CALIFORNIA DEFERRED DEPOSIT TRANSACTION LAW

Assembly Committee on Banking & Finance

March 4, 2013

Assemblymember Roger Dickinson, Chair

Mark Farouk-Chief Consultant
Kathleen O'Malley-Senior Consultant
Tiffany Morrison-Committee Secretary

PAYDAY LENDING IN CALIFORNIA: BY THE NUMBERS

The *2011 Annual Report, Operation of Deferred Deposit Originators Under the California Deferred Deposit Transaction Law,* offers some updated statistics on the California payday lending market for 2011.

1) Total dollar amount of transactions: $3,279,629,497

2) Total number of transactions: 12,427,810

3) Individual customers who obtained payday loan: 1,738,219

4) Average annual percentage rate: 411%

5) Average dollar amount of transaction made: $263

6) Total number of returned checks for deferred deposit transactions: 931,387

7) Total dollar amount of returned checks: $246,769,462

8) Total number of returned checks recovered (including partial recoveries): 642,069

9) Total dollar amount of returned checks recovered: $160,480,858

10) Total number of checks charged-off: 280,233

11) Total dollar amount charged-off: $72,367,689

Chart 1
Change in Number of Licensed Locations

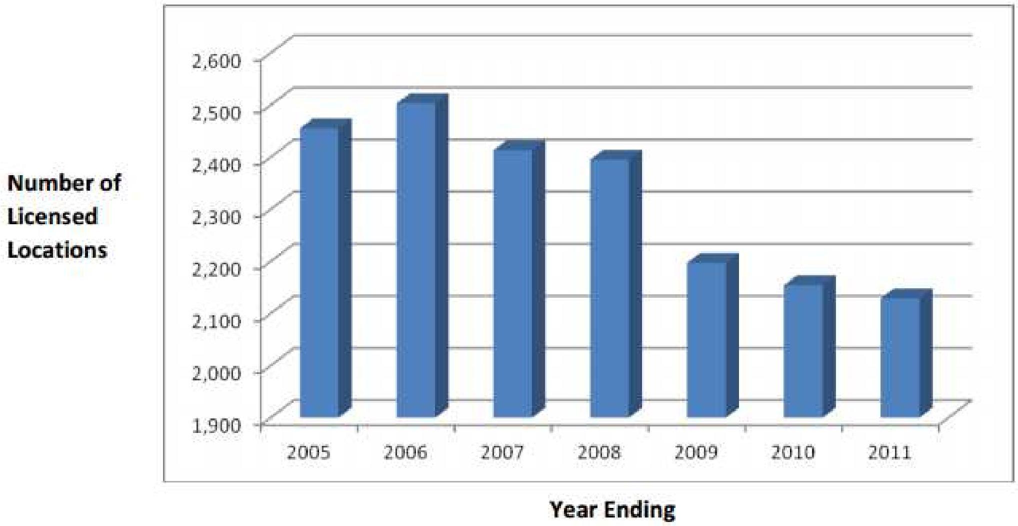


Chart 2
Change in Dollar Amount of Deferred Deposits Made

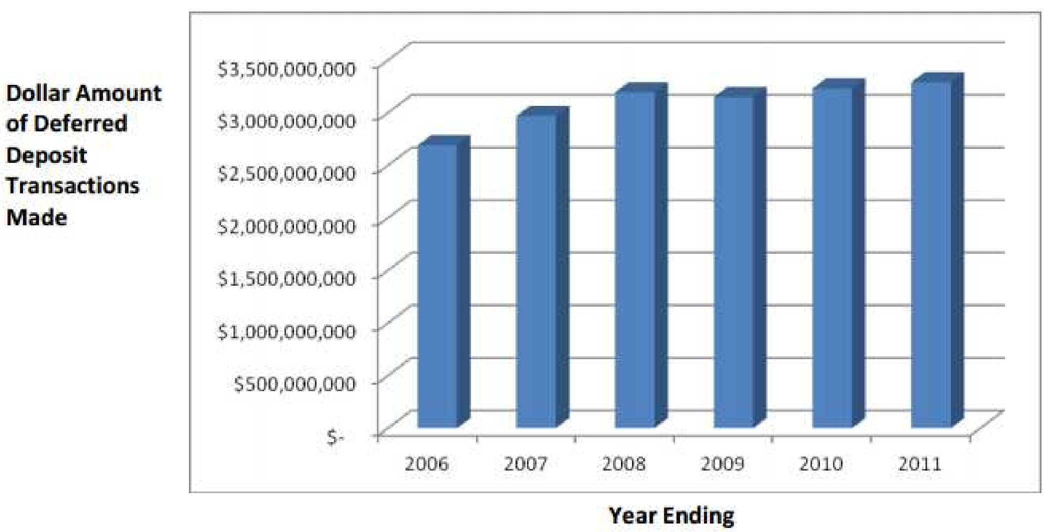


Chart 3
Change in Number of Deferred Deposits Made

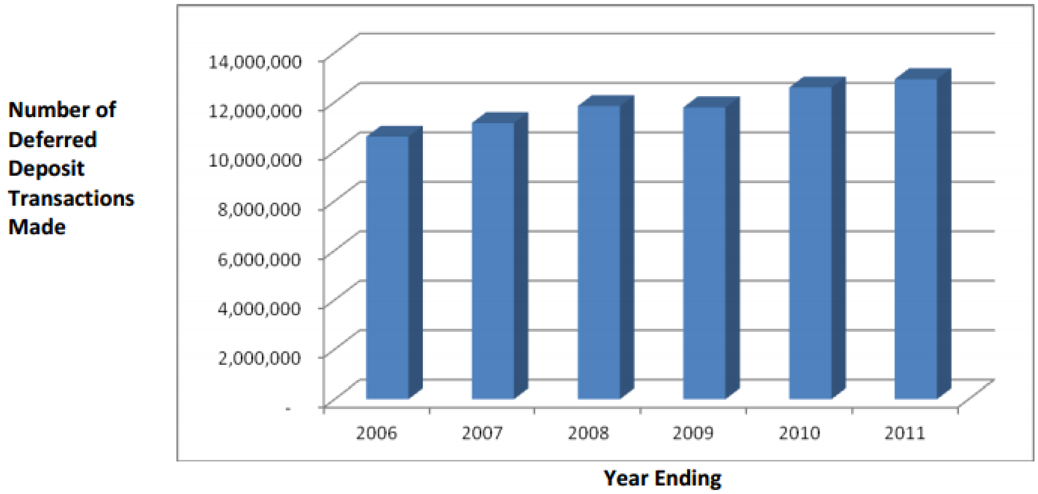
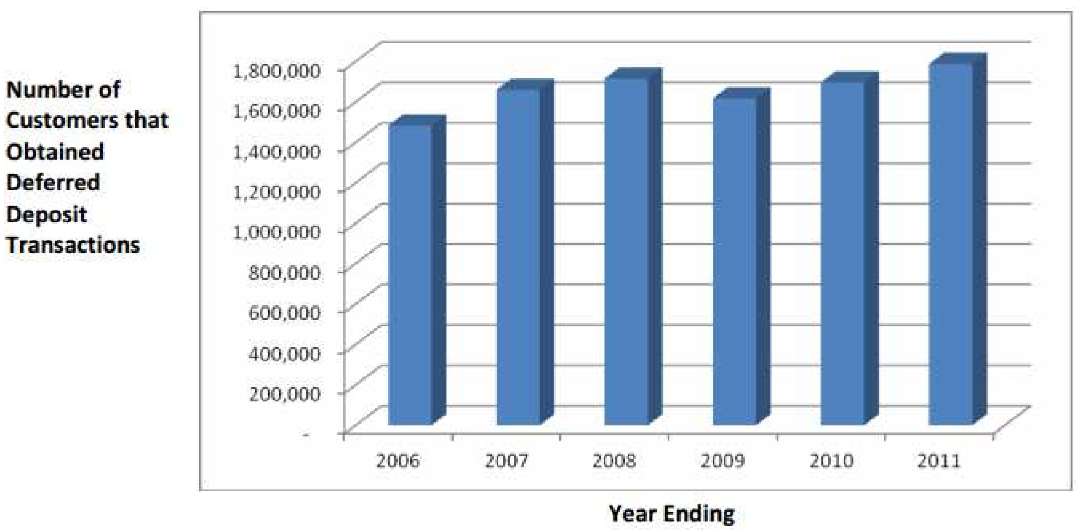


Chart 4
Change in Number of Customers that Obtained Deferred Deposit Transactions



OVERVIEW

A payday loan, known more formally in California as a deferred deposit transaction (DDT), is a short-term loan in which a borrower writes a post-dated, personal check to a lender for a specified amount, which is capped by state law. The payday lender advances the borrower the amount on the check, less the fee, which is also capped by law. The payday lender does not cash