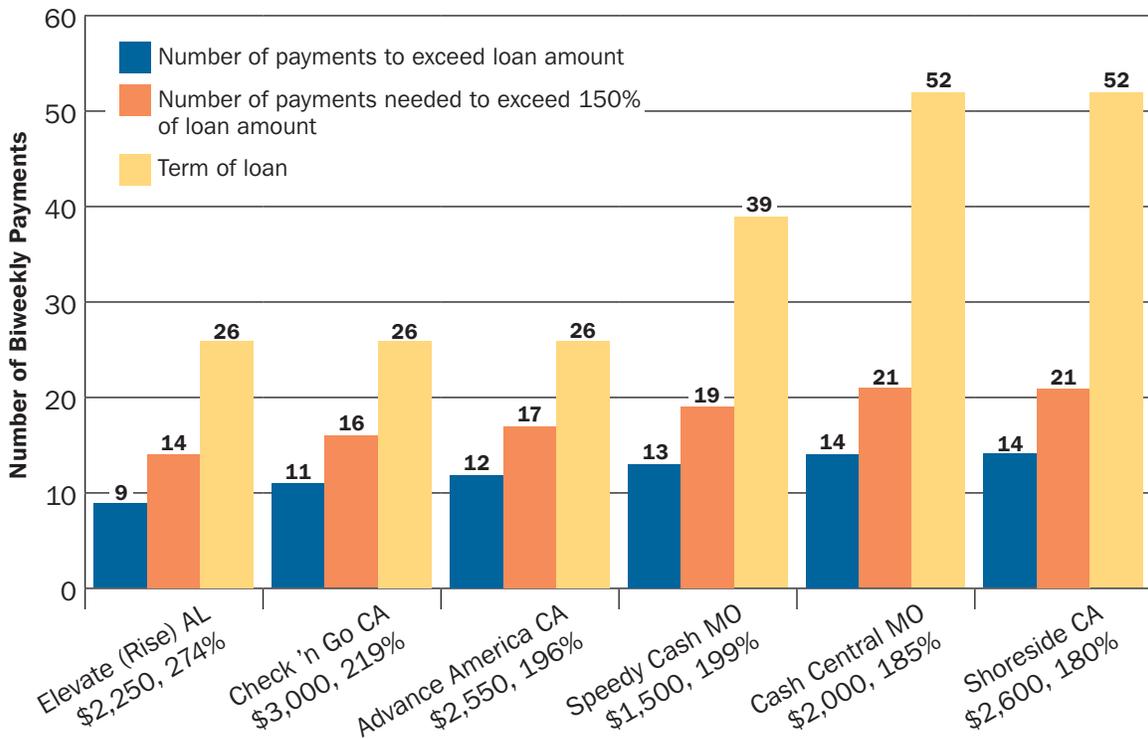
expenses, which may be significantly lower than CashCall's.<sup>44</sup> But even assuming a high 50% expense ratio, all of these lenders collect more than 150% of the loan amount well short of full term—and those payments reduce the principal owed by the consumer very little.

These loans all have yawning gaps between the months needed to pay the lender 150% of the loan and the months to go before the loan is repaid in full (see Chart 11). For example, on Elevate's \$2,250 Rise loan with a 274% interest rate in Alabama,<sup>45</sup> it takes only 14 of 26 payments for the lender to recover 150% of the loan. On Cash Central's \$2,000 loan at 185% in Missouri,<sup>46</sup> the lender might make a profit after 21 payments, but the borrower needs to make it to the 52<sup>nd</sup> payment to have a successful experience. Loans from Advance America, Check 'n Go, Shoreside and Speedy Cash<sup>47</sup> have similar gaps between the point at which the lender is likely turning a profit and the time needed for the borrower to repay the entire loan (see Chart 11). It is in these gaps that lender and borrower interests diverge.

CHART 11

**Profitable Defaults?**

**Number of Payments to Exceed 150% of Loan (Various Lenders)**



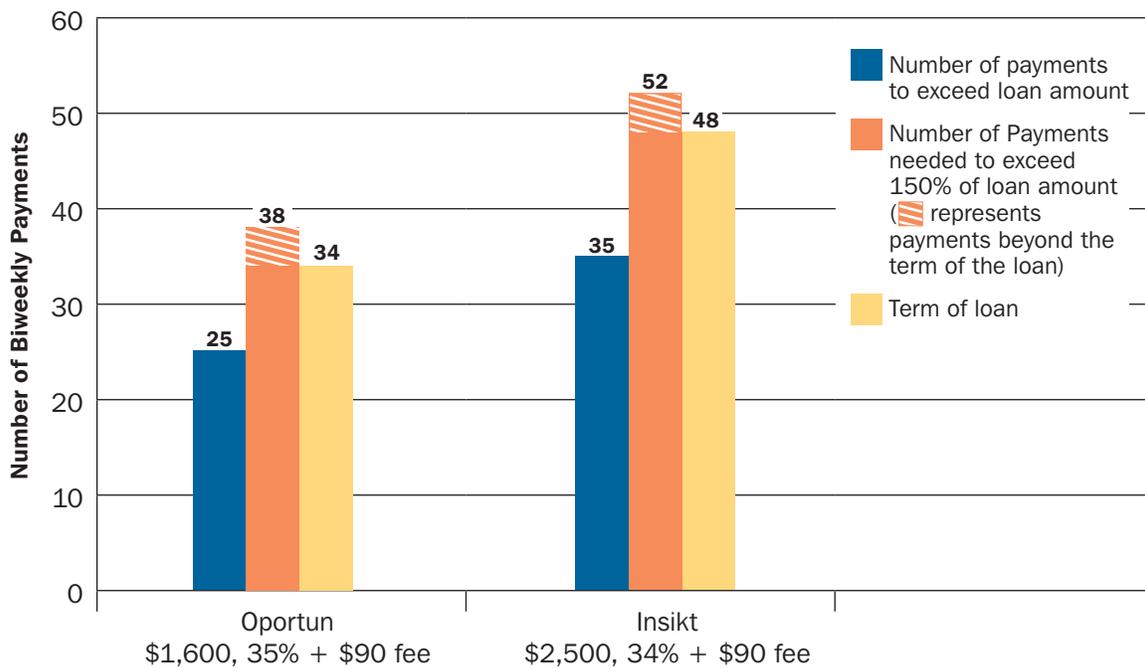
In contrast, at lower interest rates, lenders must be efficient and keep expenses down (including collection costs); must maintain a reputation that enables them to access capital at low cost; and must make greater efforts to ensure that their borrowers can repay

their loans in full. For example, both Oportun and Insikt originate loans with about 36% interest plus an origination fee for borrowers with thin or no credit reports, including borrowers with subprime credit scores.<sup>48</sup> (While these rates are considerably lower than the triple-digit rates charged by the other lenders discussed in this report, even 36% is not an especially low rate for a larger loan, especially with the fee included.) Both Oportun and Insikt need their borrowers to pay deep into the loan term in order to recover the loan itself and must keep their expenses well under 50% (see Chart 12).

CHART 12

**Lower Cost Lenders**

**Months for Payments to Reach 100% and 150% of Loan**



The interest rate makes a critical difference. At high rates, lenders can build a profitable business model making loans that a large number of consumers are unable to repay in full. When interest rates are lower, lenders have a much stronger incentive to engage in robust underwriting.

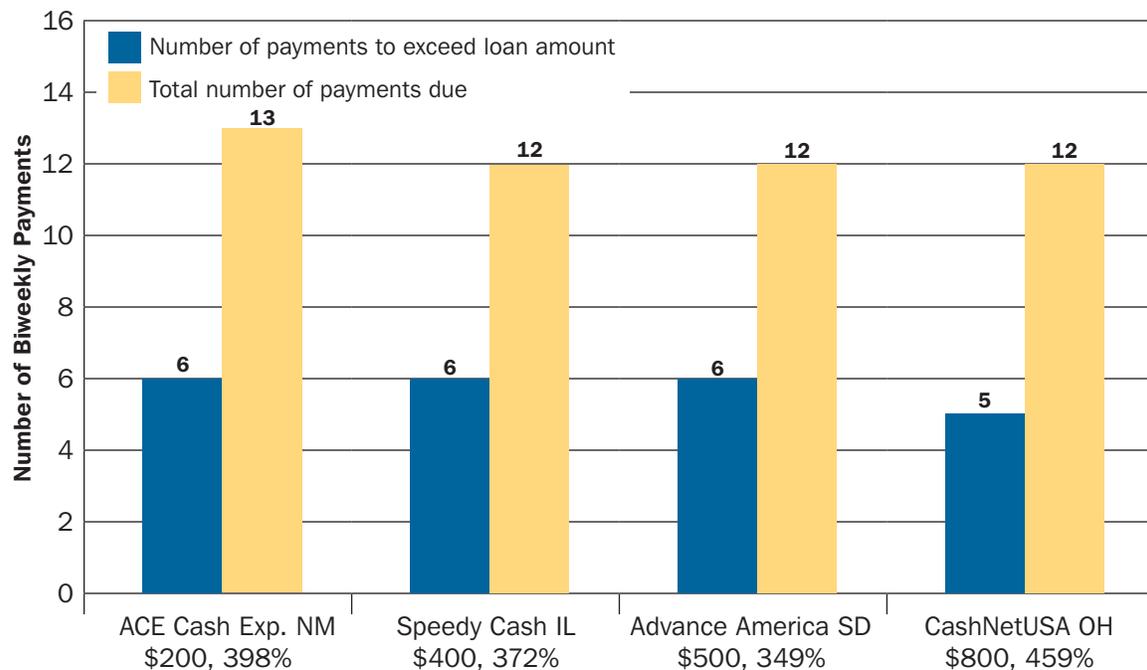
**C. Dangerous Smaller or Shorter Loans**

Larger and longer-term high-rate loans like those shown in Chart 11 have the most extreme asymmetries between substantial payments with little principal reduction. But dangerous dynamics and potentially profitable defaults can also ensue from shorter or smaller high-rate loans. High rates, long terms and refinancing can all increase the chances for misaligned incentives on smaller or shorter loans.

## 1. Small Loans with Medium Terms

The higher the interest rate, the greater is the chance that the lender will recover the loan amount, and possibly its expenses, well before the end of the term. ACE Cash Express, Advance America, CashNetUSA (a subsidiary of Enova) and Speedy Cash offer \$200 to \$800 loans of about 6 months (with 12 or 13 biweekly payments) at rates of about 350% to 460%.<sup>49</sup> On all of these loans, by the halfway mark or sooner, the borrower has made payments that exceed the loan amount (see Chart 13). With several months still to go, it is possible that a borrower who cannot manage to make payments to the end of the loan will nonetheless be profitable for the lender.

CHART 13  
Number of Payments Needed to Exceed Loan Amount  
on Smaller High-Rate Loans



Even if the borrower only makes enough payments to cover the principal, the loss on the loan may be minimal, outweighed by the profits on loans that pay longer. Thus, whether defaulting borrowers are actually profitable or are a minor cost of business, high-rate lenders may not have strong incentives to make sure that their borrowers are able to repay their loans to completion.

## 2. Small Loans with Long Terms

Most installment loans of \$500 or less have a term of no more than 6 months. Stretching out the length of the term on a smaller loan can exacerbate the likelihood of profitable defaults. Speedy Cash, for example, appears to have figured out the benefits—at least for the lender—of disproportionately long terms.

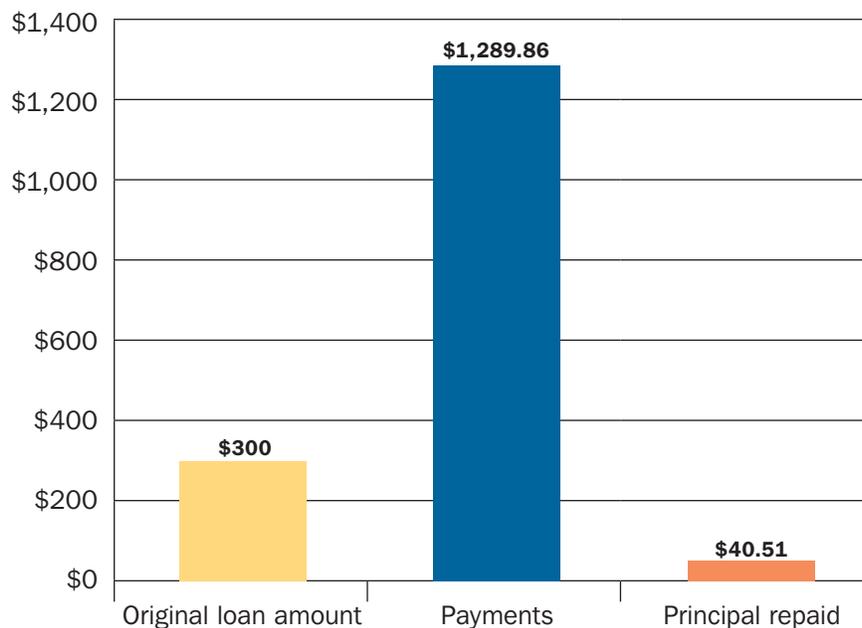
Speedy Cash makes a \$300 loan at 430% in Missouri that requires 39 biweekly payments of \$49.61 (about 18 months).<sup>50</sup> Those biweekly payments are about the same size as the rollover payment on a standard 2-week payday loan of the same size.

