

**Testimony to the Ohio General Assembly
House Financial Institutions, Real Estate and Securities Committee
Regulation of Payday Lending in Ohio**

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The following remarks and testimony represent my professional opinions and independent analyses regarding the payday lending industry as a trained economist and researcher. Although I have conducted research on the payday lending industry in the past and continue to do so to the present, I have never worked in the payday lending industry, nor am I working for or representing the industry or its interests in any way. I have been asked for my independent analysis of the payday lending industry in Ohio by the Buckeye Institute for Public Policy as a Guest Scholar. Although they have paid me a consulting fee for my time and efforts, my testimony does not necessarily represent the views of the Buckeye Institute or any other institution with which I am affiliated, including those of my employer, Indiana Wesleyan University, or the Indiana Policy Review Foundation, for whom I serve as an Adjunct Scholar. The testimony and analysis that follows represents solely my own opinion as a professional economist with a research interest in the payday lending industry.

I. My Support of HB 337

I appear here today to lend support for passage of HB 337 containing regulations on the payday lending industry. I support this bill not because I believe additional regulations on the payday lending industry in Ohio are necessary at this time, but because, of the three bills related to payday lending regulations currently pending in the Ohio General Assembly, HB 337 is the “least bad” alternative. That is, if the political climate in Ohio requires that additional regulations be passed on the payday lending industry, I believe HB 337 is the least likely to create adverse and unintended economic consequences over the long run, and is the most likely to preserve options for the low- and moderate-income customers who make convenient and tempered use of payday loan services in the State of Ohio. Compared with the likely consequences of the two alternative bills regulating payday lending in Ohio, HB 337 is clearly the preferable option from an economic point of view. It **preserves consumer choice** in the small-loan market, while also ensuring that payday loan borrowers who are unable to meet loan repayment deadlines are **given an optional extended payment plan** clearly disclosed as part of each loan contract.

II. Overview of the payday lending industry

The number of payday loan stores in Ohio has doubled over the past five years (Stegman, 2007). This is consistent with the experience of other states, and **what has happened in Ohio is not unique to Ohio. The same trend appears nationwide.** According to the Indiana Department of Financial Institutions, there were a total of 563 licensed payday loan locations in my home state of Indiana in January of 2007. Of those, just 27, or less than five percent, were licensed and operational before 1996, an over twenty-fold increase in payday loan storefront locations in the last decade (Lehman, 2007). Over the past ten years, the number of payday loan outlets has grown twenty-fold in Utah and ten-fold in Kansas. California has grown from zero payday loan stores in 1996 to over 2,300 in 2004 (Stegman, 2007). The demand for short-term credit is booming, and cash advance firms have responded rapidly to meet this market demand over the last decade.

The strong rise in payday loan storefront locations in Ohio and elsewhere indicates a rising demand for short-term loan products that is, in turn, being met by a rise in supply, a routine outcome in a competitive market economy, and an outcome that should not create the sense of alarm that many payday loan critics seem eager to cultivate. **The payday loan industry is filling a market niche for short-term, small-denomination loans not easily met by traditional banks and credit unions**, and this is a growing part of the financial landscape accompanying the “democratization of credit” in the U.S. over the past 20 years.

Conventional bank and credit union institutions are economically discouraged from making small-denomination, short-term loans due to the widespread passage of state “usury” laws and rate caps that typically limit lending rates to a maximum annual percentage rate (APR) of 36 percent. Payday loan firms have come to fill the void in the short-term loan market vacated by more traditional lending institutions. They fill an important role in the marketplace for credit-constrained low- and moderate-income individuals who would otherwise have less appealing options. Federal Reserve Research by Samuel Hanson and Donald P. Morgan (2005) shows that the unique product supplied by the payday loan industry competes more intensely with pawn shops and the informal lending sector than with conventional banking institutions. Thus, further restrictions on or complete banning of the practice of payday lending would likely *not* encourage users to seek alternatives from traditional banking sources (since they are unlikely to be available), but would rather lead them to seek solutions for short-term loans in the semi-formal and informal sectors where legal protections on contract enforcement are weaker (Lehman, 2007).

If Ohio legislators wish to improve consumer choice and lower the fees charged in the formal small-loan market, the best possible approach, in my view, would be to clear the way for free and open competition for small-balance, short-term loans not by eliminating the payday lending industry, **but by instead exempting traditional banking institutions, such as banks and credit unions, from state usury laws that cap interest rates at levels far too low to make small loans a profitable alternative for conventional banking to offer** (see below, page 4, for further explanation). By exempting traditional banking institutions from state usury laws, legislators could open the door for these institutions to penetrate the growing

small loan market and offer a viable alternative to payday lending, introducing additional competitive pressure that may actually reduce the effective APR on these types of loans. In my professional view, it is the enforcement of state usury laws in conventional banking markets that, in part, has led to the rise of payday lending institutions to begin with. Were it not for state usury laws applied to small-balance, short-term loans, conventional banks would likely have been offering a product similar to that of the payday lending industry all along.

