CITY OF PHILADELPHIA PENNSYLVANIA

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IMPACT OF LEGALIZING PAYDAY LENDING IN PHILADELPHIA

High-Cost Loans Target the City's Most Vulnerable

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Impact of Legalizing Payday Lending in Philadelphia

I. Executive Summary:

A payday loan is a short-term, high-interest loan collateralized both by access to a borrower's bank account via a post-dated check and the promise of a future paycheck to pay off the loan. Currently, under Pennsylvania law payday lenders cannot charge more than 24% annually for a two-week loan. Payday lenders in the state of Pennsylvania are also barred from offering loans greater than $500. These provisions effectively limit the maximum fee on a two-week loan to $3.80, a profit margin apparently insufficient to incentivize the development of a major payday lending industry in Pennsylvania.[1]

Philadelphia's many citizens of moderate means, high unemployment, large numbers of "underbanked" citizens, and other demographics favorable to the payday lending business model, is fertile ground for the rapid growth of the industry. Pennsylvania's consumer protection provisions are perhaps the only thing standing between the growth of the industry and the citizens of the City of Brotherly Love. That may be about to change. Senate Bill 975, approved by the Senate's Banking Committee on June 4, 2013, aims to remove these protections, thereby creating conditions in Pennsylvania for the rapid growth of payday lending.

Payday lending proponents in Harrisburg are trying to market these "micro loans" and "short-term loans" as a virtuous type of credit instrument intended to cover sudden and unexpected expenses on the part of those with few alternatives. However, on closer inspection, payday loans are virtually designed to ensnare borrowers in a debt trap. According to a recent national study by Pew, such short-term loans are frequently offered at terms equivalent to an Annualized Percentage Rate (APR) of 391% or more, with a $15 fee per $100 loan; they often quickly lead consumers into a downward spiral of rapidly mounting fees and interest.[2] Proponents of payday lending claim that their products allow borrowers to build creditworthiness and transition to more traditional forms of credit,[3] that they serve populations marginalized by the traditional banking sector, and that they provide a cheaper alternative to loans offered by credit unions, for example. In practice, the majority of research suggests that for many if not most borrowers, payday loans amount to a form of a predatory lending that does not build credit in any way, and, in fact, is considered a red flag to traditional lending institutions.[4] Moreover, many of the purported consumer protections advanced by the industry are easily and legally circumvented by lenders, while others do not contribute to the protection of consumers at all.

Drawing on national studies of payday lending and applying some of their findings to the specific conditions in Philadelphia, we conclude that Philadelphians would be much better served by alternative pathways to short term credit rather than removing the long-standing limits on such loan products. We highlight the specific dangers of payday loans to Philadelphians, both on an individual and aggregate level, while offering possible alternative and considerably healthier forms of credit for low income individuals and other demographic segments who might otherwise consider payday loans.

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[1] Pennsylvania General Assembly, Act 167 of 1998. Available at http://www.legis.state.pa.us

[2] From The Pew Charitable Trusts' series on payday lending titled *Payday Lending in America*, "Who Borrows, Where They Borrow, and Why," 6.

[3] Muschick, Paul. "Another payday loan debate on the horizon." *The Morning Call*, Online edition, sec. Local News, May 18, 2013. http://articles.mcall.com/2013-05-18/news/mc-payday-loans-watchdog-20130518_1_payday-loans-browne-military-officers-association (accessed May 28, 2013). For the full array of pro-payday lending arguments, see the Pennsylvania Consumer Credit Association's website at http://consumercreditpa.com/faqs/. Interestingly, the site contains no information about the stakeholders who comprise PACCA.

[4] "Payday Lending to Return to Pennsylvania? Future Homeowners Beware," http://www.philadelinquency.com/?p=2681 (accessed June 11, 2013).

