



Searching for “Harm” in Storefront Payday Lending

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As an attorney, this writer’s job is usually to apply the law to facts presented by clients. Sometimes, however, the opportunity arises to develop facts that will inform the legal process, because not all the facts are known. That unusual situation arose when our client, Clarity Services Inc., offered us the opportunity to direct a team of statisticians analyzing a very large dataset of storefront payday loans in order to test the factual basis for the CFPB’s ongoing rulemaking on Small Dollar Lending. As a former CFPB executive involved in payday loan research, I jumped at that chance to lead the research and write up the results.

The Report on the results of our analysis was published on February 12, 2016 at <https://www.nonprime101.com/wp-content/uploads/2016/02/Report-7-B-Searching-for-Harm-in-Storefront-Payday-Lending-nonPrime101.pdf>. This article summarizes the findings of that Report.

Purpose of Study

As a consumer reporting agency, Clarity has a longer duration, and larger, data set than the Consumer Financial Protection Bureau (CFPB) had available for its two published reports on storefront payday lending, including *Payday Loans and Deposit Advance Products* (2013) and *CFPB Data Point: Payday Lending* (2014). The Clarity Report data can also follow borrowers crossing the street to a different lender, which the CFPB data set did not allow.

The Clarity Report conducts some of the same tests of borrower use patterns as the CFPB to see if the outcomes are different with a larger data set, and to see if a borrower’s use of multiple lenders changes the outcomes.

The Report also analyzes several questions that the CFPB could not, given the short duration of the CFPB’s sample:

- How long do storefront payday customers use the product from first loan to last loan?
- Do the measures of intensity of use studied by the CFPB change when looking at an entire life cycle in the product?
- Looking at a large number of borrowers over their entire life cycle of use, what is the worst case scenario (the longest sequence of related loans) for each borrower?
- What is the size of the groups who use the product lightly (in short sequences) versus those who use it more heavily (in long sequences)?

- Is there a difference in the rate at which lighter users and heavier users exit the product and are replaced?
- Looking longitudinally over a long period of time, what is the count of light users versus heavy users?

The CFPB's Current Proposal — The Legal Context for the Facts

The CFPB's report relies on two studies of storefront payday lending, *Payday Loans and Deposit Advance Products*, a white paper published in 2013 and *CFPB Data Point: Payday Lending* published in 2014. Those studies form the basis for a pre-rule outline of a regulatory intervention. The outline was published in March 2015, as part of a required process to discuss the impact of the proposal with small business representatives, before issuing a draft rule. The complete draft rule is expected in May 2016.

The CFPB has outlined a plan to regulate small-dollar lending that would put the storefront payday industry out of business. The CFPB and industry sources have predicted the rules will cause a 60-70 percent reduction in storefront payday loan volume.

The CFPB's basis for the proposal is that existing payday lending is "unfair and abusive." These are legal terms that depend on a finding that borrowers are "harmed" by the product. The CFPB has stated that "harm" occurs in short-term, small-dollar products because the borrower cannot afford to both make the payment of principal and fees and meet other obligations and cost of living. According to the CFPB, this results in borrowers frequently renewing their loans (for another fee) or repeatedly paying off and immediately re-borrowing a loan. As the reasoning goes, if the re-borrowing occurs in the same pay period that the loan was last paid off, then the re-borrowing is economically the same as a renewal or roll-over. It's borrowing the same money. The CFPB calls a series of loans that have this relationship a "loan sequence," and declares there is "harm" where the cost of loan fees in the sequence "eclipses the loan amount." According to its proposal, the CFPB is willing to allow a sequence of three loans to occur, without compliance with the proposed rule's draconian underwriting requirements. Three fees apparently are not too much to pay. On the other hand, at the going rate of \$15 per \$100 per pay period, a sequence of seven loans would clearly meet the CFPB's definition of "harm," because seven loans cost 105 percent of the principal.

Since the CFPB theory is that re-borrowing before a new paycheck is received is basically an extension of a single loan, the Clarity Report linked together as "sequences" all loans taken out in the same pay period that a prior loan was paid off. If a bi-weekly payroll borrower pays off a loan on a payday, any loan taken out before two weeks later is in the sequence. The Report used the exact pay period of each borrower to make this analysis, whether weekly, bi-weekly or monthly.[1]

The CFPB's Data Supporting Its Proposal vs. Clarity Data in The Report

Clarity has five years of data from 20 percent of the storefront market. Clarity can see the same borrower dealing with multiple lenders. In the Report, Clarity used a subset of 72.5 million loans and 4.1 million borrowers over four years. The dataset also allowed the analysts to look back 6 months before the study period to detect recent borrowing. The CFPB studied 15 million loans over one year. Clarity can see borrowers enter and leave the market over a market life cycle, which is usually much more than 12 months.