the check at the time the loan is made. Both parties are aware that the borrower lacks sufficient funds to cover the check when the check is written. The assumption underlying the loan is that the borrower will repay the loan by the agreed-upon date, either by depositing sufficient funds in his or her checking account to cover the check, or by paying the payday lender in cash on the loan's due date, and having the lender return the original check to the borrower, without cashing it.

Under the California Deferred Deposit Transaction Law (DDTL), any payday lender who makes a payday loan must be licensed. Each licensee may defer the deposit of a customer's personal check for up to 31 days. The face amount of the check presented by a borrower may not exceed $300, and the fee charged by the licensee may not exceed 15% of the face amount of the check ($45 on a $300 check). This statutorily capped fee must be expressed to borrowers in the form of an Annual Percentage Rate (APR). Given the short-term nature of payday loans (average is 17 days) the average APR is 411%. However, while the APR is high on a short-term product, the dollar costs of the fee does not to exceed 15% of the face amount of the check.

Licensees may charge one non-sufficient funds fee, capped at $15, for checks that are returned by a customer's financial institution. In addition, licensees may not directly or indirectly charge any additional fees in conjunction with a payday loan. Licensees may not enter into a payday loan with a customer who already has a payday loan outstanding and may not allow a customer to use one loan to pay off another. Licensees are also forbidden from accepting any collateral for a payday loan or making any payday loan contingent on the purchase of any goods or services. Each payday loan must be made pursuant to a written agreement. Licensees must clearly post their fees and charges at their business locations.

