Commentary:

The Pew Charitable Trusts Report

Fraud and Abuse Online:

Harmful Practices in Internet Payday Lending

November, 2014

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About the Author

G. Michael Flores is CEO of Bretton Woods, Inc. (www.bretton-woods.com) and is a researcher and business adviser who has studied financial services companies and consumer credit in general for over 30 years, with a particular focus on "alternative" credit programs for the last 10 years. Since 1995 he has been actively involved in advising banks seeking to establish their overdraft programs. He has written and published research papers on consumer credit in the United States and the United Kingdom, as well as papers on payments, including general-purpose reloadable and payroll prepaid cards. Based on these studies, he has testified before several House and Senate subcommittees and spoken to industry groups. He has also authored articles for industry publications. He is a faculty member with Pacific Coast Banking School at the University of Washington in Seattle.

Introduction

The Pew Charitable Trusts' fourth report on payday lending released in October, 2014 focusses on online lending.[1] This report is based on survey results of interviews and focus groups of individuals who responded to questions based on their recollection of their use of online loans. Bretton Woods appreciates the work of The Pew Charitable Trusts and other researchers in this most important field of understanding the short-term, small dollar credit needs of individuals.

Bretton Woods has studied payday lending for the last ten years and earlier in this year, released an in depth analysis of 60 million application and 10.6 million loan records of online payday loans. This was the first extensive analysis of online customers which was sponsored by the Online Lenders Alliance (OLA).

This paper is intended to comment on the findings of the Pew report and discuss areas of agreement as well as areas we suggest need further analysis. We believe it is very important to provide a scale from which to measure these reported abusive activities. A relatively small number of companies provide the majority of online loans. To highlight the practices of some "bad actors" without framing the discussion that they may impact a very small percent of the online loan customers is unfair to the legitimate companies providing a legal product.

We continue to express concerns that any legislation and regulation must be based on data and the potential unintended consequences of restricting credit to this most vulnerable group of individuals.

[1] See Nick Bourke, Alex Horowitz, Walter Lake and Tara Roche, Pew Charitable Trusts, *Fraud and Abuse Online: Harmful Practices in Internet Payday Lending*, Page 8, October 2014 (hereinafter, "Pew Report").

Analysis

Bretton Woods estimates the size of the market for online payday loans to be close to 12 million unique customers, derived as follows:

- Annual dollar volume = $18.6 billion [2]
- Median loan size = $388[3]
- Median loans per customer = 4[4]
- Calculation: $18.6 billion/$388/4 = 11,984,536

The survey on which the Pew report is based started with 49,684 people that had been screened for usage of storefront payday loans, online payday loans, and auto and title loans. From this, 252 adults completed a full length online payday loan survey. The Pew analysis is based on the recollections of the survey responders. These recollections have not been validated with third-party data, such as from the responder's bank, lead generators, lenders, collectors or credit bureaus.

BBB complaint data are unhelpful: of 3600 complaints, 1200 were related to a single lender, and no other lender had more than 150 complaints.[5]

[2] Center for Financial Services Innovation, *2012 Financially Underserved Market Size Study,* December 2013. Retrieved from http://www.cfsinnovation.com/system/files/RES_2012%20Market%20Size%20Knowledge-Brief-Dec2013%20%281%29_0.pdf.

[3] G. Michael Flores, Bretton Woods, Inc., *Online Short-term Lender, Statistical Analysis Report*, produced for the Online Lenders Alliance, February 2014. Retrieved from http://bretton-woods.com/media/a28fa8e9a85dce6fffff81bbffffd502.pdf.

[4] Ibid.

[5] *Pew Report*, supra note 1, at 18.

Areas of Agreement

Pew recognizes the need for strong, clear federal guidelines for the small dollar lending market. Bretton Woods has written a report[6] that supports a national charter for small dollar loans in order to provide a level playing field and access to quality lenders on a national scale.