Clarity Results

1. Measuring Life Cycles

The Report defines life cycle as the number of days between the first loan and the last loan in the data set. It does not indicate the intensity of loan use during that period. The Report looks at intensities when looking at number of loan sequences per borrower and length of loan sequences per borrower.

The Report finds that a group or cohort consisting of all borrowers who had loans in January 2010 (about one million people) had average life cycles of almost exactly two years. Although the data is affected by some truncation effect, it captures full life cycles for at least 85 percent of borrowers. On the other hand, about 10 percent of the borrowers are in the product for more than four years. Thus, the data will present an accurate picture of how different groups of users (lighter and heavier) use the product. In contrast, a one-year test used by the CFPB is not likely to be accurate for comparing the relative size of lighter and heavier user groups (something the CFPB did not try to measure).

2. Measuring Sequences per Borrower

In its *Data Point*, the CFPB compared multiple ways to build the test population (sampling methods) to test the number of borrowers with one sequence, two sequences, etc. All other things being equal, fewer sequences suggest less “harm.” The sampling methods include looking at all borrowers in a month and looking at borrowers in that month who have not had a loan in the previous 30 days. The Report adds two new screens for “newer” borrowers: no loan in the previous 90 days and no loan in the previous 6 months.

The Report applied the same sampling and analytical methods as the CFPB to its larger data sample to see if it produced results similar to *Data Point*. Using the CFPB’s relatively short time window to measure use patterns (11 months), the Report found results very similar to the CFPB studies. However, when reviewing entire market life cycles of storefront payday use, the Report found different results. The takeaway is that the CFPB’s white paper suffered from sampling bias and both of the CFPB studies covered too short a time period to get a full picture of borrower use patterns.

The Report also measures sequences involving *multiple lenders*. Borrowing intensity is not greatly increased when adding in the effect of using multiple lendersto extend a sequence. It does not increase the number of sequences per borrower.

3. Number of Loans per Sequence

The counting of number of loans per sequence goes to the heart of the CFPB’s theory of “harm,” long sequences in which the fees “eclipse the loan amount.” The Report computes the average and the median sequence duration using samples drawn using all of the CFPB methodologies, as well as testing borrowers with no loans 90 days and six months prior to the cohort month (January 2010).

There are several significant findings. First, for all but one of the samples, the median sequence duration was two loans in a row. For the method used in the CFPB’s white paper, it was three loans in a row. The median is the point at which half of the sample is higher and half lower. In other

words, half of all loan sequences are within what the CFPB would define as “safe” in its recent outline of a regulatory proposal for small-dollar loans. In contrast, the average (or mean) sequence duration was between four and five for the various samplings of new borrowers (those without loans before the cohort month) and between six and seven for the method used in the CFPB’s white paper. The latter sample suggests average borrower experience that approaches the CFPB’s “fees that eclipse the loan amount.” All other samples do not.

The significant difference between the median borrower experience (two or three loans in a row) and average experience (four to seven loans in a row) suggests that *a minority of loan sequences tend toward extreme length, dragging the average up into the realm of where the CFPB believes “harm” exists.*

The Report also asks whether borrowers cross the road to another lender to extend their sequences. They do, but not very much. The difference in mean sequence duration between single-lender sequences and multiple-lender sequences ranges from nil to insignificant.

4. What’s the Worst Case per Borrower?

The Report then measures the worst case (the longest loan sequence) for each borrower. If a borrower can go up to four years in the product without a sequence of loans in which the “fees eclipse the loan amount,” there is a good argument that borrower is not “harmed” (at least not by the price of the extended loan).

The median worst case for all newer borrowers in January 2010 (those without a loan in the prior 30 days), measured over four years, was five loans in a row. For *all* borrowers in that cohort (CFPB’s method), it was nine loans in a row. These statistics reflect the fact that, in any given month, 75-80 percent of borrowers are in an extended borrowing experience. They are heavier users. The CFPB chose to test this “all borrowers in a month” group. The mean worst case confirms this. For newer borrowers, the mean worst case is around nine loans in a row. For all borrowers in January 2010, it is close to 16 loans in a row.

The Report also examines outliers to see what extended sequence durations are dragging the mean (average) so high. At the 90th percentile (the top 10 percent), the Report finds the duration of a single-lender sequence is 26 loans and a multi-lender sequence at 42 loans in a row. These are the worst of worst cases and suggest that there is room for regulatory intervention that has little to do with single-digit sequences.