In the early 1990s, check cashers operated in what could only be termed as a legal gray area as they cashed checks from consumers for a fee (ranging from 10-20%) in which the check might be deposited immediately or held for 14 days. The reasoning behind this practice was the belief that sections of the California Commercial Code concerning the use of checks was the governing body of law for these transactions. These transactions did not involve loan agreements or loan disclosures and the fees were generally the same regardless of the length of time the check was held by the check casher. However, subsequent discussions and opinions led to the creation of clear statutory authority for offering payday loans via SB 1959, (Calderon, Chapter 682, Statutes of 1996). SB 1959 permitted check cashers to defer deposit on payday loans made by the check casher. These transactions were originally regulated by the State Department of Justice. SB 898 (Perata, Chapter 777, Statutes of 2002), shifted the responsibility for administering payday lending from the California Department of Justice to the Department of Corporations (DOC).

Payday loan customers are underbanked, but not unbanked because the transaction requires that the borrower have a checking account. The debate over the appropriateness of the payday loan product has been the subject of numerous bills appearing before this legislature since the first statute authorizing the product. Consumer organizations highlight that payday loans are a "debt trap" meaning that the borrower gets stuck in a cycle of debt leading to further deficits in personal income. For example, if the borrower doesn't have $300 today for expenses then will the borrower have the extra money after paying their regular bills, to pay back the loan in two weeks when the loan comes due? In many cases, the borrower simply takes out additional loans, back-to-back, in an attempt to make up the income deficit. As will be discussed later, many payday borrowers take out numerous loans throughout the year. The other side of this debate is that payday loans are a necessary product for consumers to fill short term needs and pay emergency expenses. Additionally, some argue that it is a product is one of last resort for borrowers as they may have exhausted other options, or they may not have had options to begin with. Another factor is that a payday loan is convenient and relatively easy to obtain. This ease may also add to consumer demand for payday loans in that they may be easy to get and simple to understand.

As mentioned previously, much of the criticism of the payday product is that it creates a cycle of debt where a borrower uses the product back-to-back numerous times during the year. In this case a borrower may not be using the product for short term needs but to fill gaps in their actual income. The counter to this argument is that the actual economic conditions of the borrower may be creating the debt trap, or the short term expense was one that was not realized by the borrower in advance and has created an unfilled income deficit. Even if consensus could be achieved on these issues, the next hurdle is attempting to find consensus on potential solutions. The legislative history of this issue demonstrates the vast differences in approaching this problem. Many of these efforts are listed later in this background paper, but overall the themes of previous legislative attempts in this area have consisted of the following approaches:

- Cap the APR on payday loans to 36%.

- Increase the loan limit to $500.

- Create alternative loan programs under other lending laws. Example would be the Affordable Credit Building Opportunities Pilot under the California Finance Lenders

Law.

- Create a real time payday lending database.
- Regulate and restrict online payday loan advertisements.
- Provide borrowers with right to request and enter into an extended repayment plan.
- Require further study and reporting of payday lending by DOC.
- Provide enhanced enforcement and penalties.

Over the last decade as states across the nation have expanded or restricted payday lending the availability of research and data has increased. The latest in the series of research offerings are two reports from the Pew Charitable Trust, Safe Small Dollar Loans Research Project. These reports offer the latest findings from Pew's research in this field. The research, as with opinion on this issue, has had a tendency to vary. While certain themes are common (borrowers tend to take out multiple) loans, some researchers have drawn different conclusions, or have acknowledged the dangers of the payday product while realizing that it may be a "necessary evil." In order to sample snippets of the research available, the following are excerpts from various research papers and projects. (Committee staff encourages readers to read the body of research for themselves.)

- ❖ Operating costs for payday lenders are high relative to the size of the payday loan and these high costs offset much of the revenue generated from the loan (Elliehausen).
- ❖ Less than half of payday customers have savings or other types of liquid credit (Elliehausen).
- ❖ Fifty-four percent of payday borrowers have a bank credit card compared to 74.5% of the general population (Elliehausen).
- ❖ Most payday borrowers are aware of the finance charge but not the APR (Elliehausen).
- ❖ Lack of knowledge concerning payday loan alternatives may assist with a perception that options don't exist (Edmiston).
- ❖ Payday borrowers may be option limited due to the constraints of their credit ratings (Edminston).

- ❖ In reviewing small dollar credit (payday loans are included in this definition) researchers found that the top three loan attributes that mattered most were: quick access to money, ability to qualify, and clear terms (Levy & Sledge).

- ❖ Repeat loan usage has been correlated with the ratio of loan size to income, and that the need for credit came from a consistent shortfall of income relative to expenses (Levy & Sledge).

- ❖ Many borrowers report taking out several payday loans (8-14) per year. (The majority of research on the issue reports in the repeated use of the product).

- ❖ Research on states that have banned payday lending concludes a range of impacts, from increased use of unregulated online lending to other negative credit effects. Other studies and surveys have found consumer satisfaction that the product is gone, or a belief that the dangers of the product outweigh the benefits. Media reports suggest that online lending has increased in states with a ban, while the Pew research disputes this.

- ❖ The Pew research, mentioned earlier, provides the following:

    - o Twelve million American adults use payday loans annually. Nationally, on average, a borrower takes out eight loans of $375 each per year and spends $520 on interest.

    - o Most borrowers use payday loans to cover ordinary living expenses over the course of months, not unexpected emergencies over the course of weeks. The average borrower is indebted about five months of the year.

    - o If faced with a cash shortfall and payday loans were unavailable, 81% of borrowers say they would cut back on expenses. Many also would delay paying some bills, rely on friends and family, or sell personal possessions.