The payments are virtually interest-only for the first year. After paying Speedy Cash for a full year, the consumer has paid \$1,289.86 but has reduced the loan by just \$40.51 (see Chart 14). Speedy Cash has created an installment loan that is little different than a series of balloon payment payday loans with rollover fees that do not reduce the amount owed.

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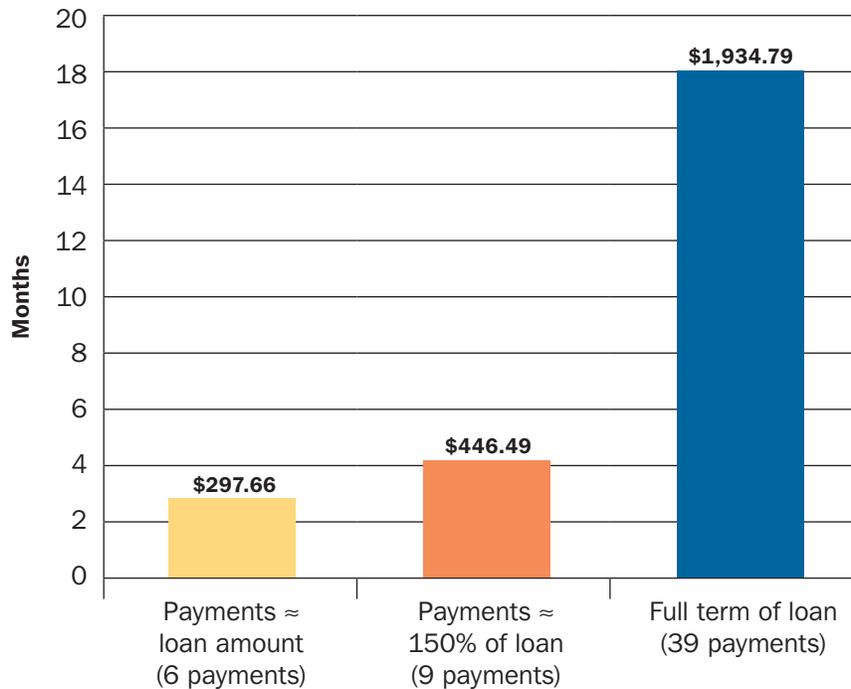
CHART 14

### Progress in 12 Months on Speedy Cash \$300, 18-Month Loan 430%, 39 Biweekly Payments of \$49.61 (Missouri)



Speedy Cash recovers the original loan amount after only 6 payments and collects almost 150% of the loan after 9 payments (see Chart 15). Yet the borrower has to make 30 more payments before that small \$300 loan is paid off.

CHART 15  
**Gap Between Lender and Borrower Success  
 on Speedy Cash \$300 Loan**  
 439%, 39 Biweekly Payments (Missouri)



The enormous gap between lender profits and borrower success gives Speedy Cash powerful reasons to aggressively market its loans to borrowers who cannot manage payments for the full 18 months.

### 3. *Medium-Term Loans that are Refinanced*

Refinancing or “loan flipping” can also increase the divergence between lender and borrower success. High-rate lenders have an especially strong incentive to push refinancing of loans with shorter terms in order to keep borrowers trapped in a cycle of debt. Refinancing can lengthen the time in debt and increase the likelihood that the consumer will eventually default, while nonetheless producing a profitable experience for the lender.

Typically, when a loan is refinanced, the original loan is paid off and the consumer enters into a new loan, extending the payoff date beyond the original date. The consumer may pay any outstanding finance charges and simply extend the term of the outstanding

balance, or the consumer may receive some cash out in exchange for a new loan in the same (or higher) amount as the original loan.

High-rate installment lenders have several incentives to engage in loan flipping.

First, refinancing can mask a borrower's inability to pay. If a consumer is struggling to make a payment, refinancing can give the consumer enough cash to skip a payment.<sup>51</sup> Lenders often contact borrowers before the payment is late, and the loan may be refinanced if the consumer expresses trouble paying, even though the borrower has never become delinquent. Loan flipping also makes default rates appear artificially low because each refinance is counted as a new loan and the default is not attributable to the original loan. (This is why per-borrower and not per-loan default rates are important gauges of loan portfolio performance.)

Second, loan flipping keeps the consumer trapped in debt, making many more payments for the loan than initially contemplated.

Third, loan flipping combined with up-front fees or interest-only payments can greatly increase the cost of the loan (see Appendix 3).<sup>52</sup>

For all of these reasons, high-rate lenders often push refinancing on struggling consumers. A recent study by the Consumer Financial Protection Bureau (CFPB) found that 37% of payday installment loans are refinanced.<sup>53</sup> While not captured in the CFPB study, repeat refinancing is also common in the high-rate installment loan world.

Lenders often offer borrowers cash out as an inducement to refinance. For example, after the consumer has made a few payments and paid down the loan somewhat, the lender may claim that the consumer has "equity" in the loan and can access it by paying off the old loan and taking out a new one.<sup>54</sup> The CFPB found that borrowers almost always take cash out when they refinance their loans. The median cash-out was \$345 for online payday installment loans and \$402 for storefront payday installment loans.<sup>55</sup>

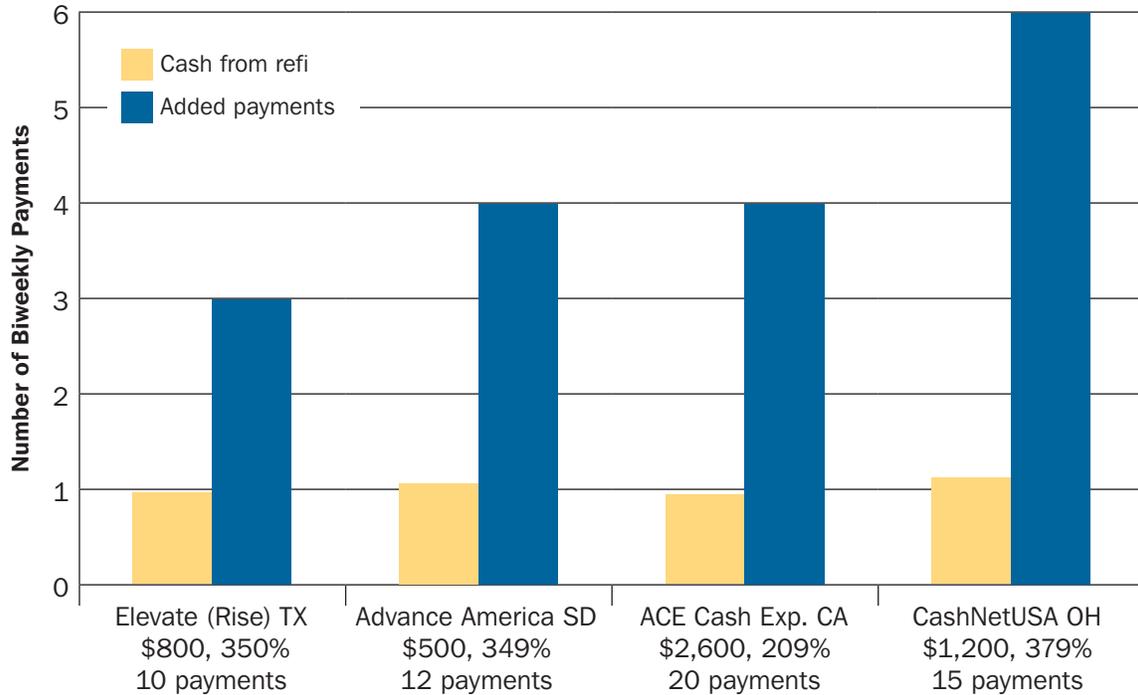
Even if the cash out is only enough to cover one payment, refinancing can add significantly to the loan term.

Chart 16 analyzes several loans with terms of 10 to 20 biweekly payments by Elevate (Rise), Advance America, ACE Cash Express and CashNetUSA.<sup>56</sup> The chart shows the impact if a consumer repays and reborrows at the point at which the principal has been reduced by about one payment's worth. That is, a new loan in the original amount would effectively enable the consumer to skip one payment.

For example, with Advance America's \$500 loan at 349% with 12 biweekly payments of \$86.11, after 4 payments the borrower has paid down the loan by \$92.69. Refinancing at that point (i.e., repaying the original loan and taking out a new loan in the same amount), gives the consumer enough cash to skip one payment. But she starts the loan all over again, adding 4 more payments before she is out of debt. The loans by the other lenders are similar: a refinance that produces only enough cash to cover about one payment adds 3 to 6 payments to the time to retire the loan (see Chart 16). The time added to the loan term may be even longer if the loan has up-front fees or an interest-only period.

CHART 16

**Lengthening the Tunnel of Debt:  
Payments Added by Refi Allowing One Skipped Payment**



Note: Each loan is refinanced at the point where the principal reduction (and thus the cash out from a refinance) is about one payment.

The more times a loan is flipped, the more payments the lender receives—and the more payments the consumer has to make to retire the debt. Thus, when a high-rate loan is flipped multiple times, it becomes more likely that a consumer who defaults will have made enough payments to cover the original loan, the lender’s expenses, and a profit. Indeed, lenders can be expected to push refinances at the point that maximizes profits.<sup>57</sup>

The higher the interest rate, the longer it takes for the consumer to see the light at the end of the tunnel after refinancing a loan. At high interest rates, an early refinance may also provide the consumer with very little cash out—enough to be an incentive to refinance, but not enough to even cover one payment.

Below, we illustrate the impact of refinancing using a loan from The Cash Store, a high-rate installment lender known for its loan flipping practices. The employee training manual encourages employees to offer to refinance loans in the reminder calls that are made before every payment:

*“By the way, Tracy, with your scheduled payment, you could qualify for a cash amount of \$\_\_\_ [amount].”<sup>58</sup>*

Refinance and cash back are the first payment options listed in courtesy calls, ahead of making a payment.<sup>59</sup> Another courtesy script describes “Selling Refinance with Cash Pay Out” for a consumer who responded that he would have trouble paying and had been in the hospital:<sup>60</sup>

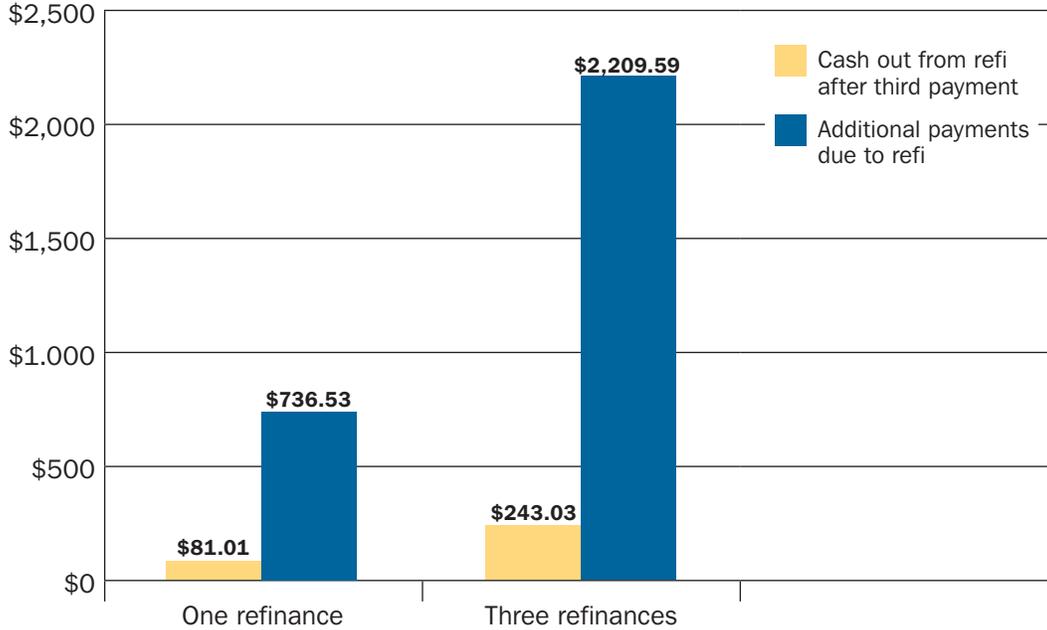
*“I’m sorry to hear you have been ill. I hope you are feeling better. Well, how would you like some extra cash to help you out?”<sup>61</sup>*

Even when a payment is late or has bounced, Cash Store employees must offer refinancing “as the first choice” because it “keeps the customer in an active loan, thus increasing profitability for the store.”<sup>62</sup> Sample scripts for dealing with delinquent loans explain “Selling Extension/Refinance.” Employees are trained to offer only the choice of refinancing or payment in full and to discourage partial payments:<sup>63</sup>

*“If the customer wants to pay part of the debt balance, strongly encourage him or her to take advantage of the Refinance option.”<sup>64</sup>*

Even when a payment is late or has bounced, Cash Store employees must offer refinancing “as the first choice” because it “keeps the customer in an active loan, thus increasing profitability for the store.”