III. Likely impact of alternate legislation

In my professional opinion, the proposed regulations contained in both alternatives to HB 337 that are economically problematic are **the mandated APR caps on payday loans of 36 and 25 percent, respectively, which amount to a binding price ceiling that will throw the supply and demand of payday lending in Ohio into permanent disequilibrium.** These proposed annualized rates may seem “high” to the casual observer, but the short-term small-balance aspects of payday loans means that **rates capped at this level will end the practice of payday lending in Ohio.** This is why HB 337 is the best of the three alternatives. While rate caps are the most celebrated components of the alternate bills by critics who allegedly support “reform” of the payday lending industry, one cannot help but suspect that “reform” is less the goal of these critics than outright banning of the industry altogether, albeit indirectly.

The APR on payday loans must, of necessity, be significantly higher than the APR on conventional higher-balance and longer-term loans due to the much smaller economies of scale on small-balance loans. The fixed costs of originating a note loan are roughly the same, regardless the size of the loan. That is, it would require roughly the same fixed capital and labor inputs for a lender to offer, say, a \$1,000 non-collateralized loan for 12 months that it does to offer a \$500 payday loan for two weeks. However, the larger and longer-term loan can generate more revenue for the lender at a relatively low APR and still allow the lender to remain profitable due to the size and duration of the loan, whereas the smaller and shorter-term loan would generate only a fraction of the revenue necessary to

cover fixed and variable costs at the same APR.¹ Thus, by necessity, if the payday lender in this example is to expect to profit and remain in business, it must charge a significantly higher APR. Banks and other traditional lenders, because they are regulated by state usury laws, cannot charge the higher rates necessary to cover costs for a small-balance short term loan, and have thus essentially vacated the short-term small-loan marketplace. This has left payday lending firms (who are thankfully at present not governed by state usury laws in many states) to fill the void in the small-loan market, providing a valued service to cash advance customers who are apparently satisfied with the services they receive by evidence of their willingness to pay the significantly higher APR (Lehman, 2007).

The economic consequences of HB 333 or HB 358 create two distinct but related problems resulting from the proposed rate caps, one on the demand side and the other on the supply side. **The combination of these two problems will lead to a chronic shortage of small-balance short-term loans in the State of Ohio.**

First, by lowering the consumers' cost of obtaining payday loans, the rate caps would lead to an increase in the number of payday loan customers, encouraging many additional borrowers to consider payday loans to meet their credit needs. The law of demand is very clear: as the price of a payday loan declines, the number of payday loans demanded will increase, all else equal. Given payday loan critics' stated objections to payday loan practices, it seems peculiar that they would propose regulations that would give potential borrowers a *greater* incentive to consider and use payday loans as opposed to alternative credit products. If anything, it would seem that if the goal were to discourage borrowers from using payday loan services, critics of payday lending would propose *raising*, not lowering, the price of a payday loan. Thus, on the demand side alone, the policies proposed by critics supporting either of these bills would have consequences directly opposite those they intend.

Second, and more to the point, the lower APR caps would eliminate any incentive for creditors to offer small-balance short-term loans. **The proposed rate caps on payday**

¹ At an APR of 36 percent, the larger pre-computed 12-month loan would generate \$360 of revenue for the lender ($\$1,000 \times .36 = \360). At the same APR, the smaller two-week loan would generate only \$6.90 in revenue for the lender ($[\$500 \times .36] \div 365 \text{ days} \times 14\text{-day loan term} = \6.90).

lending would lead to an acute reduction in the number of small loans supplied, essentially eliminating the practice of payday lending in Ohio and forcing payday loan customers to pursue less appealing alternatives in semi-formal and informal markets, such as pawn shops or even black market lending where legal contract enforcement is weak or non-existent. These are alternatives short-term borrowers can presently avoid by tapping into the convenient services offered by payday loans.

By capping rates at a 36 percent APR, **HB 333 would reduce the revenues flowing to the payday loan industry in Ohio by an average of approximately 90 percent.** For example, current regulations and current practice in Ohio permit a payday loan firm to charge a \$15 fee for a \$100 two-week payday loan, which implies an APR of roughly 391 percent.² **Were the APR capped at 36 percent as proposed by HB 333, the fee on this same \$100 two-week loan would amount to just \$1.38.**³ The reduction in fees per \$100 borrowed for a two-week period from \$15 to \$1.38 amounts to a 90.8 percent reduction in revenues, on average, for the payday lending industry in Ohio. The consequences for payday lending industry revenues under HB358 would be even more dire.