    - o In states that enact strong legal protections, the result is a large net decrease in payday loan usage; borrowers are not driven to seek payday loans online or from other sources. Fifty-eight percent of payday loan borrowers have trouble meeting monthly expenses at least half the time.

    - o The choice to use payday loans is largely driven by unrealistic expectations and by desperation. A majority of borrowers say payday loans take advantage of them, and a majority also say they provide relief. The appreciation for urgently needed cash and friendly service conflicts with borrowers' feelings of dismay about high costs and frustration with lengthy indebtedness.

    - o By almost a 3-to-1 margin, borrowers favor more regulation of payday loans. In addition, two out of three borrowers say there should be changes to how payday loans work. Despite these concerns, a majority would use the loans again. In a state where payday storefronts recently stopped operating, former borrowers are relieved that payday loans are gone and have not sought them elsewhere.

- 55% of borrowers surveyed believe that payday loans take advantage of borrowers, while 48% say the loans help more than hurt, with 8% reporting that the loans both help and hurt. Furthermore, 56% say the loans relieve stress and anxiety versus causing it.

- Six reasons people use payday loans:

  - Desperation, as more than a third of borrowers report that situation in which they were so desperate they would accept a loan on any terms offered.

  - Perception that payday loans do not cause ongoing debt.

  - Reliance on accurate information provided by the payday lender that the product is a two week loan.

  - Focus on fee, rather than how a lump sum repayment will affect their budget.

  - Trust that by some bank deposit borrowers that bank payday loans are safer than non-bank payday loans.

  - Temptation as some borrowers consider them to easy to obtain.

In 2008, DOC released two reports, "California Deferred Deposit Transaction Law, California Department of Corporations, December 2007" (DOC Report) and "2007 Department of Corporations Payday Loan Study" (AMPG study).

The DOC report was based upon a survey of payday lenders and DOC's annual report for 2005-06. The AMPG study was based on an online survey of payday lenders, a telephone survey of borrowers, and five customer focus groups. AMPG's study was conducted between August and December 2007, for the 18-month period between April 15, 2006 through September 11, 2007.

Both reports highlighted that, while a payday loan is intended to be a short-term, one-time loan to meet emergency financial needs, a large number of Californians use payday loans on a regular, on-going basis and find that establishing a payday loan account "opens the door to a repetitive cycle of borrowing that is difficult if not impossible to end" (AMPG study). The DOC report also found that 2.4% of payday loan borrowers took out more than one loan at the same time from multiple payday lenders.

The key findings from the DOC AMPG reports:

- Eighty four percent of licensees' business is attributable to repeat customers (only sixteen percent comes from customers who take out only one loan). Nineteen percent of licensees' business is attributable to customers who took out more than 15 loans during the 18-month period studied by AMPG.

- Forty one percent of licensees offer some type of bonus (either cash or gifts) to customers who refer new business to the licensees. Cash is much more common than other types of gifts. Of those who offer cash bonuses, nearly one half offer $10 or less, and just under one third offer between $20 and $25 (AMPG).

- Very few licensees accept personal checks for repayment (despite the fact that a post-dated check is required in order to obtain a payday loan). Customers commonly pay off their loans in cash. Nearly all payday lenders who do accept personal checks for repayment charge non-sufficient funds (NSF) fees for returned checks (DOC and AMPG).

- Fifty seven percent of licensees require customers to borrow at least $50. The majority of loans (63%) are between $200 and $255. Twenty payday lenders responded that the minimum amount they would lend was $255 (AMPG).

- Although payday lenders may charge up to $45 in loan fees to lend the maximum amount of $300, 14% of lenders charge less than $45 on $300 loans. The smallest amount charged on a $300 loan was $25, corresponding to a maximum loan amount of $275 (AMPG).

- To prevent the loss of revenue due to defaulted loans, most payday lenders (87%) offer arrangements in which borrowers are allowed to pay back loans at a reduced rate or based on an agreed-upon schedule. Payday lenders reported that about 20% of loans issued during the eighteen-month study period required some type of workout arrangement (AMPG). However, less than 1% of all payday loan customers entered into formal, written payment plan arrangements during 2006 (DOC).

- Customers who take out multiple loans in a year tend to do so in a consecutive fashion (with less than five days elapsing between paying the first one off and obtaining a second one).

- Nearly 450,000 borrowers had back-to-back time-frames of 6 loans or more (DOC).

- Of those borrowers who obtained more than one payday loan in the last eighteen months, 28% used multiple locations of the same payday lender; 72% used multiple payday lenders (AMPG).

- Borrowers were asked whether the amount borrowed was the amount needed or the most the lender would loan. When asked in this way, 63% of borrowers said they borrowed the amount needed; 32% said they would have borrowed more, but the lender wouldn't loan it; and only 3% said that the lender offered more than the borrower needed.

- When borrowers were asked where they obtained the rest of the money they needed if they could not obtain all they needed from the payday lender, 8% said they borrowed the money from family or friends, 8% said they did not get the rest of the money they needed, 5% waited until their next payday, 3% went to another payday lender, and less than 1% borrowed money from a bank.

- Thirty-six percent of borrowers indicated they had used more than one payday lender. When asked why, 73% said they needed more money than one location would loan them at one time, 12% said they needed more money before the loan with the first company could be paid off, and 11% said they used one loan to pay off another.