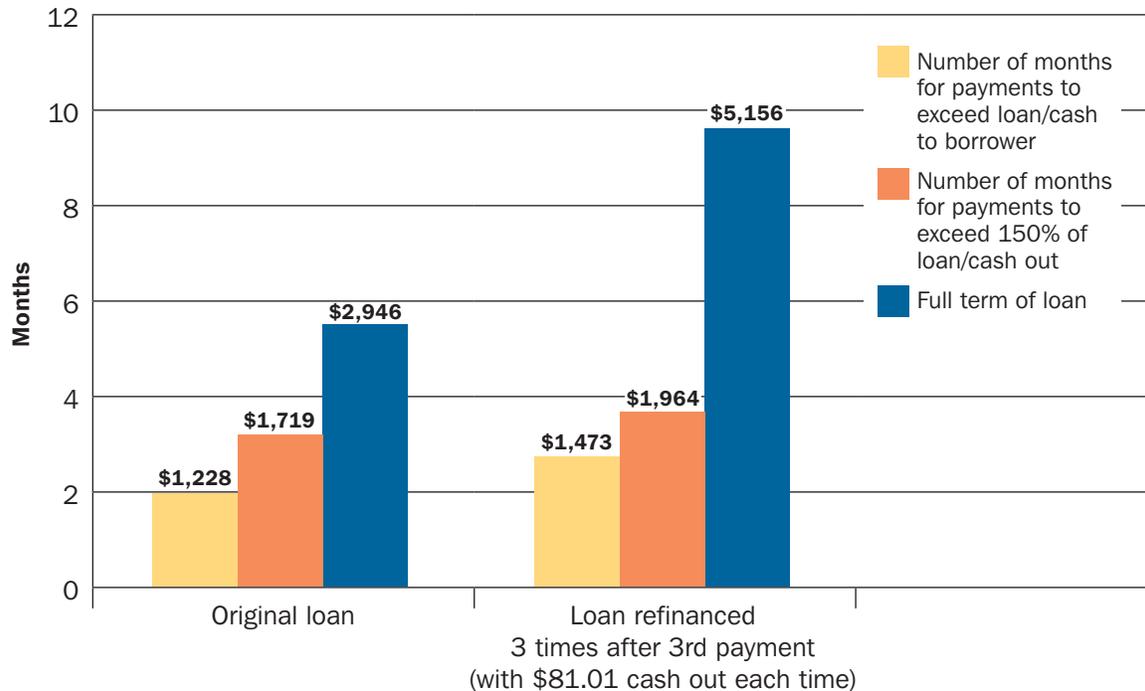
CHART 17  
**Payments Added by Refinancing Cash Store \$1,000 Loan**  
**582%, 12 Biweekly Payments**



Charts 17 and 18 show the impact of multiple refinances of a Cash Store loan in Texas.<sup>65</sup> The \$1,000 loan at 582% requires 12 biweekly payments (about 5 ½ months). With the

original loan schedule, it only takes 6 payments (less than 3 months) for the borrower to repay the original loan and another 50% (see Chart 18).<sup>66</sup> The 6-payment gap between the point at which the lender receives 150% of the loan and the point at which the loan is fully repaid may be enough to lead the lender to be callous about defaults.

CHART 18  
**Repeat Refinancing of Cash Store \$1,000 Loan**  
**582%, 12 Biweekly Payments**



But the gap between lender success and borrower success becomes even greater when the loan is flipped. If the loan is refinanced with a new \$1,000 loan after three payments are made, the consumer gets only \$81.01 cash out but adds three payments totaling \$736.53 to the loan term (see Chart 17). If the loan is refinanced three times, the consumer must pay for nearly 10 months (21 biweekly payments), but the lender recovers 150% of the amount loaned<sup>67</sup> after less than 4 months (8 payments) (see Chart 18).

Loan flipping can also be combined with a stretched-out, longer term to mask default rates and evade underwriting requirements. The CFPB has proposed tighter underwriting requirements for refinancings (with a presumption that a borrower does not have the ability to repay) if, at the time of refinancing, the borrower is in default or has expressed an inability to pay.<sup>68</sup> However, the tighter rules do not apply if the refinanced loan has a payment that is substantially smaller than the original payment.<sup>69</sup> Thus, if the rule is finalized as proposed, lenders may be able to make unaffordable loans and then refinance them into a longer-term loan if the borrowing is struggling (with a lower payment

but a higher overall cost) without triggering the presumption of inability to repay. Yet the loan flipping combined with the longer term will increase the likelihood that the lender will profit even if the borrower eventually defaults.

Loan flipping is very common in the high-rate installment loan industry. High-rates combined with loan flipping can create dangerously misaligned incentives between lender and borrower success, even when loans are small and loan terms are short.

### III. HIGH-RATE LOANS AND DEFAULT RATES

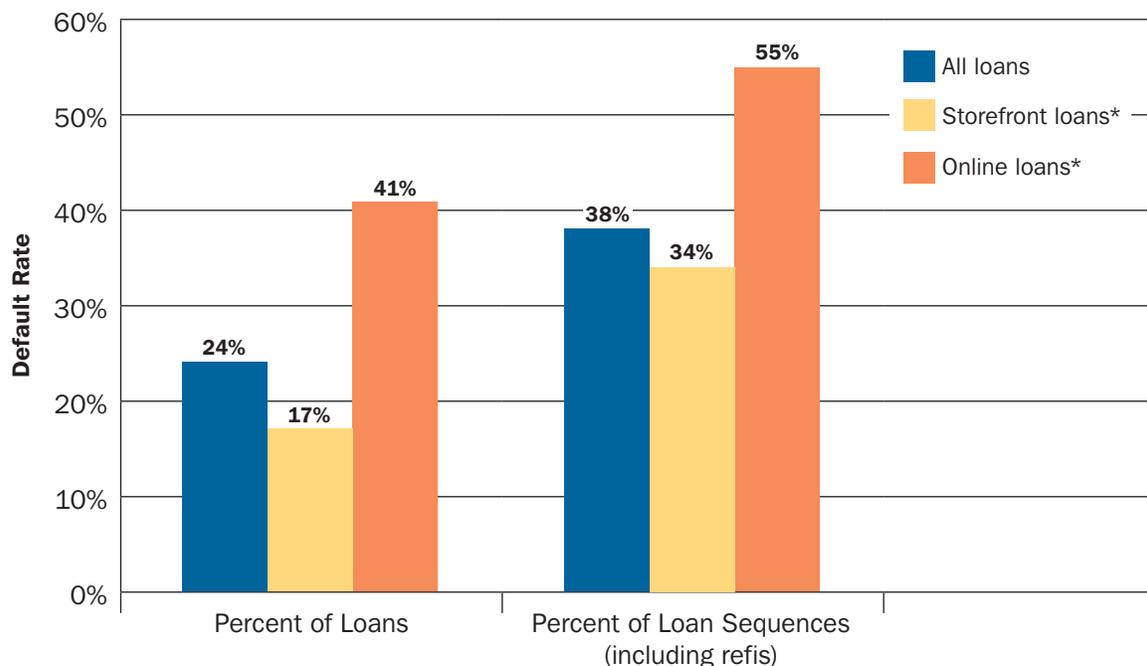
#### A. Industry-Wide Default Rate Statistics

Many high-rate installment loans have high default rates as well as other indications that borrowers are having trouble repaying. High interest rates enable business models that tolerate and even thrive on consumer pain.

The CFPB analyzed the default rates of 2 million payday installment loans made by 7 different lenders that charged interest from 197% to 369% with a median of 249% (see Chart 19).<sup>70</sup> The lenders generally tied payment to the borrower’s payday or benefit payment date and obtained payments through access to the consumer’s checking account.

CHART 19

**Default Rates for Payday Installment Loans**



Source: Consumer Financial Protection Bureau.

\*Only includes loans for which the CFPB could identify the origination channel.

The CFPB found:

[E]ven with the priority provided by leveraged payment mechanisms and vehicle title, an extremely high number of loans ultimately end in default....

The overall loan level default rate across payday installment loan products the Bureau [analyzed] is 24 percent.

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*The overall loan level default rate across payday installment loan products the Bureau [analyzed] is 24 percent. The default rate on loans originated online is much higher, at 41 percent, while for loans originated through storefronts that rate is 17 percent.<sup>71</sup>*

Another study found similarly high default rates among payday installment loans: 34% of loans overall, with a 27% loan-level default rate at storefronts and 42% online.<sup>72</sup>

These loan-level default rates are lower than per-consumer default rates, because many consumers refinance their loans. To attempt to estimate a per-consumer default rate, the CFPB analyzed sequences of installment loans including the initial loan, refinancings, and loans taken out within 30 days of repayment. The CFPB found that, when these refinancing sequences are considered as a single string of borrowing, the default rate for payday installment loans was 38% of sequences —55% for loans originated online, and 34% for storefront loans (see Chart 19).<sup>73</sup>

The CFPB found quite high default rates even when payments were 5% or less of the borrower's income. Even after excluding loans on which no payments were made (which could reflect fraud and not inability to pay), roughly 35% of loans defaulted even when payments were under 5% of gross income (see Chart 20).<sup>74</sup> Only about 60% of consumers repaid without reborrowing or defaulting. With first-payment defaults included, these rates would be even higher.

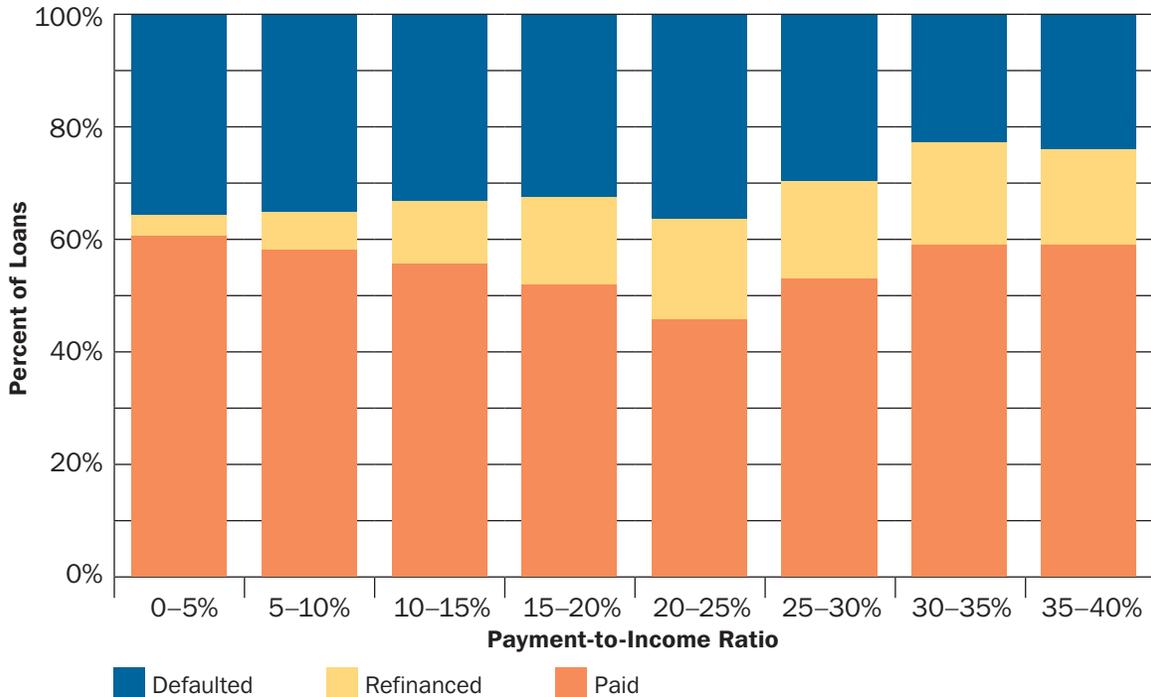
When the CFPB analyzed payday installment loans that had terms under 6 months, with 12 biweekly payments, it found a shockingly high default rate of over 40% when payments were 5% or less of the borrower's monthly income.

When the CFPB analyzed payday installment loans that had terms under 6 months, with 12 biweekly payments, it found a shockingly high default rate of over 40% when payments were 5% or less of the borrower's monthly income (see Chart 21).<sup>75</sup> The per-loan default rate when down as payment-to-income ratios (PTI) increased, but the refinancing rate shot up, a clear sign that borrowers were refinancing unaffordable loans. At every level of PTI, at most about 55% of borrowers of payday installment loans with 12 biweekly payments repaid their loans without defaulting or refinancing.