I do not know of, nor can I conceive of any possible scenario under which, any industry in Ohio or elsewhere could possibly survive in a competitive marketplace after having over 90 percent of its revenues arbitrarily regulated away. It is inconceivable to me that the payday lending industry in Ohio could meet the costs of supplying small-balance short-term loans and continue to survive under such conditions. As anecdotal evidence in support of this assertion, in my own state of Indiana, when the Indiana Supreme Court ruled in August of 2001 that an APR in excess of 72 percent on small loans originating in Indiana violated Indiana law, the number of payday loan firms in the state dropped by approximately half in a span of roughly 12 months. Only after the Indiana State Legislature revised and reformed the regulations governing payday lending in 2002, exempting payday loan firms from state usury laws, did the industry revive (Lehman, 2007).

² $[\$15 \div \$100] \div 14\text{-day term} \times 365 \text{ days} = 391.1 \text{ APR}$

³ $36\% \div [365 \text{ days} \div 14\text{-day term}] = \$1.38 \text{ fee per } \$100 \text{ borrowed}$

It is my belief that the critics of payday lending who support alternate legislation capping rates on payday loans know that the effects of either of these bills will be to drive payday loan firms out of business in Ohio. I believe this is their unstated but nonetheless clear intention in pushing for the passage of either of these alternative bills. They know what they are proposing. In my experience, many of these critics are driven by well-meaning but economically misguided intentions related to the well-being of the credit-constrained low- and moderate-income customers presently using payday loan services.

Either way, the unintended consequences of these proposed regulations will undoubtedly leave payday loan customers in Ohio worse off from their own vantage point and given their very personal circumstances. Borrowers without access to payday loans may instead incur greater costs in the form of late fees on utility bills, utility shut-off and reconnect charges, uncompleted auto repairs, and/or bounced check charges,⁴ costs that could amount to considerably more than the costs of a payday loan, both in terms of time and money (Lehman, 2007). Others may attempt to borrow cash from pawnbrokers, pawning personal property that they would prefer to keep in exchange for a short-term loan. Still others may seek credit options in informal markets without legal protection, or borrow from relatives who take pity on them. **Borrowers, by their very actions in choosing a payday loan over these alternatives, reveal their preferences in favor of a payday loan given their circumstances.** In weighing the costs and benefits of the options available to them, payday loan customers clearly believe that the benefits of a payday loan exceed the costs, and that a payday loan is preferable to any other alternative, if any, given the circumstance. **This is a reality that critics of payday lending are loath to admit and work hard to conceal.**

Thus, the critics of payday loans who ostensibly wish to help credit-constrained borrowers by pushing for the elimination of the payday lending industry are instead exacerbating the situation by limiting their options even further. Eliminating the payday lending industry in

⁴ For a comparison of the costs of bounced check fees and payday loan fees, see Consumer Credit Research Foundation, 2005a. This study concludes that bounced check fees are costlier than cash advance fees in the payday lending industry when compared by APR.

Ohio, as other legislation would certainly do, makes no improvement in the circumstances of credit constrained borrowers, and eliminates the one option that they clearly prefer when in a financial pinch: the payday loan. Such proposals are utterly lacking in economic logic even from the perspective of those who propose them.

[In the interest of time, I will skip over this section and proceed to the Conclusion.]

IV. Critique of the research critical of the payday loan industry in Ohio

The research produced by critics of the payday lending industry in Ohio⁵, and especially the reports sponsored by or linked to *The Center for Responsible Lending (CRL)*,⁶ take the payday lending industry to task for allegedly creating “debt traps” through loan rollovers or back-to-back payday loans from different payday loan companies. These critics argue that the payday loan model is itself dependent on “trapping” borrowers in a “cycle of debt” through “predatory” lending practices dependent on “repeat business” that makes the payday loan model “inherently flawed.” Yet, assumptions made by these critics, and the data presented in their reports, are unable to substantiate these claims.

First, payday loan rollovers or back-to-back same-day payday loans from the same company are prohibited by Ohio law. So, the practice of stringing together repeated payday loans from one payday to the next is significantly attenuated in Ohio relative to other states that may permit payday loan rollovers. Intrepid payday loan customers may still obtain simultaneous or overlapping payday loans from different companies or over the Internet, if they so desire. But we should not expect the payday lending industry to be responsible for the behaviors of some payday loan customers who explicitly and willfully go against the “best practice” standards of the payday loan industry itself.