<u>Report Policy Options for Future Study</u>

1) Clarify and confirm that licensees cannot refer delinquent payday loans to a local prosecutor for collection of returned checks.

2) Enhance the regulation of electronic transactions.

3) Improve consumer disclosures by requiring that the notice provided to borrowers prior to entering into a payday loan agreement be a separate, distinct document from the written agreement; require the licensee to have the borrower initial a copy of the notice to acknowledge receipt; and require the licensee to retain a copy of the notice with the borrower's initials acknowledging receipt in the file.

4) Require applicants for a license and existing licensees to notify DOC of other business that would be or is being conducted at the licensed location.

5) Expand consumer protections for payday lending conducted over the Internet by requiring that notices and disclosures are provided to Internet borrowers, and that borrowers can download the agreement, notices, and disclosures. Alternately, if the borrower cannot download those documents, require the licensee to mail copies to the borrower within 24 hours.

6) Require that payment plans entered into between licensees and borrowers specify the payment dates and amounts of each payment, be in writing, and be signed by the borrower.

7) Require a written agreement signed by the borrower in order to extend the due date of a loan. Provide the licensee with an option to notify the borrower by mail of the approval to extend the due date of the loan, if the borrower elects not to sign the extension agreement. Like the recommendation above, this recommendation would help avoid misunderstandings between payday lenders and borrowers over repayment plan terms.

8) Require licensees to prominently disclose that borrowers have the right to request a written extension agreement and payment plan.

9) Require that specific language be used in payday loan advertising to disclose one's licensure by DOC, and require that all advertising disclosures be in the same language as the advertising itself.

10) Require (rather than authorize) the use of a specific chart to compare payday loan fees and related cost information. Existing law requires licensees to post a schedule of all charges and fees, as specified, and provides an example of one way in which the information may be presented.

11) Require license applicants to list each person in charge of a payday lending location, and require that person to submit fingerprint information and a historical profile through a Statement of Identify and Questionnaire (SIQ). Require the licensee to notify DOC within ten days of a change in the person responsible for the location, and to submit new fingerprint information and an SIQ for that person. Require each licensee to notify DOC at least 60 days prior to a change of its officers, directors, or any other persons named in the application.

12) Confirm DOC's jurisdictional nexus over payday lending activities by stating that a payday lender is subject to the CDDTL when it conducts deferred deposit transaction business "in this state."

13) Expand the grounds for barring, suspending, or censuring persons managing or controlling payday payday lenders, and for denying, suspending, or revoking licenses

14) Allow DOC to issue administrative orders to prevent unsafe and injurious practices, and make these orders effective within 30 days, if no hearing is requested by the person(s) accused. Allow DOC to suspend or revoke a license for failing to maintain a surety bond, as required by law, through more expedient administrative orders.

15) Increase the civil penalty for violating the payday loan law from $2,500 to $10,000 per violation. Allow administrative penalties of up to $2,500 per violation to be levied and collected through specified administrative hearing procedures.

16) Require the preparation and retention of accurate records and reports by licensees.

17) Authorize the Commissioner to subpoena all books and records of payday lenders.

18) Allow DOC to seek a court order to enforce any administrative decision awarding restitution, administrative penalties other than citations, and cost recovery, without having to file a civil suit and motion for summary judgment.

19) Provide that a citation is deemed final if the cited licensee fails to request a hearing within 30 days of receiving the citation. Allow DOC to issue a citation to assess an administrative penalty, not to exceed $2,500 per violation (rather than $2,500 per citation).

20) Streamline DOC's ability to void loans and order fees forfeited. Clarify that DOC has the authority to order the voiding of loans and the forfeiture of fees by administrative order, rather than by pursuing a civil suit.

21) Change the payday loan origination fee from a percentage of the face value of the check to a flat fee.

22) Increase the maximum amount of a payday loan from $300 to another amount, such as $500 or $750.

23) Adjust fees based on the loan amount, with a sliding scale that reduces the fee as the amount borrowed goes up.

24) Prohibit a licensee from entering into a deferred deposit transaction with a customer during the period-of-time that the customer has an outstanding deferred deposit transaction with another licensee.

25) Restrict a customer from having a payday loan outstanding with any payday lender for more than three months during a twelve-month period.

26) Require licensees to offer a payment plan with a minimum of six equal, monthly installment payments to all borrowers who have had continuous (consecutive) loans for three months, and prohibit licensees from charging customers any additional fees or interest in connection with the payment plan.

27) Require all licensees to use a uniform database to record all transactions in real time.

PAYDAY LOAN ALTERNATIVES

Several banks offer short-term type loan products for their customers under a cash advance program. For example, Wells Fargo offers a Direct Deposit Advance Loan that charges a fee of $1.50 for every $20 borrowed. The internet website explaining the product points out that the product is an expensive option and that other options may be available. Other national banks also offer products in this lending space. These products are short term in nature so when the finance charge is calculated as an APR these products have triple digit APRs, and in turn have attracted a fair amount of criticism from community and consumer organizations and federal regulators. On January 2, 2013, United States Senators Blumenthal, Durbin, Schumer, Brown and Udall sent a letter to the chief federal regulators of national banks demanding an end to payday lending by banks. The letter claims that banks offer payday loans via "payday advances" that are structured just like payday loans.