While it may seem counterintuitive that the CFPB found higher default rates when PTI was lower than when it was higher, most likely this is due to differences in the lenders or the loans (i.e., length or rate) for the different groups of borrowers. When the CFPB

CHART 20

**Impact of Payment-to-Income Ratio on Default and Refinancing Rate for Payday Installment Loans (All Loans)**



Source: Consumer Financial Protection Bureau.

Note: First payment defaults excluded.

limited its analysis to loans from a single lender with 12 monthly payments, a more natural pattern emerged, with the default rates increasing as the PTI increased. But defaults remained very high in the lowest 0-5% bucket, with nearly 30% of loans defaulting and only about 55% of borrowers repaying in full without reborrowing.<sup>76</sup>

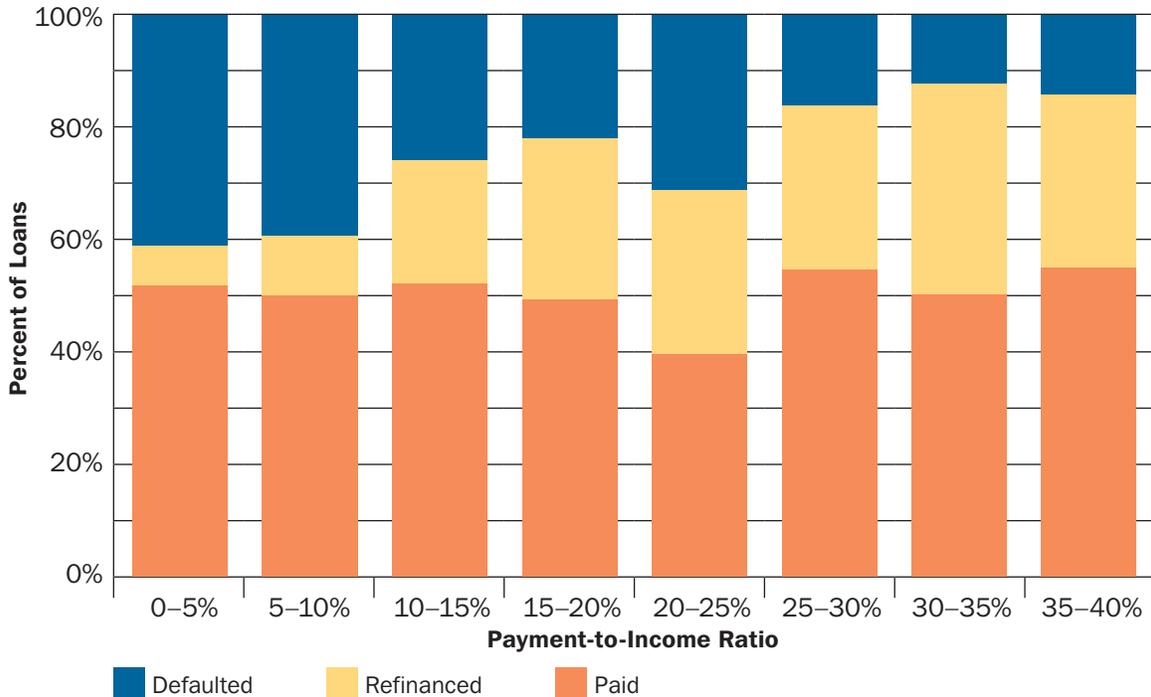
Even though payday installment loans default in high numbers, lenders generally receive some payments even on defaulted loans. The CFPB found that, for 80% of defaulted loans, the lender was repaid at least in part before the borrower defaulted.<sup>77</sup>

These default rates for payday installment loans are dramatically higher than charge-off rates at lenders that do not charge triple digit rates.<sup>78</sup> The national credit card charge-off rate was only 3% in 2014.<sup>79</sup> Even at its peak during the Great Recession, the credit card charge-off rate only reached 10.8%.<sup>80</sup> While credit card borrowers generally have better credit scores than do borrowers of high-rate loans, most credit cards are completely unsecured and will default if the consumer is unable to afford the payments. In contrast, high-rate lenders typically collect payments automatically from borrowers

The CFPB found that, for 80% of defaulted payday installment loans, the lender was repaid at least in part before the borrower defaulted.

CHART 21

**Impact of Payment-to-Income Ratio on Default and Refinancing Rate for Payday Installment Loans with 12 Biweekly Payments**



Source: Consumer Financial Protection Bureau.

Note: First payment defaults excluded.

who are struggling, which enables them to collect payments from borrowers who would default otherwise. Credit cards also require payments 12 months a year, whereas payday installment loans may be shorter.

Charge-off rates are also considerably lower at other lenders that make small dollar loans. A trade association of community banks surveyed its members about loans that would be covered by the CFPB’s proposed installment loan rule: loans under \$1,000 that are repaid automatically and have interest rates below 36% but have a fee that brings the total cost of credit above 36%. The survey found average charge-off rates for the loans of between 0.54% and 1.02%.<sup>81</sup> Another trade association survey of small dollar loans by banks of all sizes found that a third had no charge-offs at all and the remainder had charge-offs of only about 3%.<sup>82</sup> The National Credit Union Administration (NCUA) estimates that charge-off rate for loans under NCUA’s Payday Loan Alternative program—loans often made to subprime borrowers—is 7.5%.<sup>83</sup>

Even accounting for the difference between prime and subprime populations, the enormous disparity in charge-off rates compared to other lenders is further evidence of the unaffordability of high-rate loans. The charge-offs of 0% to 7.5% for lower cost lenders stand in stark contrast to the default rates of 17% to 55% for payday installment loans.

While the data are not identical and it is not possible to do direct apples-to-apples comparisons, it seems clear that, despite having access to the borrower's bank account, the default rates for high-rate installment loans are not just double but are many multiples of the default rates for other small dollar loans.

### *B. Default Rates for Specific High-Rate Payday Installment Loans*

Data from the California Department of Business Oversight (DBO) provide another window into the differing default rates at lower-cost and high-rate installment lenders. The DBO data also make it possible to compare default rates (per-loan default rates) to charge-off rates (per-dollar default rates). DBO provides one of the few public sources of data on the performance of individual lenders through its annual reports from licensees under the state's Consumer Finance Law. Those reports include the number of loans made each year that were 30 days late at year end and both the number and dollar amount of loans that were charged off each year. The reports are unaudited, so they may contain inaccuracies.

The California reports do not directly provide default rates. Instead, they provide the number of loans charged off each year and several different metrics of total loan volume. Ideally, one would want to know a "cohort" default rate: for a given group—cohort—of consumers who receive loans (i.e., consumers who borrow in 2014), what percentage of them default (both at different stages in time and in total)? However, there are several factors that make it difficult to calculate a fully accurate per-consumer default rate from the California data. Distortions arise due to the impact of:

- a) loans that stretch over more than one year;
- b) loans that both originate and pay off before year end;
- c) year-to-year loan volume fluctuations;
- d) lenders that sell or purchase loans; and
- e) double-counting loans that are refinanced.

We have used two different methods to calculate the California default rates in 2014 for five installment lenders: three lenders that charge triple-digit interest rates and two that charge lower rates.<sup>84</sup> All of the lenders make loans with an average loan term that is at least 12 months long.

The first method calculates the charge-offs that year as a percentage of new loans and refinancings in 2014. That method double counts a loan that is both originated and refinanced in the same year, and thus yields per-loan default rates that are lower than a per-consumer default rate.<sup>85</sup>

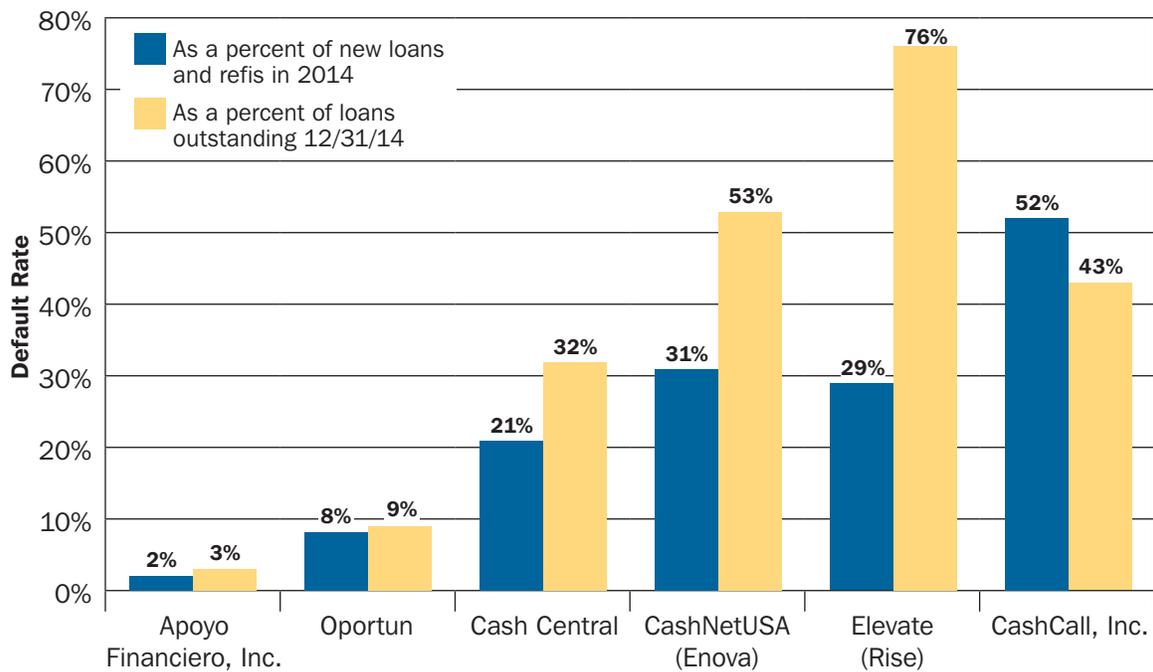
The second method calculates charge-offs as a percentage of the total number of loans that were outstanding at the end of 2014. This method avoids double counting refinances. However, the default rate can be skewed if there are variations in loan volume over time (with year-end loan volume being either higher or lower than the periods that produced the defaults).<sup>86</sup> This method could also overstate defaults to the extent that a number of loans are both originated and paid in full before year end (and thus are not

counted as outstanding loans at year end). But that is unlikely to be a large factor for loans that are at least 12 months in length.

Chart 22 displays default rates for California lenders on a per-loan basis using these two different methods of calculation. Chart 23 reflects charge-off rates on a per-dollar loaned basis using the same two methods.

Neither of these methods is perfectly precise or yields a per-consumer cohort default rate. But together they should provide reasonable ballpark estimates of default rates, especially as to how the high-rate and lower-rate lenders compare to each other. Notably, both methods produce default rates for CashCall that are consistent with those discussed earlier that were reported by the lender. Using the California data, we calculate a default rate of 43% to 52% for CashCall (see Chart 22) and a charge-off rate of 41% to 43% (see Chart 23).

CHART 22  
**Default Rates for California Installment Lenders**  
(Percent of Loans)

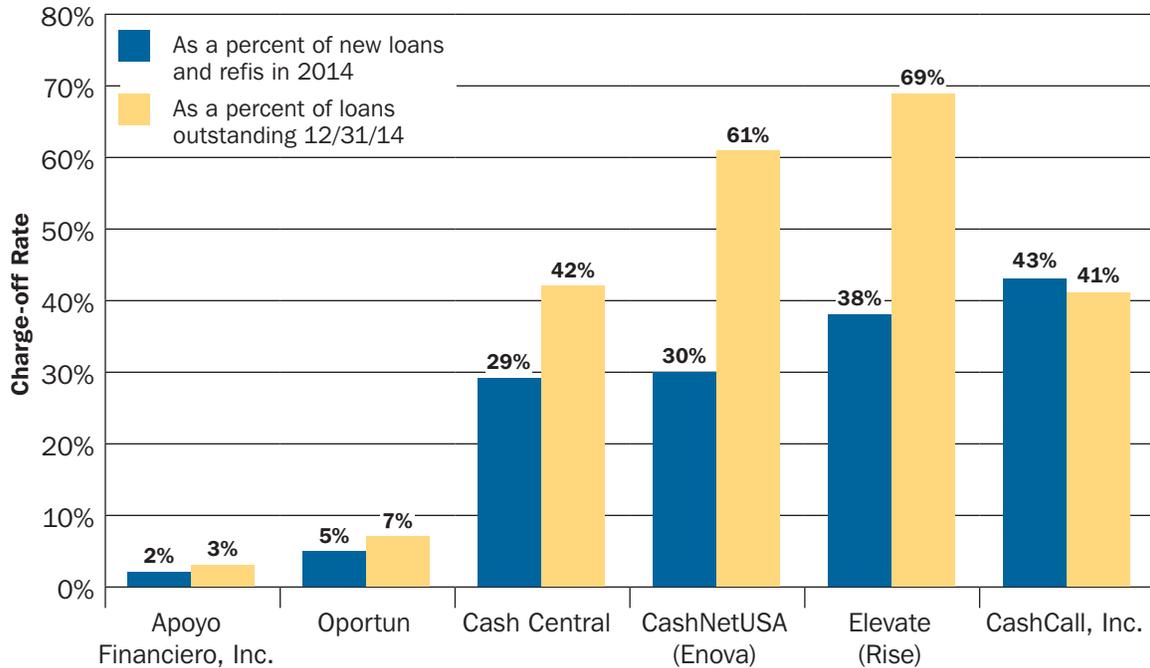


Oportun and Apoyo Financiero generally make loans with interest rates of about 36% to low-to-moderate income individuals with little or no credit history, including consumers with subprime credit scores.<sup>87</sup> Apoyo Financiero's smallest loan is \$3,000, whereas Oportun will go as low as \$300. Without triple-digit interest charges to cover loan losses and with little opportunity for profitable defaults, these two lenders have a strong incentive to underwrite their borrowers carefully to ensure ability to pay. The default rates shown in their California reports bear this out. We calculate 2014 default rates of 2% to 3%

CHART 23

**Charge-off Rates for California Installment Lenders**

(Percent of Dollars)



for Apoyo Financiero and 8% to 9% for Oportun (see Chart 22).<sup>88</sup> Their charge-off (per dollar) rates are similar though a bit lower for Oportun (see Chart 23).