Second, the desire for repeat business by payday loan firms is no different than the desire for repeat customers in any other business model. Indeed, all businesses thrive on repeat

⁵ Policy Matters Ohio, Housing Research and Advocacy Center (2007), and Ohio Coalition for Responsible Lending (2007).

⁶ For an example of the problems associated with research from the CRL, see Consumer Credit Research Foundation, 2005b.

customers, and very few would survive without them. **The fact that payday loan firms want repeat borrowers does not alone demonstrate that payday loan firms are predatory or that they seek to trap borrowers in a debt cycle.** In fact, it is in the payday lender's interest not to loan more to payday borrowers than the borrower can reasonably be expected to repay, since high default rates significantly threaten the industry's revenues (Hanson and Morgan, 2005). From retailers and wholesalers who depend on repeat buyers, to banks, credit unions and mortgage and credit card companies who depend on repeat borrowers, all business models are similar: firms thrive when they offer a demanded product at a price that consumers are willing to pay, and do so repeatedly, cultivating a positive reputation and brand loyalty. The payday loan business model is certainly no different in this regard, and should not be singled out for criticism and government harassment for its pursuit of repeat business.

Finally, the research reports offered by critics attempting to substantiate predatory lending in Ohio **play fast and loose with the data, and draw conclusions that cannot be supported by the data they use.**

The main problem with the two Ohio studies on the payday lending industry⁷ is poor research methodology (e.g., the authors use non-inferential methods to draw inferential conclusions). Both studies mix and match different univariate data sets from several different sources that fail to support their inferential hypothesis that payday lending causes debt traps among Ohio consumers. Both studies, lacking data on actual payday loan borrowers, analyze the characteristics of payday loan stores in Ohio (growth in number of stores, estimated number of loans per storefront, estimated repeat loans, estimated average loan and fee size per storefront, etc.) and then attempt to attribute characteristics of payday loan stores to payday loan consumers in Ohio. In research terminology, this error is known as the "ecological fallacy": attributing characteristics of one unit of analysis (a payday loan store) to a completely different unit of analysis (payday loan customers). In simple terms, both studies erroneously argue that growth in the number of payday loan stores and/or growth in the number of loans per storefront *ipso facto* causes payday loan customers to experience debt

⁷ Policy Matters Ohio, Housing Research and Advocacy Center (2007), and Ohio Coalition for Responsible Lending (2007).

traps. **Yet, without data on actual payday loan customers, one could not confidently substantiate this hypothesis.**

In addition to the ecological fallacy, the study by the Ohio Coalition for Responsible Lending further lacks a random sample of payday loan stores. Instead, the author chooses only the four largest payday loan firms in Ohio, speculating that these four largest companies are “representative” by comparing them to the similar findings of other studies in different states, and by making speculative assumptions and extrapolations with the data. Even though smaller payday loan companies in Ohio would surely differ from the largest on any number of important measures, the author claims confidently that “this sample is representative.” **In reality, the study is likely plagued by severe sample bias.**

One of the more frustrating errors committed by both studies is that they estimate the aggregate costs of payday loans, including aggregate fees and interest charges (costs that the authors claim are excessive), **without also identifying either the individual or aggregate benefits that Ohio consumers receive from these convenient loans as revealed by their preference in using them.** Payday loans, like any other financial product, impose a cost on the borrower (reflected in the fee or interest rate) that is intended to cover the total opportunity costs borne by payday loan firms when choosing to hire scarce resources (land, labor, capital and entrepreneurship) out of alternative competing uses to supply the loan product. Yet, the benefits of these loans to payday borrowers clearly exceed the costs (else they would not continue to use them), and may indeed lead to a net positive benefit for the overall Ohio economy. The authors of these studies, however, make no mention of benefits received by borrowers in the form of convenient small-balance short-term loans, choosing a one-sided analysis that includes only the costs. This would be analogous to adding up the aggregate costs of all owner-occupied and rental housing in Ohio, ignoring the benefits of housing and housing services to tenants and home-owners, and then arguing that the cost of housing in Ohio was an excessive burden on the Ohio economy. This is simply absurd.

A true cost-benefit analysis of the payday lending industry would include any potential additional costs beyond the price of the payday loan (such as externalities imposed on third

parties, if any), and then would compare the total social costs of payday lending with the estimated benefits accruing to both the actual users of payday loans as well as any potential spillover benefits to third parties. Then, and only then, could one compare the marginal social costs with the marginal social benefits of payday lending and determine whether there is a net benefit or net cost to the Ohio economy from these types of products. I know of no studies that have yet attempted this at a state or national level.