Many credit unions offer payday advance products for their customers. These programs typically have a savings component built into the loan and require longer repayment periods than a payday loan. The committee in previous years has highlighted several programs offered by credit unions, specifically in the Sacramento and San Francisco areas. An additional entrant into this market is 1st Valley Credit Union in San Bernardino that offers an Assist Member Program (AMP). The AMP requires that the borrower have a three month membership, established direct deposit and must be current on all loans. The maximum term of an AMP loan is 90 days with an APR of 28% (plus $10 loan application fee) with 10% of loan proceeds going to a frozen savings account to help build savings.

This kind of innovation is desperately needed in the small dollar lending market. Current short-term offerings by banks and credit unions far exceed those offered just 5 years ago. Does the existence of these programs mitigate the need for non-bank payday loans? It is plausible that many people do not belong to a bank or credit union that offers one of these products. Additionally, consumers may be fearful that going to their bank or credit union to ask about one of these products would adversely affect their account relationship with the institution.

Why don't mainstream financial institutions offer more short-term loan options? One obvious answer is that underwriting standards at most mainstream financial institutions would prohibit lending to consumers with marginal credit. Another answer is the lending in this market place is not cost effective without lending at interest rates that might bring about reputational risk to the image of the institution.

In order to better grasp the role of banks in small-dollar lending, and potentially encourage greater lending in this space, the FDIC in 2007 started a two year Small-Dollar Loan Pilot Program. This program was designed to demonstrate that banks can offer affordable small dollar products that are profitable for the participating banks, while also providing an alternative to high-costs loans and costly overdraft protection programs. The Federal Deposit Insurance Corporation (FDIC) parameters for a loan under the program was an amount of $2,500 with a term of 90 days or more at an APR of 36% or less. As the program came to a close, 34,400 small-dollar loans were made with a principal balance of $40.2 million nationwide. Small-dollar lending was often used as a relationship building opportunity in order to building long term opportunities with the customer. The Pilot began with 31 banks participating, one of which was located in California (BBVA Bancomer USA). The Pilot ended with only 28 participants. Delinquency rates for the loans ranged from 9-11%, but loans with longer terms performed better. It does not appear that the Pilot led to widespread adoption of small-dollar lending programs at non-pilot banks.

In 2005, Sheila Bair, prior to her role as Chairman of the FDIC, wrote a report (Low Cost Payday Loans: Opportunities & Obstacles) that researched the ability of financial institutions to offer affordable payday loan alternatives. She found that banks and credit unions do have the ability to offer low-cost small-dollar loans, however the use of fee-based overdraft protection programs were a significant obstacle to offer alternative programs. In additional research in this area, Micheal Stegman, "Payday Lending", Journal of Economic Perspectives concluded that "bottom lines are better served by levying bounced check and overdraft fees on the payday loan customer base than they would be by undercutting payday lenders with lower cost, short-term unsecured loan products..."

Survey and research data provide that other alternatives may be available, including credit cards or loans from family and friends. A credit card could potentially meet the short term needs of a consumer in financial hardship. However, payday borrowers as a population have a lower rate of credit card equity than the general population. Furthermore, payday borrowers may have incorrect views on the charges and fees associated with the credit cards use versus a payday loan. As for the use of friends and family, the Pew research highlights that many borrowers used loans from friends or family to pay off a payday loan indicating that the friends/family option was available prior to the use of the payday loan. A person in financial trouble may feel stigmatized about that financial hardship, whether perceived or real, and may wish to avoid the embarrassment of asking friends or family.

Technology is trending to find new ways to get consumers the goods and services they want, in ways that are cheaper and quicker. This is also the case for payday lending as new start-ups are entering this realm with an emphasis on online lending. LendUp, a recent entrant into this marketplace is a direct payday lender that created a way to use small-dollar loans as an opportunity for consumers to build credit. Consumers who have poor or no credit can apply for and receive small-dollar, short-term loans (up to $250 for up to 30 days). LendUp uses an underwriting process that uses risk analysis and only approves 15% of applicants. LendUp says that it uses data analytics, a new type of risk model that utilizes non-traditional data sources like social media to make decisions. The loan fee can be lowered and discounted for repaying the loan early, and by taking educational courses on good credit, financial planning and more.

UNREGULATED INTERNET PAYDAY LENDING

Many licensed payday lenders that have storefront operations also offer payday loans via the internet in compliance and conjunction with their state licenses in accordance with state law. However, unregulated online lending has grown in recent years. Pew research predicts that by 2016 internet loans will account for 60% of payday loans almost double from last year. Last year, on August 16, 2012 the LA Times reported, *California Warns of Online Payday Lending Risk,* that DOC had issued a consumer alert concerning the dangers of online lending, as well as sanctioned nine payday lenders for unlicensed activity. On February 23, 2013, the New York Times reported, *Major Banks Aid in Payday Loans Banned by States,* that a growing number of payday lenders had setup online operations to avoid rate caps in states that have banned payday lending. The article pointed out that for an online payday loan the borrower gives the lender their account and routing number to set up automatic repayment of the loan via their account. These authorizations can lead to numerous overdraft charges as online payday lenders repeatedly ding the consumer's account for the outstanding loan repayment. In some cases, these transactions have occurred even after the loan was paid off. In one case highlighted in the article, a consumer with six outstanding payday loans attempted to close their bank account to stop any future withdrawals. The account was not closed by the bank and the consumer racked up $1,523 in insufficient funds fees, extended overdraft and service fees. The article further placed responsibility on the banks for allowing automatic withdrawals by illegal payday lenders and for not quickly honoring consumer's requests to end these withdrawals in a timely manner.