Elevate (Rise), Cash Central, and CashNetUSA (Enova), in contrast, have much higher interest rates, in the 180% to 400% range, depending on the size of loan.<sup>89</sup> All of these lenders have substantially higher default rates than the lower cost lenders. We calculate that between 21% and 32% of Cash Central’s California borrowers defaulted in 2014, 31% to 53% of CashNetUSA’s (Enova) did, and somewhere between 29% and 79% of Elevate (Rise) loans defaulted in 2014 (see Chart 22).<sup>90</sup>

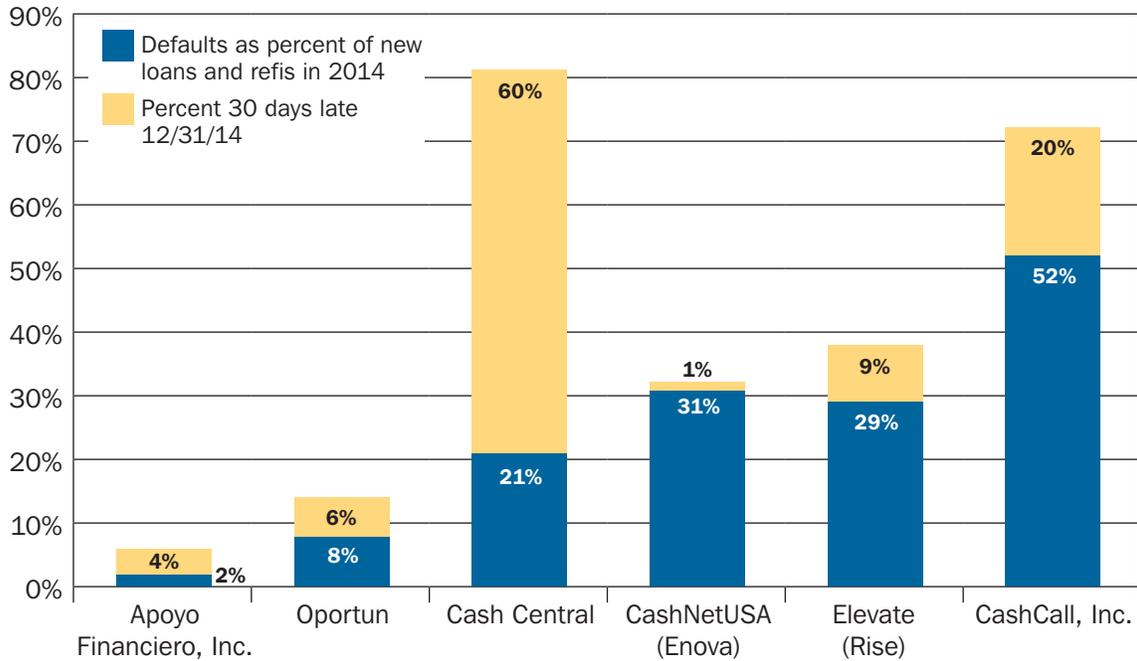
The charge-off rates (calculated as a percentage of dollars that were charged off rather than as a percentage of the number of loans that defaulted) are not much different. The 2014 charge-off rates we calculate based on the California data are in the range of 29% to 42% for Cash Central, 30% to 61% for CashNetUSA (Enova), and 38% to 69% for Elevate (Rise) (see Chart 23). The CFPB calculated nationwide charge-off rates as a percentage of outstanding loan volume in 2014 of over 50% for both Elevate and Enova.<sup>91</sup>

Moreover, default or charge-off rates do not tell the entire story. Many consumers who do not default will still struggle to repay their loans, missing payments or having trouble meeting other expenses. Default rates do not capture these consumers.

In addition to defaults, the California data show the number of loans that are 30 or more days late as of December 31.<sup>92</sup> While Cash Central had a lower default rate than

CashNetUSA (Enova) or Elevate (Rise), a shocking 60% of its loans were 30 or more days past due on December 31, 2014 (see Chart 24). For Rise, the delinquency rate was 9%. CashNetUSA reported only 1% of its consumers as delinquent, but that seems unlikely. The reports are unaudited, so the data could be inaccurate.

CHART 24  
**Struggling Borrowers:**  
**Defaults and Delinquencies of California Installment Loans**



Adding the percentages of consumers who are delinquent and those who have defaulted provides a more robust illustration of struggling borrowers. Even using the most conservative default rate calculation (which does not account for refinances),<sup>93</sup> the “struggling index” is 32% for CashNetUSA, 38% for Rise, 81% for Cash Central and 72% for Cash-Call. In contrast, the struggling index for the lower cost lenders was only 6% for Apoyo Financiero and 14% for Oportun (see Chart 24). While these numbers may not be precise, the difference between the lower rate lenders and the high-rate ones is clearly stark.

Even adding together defaults and 30-day late payments omits struggling consumers who are making on-time or slightly late payments, but only because payments are taken automatically out of their account.<sup>94</sup> Payments may be deducted even when they cause the account to go into overdraft status and trigger an overdraft fee, or when they leave the borrower with insufficient funds to meet other expenses.

For example, the CFPB found that more than 7% of online payday and payday installment loan payments are successfully processed only because the bank covers the

payment as an overdraft.<sup>95</sup> Lenders also frequently re-submit payments that bounce, usually the same day or soon thereafter. Yet 33% of the second attempts to collect those payments electronically succeeded only because of overdraft coverage.<sup>96</sup> Another study found that one-third of payday borrowers had an account that was overdrawn on the same day that they made a payment to a payday lender, and nearly half of payday borrowers incurred an overdraft or insufficient funds fee in the two weeks after a payday loan transaction.<sup>97</sup> These invisible defaults should be added in order to have a complete picture of consumers who cannot afford their high-rate loans.

Clearly, there is a strong correlation between high interest rates and high rates of consumers who default or struggle. While correlation is not always causation, it is likely to be in this situation. The lenders would probably claim that the causation happens in the opposite direction—that high default rates require them to charge high interest rates, rather than the other way around. But the economic incentives belie this protest. High rates of interest cause lenders to be callous towards and even to seek out consumers who will make several payments but ultimately default.

As previously discussed, CashCall built high defaults into its profit model and had reasons to prefer defaults over prepaids.

Elevate, the owner of Rise, has also made clear that it is comfortable with a high default rate and has no plans to reduce it. Elevate stated in a recent filing with the Securities and Exchange Commission:

*[A]lthough a more seasoned portfolio will typically result in lower net charge-offs as a percentage of revenues, we do not intend to drive down this ratio significantly below our historical ratios and would instead seek to offer our existing products to a broader new customer base to drive additional revenues.<sup>98</sup>*

In other words, Elevate is happy with its current charge-off rate; it would rather seek out more struggling consumers than reduce defaults.

Elevate's candor reflects a business model that is common to other high-rate lenders. High interest rates lead to skewed incentives where lenders are insensitive to high defaults and borrower pain.

### C. The Enormous Pain Caused by Defaults

While high-rate lenders may profit from the right kind of defaults, those defaults cause enormous pain to borrowers. The devastating consequences for the borrowers include:

- **An enormous debt that grows exponentially and plagues the borrower forever, with bankruptcy likely the only option.** Until the loan is repaid, it continues to accrue interest, often at the full loan rate of over 100%. A loan that was unaffordable before default escalates so rapidly that payoff becomes impossible, even with help from family or friends. After the lender sues and obtains a judgment, the triple-digit

High rates of interest cause lenders to be callous towards and even to seek out consumers who will make several payments but ultimately default.

contract rate may continue. Even without compounding, a \$2,000 debt at 136% interest becomes \$15,600 after five years and continues growing.

- **Aggressive debt collection tactics.** Whether a borrower eventually defaults or is only delinquent at some time, delinquencies are likely to trigger aggressive collection tactics, imposing emotional stress, embarrassment, and potential impacts on employment. A recent case brought against CashCall revealed that CashCall made 84,371 calls to its 292 West Virginia borrowers—an average of more than 288 calls per person.<sup>99</sup>
- **Possible wage garnishment and imprisonment.** As much as 25% of a borrower's income can be seized each payday in most states.<sup>100</sup> Many states also allow a creditor who has obtained a judgment against the debtor to clean out the debtor's bank account completely, even if the balance consists solely of wages.<sup>101</sup> Debtors can even end up in jail as a result of unpaid debts.<sup>102</sup>
- **Negative reports to credit bureaus that will follow the borrower for many years.** A default has a huge impact on a borrower's credit score and can remain on a credit report for seven years or longer, even if the borrower later repays the credit. In addition to making it impossible to obtain reasonably priced credit, a bad credit report may also increase the cost of auto insurance and impact the consumer's ability to find a job.<sup>103</sup>

There can be nothing more unfair or abusive than designing a profit model that is callous about these devastating impacts on borrowers.

There can be nothing more unfair or abusive than designing a profit model that is callous about these devastating impacts on borrowers.

## IV. RECOMMENDATIONS

High interest rates on longer term loans desensitize lenders to defaults and the pain those defaults cause to borrowers. While lenders may be more sensitive to defaults when loan terms are shorter, especially six months or less, loan flipping, up-front fees, interest-only periods, and other tricks can still result in the same misaligned incentives.

Significant default rates are evidence of unfair, deceptive and abusive practices and should not be tolerated. The following recommendations will help to align incentives so that the fortunes of borrowers and lenders rise and fall together.

**The easiest and most effective way to prevent predatory lending, align the interests of lenders and borrowers, and minimize defaults is to cap interest rates at 36% (or lower for larger loans, such as those over \$1,000).**<sup>104</sup> At 36% interest or below (including fees and credit insurance), the lender needs nearly full repayment of the loan to earn back the principal, the costs of the loan and a profit. Lenders then have an incentive to seek out only borrowers who can successfully repay their entire loan. The lender and borrower together will benefit from a successful loan and feel pain from an unsuccessful one.

Capping interest rates encourages credit products that have parallel, mutually beneficial incentives for both creditors and borrowers.

**Rate caps should apply to all consumer and small business loans, not just small consumer loans.** Many state usury statutes exempt loans over a certain amount such as \$600, \$2,000, or \$2,500. Those exemptions were adopted, in part, with the belief that borrowers of larger amounts were more sophisticated and did not need protection. But the result, today, is that predatory lenders are moving into the larger loan space, making high-rate loans slightly above the cutoff in an effort to avoid regulation. Those loans cause borrowers extraordinary pain. Some lenders also insist on loaning more than a consumer wants in order to avoid a usury cap. States should eliminate any size caps in their usury statutes. Small businesses also need protection against predatory lending and should be covered by rate caps.

**Regulators and enforcement authorities should insist that lenders aim only for loans that the borrower can afford to repay in full on the loan's original terms while meeting other expenses without reborrowing.** By statute, rule, or guidance, lenders should be specifically required to meaningfully consider a borrower's ability to repay. Underwriting should include verification of income and expenses and ensure that the borrower truly has enough residual income to cover basic living expenses and existing debt along with the loan payment.

**Regulators should require reporting of and monitor default rates and other indicators of unaffordability.** Default rates should be collected per loan and per borrower by type of loan and by interest rate (including fees). Reports should also include information on credit insurance and other fees or add-on products that might not be captured in the interest rate or annual percentage rate. Default rates should be reported on a yearly basis and also for each yearly cohort of loans until the loans are fully repaid or default. Charge-off rates (calculated as a percentage of outstanding balances) should also be collected. In addition to default and charge-off rates, regulators should collect data on refinancings, late payments, late fees, delinquencies, and bounced or missed payments. These broader indicators of unaffordability can help to determine the full extent to which a company is lending without regard to borrowers' ability to repay loans without jeopardizing their financial health.