5. How Many Borrowers Show Evidence of Harm?

The Report next shows that, for all sampling methods other than the CFPB white paper (all methods of looking at borrowers other than one that oversamples heavy users) 60 percent of borrowers never have a worst case greater than six loans in a row. Remember that the average sequence for those borrowers is less than five and the median is two (over four years).

All of the foregoing analysis is based on what is called a “static pool,” or a group of consumers that is selected once and then followed over a period of time. How one selects the pool makes a huge difference in finding an inference of “harm.” There is no way to avoid sampling bias in a static pool. The Report therefore sets out to find out the relative size (over time) of a longitudinal group of continuous heavier users and less frequent, lighter users. This is important because the legal issue of whether or not the product is so unfair as to justify banning it will be greatly influenced by

the balance of ending harm to heavy users versus denying access (another harm) to lighter users — over time.

6. How Many Borrowers Show Evidence of “Harm” in a Longitudinal Pool?

The Report approximates the relative size of the populations of heavier, continuous users versus less frequent, lighter users, over a four year period. Heavier users leave the product very slowly. Fifty percent are still in the product a year later. After that, 80 percent are found a year later and a similar percentage a year after that. Twenty-five percent are still in the product at the end of four years.

In contrast, when sampling the population every December from 2010 to 2013, the Report finds almost complete replacement each year of the group of lighter users with new, lighter users. This is consistent with the earlier finding that lighter users have shorter life cycles.

Using the attrition rates for heavier users found in the sample, the Report then modeled a constant population of 1,000 borrowers over four years, assuming that lighter users would be replaced every year. This admittedly rough approximation showed that, even though 80 percent of borrowers in any month are heavier users, over a period of time only 60 percent of borrowers are in a group that is likely to have a worst case of more than six loans in a row, and 40 percent are unlikely to experience “harm” of paying more than they borrowed.

7. Policy Takeaways

The discussion of how many borrowers are “harmed” versus how many are not assumes the validity of the argument that “harm” occurs when a borrower pays more in fees than the principal that is borrowed. Existing research on uses for payday loans challenges that assumption. Current research suggests that many borrowers use the product either to cover an emergency expense or to cover a mismatch between timing of income and due dates (after grace periods) of expenses. Fully a third of the use cases fall in this category, and the vast majority of the costs being covered in those use cases are for transportation, housing or utilities. A close fourth is medical care.

A consumer whose alternative to even a very expensive payday loan is to go without housing, transportation, utilities or medical care has a very high opportunity cost when not taking the loan. That cost can be loss of a job, loss of housing, loss of heat or loss of health.

If only a third of the 60 percent of cases where cost may exceed principal (once in 4 years) are nevertheless economically justified by the opportunity cost of *not* using the product, then a majority of consumers are not “harmed” by the product. That is, 40 percent of borrowers never pay more in fees than they borrow and another 20 percent have a very good reason to do so — an economically rational reason.

The Report therefore suggests that an intervention that is certain to eliminate the storefront industry may not make legal or economic sense. The CFPB should allow the product to continue, perhaps in an amortizing installment form, where high rate installment loans are permitted by state law. Where that is not allowed, a sequence of up to six payday loans should be allowed, with borrowers guaranteed an amortizing installment exit plan if they hit the six-loan trigger.

The data also shows borrowers who have not had a loan for 30 days are much less likely to get into a long loan sequence. Thus, a model permitted loan product should only require a 30-day cooling

off period (after a six-loan sequence) before the borrower could once again access the product.

The Report then models the effect of this proposal on the loan volumes in a dataset containing 20 percent of all storefront payday loans. If one assumes a legal maximum sequence length of six loans, followed by a thirty-day cooling off period, current industry loan volume would drop by 20.67 percent. Adding a four-pay-cycle period for installment repayment of principal after six loans would produce a cumulative loan volume reduction of 36.36 percent (some of which would be offset by interest revenue during the installment repayment). While a one-third reduction in loan volume and associated revenue would be a severe income shock to industry, it is much more likely to be survivable (through store and lender consolidation) than the seventy percent volume reduction proposed by the Bureau.

The full Report is available at <https://www.nonprime101.com/wp-content/uploads/2016/02/Report-7-B-Searching-for-Harm-in-Storefront-Payday-Lending-nonPrime101.pdf>. Clarity has promised a coda to its Report, measuring the precise “harm” levels in a randomly sampled longitudinal group of borrowers over 4.5 years. We will summarize that new study when it is published.

[1] The CFPB’s White Paper used a similar method, but linked all loans made within 14 days of the last payoff. The Clarity method is more precise.

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