Indiana Institute for Working Families
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What is Payday Lending?

Payday loans are small dollar loans that are generally repaid as a lump sum within a short period of time, typically on the borrower's next payday. To secure collateral, lenders require borrowers to provide either a post-dated check for the principal and finance charges or authorize lenders to withdraw the amount due directly from the borrower's bank account. By having a preferred repayment position, lenders can withdraw funds before the borrower pays for other regularly occurring expenses, often leading to overdraft charges when borrowers have insufficient funds to cover the amount deducted from their bank account.[1] In Indiana, borrowers' ability to repay the loan in the prescribed time period is not assessed beyond ensuring the borrower has an income and bank account and the loan does not exceed 20% of the borrower's income.

> "With a short duration, [small loans] are portrayed as a bridge to cover short-term needs. Many consumers, though, wind up reborrowing many times, with successive finance charges eventually eclipsing the original loan amount, before they are able to retire their debt."
> \- Consumer Financial Protection Bureau -

Payday loans provide a service for underqualified borrowers at a steep cost. On the one hand, payday lending provides a credit market for people in need of immediate funds, thereby serving a segment of the population that would otherwise be shut out of mainstream financial institutions. On the other hand, research consistently shows payday lending leads to debt traps, where borrowers are unable to repay their initial loan and re-borrow to service their debt.[2]

Payday Lending in Indiana

Payday lenders have a deep and wide footprint across Indiana. A 2013 Center for Responsible Lending report estimated there were 4,220 originated loans per store in Indiana, averaging $317 per loan.[3] The total payday loan volume for the state was $502.9 million, with $70.6 million in finance charges. As of October 2015, there were 27 active small loan lenders licensed with the State of Indiana operating 347 storefront branches.[4] The number of branches operated by a single lender ranged from one to 86.

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[1] Montezemolo, S. and Wolff, S. *Payday Mayday: Visible and Invisible Payday Lending Defaults*: http://bit.ly/1QrE4bS

[2] Consumer Financial Protection Bureau. Factsheet: The CFPB Considers Proposal to End Payday Debt Traps: http://1.usa.gov/1xBGqy9

[3] Montezemolo, S. *Payday Lending Abuses and Predatory Practices*: http://bit.ly/1Cqs4zy

[4] Indiana Department of Financial Institutions. Depository Database: http://bit.ly/1SFB7DW

Payday loan branches were found in 96 towns and cities, with 92 branches in the state capital alone. Indiana allows online payday lenders to operate in the state, which must follow the same laws as storefront lenders. Unlike other states, Indiana does not permit vehicle title loans – small dollar loans that use vehicle titles as collateral.

Even though Indiana's regulatory framework addresses some of the worst abuses associated with the payday lending industry, it still has room for improvement. Key features of Indiana's payday lending regulatory framework include:[5]

- Borrowing limits – Lenders can make loans between $50 and $605, not exceeding 20% of the borrower's monthly gross income. The upper borrowing limit can be adjusted to keep up with inflation. Borrowers may have two outstanding loans at a given time, but the loans must be lent by different lenders.
- Finance charges – Finance charges essentially function as interest rates. Indiana Code restricts finance charges to 15% of the first $250; 13% of the loan amount between $251 and $400; and 10% of the loan amount between $401 and $605. The interest rates are blended, meaning the rate applies to the amount borrowed within the dollar range for each finance charge. For example, a $400 loan would have finance charges of 15% for the first $250, equaling $37.50, and the next $150 would have finance charges of 13%, equaling $19.50. In total, a borrower would pay $400 for the principal and $57 in finance charges. While the Indiana Code does not statutorily limit payday loans' annual percentage rate (APR), the finance charges essentially cap APR at approximately 391%.
- Loan terms and repayment – Minimum of 14 days. Lenders vary the term length based on the borrower's pay period. A borrower may rescind the loan without cost within one business day following the day the loan originated. After three consecutive loans, a lender must offer the borrower an extended payment plan without any additional fees.
- Rollovers, renewals, and consecutive loans – Indiana Code prohibits loan renewals, defined as "a small loan that takes the place of an existing small loan by renewing, repaying, refinancing, or consolidating a small loan with the proceeds of another small loan made to the same borrower by a lender."[6] To receive another loan from the same lender, the borrower must pay in full the principal and finance charges of the outstanding loan. After paying the loan in full, the borrower may take out another loan. Following five consecutive loans, a borrower must wait seven days to receive a sixth loan.

The most important statutory protection is requiring a loan's principal and finance charge be paid in full prior to taking out a subsequent loan with the same lender. This prevents borrowers from rolling over their initial loan and paying a new set of finance charges to avoid having to pay the principal in full. The Pew Charitable Trust found that in states where rollovers, also called renewals, are permitted, the typical borrower rolls the loan over multiple times, extending the loan's term to five months and paying $520 in finance charges for loans averaging $375.[7] There is no cooling off period between loans in

[5] IC 24-4.5-7

[6] IC 24-4.5-7-107

[7] The Pew Charitable Trusts. *How Borrowers Choose and Repay Payday Loans*: http://bit.ly/1HF6Qyz

Indiana until after the fifth consecutive loan, making it possible for a borrower to repay a loan on his or her payday and then borrow another loan shortly thereafter to cover regularly recurring expenses. This usage pattern effectively traps borrowers in a debt cycle, in which they pay finance charges biweekly or monthly to meet their basic needs.