Restricting unregulated payday lending is difficult as many payday lenders may operate offshore in other countries or use tribal sovereignty to avoid state enforcement. Furthermore, borrowers may not be aware that an illegal payday loan (loan made by unlicensed lender) is unenforceable. These unregulated payday lenders typically will not follow consumer protection laws, fair debt collection laws, and in some cases may abuse the court process to intimidate borrowers into paying their loans. While storefront payday lenders may be limited by geographic location, internet payday lenders (both legal and illegal) are available by the thousands online and those that are unlicensed are not constrained by fee caps. This lack of regulation may, unfortunately, make them an attractive option for borrowers seeking to borrow beyond the California limit of $300.

Research on the impact of storefront payday lending restrictions and a potential growth in online lending reveal that consumers would not necessarily choose the online lending route if storefront payday lenders were eliminated. However, some media reports have highlighted concerns with the rising use of unregulated online payday. The Portland Business Journal reported on February 11, 2009, *Borrowers Flock to Online Payday Lenders,* that Oregon laws effectively banned 80% of the state's storefront payday lending businesses forced borrowers to turn to unregulated online payday lenders. As with the previously mentioned articles, online borrowers in Oregon faced harassing and illegal debt collection tactics, extremely high fees and interest rates, and deceptive marketing ads. The Portland Business Journal article did not reveal actual data on the amount of online lending before or after Oregon's heavy restrictions on storefront lending. This lack of data is a typical problem in researching this issue.

The Consumer Federation of America, conducted a survey of online payday lending in 2011, *CFA Survey of Online Payday Loan Websites*. This survey of twenty online payday lenders, included a mix of California licensed and unlicensed payday lenders. Key findings include:

- Payday lenders require electronic access to borrowers' bank accounts. Instead of holding a paper check to secure payment of loans made at payday loan stores, Internet payday lenders gain authorization to electronically deposit loan proceeds and withdraw payments directly from borrowers' bank accounts.

- Borrowers complete online applications and provide Social Security numbers, bank account and bank routing numbers in online applications.

- Surveyed loan size ranges from $100 to $1500, with payment/s due on the borrower's next payday with loan terms ranging from five to thirty days.

- Typical cost of a $500 loan is $125 or 652% APR for a two-week loan. Surveyed loan cost ranged from a low of 378% in Kansas to 780% charged by six payday lenders.

- The default payment plan for most sites is to pay the finance charge only, with no reduction in loan principal for several paydays. To initiate payment in full, a borrower has to notify the lender days before the due date to request the lender to withdraw the full amount.

- While some payday lenders purport to be state-licensed and to comply with state rate caps and loan terms, many online payday lenders claim a choice of law from states with no rate caps or from foreign countries. A growing number of online payday lenders claim to be exempt from state law enforcement due to tribal sovereign immunity.

- Online payday lenders pay up to $110 for referrals of qualified loan applications from lead generators or affiliate marketers and some payday lenders encourage borrowing by offering discounts on the initial loan. Online payday lenders that make loans in states where licensed typically also link applicants to lead generators when applications come from states they do not serve.

Finally, online payday lending largely functions through the use of third party online finders or referral services. Many of the online loan portals a consumer may find on the internet may be finders and not actual payday lenders. These finders take the borrower's information and then send it out for bids from payday lenders on what they will pay to the finder to lend to the particular borrower. Once a lender is matched with a borrower, the borrower is forwarded to that specific lender's loan website. This process happens behind the scene in only a few minutes. This system of finders, however, fuels unregulated online lending. If a borrower from California goes through one of these services (often the borrower will not know whether the site they are visiting is a lender or finder) the third party service does not determine whether the payday lenders who bid for the loan are licensed in California, or for that matter, licensed anywhere. Typically the factors that determine whether the loan is funded is the referral fee that the lender is willing to pay to the finder, and if the borrower meets that lender's risk profile.

In conclusion, an illegal loan made in violation of state law is void and unenforceable.

PRIOR STATE LEGISLATION

AB 1158 (Calderon), would have raised face value of the check securing the pay loan to $500. Held in Senate Judiciary.

AB 2511 (Skinner). Would have prohibited the offering of a payday loan to someone receiving unemployment benefits, unless the APR for the loan was 36%. Held in Assembly Banking Committee.

AB 377 (Mendoza). Provided for various changes and reforms to the DDTL. Additionally, would have raised the face value of the check amount to $500. Died in Senate Judiciary.

AB 2845 (Jones, Bass & Feuer). At one point, would have capped the APR on payday loans at 36%. Was amended in Assembly Banking & Finance committee to state the intent of the Legislature to enact changes recommended in the DOC reports. Held in Assembly Rules Committee.

AB 7 (Lieu, Chapter 358, Statutes of 2007): Gave DOC the authority to enforce specified federal protections granted to members of the military and their dependents under the Payday Lending Law.

SB 1551 (Correa): Would enact various changes intended to improve regulatory oversight of the payday lending based on recommendations found in the two reports referred to in this analysis. Failed passage in Senate Judiciary.