II. Legislative Proposals:

In recent years there have been several attempts to modify the Pennsylvania law that currently limits the interest rate that lenders can offer on short-term loan products commonly known as payday loans. Table 2.1 lists these bills, when they were introduced, their general content, and the last action that was taken on them before they died. These bills have all been proposed in the name of offering a new credit option to those without access to traditional credit:

Table 2.1- Legislative History

Bill	Year	Content	Last Action
HB 2005	1998	Current limits to interest charges	Passed – Act 167
SB 1071	2010	Alterations to limits	Baking and Insurance Committee
HB 2191	2012	"Short-Term Loans", similar to 2010 bill	Banking and Insurance Committee
SB 975	2013	See Table 2.2 below	Tabled by Senate (July 3, 2013)

On May 31, 2013, Senator Pat Browne (R-16) filed Senate Bill 975, which addresses the topic of "Micro Loan Reform." The bill creates a tier called "short-term loans," which allows lenders to make loans at a maximum flat interest rate of twenty-eight percent annually with an application fee of five percent, a processing fee of five percent and a five-dollar verification fee over a two week period; this translates into an effective annualized interest rate of 332%. This loan tier, which is at the core of the most recent failed attempt to legalize payday lending (HB 2191 from 2012), establishes the conditions for the most typical payday loan. The bill also provides for the creation of "micro loans" with even higher effective interest rates than the short-term loan tier. The charges and fees associated with a hypothetical $300 loan borrowed under each tier authorized by SB 975 bill is illustrated in Table 2.2.

Table 2.2 Charges and Fees on a Hypothetical $300 Loan Under Various Tiers Created By SB 975

Loan Tier (Example)	Annual Interest	Application Fee	Processing Fee	Verification Fee	Annual Fee	Effective APR	TOTAL fees on $300 loan
Short-Term Loan (14-day)	28% ($3.24)	5% ($15)	5% ($15)	$5 ($5)	N/A	332%	**$38.21**
"Micro Loan" (14-day)	28% ($3.22)	Greater of 5% or $25 ($25)	Greater of 5% or $25 ($25)	$5 ($5)	N/A	506%	**$58.22**
Extended Short-Term Loan (61 days)	28% ($27.61)	Greater of 5% or $25 ($25)	Greater of 5% or $25 ($25)	$5 ($5)	N/A	126%	**$63.12**
"Micro Loan" ($300, 52 weeks)	28% ($84)	Greater of 5% or $25 ($25)	Greater of 5% or $25 ($25)	$5 ($5)	$95	65%	**$195.54**

SB 975 merely establishes ceilings on interest rates and lenders could potentially offer loans at lower rates below 28%. However, experience in other states such as Arizona and Virginia with legalized payday lending suggests that the vast majority of lenders would charge the maximum legal rate.

Many proponents of payday loans justify a high APR by claiming the short nature of the loan necessitates high fees, but this argument is weakened by the fact that even a longer-term "micro loan" comes with an effective interest rate of 65% - roughly three to four times the rate of the average credit card.[5] Also, while the bill authorizes these alternative micro loans, it is not clear whether they will be offered to consumers, since payday lending institutions will be permitted to pick and choose which products they offer.

However, the exorbitant fees and interest illustrated above are not the biggest problem associated with payday lending; repeat borrowing is. It is the process of consecutive loans that constitutes the true debt trap. Payday borrowers typically resort to short-term loans precisely because they are on very tight budgets. Additionally, because payday loans are collateralized with a post-dated check tied to the deposit of the borrower's next paycheck, the lender will always be repaid on a payday, while the borrower will often find herself lacking enough cash to meet the following pay period's obligations. These circumstances will compel her to borrow again, and consequently open the debt trap. While SB 975 prohibits the classic "rollover" of one loan into another with additional fees, it allows customers to borrow again the very next day as long as their previous loan is paid off. Data from the Center for Responsible Lending show that more than three-quarters of payday loan volume is generated by borrowers who take out consecutive loans within two weeks of paying off the prior loan. Thus starts a downward spiral of increasing indebtedness.