Unlike many states, Indiana does have an ability-to-repay (ATR) requirement, though it offers insufficient protection to borrowers. The state requires lenders to verify that a loan does not exceed 20% of the borrower's next paycheck. However, the extent to which this regulation is adhered to in practice is unclear. A Pew study estimated that a loan payment in Indiana consumes 36% of the typical borrower's biweekly gross income.[8] Indiana's ATR regulation does not account for the other side of a borrower's budget: expenses. Without reviewing borrowers' outstanding debts and living expenses, lenders cannot get a true sense of a borrower's ability to repay a loan. And because default rates on payday loans are low due to lenders' preferred repayment positions, lenders have little incentive to do thorough and potentially costly underwriting to ensure borrowers truly have the ability to repay the loan.[9]

Aside from allowing a usuriously high APR of 391%, one of the greatest shortcomings of Indiana's regulatory framework is the lack of a provision requiring lenders to offer an installment repayment plan for the initial loan. The typical borrower can afford to use only 5% of their paycheck to repay a loan without having to re-borrow.[10] By allowing borrowers to take out up to 20% of their paycheck, a borrower may receive a loan that is four times as large as their ability to repay. Consequently, borrowers fall into a debt trap. Indiana statute offers repeat borrowers an avenue out of the debt trap by requiring that lenders offer an installment plan after the third consecutive loan. But by not requiring lenders to offer an installment plan for the initial loan, the state effectively condones a payday loan usage pattern that traps some people in a cycle of high-priced borrowing.

Recommendations

The Indiana General Assembly should require additional truth-in-lending disclosures. For financial markets to function fairly and efficiently, consumers must have adequate information about loan products. Payday loans are marketed as short-term alternatives to tide people over until their next payday but often end up being longer-term commitments.[11] Prospective borrowers should have access to information about the borrowing trends of customers at the lender from which they intend to borrow. By seeing that repeat and longer term borrowing is prevalent, prospective borrowers will better understand that they may also fall into the debt trap. The statistics proposed below will empower consumers to make sound financial decisions.

"WARNING: A small loan is not intended to meet long term financial needs. A small loan should be used only to meet short term cash needs. The cost of your small loan may be higher than loans offered by other lending institutions."
- Statutorily required payday loan disclaimer (IC 24-4.5-7-301) -

8 The Pew Charitable Trusts. *Payday Lending in America: Policy Solutions*: http://bit.ly/1MxKX9Y

9 Montezemolo, S. and Wolff, S. *Payday Mayday: Visible and Invisible Payday Lending Defaults*: http://bit.ly/1QrE4bS

10 The Pew Charitable Trusts. *Payday Lending in America: Policy Solutions*: http://bit.ly/1MxKX9Y

11 Consumer Finance Protection Bureau. *Payday Loans and Deposit Advance Products*: http://1.usa.gov/NssoJ1

In addition to the statutorily required disclaimer above, lending companies should publicly display the median number of days their clients are indebted during a calendar year and the median number of loans taken by consumers during the year. These statistics would illustrate the tendency for payday loans to become longer-term commitments. Lenders are required to maintain their records in a third-party database, making the burden of collecting these data minimal.

Payday lenders should offer installment repayment plans to all borrowers, using the repayment model described below. Currently, installment repayment plans are only available to borrowers who have at least three consecutive loans. To make loan repayment more feasible, borrowers taking out an initial loan should have the option to make installment payments of no more than $100 per month, *without higher service fees or additional charges*. While the extended payment plan will lengthen the total time a borrower is indebted during the year, it will also limit the total amount a borrower can receive during the year, due to the requirement that a loan must be paid in full before another can be provided. For example, a borrower who takes out the maximum loan ($605 in principal + $77.50 in service fees) would amortize the loan over a seven-month period, during which the borrower could not receive another loan from the same lender. This repayment system organically limits the number of loans and amount of money consumers can borrow.

The $100 monthly limit is supported by typical borrowers' stated ability to repay and survey research. According to a Pew survey, 49% of respondents said they could not afford to pay more than $100 per month.[12] A different Pew survey found that Americans believed a four-to-six-month repayment period is reasonable for a $500 loan, which equates to about $100 per month.[13] Offering longer repayment periods reduces the likelihood of borrowers falling into the debt trap, while still allowing the payday lending industry to operate.

Indiana should cap the maximum allowable APR at 36%. This rate has been deemed affordable by the Center for Responsible Lending and the National Consumer Law Center.[14,15] Three federal government agencies –Department of Defense, Federal Deposit Insurance Corporation, and National Credit Union Administration – support an APR of 36% or lower for small dollar loans.[16] Even Congress acknowledged 36% as a reasonable APR when it passed legislation in 2006 preventing lenders from offering small loans to military service members at more than 36% APR. If a 36% cap is necessary to protect service members, it should also be instituted for all Hoosiers.

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[12] The Pew Charitable Trusts. *How Borrowers Choose and Repay Loans*: http://bit.ly/1HF6Qyz
[13] The Pew Charitable Trusts. *CFPB Proposal for Payday and Other Small Loans*: http://bit.ly/1Y2fC2V
[14] Montezemolo, S. *Payday Lending Abuses and Predatory Practices*: http://bit.ly/1Cqs4zy
[15] Saunders, L. *Why 36%? The History Use, and Purpose of the 36% Interest Rate Cap*: http://bit.ly/1iRiGPu
[16] *Ibid*