Skirting the Law:

Five Tactics Payday Lenders Use To Evade State Consumer Protection Laws

I. Executive Summary

The Context. Over the past two decades, the landscape for the short-term, small-dollar credit market has changed dramatically. Previously rejected by a number of states under usury limits, payday lending has become one of the fastest growing segments of the consumer credit industry.[1] As a niche financial product targeting subprime borrowers, payday loans have proven costly for their users while incredibly lucrative for the purveyors of the debt. According to the Center for Financial Services Innovation, consumers of short-term, small-dollar debt spent $41.2 billion on these products in 2012 alone.[2]

For millions of cash-strapped consumers living in the United States, short-term loans can appear to be the answer to their immediate financial problems. Yet, more often than not, a payday loan solution to a short-term lack of cash ends up trapping consumers in an endless cycle of unaffordable loans. According to research conducted by the Consumer Financial Protection Bureau,[3] the average payday borrower in the United States is in debt for nearly 200 days — more than half a year. One in four of those borrowers also spends at least 83% of the year owing money to a payday lender.[4]

Payday loans, also known as “deferred presentments,” “cash advances,” or “check loans,”[5] are small-dollar, short-term loans where the agreement requires the consumer to give electronic access to their bank account or a postdated check to the lender for the amount borrowed plus a finance charge. The lender holds the authorization or check as collateral for the loan until the borrower’s next payday, [6] a period that can range from one to four weeks. At the end of that timeframe, the borrower can pay off the loan by paying in cash, allowing the lender to deposit the check, or letting the lender utilize the electronic authorization. If the borrower cannot repay the loan or does not have enough money in the bank account to cover the check at the agreed upon date, they may then pay another fee to extend or “rollover” the loan for an additional period. [7]

To regulate payday lending, states have usually adopted one of three approaches. Legislatures enact a statutory regime that either: (1) enables payday lending without restriction, (2) controls payday lending through some set of product or servicing

limitations, or (3) prohibits the practice of payday lending entirely. Typical state legislative efforts include mandating interest-rate caps, limiting the amount of loans that a borrower can take out on an annual basis, and requiring more consumer friendly repayment terms—such as an expanded repayment period.[8] A breakdown of each state's payday lending requirements is included as an appendix to this report.

The Challenge. Despite legislative efforts to govern short-term, small-dollar lending by states, some payday lenders have proven to be adept at avoiding state regulations. In states that have been able to mandate meaningful consumer protections for payday-loan consumers, lenders have quickly found new ways to avoid compliance. For example:

- Texas payday lenders circumvent state law by having their affiliated storefronts pose as separate Credit Access Businesses. By disguising themselves as a completely different kind of financial service provider—one that isn't subject to the limits imposed on payday lenders—Texas payday lenders are able to collect additional fees and interest for the act of directing consumers to them through the affiliated credit access business.

- Similar to the rent-a-bank model that, before being shut-down by federal banking regulators, was previously embraced by lenders to avoid complying with state-enacted payday bans, some lenders have established partnerships with Native American Tribes to use tribal sovereign immunity to circumvent the laws barring payday lending in states like Arizona, Georgia, and Maryland.

- When Ohio capped interest rates on short-term, small-dollar loans, unfazed payday lenders operating in the state started offering cash advances under the mortgage lending statute.

- In many other states with payday-loan restrictions, like California, lenders use online lending to broker payday loans to consumers without first obtaining a state business license or complying with state regulations on the loan's terms.

- In Florida, lenders allow consumers to take out multiple payday loans during the same pay period by taking advantage of the state's 24-hour, cooling-off period.

This report illustrates these five tactics by looking at events unfolding in the states of Ohio, California, Florida, Texas, and Colorado as case studies.

The Dodd-Frank Wall Street Reform and Consumer Protection Act and the Consumer Financial Protection Bureau's Power to Regulate Payday Lending.

In order to protect consumers from the predatory practices of payday lenders, it is clear that we need to develop a federal regulatory framework that uniformly applies to all payday lenders operating in the United States. That framework must establish a minimum set of consumer protections to ensure that short-term, small-dollar products are not predatory. On June 2, 2016, the Consumer Financial Protection Bureau ("CFPB") released a proposed rule for payday lending that would create that federal regulatory framework.

Under Dodd-Frank, Congress granted the CFPB oversight of previously unregulated nonbank lenders, including payday lenders.[9] Relying upon that authority, the Bureau has devoted extensive attention to payday lending and the effectiveness of existing regulations, starting with the CFPB's release of its White Paper of Initial Data Findings on Payday Loans and Deposit Advance Products in April 2013.[10] The following year, 2014, the Bureau's full report was released and contained findings identifying the harms associated with some product features frequently found in payday loans.[11] Further, on March 26, 2015, the CFPB published an outline of a proposed rule on short-term, small-dollar lending in preparation for the required Small Business Review Panel (SBRP) that must be held as a preliminary step of the Bureau's rule-making process.[12] These actions, combined with a series of public field hearings and ongoing conversations with consumer and industry stakeholders, helped the agency propose a framework designed to eliminate the worst predatory practices in the payday lending industry, while preserving consumer access to small-dollar credit.

Metrics for Evaluating the Proposed Rule. The CFPB's proposed rule is a step in the right direction. In its current state, the rulemaking would better protect borrowers from unaffordable loans, cycles of re-borrowing, exorbitant fees, and unfair transaction practices through the Automated Clearing House. However, to ensure that the rule is as strong as

possible, it is also imperative that the evasive tactics that some payday lenders have employed to circumvent state laws are adequately prohibited by the CFPB's regulation. Accordingly, the following metrics can serve as useful tools when evaluating the effectiveness of both the Bureau's proposed rule and the resources that have been allocated to the agency to properly enforce consumer protections for borrowers of payday loans:

Metric 1: When evaluating the CFPB's rule, stakeholders should consider whether or not the definition of covered persons and covered products is broad enough to capture the various business designations or modified product features that lenders have previously used to skirt compliance with consumer protections.

Metric 2: When evaluating the CFPB's rule, stakeholders should consider whether the Bureau's prohibitions are broad enough to cover both lenders and affiliated credit service organizations or credit access businesses.

Metric 3: When evaluating the CFPB's rule, stakeholders should consider whether the rule requires a meaningful cooling-off time between a consumer's loans in order to ensure that the debt concern raised by frequent rollovers is adequately addressed.

Metric 4: When evaluating the CFPB's rule, stakeholders should consider whether the rule provides a definition for covered entities that explicitly includes tribal-owned operators. Unlike states, which lack the authority to regulate tribal lending due to sovereign immunity, Congress had direct authority to regulate commerce with Tribes when granting the CFPB rulemaking authority over payday lending.

Metric 5: When evaluating the CFPB's rule, stakeholders should consider whether funding for the CFPB's enforcement efforts should be increased in order to allow the agency to effectively monitor the activities of online lenders and adequately enforce consumer protection laws.