SB 975 also stipulates a borrowing limit of eight "consecutive" loans; however, closer inspection reveals that this ostensible protection is very weak, at best. First, the bill defines a "consecutive" loan as one which takes place within two days of another loan term ending.[6] There is nothing stopping a lender from persuading a borrower to wait until the third day after they have paid off an old loan to take out a new one, and, in fact, the lender has great incentive to do so. Second, and more important, national studies show that the average payday customer borrows eight consecutive times; this is the heart of the payday lending business model. As Table 3.2 below illustrates, for someone living on a $700 bi-weekly paycheck, a $300 loan can quickly snowball into a budget-busting obligation. Thus, it can be argued that the "limit" merely pays lip service to consumer protection while preserving the core mechanism of the debt trap.

III. Individual Impact:

Table. 3.1 Payday Loans and Associated Interest Under SB 975

Loan Amount	**$ 100.00**	**$ 200.00**	**$ 300.00**	**$ 400.00**	**$ 500.00**
Processing Fee	$ 5.00	$ 10.00	$ 15.00	$ 20.00	$ 25.00
Verification Fee	$ 5.00	$ 5.00	$ 5.00	$ 5.00	$ 5.00
Application Fee	$ 5.00	$ 10.00	$ 15.00	$ 20.00	$ 25.00
Interest	$ 1.08	$ 2.16	$ 3.21	$ 4.28	$ 5.35
Total	**$ 116.08**	**$ 227.16**	**$ 338.21**	**$ 449.28**	**$ 560.35**

[5] http://www.bankrate.com/finance/credit-cards/rate-roundup.aspx gives the latest national average APR on credit cards

[6] Pennsylvania General Assembly, SB 975 (2013), Ch. 51, SubCh. A. The definition of "consecutive short-term loan" is one which comes no less than one day and no more than two from the termination of the previous loan's term. This means that any loan taken out on the third day after the previous loan's term has ended is not subject to the eight loan limit.

Loan Amount	$ 600.00	$ 700.00	$ 800.00	$ 900.00	$ 1,000.00
Processing Fee	$ 30.00	$ 35.00	$ 40.00	$ 45.00	$ 50.00
Verification Fee	$ 5.00	$ 5.00	$ 5.00	$ 5.00	$ 5.00
Application Fee	$ 30.00	$ 35.00	$ 40.00	$ 45.00	$ 50.00
Interest	$ 6.42	$ 7.49	$ 8.56	$ 9.63	$ 10.70
Total	**$ 671.42**	**$ 782.49**	**$ 893.56**	**$ 1,004.63**	**$ 1,115.70**

Under the best-case scenario, in which a borrower would pay the loan back within the two-week period, the effective interest rate is between 11% and 16%. It is important to remember these loans are collateralized by a post-dated check that will be cashed on the borrower's next payday. This post-dated check will then take precedence over all other uses of the incoming funds, meaning that bills, groceries, and other recurring budgetary items must be split among what's left. Since many if not most payday borrowers live paycheck-to-paycheck with little or no discretionary funds or safety net, the additional fees quickly force choices among basic necessities – or taking out another loan to cover the shortfall. And in fact, the quickest and easiest way to cover the increasing budgetary gap for many in this situation is to take out a new loan and use these funds to ensure that rent and utility bills are paid and food is on the table. The interest and fees continue to accrue and the budgetary gap grows.

Table 3.2 displays a scenario in which a borrower, let's call him Jim, takes out a loan of $300 to cover a sudden expense. Jim has a steady job that pays $10.50 an hour, earning him a paycheck of $700 every two weeks. Jim, like many others who use payday lending services, lives paycheck to paycheck with no substantial savings, thus he must budget very carefully in order to stay on his feet. However, as this chart shows, Jim has very little hope of avoiding the debt trap that he has just unwittingly walked into:

Table 3.2: The Debt Trap at work

Period	Item	Amount
Baseline	Jim's biweekly paycheck	$700.00
	Unexpected expense	$300.00
Weeks 0-2	Loan Amount	$300.00
	Interest and Fees	$38.21
	Amount Due	$338.21
	Remaining paycheck	**$ 361.79**
Weeks 2-4	Loan Amount	$ 338.21
	Interest and Fees	42.44
	Amount Due	$ 380.65
	Remaining paycheck	**$319.35**
Weeks 4-6	Loan Amount	$ 380.65
	Interest and Fees	47.14
	Amount Due	$ 427.79
	Remaining paycheck	**272.21**
Weeks 6-8	Loan Amount	$ 427.79
	Interest and Fees	52.36
	Amount Due	$ 480.14
	Remaining paycheck	**219.86**