**A per-consumer default rate of 10% or higher should trigger scrutiny (with a lower threshold for auto title loans, payroll deduction loans, and other loans with especially coercive repayment devices).** If per-consumer default rates are unavailable, charge-off rates should be used. The CFPB designated a 5% charge-off rate as safe enough to avoid a significant risk of harm and to qualify for an exemption from its ability to pay requirements.<sup>105</sup> A charge-off rate of twice that amount (which does not include consumers who struggle but do not default) should raise questions about whether a lender is making loans to a large number of consumers who cannot afford their loans. After further research, regulators should consider rules or guidance on an appropriate default or charge-off rate. The lender's interest rates as well as collection practices should also factor into assessing what level of defaults reflects unfair, deceptive or abusive practices. A somewhat elevated default rate is more tolerable for lenders, like credit unions, that

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charge low interest rates and may not make serious attempts to collect defaulted debts than it is for lenders that charge high rates and are aggressive with their collections or sell their debts to debt buyers.

**Lenders that make high numbers of unaffordable loans should be found to be in violation of ability to pay requirements and rules prohibiting unfair, deceptive, abusive or unconscionable practices.** Regulators should consider supervisory actions against particular lenders for high default rates, potential license revocations, and enforcement actions as appropriate.

Lenders should not be allowed to pursue a business model that imposes harm on a significant number of borrowers. Interest rate caps and front-end underwriting requirements can steer the market towards affordable loans. Monitoring and holding lenders accountable for how loans perform in practice are also critical to ensuring responsible lending that is beneficial to lenders and borrowers alike.

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# APPENDIX 1

## AMORTIZATION TABLE

**\$2,600, 42-month loan with 96% interest**

PAYMENT NUMBER	INTEREST DUE	PAYMENT AMOUNT	AMOUNT TO PRINCIPAL	NEW BALANCE	TOTAL PAYMENTS	TOTAL PRINCIPAL REPaid
0				\$2,600.00		
1	\$208.00	\$216.55	\$8.55	\$2,591.45	\$216.55	\$8.55
2	\$207.32	\$216.55	\$9.23	\$2,582.23	\$433.09	\$17.77
3	\$206.58	\$216.55	\$9.97	\$2,572.26	\$649.64	\$27.74
4	\$205.78	\$216.55	\$10.77	\$2,561.50	\$866.18	\$38.50
5	\$204.92	\$216.55	\$11.63	\$2,549.87	\$1,082.73	\$50.13
6	\$203.99	\$216.55	\$12.56	\$2,537.32	\$1,299.27	\$62.68
7	\$202.99	\$216.55	\$13.56	\$2,523.76	\$1,515.82	\$76.24
8	\$201.90	\$216.55	\$14.65	\$2,509.11	\$1,732.37	\$90.89
9	\$200.73	\$216.55	\$15.82	\$2,493.30	\$1,948.91	\$106.70
10	\$199.46	\$216.55	\$17.09	\$2,476.21	\$2,165.46	\$123.79
11	\$198.10	\$216.55	\$18.45	\$2,457.77	\$2,382.00	\$142.23
12	\$196.62	\$216.55	\$19.93	\$2,437.84	\$2,598.55	\$162.16
13	\$195.03	\$216.55	\$21.52	\$2,416.32	\$2,815.10	\$183.68
14	\$193.31	\$216.55	\$23.24	\$2,393.09	\$3,031.64	\$206.91
15	\$191.45	\$216.55	\$25.10	\$2,367.99	\$3,248.19	\$232.01
16	\$189.44	\$216.55	\$27.11	\$2,340.89	\$3,464.73	\$259.11
17	\$187.27	\$216.55	\$29.28	\$2,311.61	\$3,681.28	\$288.39
18	\$184.93	\$216.55	\$31.62	\$2,280.00	\$3,897.82	\$320.00
19	\$182.40	\$216.55	\$34.15	\$2,245.85	\$4,114.37	\$354.15
20	\$179.67	\$216.55	\$36.88	\$2,208.97	\$4,330.92	\$391.03
21	\$176.72	\$216.55	\$39.83	\$2,169.15	\$4,547.46	\$430.85
22	\$173.53	\$216.55	\$43.02	\$2,126.13	\$4,764.01	\$473.87
23	\$170.09	\$216.55	\$46.46	\$2,079.68	\$4,980.55	\$520.32
24	\$166.37	\$216.55	\$50.18	\$2,029.50	\$5,197.10	\$570.50
25	\$162.36	\$216.55	\$54.19	\$1,975.32	\$5,413.64	\$624.68
26	\$158.03	\$216.55	\$58.52	\$1,916.80	\$5,630.19	\$683.20
27	\$153.34	\$216.55	\$63.21	\$1,853.59	\$5,846.74	\$746.41
28	\$148.29	\$216.55	\$68.26	\$1,785.34	\$6,063.28	\$814.66
29	\$142.83	\$216.55	\$73.72	\$1,711.62	\$6,279.83	\$888.38
30	\$136.93	\$216.55	\$79.62	\$1,632.01	\$6,496.37	\$967.99
31	\$130.56	\$216.55	\$85.99	\$1,546.02	\$6,712.92	\$1,053.98
32	\$123.68	\$216.55	\$92.87	\$1,453.15	\$6,929.47	\$1,146.85

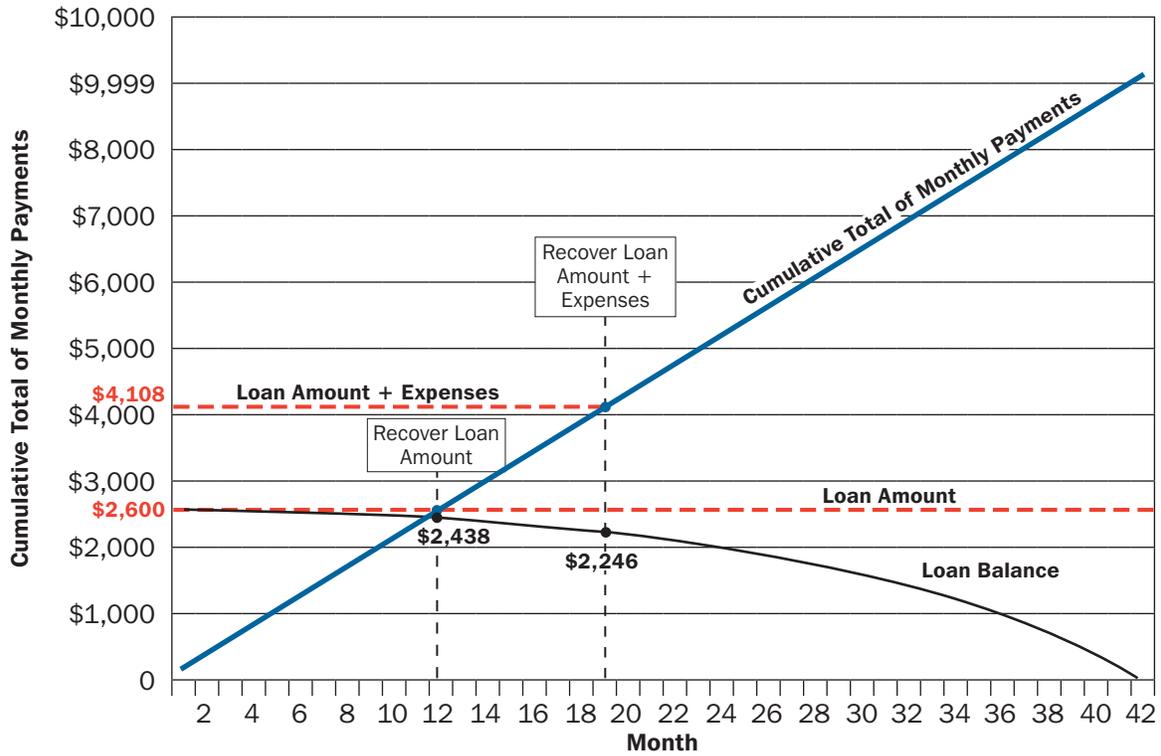
APPENDIX 1 *(continued)*  
**AMORTIZATION TABLE**  
 \$2,600, 42-month loan with 96% interest

PAYMENT NUMBER	INTEREST DUE	PAYMENT AMOUNT	AMOUNT TO PRINCIPAL	NEW BALANCE	TOTAL PAYMENTS	TOTAL PRINCIPAL REPAID
33	\$116.25	\$216.55	\$100.30	\$1,352.86	\$7,146.01	\$1,247.14
34	\$108.23	\$216.55	\$108.32	\$1,244.54	\$7,362.56	\$1,355.46
35	\$99.56	\$216.55	\$116.99	\$1,127.56	\$7,579.10	\$1,472.44
36	\$90.20	\$216.55	\$126.35	\$1,001.21	\$7,795.65	\$1,598.79
37	\$80.10	\$216.55	\$136.45	\$864.77	\$8,012.19	\$1,735.23
38	\$69.18	\$216.55	\$147.37	\$717.40	\$8,228.74	\$1,882.60
39	\$57.39	\$216.55	\$159.16	\$558.24	\$8,445.29	\$2,041.76
40	\$44.66	\$216.55	\$171.89	\$386.36	\$8,661.83	\$2,213.64
41	\$30.91	\$216.55	\$185.64	\$200.72	\$8,878.38	\$2,399.28
42	\$16.06	\$216.55	\$200.49	\$0.24	\$9,094.92	\$2,599.76

Note: The final payment is short due to rounding.

## APPENDIX 2 ECONOMICS OF CASHCALL

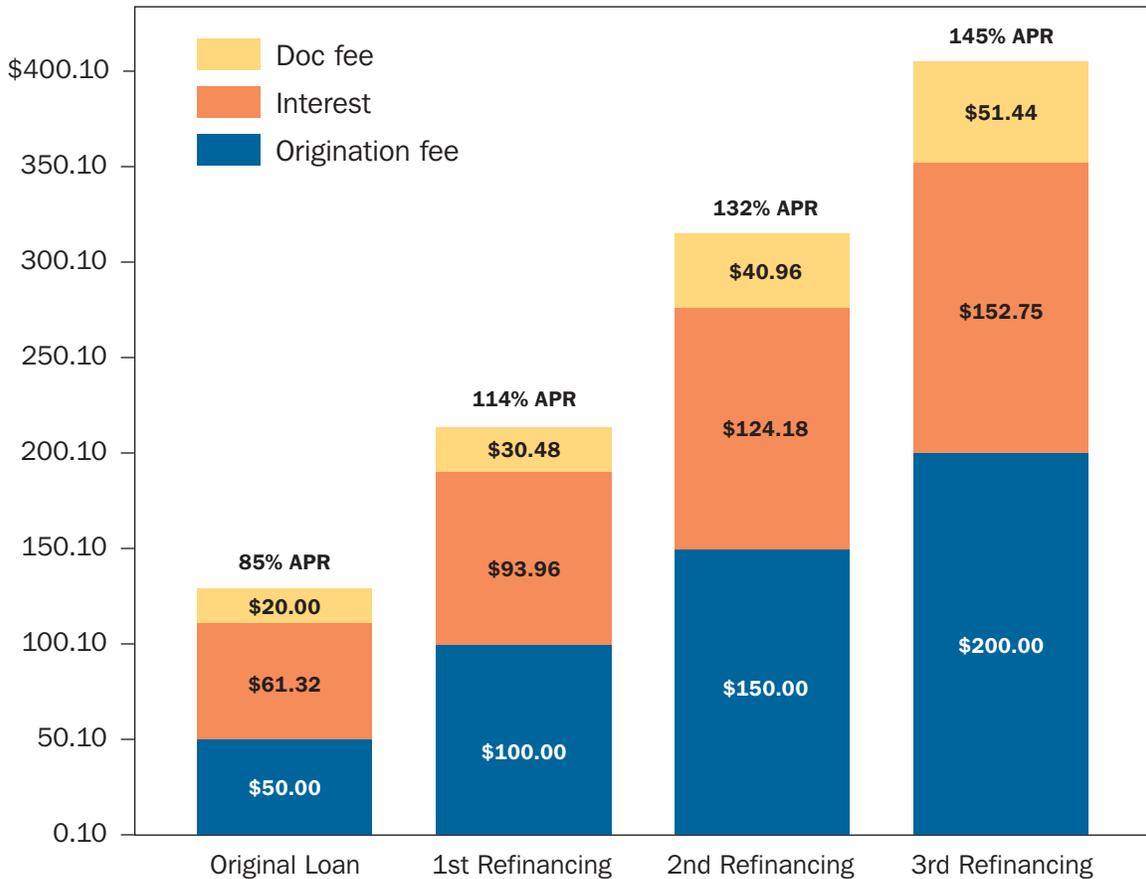
**\$2,500, 96%, 42-Month Loan**



Source: Expert Report of Bruce McFarlane, Litinomics, De la Torre v. CashCall.

## APPENDIX 3

### EFFECT OF REFINANCING A \$500 SIX-MONTH LOUISIANA LOAN THREE TIMES



The example assumes that 1) the borrower refinanced the loan three times, each time after making the second payment; and 2) the borrower did not obtain any new money upon refinancing, but simply refinanced the remaining balance each time so that it would be repayable over six months. The result of the three refinancings is an increase in the repayment period from 6 months to 12 months.