SB 1959 (Calderon, Chapter 682, Statutes of 1996): Enacted the earliest version of a payday lending law in California. Gave regulatory authority to the California Department of Justice.

SB 898 (Perata, Chapter 777, Statutes of 2002). Enacted the Deferred Deposit Transaction Law and shifted the responsibility for administering the law to DOC;

ISSUES AND QUESTIONS FOR CONSIDERATION

1) What is the appropriate amount of regulation for payday loans in California? Is more regulation necessary? Are the perceived or real dangers of the product acceptable risk given that consumers may have desperate needs, or is it not worth those risks?

2) Options to payday loans do exist. Loans from friends or family, credit cards, bank and credit union products. However, these options may not be available at all times to all borrowers. Can policy makers assist with creating or expanding alternative small dollar products?

3) As described earlier, Pew research finds that 55% of borrowers surveyed believe that payday loans take advantage of borrowers, while 48% say the loans help more than hurt, with 8% reporting that the loans both help and hurt. Furthermore, 56% say the loans relieve stress and anxiety versus causing it. Three in five borrowers would use the product again if necessary. This information presents a confusing picture of borrowers believing that the product takes advantage, yet seemingly they would continue to use it if needed. How can this contradiction be explained? Does the product itself create this contradiction?

4) The research and data demonstrates a lack of financial literacy on the part of borrowers. Borrowers may perceive they have no other option than a payday loan because they are unaware of other options or have unrealistic concerns about approaching other options. What policies can be promoted to increase financial empowerment and financial literacy?

5) *Hyperbolic discounting* is a concept in economics and human behavior research that describes that a person with the choice between two equal rewards, one occurring now and one occurring later, the person will choose the immediate reward. A simpler way to explain, is that the self today makes choices that the future self would prefer not to make. This behavior may explain why some borrowers use the payday product when saving or other financial options may be available.

6) The academic survey and research data on payday lending studies the issue from a nationwide perspective. Nationwide research is vital and important for any financial policy debate. On the other hand, California is the most diverse state in the nation with a cost of living higher than other states. The only California research on the behavior of borrowers was conducted via the DOC studies mentioned earlier in this background.

Those studies have been the subject of debate and disagreement since they were released in 2007.

7) Between the parties of this debate, very little agreement can be found on the future of enhanced regulation. For a more in depth look at these disagreements, staff recommends a review of the committee analyses of the legislation mentioned under "Prior State Legislation."

SOURCES AND ADDITIONAL READING.

Applied Management & Planning Group and Analytic Focus, *2007 Department of Corporations Payday Loan Study* (2008), www.corp.ca.gov/Laws/Payday_Lenders/Archives/pdfs/PDLStudy07.pdf

Agarwal, Kiba & Tobacman. *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles*? Federal Reserve of Chicago, Banderbilt University, and University of Pennsylvania. January 13, 2009. http://www.nber.org/papers/w14659

DeYoung and Phillips, *Payday Loan Pricing* (Federal Reserve Bank of Kansas City Economic Research Department, 2009), www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf

Edmiston, Kelly, Federal Reserve of Kansas City. (2011) *Could Restrictions on Payday Lending Hurt Consumers?* http://www.kc.frb.org/publicat/econrev/pdf/11q1Edmiston.pdf

Elliehausen, Gregory. (2009) *An Analysis of Consumers' Use of Payday Loans*. http://www.cfsaa.com/portals/0/RelatedContent/Attachments/GWUAnalysis_01-2009.pdf

Logan and Weller. *Who Borrows from Payday Lenders*? (2009) http://www.americanprogress.org/wp-content/uploads/issues/2009/03/pdf/payday_lending.pdf

Missoulian. *Payday lenders find new home online; interest rates hit 1,000 percent*; December 18, 2011. http://missoulian.com/news/local/payday-lenders-find-new-home-online-interest-rates-hit-percent/article_a428eea2-2922-11e1-b2eb-001871e3ce6c.html

Morgan, Donald & Strain, Michael, Federal Reserve of New York. (2007) *Payday Holiday: How Households Fare after Payday Credit Bans*. http://www.newyorkfed.org/research/staff_reports/sr309.pdf

The Pew Charitable Trusts, *Payday Lending in America: Who Borrowers, Where They Borrower, and Why*. July 2012 http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_Choosing_Borrowing_Payday_Feb2013.pdf

The Pew Charitable Trusts, *Payday Lending in America: Report 2 How Borrowers Choose and Repay Payday Loans.* February 2013. http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Payday_Lending_Report.pdf

Portland Business Journal. *Borrowers flock to online payday*; Feb 11, 2011. http://www.bizjournals.com/portland/print-edition/2011/02/11/borrowers-flock-to-shady-payday-lenders.html?page=all

Zinman, Jonathan. (2008) *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap*. http://www.dartmouth.edu/~jzinman/Papers/Zinman_RestrictingAccess_oct08.pdf

Zywicki, Todd. (2009) *The Case Against New Restrict ions on Payday Lending*. http://mercatus.org/publication/case-against-new-restrictions-payday-lending-0

January 2, 2013 letter from U.S. Senators urging federal regulators to demanding regulators to prevent national banks from engaging in payday lending. http://www.responsiblelending.org/payday-lending/policy-legislation/regulators/2013-0102-federal-reserve-comptroller-fdic-payday-lending.pdf