Period	Item	Amount
Weeks 8-10	Loan Amount	480.14
	Interest and Fees	58.15
	Amount Due	538.30
	Remaining paycheck	**$ 161.70**
Weeks 10-12	Loan Amount	$ 538.30
	Interest and Fees	64.59
	Amount Due	602.89
	Remaining paycheck	**97.11**
Weeks 12-14	Loan Amount	$ 602.89
	Interest and Fees	$ 71.74
	Amount Due	$ 674.62
	Remaining paycheck	**$ 25.38**
Weeks 14-16	Loan Amount	$674.62
	Interest and Fees	79.68
	Amount Due	754.31
	Remaining paycheck	**(54.31)**
Final Costs	Total Fees and Interest	454.31
	Percentage of Jim's biweekly paycheck	65%

Table 3.2 illustrates in stark terms how fast a typical $300 payday loan can spiral out of control for someone with limited discretionary income. A 2012 Pew study of payday lending in the U.S. showed that as many as 69% of payday loan borrowers are using these loans to cover recurring budgetary shortfalls and that 37% of payday loan borrowers can only afford $100 payments on their loans every two weeks.[7] In light of the fees outlined in the tables above, it is quite plausible that many individuals will find themselves stuck in a fairly tenacious debt trap.

IV. The Potential Impact on Philadelphia:

In its 2012 study *Payday Lending in America*, the Pew Foundations identified the five most common demographic categories of those at risk for utilizing payday lending:

- Renters are 57% more likely to use payday loans than homeowners
- Those earning less than $40,000 annually are 62% more likely than those who earn more than $40,000
- Those without a college degree are 82% more likely versus than those with a four-year degree or higher
- Divorcees or separated couples are 103% more likely than those of any other marital status
- African Americans are 105% more likely than members of any other race or ethnicity.

The study also determined that 5.5% of the national population has used payday loans at one point or another.[8] Applying the Pew results to Philadelphia's demographic profile, it becomes clear that there is a significant at-risk population. In every category Philadelphia exceeds national averages.

It also useful to examine the "underbanked," population who have bank accounts, but still rely on check cashing or other institutions to meet their banking needs. According to data maintained by the Corporation for Enterprise Development and a FDIC National Survey for Unbanked and Underbanked, there are 133,173 underbanked households in Philadelphia, which accounts for 23.5 percent of all City households. Figure 4.1 shows the percentage of Philadelphia's underbanked by neighborhood. The majority of check-cashing institutions are found in the dark purple, traditionally low-income areas where people use these services the most.[9] If payday lending were to be legalized, it is highly likely that check-cashing institutions would obtain payday lending licenses and begin to offer loans to low-income residents of these neighborhoods. In a city already struggling with the highest poverty rate of any large U.S. city, with very high rates of unemployment in many outlying neighborhoods, and with numerous renters and homeowners already having a hard time making ends meet, it is hard to imagine that adding high-interest short-term credit to the financial services mix will make things better.