Source: National Consumer Law Center, *Installment Loans: Will States Protect Borrowers From a New Wave of Predatory Lending?* (July 2015) available at: <http://www.nclc.org/issues/installment-loans.html>

## ENDNOTES

1. CFPB, Press Release, “Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps” (June 2, 2016), <http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-rule-end-payday-debt-traps/>.
2. See Center for Responsible Lending, CRL Issue Brief, “Payday and Car Title Lenders’ Migration to Unsafe Installment Loans” (Oct. 2015), [http://www.responsiblelending.org/other-consumer-loans/car-title-loans/research-analysis/crl\\_brief\\_cartitle\\_lenders\\_migrate\\_to\\_installmentloans.pdf](http://www.responsiblelending.org/other-consumer-loans/car-title-loans/research-analysis/crl_brief_cartitle_lenders_migrate_to_installmentloans.pdf).
3. See National Consumer Law Center, *Installment Loans: Will States Protect Borrowers from a New Wave of Predatory Lending?* (July 2015), available at <http://www.nclc.org/issues/installment-loans.html>.
4. See note 22, *infra*.
5. As discussed in Section II.A, CashCall made a \$2,600 loan at 96% interest for many years. CashCall deducted a \$75 fee, so that the borrower only received \$2,525, while paying interest on \$2,600. The interest rate was 96% but the APR including the fee was 99%. For our sample loan, we have assumed that the loan has no fees. Thus, in our example, the annual percentage rate (APR), which includes fees, and the interest rate are the same. Elsewhere in this report, we have either used APRs as reported by the lenders or have assumed that the interest rate and the APR are the same.
6. Amortization is the process by which the principal is repaid gradually over time. Under a regular amortization schedule, each payment consists of the periodic interest owed based on the outstanding balance, along with part of the principal. Irregular amortization schedules include interest-only payments and payments with finance charges that are based on flat fees, not periodic interest.
7. We have generally rounded dollar amounts to the dollar and interest rates to eliminate decimal points.
8. Appendix 1 provides an amortization table for this loan, illustrating these points.
9. See Pew Charitable Trusts, *How State Rate Limits Affect Payday Loan Prices* (April 2014), [http://www.pewtrusts.org/~media/legacy/uploadedfiles/pes/content-level\\_pages/fact\\_sheets/stateratelimitsfactsheetpdf.pdf](http://www.pewtrusts.org/~media/legacy/uploadedfiles/pes/content-level_pages/fact_sheets/stateratelimitsfactsheetpdf.pdf).
10. See Tom Grant, “Marketplace Lending: Bruised, Not Buried,” *American Banker* (May 10, 2016) (describing presentation by Lending Club).
11. It is not necessary to include losses in our analysis because the question is whether a lender’s loan program would be profitable if the entire portfolio, on average, defaulted after the profit point. The losses from those loans are already built in by requiring the payments on a loan that defaults to cover the entire principal loaned. In practice, some loans will default sooner and generate net losses, while others default later or pay in full, generating additional profits that can cover those losses.
12. Memorandum from Insikt, Inc. to Consumer Financial Protection Bureau re Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle, Auto Title, and Similar Loans at 6 (May 13, 2015) (“Insikt CFPB Memo”), [http://www.consumerfinance.gov/documents/373/3b\\_-\\_SBREFA\\_Panel\\_-\\_CFPB\\_Payday\\_Rulemaking\\_-\\_Appendix\\_A\\_part\\_1.pdf](http://www.consumerfinance.gov/documents/373/3b_-_SBREFA_Panel_-_CFPB_Payday_Rulemaking_-_Appendix_A_part_1.pdf).
13. The report focuses on return on investment, and concludes that the average profit margin (profits as a percent of expenses) consistently falls between 9% and 10%. A simplified example in the conclusion uses a \$2000 loan that generates \$480 in interest and yields a \$48 profit after expenses. Thus, expenses would be \$432, or 21.6% of the \$2,000 loan. See North

Carolina Office of the Commissioner of Banks, The Consumer Finance Act: Report and Recommendations to the 2011 General Assembly at 42 (Feb. 2011), available at [http://ccc.sites.unc.edu/files/2013/02/NCCOB.CFA\\_Report.pdf](http://ccc.sites.unc.edu/files/2013/02/NCCOB.CFA_Report.pdf). Put differently, the report found that the average profit margin consistently falls between 9% and 10%, *id.*, that is, operating expenses averaged 90% to 91% of income. *Id.* at 36. The average interest rate for the lenders surveyed was 24%, *id.* at 34, and thus average expenses (which may include write-offs, which we have excluded, *see n. 11, supra*) would be under 22%.

14. *Id.* at 19 (summarizing 2009 report by Equifax covering the prior seven years).
15. *Id.* at 6, 34.
16. Declaration of Delbert Meeks in Support of CashCall, Inc.'s Motion for Summary Judgment on the Unconscionability Claim, *De La Torre v. CashCall* ¶ 17 at 4-5 (filed Oct. 17, 2013) ("Meeks Declaration").
17. The minimal benefit from a small loan does not justify the burden of long-term debt. A longer term also makes it more likely that a subprime borrower will not be able to complete the full term.
18. A lower rate lender also cannot tolerate an inefficient business model with expenses as high as 50% of the loan amount. As discussed above, high rates encourage inefficiency.
19. The CFPB's proposed rule appropriately requires lenders to consider the borrower's ability to make *all* of the payments when due, and to reasonably account for likely volatility in income or expenses over the term of the loan. However, it is not clear if the rule will prevent lenders from constructing underwriting scenarios that sound plausible but that are ultimately unsustainable for longer loans. While the CFPB will consider default rates, a pattern of refinancing may obscure default rates.
20. *See De La Torre, et al. v. CashCall, Inc.*, 56 F.Supp.3d 1073 (N.D. Cal. 2014) (finding loans unconscionable), *vacated on reconsideration*, 56 F.Supp.3d 1105 (N.D. Cal. 2014) (holding that, even if the loans were unconscionable, the court could provide no remedy without impermissibly intruding upon the legislature's province) (hereinafter, *De La Torre v. CashCall*).
21. The \$2,600 loan was the overwhelming majority of CashCall's loans and in some years the only loan that Cash Call made. Meeks Declaration ¶ 3 at 1. The loan had a \$75 origination fee, so the consumer netted \$2,525 in cash. But for simplicity and consistency with the way the court described the loan, we will refer to it as a \$2,600 loan.
22. CashCall paid a \$1 million settlement in response to charges that it falsely advertised smaller loans and pushed consumers into taking out larger loans even though the customers didn't need or want to borrow that much money. Calif. Dept. of Bus. Oversight, Press Release, "CashCall Pays Nearly \$1 Million of Restitution to California Borrowers Under DBO Settlement" (July 10, 2015), [http://www.dbo.ca.gov/Press/press\\_releases/2015/CashCall%20Restitution%20Announcement%2011-18-15.asp](http://www.dbo.ca.gov/Press/press_releases/2015/CashCall%20Restitution%20Announcement%2011-18-15.asp).
23. Meek's Declaration ¶ 8 at 2-3. The loans also had a \$75 origination fee, so the 96% interest rate loan had an APR over 99% and the 135% rate loan had an APR over 138%. *De La Torre v. CashCall*, 56 F.Supp.3d 1073, 1085 (N.D. Cal. 2014), *rev'd on reconsideration*, 56 F. Supp.3d 1105 (N.D. Cal. 2014) (finding that whether high-rate loans were unconscionable is a question for the legislature). The parties and witnesses in the litigation referred to the loans by interest rate, not APR, so we have done so as well to avoid confusion.
24. *Id.* With the \$75 origination fee, the 135% rate loan has an APR over 138%. *See* <https://www.cashcall.com/rates> (select California and \$2,600).
25. Expert Report of Bruce McFarlane, Litinomics ¶¶ 76-81 at 24-27, Exhibit D to Declaration of Brad W. Seiling, *De La Torre v. CashCall*, No. 3:08-cv-03174-MEJ (N.D. Cal. filed Oct. 17, 2013)

(citing deposition of Delbert Meeks, CashCall's Chief Financial Officer) ("McFarlane CashCall Report").

26. In addition to collecting late fees, CashCall used the "daily accrual" method of calculating interest, which means that additional interest is charged at the contract rate for each day that a payment is late.
27. McFarlane CashCall Report ¶ 81 at 27. A graph from the McFarlane report illustrating this point is reproduced in Appendix 3.
28. Meeks Declaration ¶ 16 at 4.
29. Meeks Declaration ¶ 16 at 4.
30. McFarlane CashCall Report ¶ 81 at 26-27.
31. Meeks Declaration ¶ 23 at 6. CashCall initially decreased the term to 36 months.
32. McFarlane CashCall Report ¶ 95-at 35-37; Meeks Declaration ¶ 8 at 2-3.
33. McFarlane CashCall Report ¶ 95 at 36; *see also id.* at 36 n.88 (quoting CashCall Chief Financial Officer Delbert Meeks acknowledging that with an increase in the interest rate and in the payment, the default rate would be higher).
34. McFarlane CashCall Report ¶ 81 at 27. *See also id.* at 26 n. 57 (quoting CashCall's CFO Meeks as saying "You really haven't broken even until you are at month 14, 15.")
35. *De La Torre v. CashCall*, 56 F. Supp. 3d at 1083.
36. 36 Expert Report of Margot Saunders at 14, Attachment 2 to Declaration of Arthur D. Levy in Support of Response to Motion for Summary Judgment on Unconscionability Claim filed by Eduardo De La Torre, Lori Saysourivong, *De La Torre v. CashCall, Inc.*, Case # 3:08-cv-03174-MEJ (N.D. Cal. filed Oct. 21, 2013).
37. *De La Torre v. CashCall*, 56 F. Supp. 3d at 1083.
38. Meeks Declaration ¶ 34 at 8. CashCall claimed that it would have preferred a lower default rate and was merely making assumptions based on past performance. *Id.* But it created a profitability model that aimed at that default rate. *Id.* Given the company's knowledge of past performance, and its data on the impact of looser underwriting standards and higher interest rates on default rates, it could have made changes if it had wanted to lower the default rate.
39. Margot Saunders CashCall Report at 21 (quoting Meeks Deposition as saying "if prepayment speed goes up, interest income goes down. If default rates go up, normally prepayments rate goes down.").
40. *Id.*
41. *Id.* at 20-21 (citing Meeks Deposition).
42. *Id.* at 20 (citing Meeks Deposition).
43. *De La Torre v. CashCall*, 56 F.Supp.3d at 1081. On average, the monthly payment was 6.9% of the borrower's total monthly income and 11.5% of the borrower's residual income. Decl. of Brad W. Seiling in support of CashCall, Inc.'s Motion for Summary judgment on the Unconscionability Claim, *De La Torre v. CashCall* ¶ 64 at 23 (filed Oct. 17, 2013). Payments of that size might have been manageable for a few months, but they were not affordable over the long haul for many borrowers.
44. Many of these loans have shorter terms, reducing servicing expenses and cost of funds. These lenders may not have been involved in as many private and public enforcement actions as CashCall has, with the resulting litigation costs. And while the default rates for these lenders are high (as discussed in the next section), they are not as sky high as CashCall's, so collection costs are likely reduced. In addition, some of the lenders may have more efficient business models than CashCall does.
45. *See* <https://www.risecredit.com/how-online-loans-work#WhatItCosts> (select Alabama).
46. *See* <http://www.cashcentral.com/Terms/Missouri>.