The report also understands that extensive underwriting is in place given that up to 85% of all applications are rejected and that the major costs of online loans are the credit and fraud losses experienced by the lenders. Finally, we agree with Pew that the demographic characteristics of online borrowers who are more highly educated with higher incomes than storefront borrowers.

Areas Requiring Clarification

<u>Sourcing</u>

As in any analysis of this type, it is necessary to be backward looking and given the availability of data, conclusions may not coincide with current practices. That said we believe the report's findings are dated since the survey was conducted between August 2011 and April 2012, and the only focus groups consisting of only online borrowers were conducted in September 2011.[7] As a result the survey and focus group testing relied largely upon consumers who were describing business practices that date from 2011 or earlier. Industry practices have changed fairly dramatically, however, particularly with respect to lenders that automatically renew outstanding loans and debit only a finance charge but no principal. Following a series of FTC enforcement actions in 2011 and 2012, we believe that most industry participants no longer engage in this practice.[8] For example, Pew cites to the inactive websites of one of the defendants

[6] See http://bretton-woods.com/media/2a7e1935be98b894ffff8004ffffd523.pdf

[7] Subsequent focus groups were conducted in May, 2014 in St. Louis and Houston, but these focus groups included both online and storefront borrowers, and the Pew Report does not disclose the number of online borrowers participating in these studies.

[8] *FTC v. Payday Financial*, complaint filed Sept. 6, 2011, available at http://www.ftc.gov/sites/default/files/documents/cases/2011/09/110912paydaycmpt.pdf; *FTC v. AMG Services*, complaint filed April 2, 2012, available at http://www.ftc.gov/sites/default/files/documents/cases/2012/04/120402amgcmpt.pdf.

in the FTC actions for the proposition that fee-only payments are the default, and consumers must make special arrangements if they wish to pay off principal, in addition to finance charges.[9]

Loans Designed to Promote Renewals

Pew reports that one in three online borrowers has taken out a loan that was set up to withdraw only the fee. Again this conclusion is based on anecdotal responses from a pre-2012 survey. While this may have been practice from some lenders in the past, following the FTC actions, it no longer appears to be a common practice among the lenders that represent the largest market share of online loans.

Threatening Collection Practices

It is reported that 30 percent of borrowers report being threatened by a lender or debt collector. The report states this as a problem while also admitting that *"Others reported receiving threats even when they were current on or had already repaid a loan. In those instances, federal data indicate that it is likely that many of the threats came from scam artists or fraudulent third-party debt collectors."* The report frequently draws the tenuous conclusions from the anecdotes of the participants. For example, on page 15, the study quote several anecdotes regarding "unauthorized withdrawals," implying that these withdrawals were made by online lenders, when in fact in every case the withdrawals were clearly made by non-lender scammers (e.g., advance fees, membership clubs, payment protection).

We believe that a more thorough analysis to better quantify actual abusive practices from fraudulent actions should be undertaken before leaving the impression that the industry is rife with these unconscionable acts.

[9] *Pew Report*, supra note 1, at 8.

Lead Generators

The report also makes thinly sourced assertions against lead generators. It implies that all lead generators sell leads multiple times and relies on speculation for the proposition that lead generators routinely sell information without consumer permission. The survey results indicate that 39% of borrowers *"believe that their personal or financial information was sold to a third-party without their knowledge"*. This begs the question, how do the respondents believe this if indeed, it was without their knowledge.

Pew Policy Recommendations

The specific policy recommendations by Pew are reviewed and comments for each are listened below:

Ensure that the borrower has the ability to repay the loan as structured.

Pew's research indicates that for most borrowers, monthly payments above 5 percent of gross monthly income are unaffordable. Regulators should treat frequent refinancing or high default rates as evidence of unaffordability and poor underwriting.

- Bretton Woods agrees to this basic credit principle of ability to repay. However, the 5 percent number as a hard limit would unnecessarily limit a lender's ability to consider other variables in underwriting an individual request.

Spread loan costs evenly over the life of the loan.

Front-loading of fees and interest creates incentives for lenders to refinance loans and extend overall indebtedness. Any fees should be paid evenly over the life of the loan. Loans should have substantially equal payments, each of which reduces the principal, amortizing smoothly to a zero balance.