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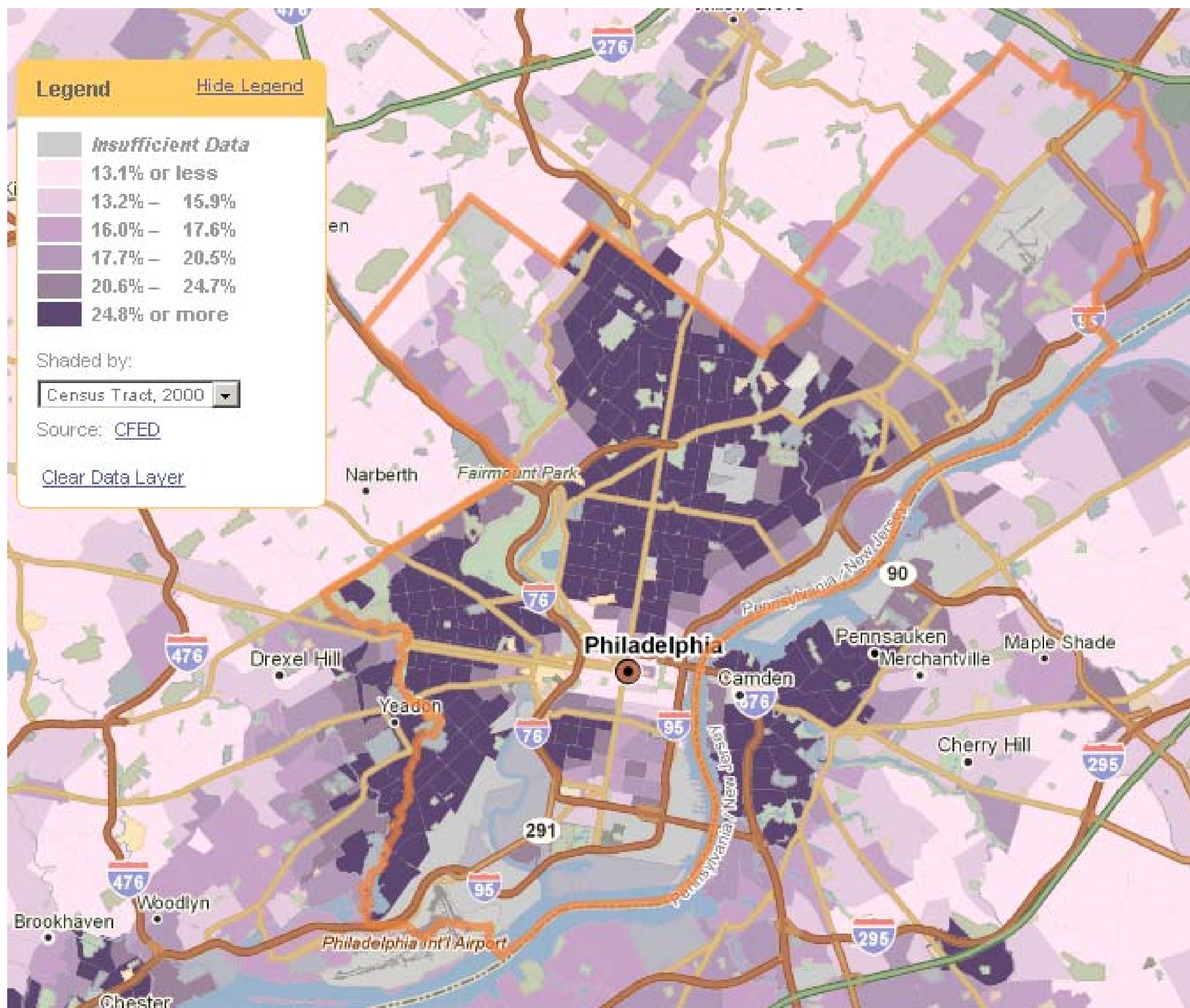
[7] From The Pew Charitable Trusts' series on payday lending titled *Payday Lending in America* and the specific report, "How Borrows Choose and Repay Payday Loans". Pg. 14.

[8] From The Pew Charitable Trusts' series on payday lending titled *Payday Lending in America* and the specific report, "Who Borrows, Where They Borrow, and Why". Pg. 8-9

[9] A result of a cross reference of the above map and a Google Maps result for "Check Cashing Service". Traditional banking institutions were excluded from the cross reference, as these institutions carry out only a small percentage of payday-like loans.

Fig. 4.1- Underbanked Population



V. <u>Alternative Sources of Credit:</u>

The financial services market already offers a number of lower-risk loan products designed for those Philadelphians struggling to meet basic obligations. The payday lending business model hinges on consecutive borrowing, while financial services designed to serve low-to-moderate income individuals include provisions that will empower them to build creditworthiness and become independent from their loans. While SB 975 includes sections that require payday lending institutions to offer credit counseling for troubled borrowers, these services will not be offered at the door and must be requested by the borrower. In addition, there are no quality guidelines for such programs. By contrast, local credit unions offer fair payment plans and full credit counseling.