The ideal research methodology for investigating whether payday lending causes debt traps or is predatory would be a stratified random sample of data on payday loan borrowers, matched with a second stratified random sample of data on non-payday loan borrowers as a control group. To support the hypothesis that payday lenders “cause” debt traps, the data must be able to show that the payday loan sample of borrowers is statistically significantly more likely to experience predatory debt traps or debt cycles than the non-payday loan sample of borrowers (or that there is a statistically significant difference between the two samples on some measure of indebtedness or predatory lending), and that this difference is *not* caused by other spurious or intervening variables other than the presence of a cycle of payday lending. In other words, the researcher would ideally need sample data on actual payday loan consumers, and would need to show that payday loan users are more likely to experience debt traps than non-payday loan users, and that traps are caused by the presence of payday loans while controlling for alternative explanations for the indebtedness cycle (such as customer character, capacity for loan repayment, amount of collateral, if any, and various demographic characteristics such as gender, age, and race or ethnicity).⁸

This hypothesis would be extremely difficult to support even if one had access to all the necessary and detailed data on individual borrowers, and even if the researcher utilized a robust econometric technique, such as that based upon multiple regression analysis. Indeed, Hanson and Morgan (2005) attempted an approach vaguely similar to this (although without data on individual payday loan customers), and could not support the hypothesis that payday lending was predatory. The two research reports by payday loan critics in Ohio contain no

⁸ A tentative theoretical model of what this research investigation might look like is presented in the Appendix to this report.

data that even begin to approach this level of detail. Specifically, the studies do not contain data on individual borrowers. Yet, their conclusions confidently claim to have demonstrated the presence of debt cycles and predatory lending caused by repeat payday borrowing in the state of Ohio. In my view, their conclusions are not supported by the research data they muster, and their research methods are highly suspect or simply wrong.

V. Conclusions

Payday lending has come to fill a market niche in the consumer finance industry between the informal sector and conventional but larger and longer-term consumer loan products offered by traditional banks. **Eliminating access to payday loan services, as alternative legislation would certainly do, only encourages borrowers to seek out and utilize less attractive alternatives that put the borrower in an even weaker financial position.** Yes, payday loan customers are often in dire financial straights. However, it does not follow that the payday lending industry *causes* these dire straights simply because they offer a financial product that appeals to cash-poor consumers. Binding interest rate caps or outright banning of payday lending will have the adverse consequence of reducing credit options for those who may have few alternatives to begin with. **You do not help credit-constrained or cash-poor borrowers by identifying their list of available options and then eliminating the one they actually choose.**

To that end, I encourage the subcommittee to scrap HB 333 and HB 358 and instead pass HB 337. HB 337 will do much less economic damage to the small loan market in Ohio, and will leave credit constrained small-loan borrowers in Ohio with the market option they clearly prefer. HB 333 and HB 358, on the other hand, are economically unsound, proposed and supported out of economic ignorance or worse, and will prove to be harmful to the credit-constrained borrowers the supporters of these bills ostensibly seek to help.

Thank you for your time, and I would be willing to entertain any questions the subcommittee may have regarding my testimony.

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Appendix

A crude and tentative theoretical model of the proposed relationship between debt traps and payday lending is found below in *Equation 1*, and may begin a dialogue on a much improved methodology for investigating whether this relationship exists.

$$(1) \quad y_i = \alpha + \tau_i b_1 + x_i b_2 + \varepsilon_i$$

where y_i is the predicted value of some arbitrary measure of debt entrapment or predatory lending (the dependent variable) exhibited by borrower i ; τ_i is a dichotomous variable indicating either a payday loan borrower or a non-payday loan control group borrower; x_i is a vector of control variables theoretically correlated with y , such as the age, gender, race or ethnicity, and income of the borrower, and any additional control variables the researcher may wish to include; α is a constant; b_1 and b_2 are computed partial coefficients measuring the influence of τ_i and x_i on y_i ; and ε_i is a standard regression error term anticipating omitted variable bias.

The assumption, here, is that detailed data on individual payday loan borrowers, as well as comparable data on a control group, could be obtained from a true probability sample (survey), and that such data could be properly coded and inserted into a database and multiple regression model to determine whether a positive relationship between payday lending and debt entrapment could be shown.

To begin to tentatively assert causation between payday lending and debt cycles or predatory borrowing, the researcher would need to observe a positive and statistically significant correlation between the partial coefficient on τ_i and the predicted value of y_i . This would not, in itself, “prove” that payday lending causes debt traps for cash advance borrowers, but it would allow us to support the hypothesis that a positive relationship exists, something that no research has been able to demonstrate to date.