- This is an effective argument for add-on loans based on the Rule of 78 where early payments are primarily allocated to interest.

Guard against harmful repayment or collections practices.
Borrowers need stronger rights to protect their checking accounts against unscrupulous lenders or debt collectors, and banks should be held more accountable for honoring their customers' requests to stop payments or cancel automatic electronic withdrawals.

- This is too broad a statement. Enforcement against fraudulent practices is a given, but care should be taken not to usurp the lenders contractual rights to receive payment.

Require concise disclosures of periodic and total costs.

- Agreed and appropriate.

Continue to set maximum allowable charges.

Research shows loan markets serving those with poor credit histories are not price competitive.

- We do not agree with this policy recommendation. Price controls never work as supported by years of academic literature[10]. Examples include the movement of credit card companies to selective states from states with usury caps in the 1970's and 1980's. The Nixon era wage and price controls were an abysmal failure and were a precursor to the rampant inflation of the 1970's. Markets are continually evolving as shown in peer-to-peer lending entities entering the marketplace and the movement from the single-pay payday loan model to the installment loan model.

[10] Robert L. Schuettinger, Eamonn F. Butler, The Heritage Foundation, *Forty Centuries of Wage and Price Controls: How Not to Fight Inflation*, February 1979. Retrieved from https://mises.org/books/fortycenturies.pdf

Conclusion

A colleague of Bretton Woods, Professor Todd Zywicki co-authored, *"Consumer Credit and the American Economy"* a book that tracks consumer credit usage over the years and ties various demographic markers to the usage.[11] In particular, it is well-established in economic literature that use of credit, and particularly nontraditional and higher-cost consumer credit, follows a predictable lifecycle pattern.

Demand for consumer credit is highest early in a person's life, when they are beginning their adult lives, forming households, and starting families. At the same time, however, younger borrowers typically have fewer assets, lower incomes, and less-established credit histories than later in life, thus the *supply* of consumer credit is typically lower at the same time demand is highest. As consumers age and households mature, consumers begin to transform from net borrowers to net savers.

As a result, consumers frequently find themselves in a period of their lives of having their access to credit rationed at the same time that their demand for credit is highest. Thus, these same consumers are also more likely to exhaust available sources for standard credit (such as credit cards) and are more likely to rely on alternative credit products such as payday lending, pawn shops, and overdraft protection which does not require traditional credit qualification in most programs.

The likely unintended consequence of restricting access to payday loans is again clear and predictable. The demand is not satiated and the supply of credit is limited, the cost to the consumer rises.[12]

For example, research has found that consumers generally appear to choose rationally in deciding whether to use overdraft protection or payday lending to cover a particular payment.[13]

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[11] *See* Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy* at Chapter 8 (2014).
[12] *See* Robert L. Clarke and Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 REV. OF BANKING AND FIN LAW 235 (2013-2014).
[13] Donald P. Morgan, Michael R. Strain, and Ihab Seblani, "How Payday Credit Access Affects Overdrafts and Other Outcomes," *Journal of Money, Credit, & Banking* 44 (2012): 519–31.

One must also consider the full costs of alternatives, such as the time cost of delaying purchases or payments (i.e., inability to get a car repaired, being late paying rent, forgoing purchases of necessities, etc.).

Payday lending can be less expensive than overdrafts for many transactions. Similarly, pawn shops by definition require the borrower to part with valuable personal goods and to bear the time and inconvenience of transporting those goods to the store. Understanding the role played by these *non-financial* elements of the full cost of alternative sources of credit is essential to understanding how consumers use different types of consumer credit and to understand the implications of reducing access to short-term loans.

We hope Pew, as it continues its analyses of short-term credit, accounts for welfare enhancing effects of the product in addition to highlighting the poor practices of outlier lenders. Finally, we want to stress again that framing the arguments, made in the Pew reports, to the size of the market would greatly add to understanding how many customers are truly negatively impacted.