We provide the following as a guide for Philadelphians who find themselves in a short-term credit crunch. It implies no endorsement of any particular financial institution or product.

a. Non -Profit Credit Counseling

Credit counseling is a free service provided by many government agencies and non-profit organizations. These services provide advice on how to manage loans, credit, and other forms of external debt. Since the passage of the American CARD Act of 2009, bills and credit card statements must include information about accessing credit counseling and debt management services.[10] There are many such agencies in Philadelphia.

Thanks to funding from Bloomberg Philanthropies, since April 2013 the City of Philadelphia has opened several Financial Empowerment Centers in neighborhoods across the City. These centers offer one-stop help for those in financial distress. Locations currently include:

LOCATION	ADDRESS	TELEPHONE	HOURS
Congreso Headquarters	216 W. Somerset Street Philadelphia, PA 19133	215-763-8870	Mon & Wed: 8am-6pm Tues: 9am-7pm Thur: 8am-7pm Fri: 8am-5pm
Municipal Services Building Concourse Level	1401 John F. Kennedy Blvd Philadelphia, PA 19103	215-686-8686	Mon -Thur: 9am-7pm Fri: 8am-5pm Sat: 9am - 3pm
Community College of Philadelphia, Center for Business and Industry	1751 Callowhill Street Philadelphia, PA 19130	215-751-8000	Mon & Wed: 8AM-5PM
Community Legal Services	1410 W. Erie Avenue Philadelphia, PA 19140	215-227-2400	Mon: 9AM-6PM Thur & Fri: 8AM-5PM
People's Emergency Center	Families First Building 3939 Warren Street Philadelphia, PA 19104	215-382-7522	Tue-Thu: 9AM-6PM Fri: 8AM-5PM
Welcoming Center for New Pennsylvanians	1617 John F. Kennedy Blvd Philadelphia, PA 19103	215-557-2626	Tue: 11AM-8PM Fri: 9AM-5PM

b. Credit Union Signature or Personal Loans

There are 57 credit unions located within the City of Philadelphia. These consumer-owned banks have signature loans ranging from $500 to $15,000 with an annual interest rate between 8% and 18%.[11] These rates are significantly lower than the 28% APR one-year micro-loan authorized by SB 975. A $300 credit union loan at 18% would cost the consumer $354 by the end of the term; a comparable loan under SB 975 would cost $454.95. Credit unions encourage patrons to attend financial literacy seminars designed to help avoid the need for lines of credit for normal budgetary requirements. Credit union loans help to build credit and contribute to a positive financial history.

For further information on credit unions, call the Pennsylvania Credit Union Association at 800-932-0661 or visit its website at www.PACreditUnions.com. To find a local credit union, visit www.iBelong.org.

[10] http://www.govtrack.us/congress/bills/111/hr627/text

[11] https://www.pfcu.com/loans-and-credit/personal-loans/signature-loan.aspx

c. Credit Cards

While spending on a credit card isn't always ideal, it can be a more controllable alternative to payday borrowing. Many local institutions offer secured credit cards specifically for those with a poor credit history. Unlike cards for those with better credit scores, a secured credit card requires a deposit; the more a customer can afford to put down, the higher the credit limit and the lower the interest rate offered. A CNN-Money report on the "best cards for bad credit" featured several secured cards with interest rates as low as eight percent, as well as unsecured cards with much higher rates.[12] Rates for even the highest-rate cards targeted for customers with poor credit fall well below the typical payday loan rates. Also, all payments and charges are reported to the three leading credit rating agencies, ensuring that timely payment is rewarded with a better credit score, opening the door to future credit opportunities. However, credit cards can also lead to significant debt if used improperly.

For more resources, call Bank on Philadelphia at 215-686-3885 or online at: http://www.philadelphiacontroller.org/bop

[12] "7 best cards for bad credit," http://money.cnn.com/galleries/2011/pf/1104/gallery.best_credit_cards_bad_credit/ (accessed June 11, 2013).