47. See <https://www.advanceamerica.net/apply-for-a-loan>; [https://www.checkngo.com/wp-content/themes/cng/assets/stateDisclosures/California\\_ILP/schedcharges\\_\\_ILP\\_\\_CA\\_\\_online\\_.jpg](https://www.checkngo.com/wp-content/themes/cng/assets/stateDisclosures/California_ILP/schedcharges__ILP__CA__online_.jpg); <https://www.shoresideloans.com/loan-rates-and-fees/>; <https://www.speedycash.com/rates-and-terms/missouri/> (assuming a 39 week term on a \$1,500 loan).
48. Oportun's loans generally bear interest at about 36% and have an origination fee that ranges from \$35 on smaller loans to \$90 on larger loans. Source: Oportun. Insikt is a white label loan origination platform (i.e., it originates and underwrites the loans for other companies that market and brand the loans). Its loans bear interest of 34% to 36% with an administrative fee of 5-7% of the loan amount. Insikt CFPB Memo at 2.
49. See [https://media.acecash.com/~media/files/products/installment/internet/rates/nm\\_feeschedule.ashx](https://media.acecash.com/~media/files/products/installment/internet/rates/nm_feeschedule.ashx); <https://www.advanceamerica.net/apply-for-a-loan> (select a store in South Dakota and Installment Loan); <https://www.cashnetusa.com/rates-and-terms.html> (select Ohio and CSO Brokered Installment Loan); <https://www.speedycash.com/content/pdf/store-price-disclosures/2015/illinois.pdf>. The price shown is for loans with recurring payment authorization. Rates may be higher without payment authorization.
50. See <https://www.speedycash.com/rates-and-terms/missouri/>.
51. The CFPB found that borrowers who refinance are no less likely to be delinquent on their loans in the periods leading up to the refinancing than are those who repay in full without refinancing. The CFPB concluded from this that borrowers did not refinance because they were having difficulty making loan payments. See CFPB, Supplemental Findings on Payday, Payday Installment, and Vehicle Title Loans, and Deposit Advance Products at 16 (June 2016), <http://www.consumerfinance.gov/data-research/research-reports/supplemental-findings-payday-payday-installment-and-vehicle-title-loans-and-deposit-advance-products/> ("CFPB Payday Supp. Findings"). However, lenders often contact borrowers before payments are due to remind them of the payment, and the lender may offer a refinancing at that time. In addition, the CFPB did not evaluate whether borrowers who refinance ultimately are more likely to default. Moreover, the lender's ability to seize repayment from the borrower's bank account masks the struggles of all borrowers who repay their loans without defaulting, whether they refinance or not.
52. See Appendix 2 for a graph illustrating the way that loan flipping can add to the cost of the loan.
53. CFPB Payday Supp. Findings at 15.
54. In contrast to a mortgage, this is not true equity. With a mortgage, the consumer actually owns the value of the home equity. With a payday installment loan, the "equity" is simply the amount of debt that the consumer no longer owes.
55. CFPB Payday Supp. Findings at 19-20.
56. See <https://www.risecredit.com/how-online-loans-work#WhatItCosts> (select Texas); <https://www.advanceamerica.net/apply-for-a-loan> (select South Dakota and Installment Loans); [https://media.acecash.com/~media/files/products/installment/internet/rates/ca\\_feeschedule.ashx](https://media.acecash.com/~media/files/products/installment/internet/rates/ca_feeschedule.ashx); <https://www.cashnetusa.com/rates-and-terms.html> (select Ohio and CSO Brokered Installment Loan). The price shown is for loans with recurring payment authorization. Rates may be higher without payment authorization.
57. While refinancing a loan early in the term may add somewhat to the lender's expenses, it is unlikely to increase them substantially relative to the extra payments received. The lender has no costs of marketing/acquisition for the refinance, the consumer is already in the system, and additional underwriting expenses are likely to be minimal. Thus, the longer, renewed term is likely to increase the length of the period after the loan crosses the profit point during which a struggling consumer is at risk of defaulting.

58. One sample script says, “By the way, Tracy, with your scheduled payment, you could qualify for a cash amount of \$\_\_\_[amount].” Cottonwood Financial, LTD, New Hire Instructor Guide-Tex, Handling Customers, Part 1 at 7 (2013) (“Cottonwood New Hire Guide”).
59. *Id.* at 2.
60. Cottonwood New Hire Guide, Handling Customers at 17.
61. *Id.* at 17.
62. Cottonwood New Hire Guide, Collection Transactions at 6.
63. Cottonwood New Hire Guide, Collections at 12.
64. Cottonwood New Hire Guide, Collections at 11.
65. The loan terms are based on an actual loan to a consumer in Texas. Documentation is on file with NCLC. The loan flipping scenario is theoretical.
66. After six payments, the consumer has paid \$1,473.06, just \$27 shy of 150%. After seven payments of \$245.51, the consumer has paid 172% of the original loan amount.
67. As with our other examples, we are generously assuming that the lender’s costs amount to 50% of the amount loaned, so it reaches the profit point once the consumer has paid 150% of the amount loaned. We have included the additional cash advances in calculating the 150% point on the refinanced loan.
68. See CFPB Payday NPR at 1154-55 (proposed § 12 C.F.R. § 1041.10(c)(1)).
69. See CFPB Payday NPR at 1155 (proposed § 12 C.F.R. § 1041.10(c)(2)).
70. CFPB Payday Supp. Findings at 11-12.
71. Bureau of Consumer Financial Protection, 12 CFR Part 1041, [Docket No. CFPB-2016-0025], RIN 3170-AA40, Payday, Vehicle Title, and Certain High-Cost Installment Loans, Proposed Rule with Request for Public Comment at 465-66 (June 2, 2016) (“CFPB Payday NPR”), [http://files.consumerfinance.gov/f/documents/Rulemaking\\_Payday\\_Vehicle\\_Title\\_Certain\\_High-Cost\\_Installment\\_Loans.pdf](http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf). The CFPB defined “leveraged payment mechanisms” to include automatic electronic payments, payroll deduction plans, and other mechanisms that enable the lender to automatically deduct the payment from the borrower’s account or paycheck.
72. Howard Beales & Anand Goel, *Small Dollar Installment Loans: An Empirical Analysis*, at 24-25 (2015), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2581667](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2581667).
73. CFPB Payday NPR at 466.
74. See CFPB Payday Supp. Findings at 28. The CFPB’s study does not list the specific default rates. The 35% figure cited was approximated from looking at the CFPB’s chart.
75. CFPB Payday Supp. Findings at 30 (Figure 11).
76. CFPB Payday Supp. Findings at 25 (Figure 6).
77. CFPB Payday NPR at 466.
78. We are generally using the term “default rate” to refer to per loan, per sequence or per consumer rates, and the term “charge-off” rate to refer to rates that are calculated as a percentage of loan balances outstanding. Charge-off rates are not identical to default rates although they tend to be close (as can be seen in Charts 21 and 22 in the next section). Charge-off rates could be higher and more accurate than loan-level default rates because they do not double-count loans that are refinanced. However, charge-off rates can also be lower than consumer-level default rates because lenders often recover part of the loan before it defaults.
79. Averaging the nationally, seasonally adjusted charge-off rates for each of the four quarters in 2014, the national credit card charge-off rate was 3.16%. Board of Governors of the Federal Reserve System, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, available at <http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm>.
80. *Id.* (second quarter of 2010).

81. CFPB Payday NPR at 671, n.765 (citing ICBA Letter Oct. 6, 2015).
82. *Id.* (citing ABA Letter Dec. 1, 2015).
83. CFPB Payday NPR at 617-18.
84. We have omitted lenders who did not report any charge-offs (likely an error), those that reported a low volume of loans in 2014, and those that had other anomalies that made their data questionable or difficult to interpret.
85. For example, if two consumers each take out a loan and refinance the loan once, and one consumer ultimately defaults, this method would show the default rate as 25% rather than 50%. This method also leaves out loans that were originated or refinanced in 2014 but are charged off the next year, although it includes loans that were originated in a prior year but charged off in 2014. Ideally, those two groups will balance each other out, but changes in yearly loan volume could make the default rate artificially high or low.
86. The defaults could also include loans that were originated in 2013 or earlier, but they also exclude loans that are outstanding on December 31, 2014 but default later.
87. With origination fees included, the APRs are somewhat higher than 36% but still considerably lower than those charged by payday installment lenders.
88. We have not included Insikt in this analysis because it was just getting started in 2014 and reported only 35 unsecured loans in California that year.
89. The California reports list the loans by size and APR range, but the top range is simply “over 100%.”
90. Unlike the other lenders, Rise had dramatically more loans that were originated or refinanced in 2014 (42,369) than the number of loans that were outstanding at the end of either 2013 (8,515) or 2014 (16,229). Rise had 12,292 defaults. Rise either had a lot of refinances or it had a lot of borrowers who took out loans after December 31, 2013 and paid them off before December 31, 2014 (so that the loans are not reflected in the numbers for either year-end 2013 or year-end 2014 outstanding loans). High refinancing seems more likely for two reasons. First, Rise reported an average loan term of 18 months, and thus most loans originated in 2014 would likely still be outstanding at the end of 2014 unless they were refinanced. Second, the CFPB calculated a 2014 national charge-off rate (as a percent of outstanding balances) for Elevate of 50%, *see* CFPB Payday NPR at 81 & n.246, which would not be possible if a large number of Rise loans were successfully paid off early. (Rise made up about 85% of Elevate’s national portfolio in 2015. *See* Elevate Credit, Inc. SEC Form S-1 at 122 (filed Nov. 9, 2015), [http://www.sec.gov/Archives/edgar/data/1651094/000119312515371673/d83122ds1.htm#toc83122\\_4](http://www.sec.gov/Archives/edgar/data/1651094/000119312515371673/d83122ds1.htm#toc83122_4).)
91. *See* CFPB Payday NPR at 81 & n.246.
92. Late payment rates can be accurately calculated from the California reports because the reports include both the total number of loans outstanding and the loans that are 30 or more days late as of December 31, 2014. Thus, both the numerator and denominator are based on the same group of loans.
93. We have used the default rate based on the number of loans that were originated or refinanced in 2014, which double-counts loans that are financed (thus lowering the per-consumer default rate).
94. Under federal law, a lender may not require a borrower to repay a loan by preauthorized electronic fund transfers. 15 U.S.C. § 1693(k); Reg. E, 12 C.F.R. § 1005.10(e)(1); Reg. E, Official Interpretations § 1005.10(e) [§ 205.10(e)]. Lenders use various devices to get around this prohibition. They may delay disbursement of the loan unless the consumer agrees to electronic payments, design the loan application to make it look required, or make electronic payments the default option, or impose hurdles to elect any other method.

95. CFPB, Online Payday Loan Payments at 4 (April 2016), *available at* [http://files.consumerfinance.gov/f/201604\\_cfpb\\_online-payday-loan-payments.pdf](http://files.consumerfinance.gov/f/201604_cfpb_online-payday-loan-payments.pdf).
96. *Id.* at 12.
97. Susanna Montezemolo & Sarah Wolff, Center for Responsible Lending, *Payday Mayday: Visible and Invisible Payday Lending Defaults* (March 2015), *available at* [http://www.responsiblelending.org/payday-lending/research-analysis/finalpaydaymayday\\_defaults.pdf](http://www.responsiblelending.org/payday-lending/research-analysis/finalpaydaymayday_defaults.pdf).
98. Elevate Credit, Inc., Amendment No. 3 to SEC Form S-1 at 80 (filed June 3, 2016) (emphasis added), [https://www.sec.gov/Archives/edgar/data/1651094/000119312516612826/d83122ds1a.htm#toc83122\\_3](https://www.sec.gov/Archives/edgar/data/1651094/000119312516612826/d83122ds1a.htm#toc83122_3). The filing revealed that Elevate's net charge-offs as a percentage of revenues are historically between of 43% and 53%. *Id.* at 81. The revenues and charge-offs reflect Elevate's entire portfolio, but the Rise installment loans were 76% of the outstanding balances at year end 2015. *Id.* at 98.
99. West Virginia *ex rel.* McGraw v. CashCall, Inc. et al., Final Order on Phase I of Trial: The State's Debt Collection Claims, Sept. 10, 2012, at ¶¶ 24 (number of calls), 49 (number of consumers), *available at* [http://www.nclc.org/images/pdf/unreported/cashcall\\_phase\\_I\\_debt\\_collection\\_decision.pdf](http://www.nclc.org/images/pdf/unreported/cashcall_phase_I_debt_collection_decision.pdf).
100. Wage garnishment is available as a means of enforcing a judgment for a consumer credit debt in all but four states. There are protections against garnishment for some multiples of the minimum wage, starting with the federal Consumer Credit Protection Act (which protects the lesser of seventy-five percent of weekly wages or thirty times the minimum wage per week), depending on the state. *See* National Consumer Law Center, Collection Actions § 12.4.3 (2nd Ed. 2011); National Consumer Law Center, *No Fresh Start: How States Allow Debt Collectors to Push Families into Poverty* (Oct. 2013), *available at* <http://www.nclc.org/issues/no-fresh-start.html>
101. *Id.*
102. *See* National Consumer Law Center, Collection Actions §§ 12.10, 12.11 (2d ed. 2011 and Supp.) (imprisonment for debt; debtor's examinations).
103. Caroline Ratcliffe et al., Urban Institute. Delinquent Debt in America at 7 (July 30, 2014), <http://www.urban.org/sites/default/files/alfresco/publication-pdfs/413191-Delinquent-Debt-in-America.PDF>.
104. *See* Lauren Saunders, National Consumer Law Center, *Why 36%? The History, Use and Purpose of the 36% Interest Rate Cap* (April 2013), *available at* <http://www.nclc.org/images/pdf/pr-reports/why36pct.pdf>; Carolyn Carter et al., National Consumer Law Center, *Installment Loans: Will States Protect Borrowers From a New Wave of Predatory Lending?* at vi (July 2015) ("States almost always impose lower rate caps for larger loans, which is appropriate. Rate caps are often structured based on tiers of credit. For example, Iowa's Regulated Loan Act caps interest at 36% on the first \$1,000, 24% on the next \$1800, and 18% on the remainder."), *available at* <http://www.nclc.org/issues/installment-loans.html>
105. CFPB Payday NPR at 646-51, 657.



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