BANK PAYDAY LENDING

The State of Lending in America &
its Impact on U.S. Households

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Lending Abuses and Predatory Practices

In spite of public controversy and warnings from regulators, a few national and regional banks are routinely making payday loans, marketed under more appealing names. As shown by previous research and discussed here, these loans are promoted as a short-term solution to a financial shortfall, but in fact they keep borrowers trapped in extremely high-cost debt for a significant portion of the year.

Bank payday loans are structured in the same way as other payday loans. The bank deposits the loan amount directly into the customer's account and then repays itself in full, plus a very high fee, directly from the customer's next incoming direct deposit of wages or funds such as Social Security checks. If the customer's direct deposits are not sufficient to repay the loan, the bank typically repays itself anyway within 35 days, even if the repayment overdraws the consumer's account, triggering high overdraft fees for subsequent transactions.

The great majority of banks do not offer payday loans, but as of August 2013 we are aware of at least six that do: Wells Fargo Bank, U.S. Bank, Regions Bank, Fifth Third Bank, Bank of Oklahoma and its bank affiliates,[1] and Guaranty Bank.

The federal prudential banking regulators—who have long expressed concern about payday lending and who stopped banks from partnering with non-bank payday lenders years ago—have recently expressed serious concern about bank payday lending and proposed guidance that would put in place important protections. In addition, the Consumer Financial Protection Bureau (CFPB) recently released initial findings based on its analysis of bank payday data, expressed concern based on those findings, and indicated that it will take further action to address those concerns. CFPB's findings are noted throughout this chapter, and the supervisory developments are discussed in the Legislation and Regulation section at the end.

Extremely high-cost credit

Banks impose fees in the range of $7.50 to $10 per $100 borrowed for bank payday loans.[2] CRL's latest analysis of checking account data for the year 2011 found that the average bank payday loan term is 12 days—that is, the bank repays itself from the borrower's next direct deposit an average of 12 days after extending the credit (Borné and Smith, 2013).[3] The CFPB's recent white paper similarly found that 12 days was the typical period a bank payday borrower had an outstanding advance balance before it was repaid (CFPB, 2013).

This cost and loan term translate to an annual percentage rate (APR) ranging from 225% to 300%, an extremely high cost for credit, particularly since the lender virtually guarantees repayment by putting itself first in line when a direct deposit hits the account.

1 Bank of Albuquerque, Bank of Arizona, Bank of Arkansas, Bank of Kansas City, Bank of Texas, and Colorado State Bank and Trust.

2 While it continues to charge $10 per $100 borrowed during a borrower's first year of payday loan use, as it did in 2011, Regions Bank recently began charging $7 per $100 borrowed under certain circumstances for customers whose first Regions payday loan was taken out at least one year prior (Regions, 2013).

3 The median loan term is 12 days; the mean loan term is 14 days. For a detailed discussion of our methodology, please see Appendix A.

Predatory loan structure that drives account holders into a cycle of debt

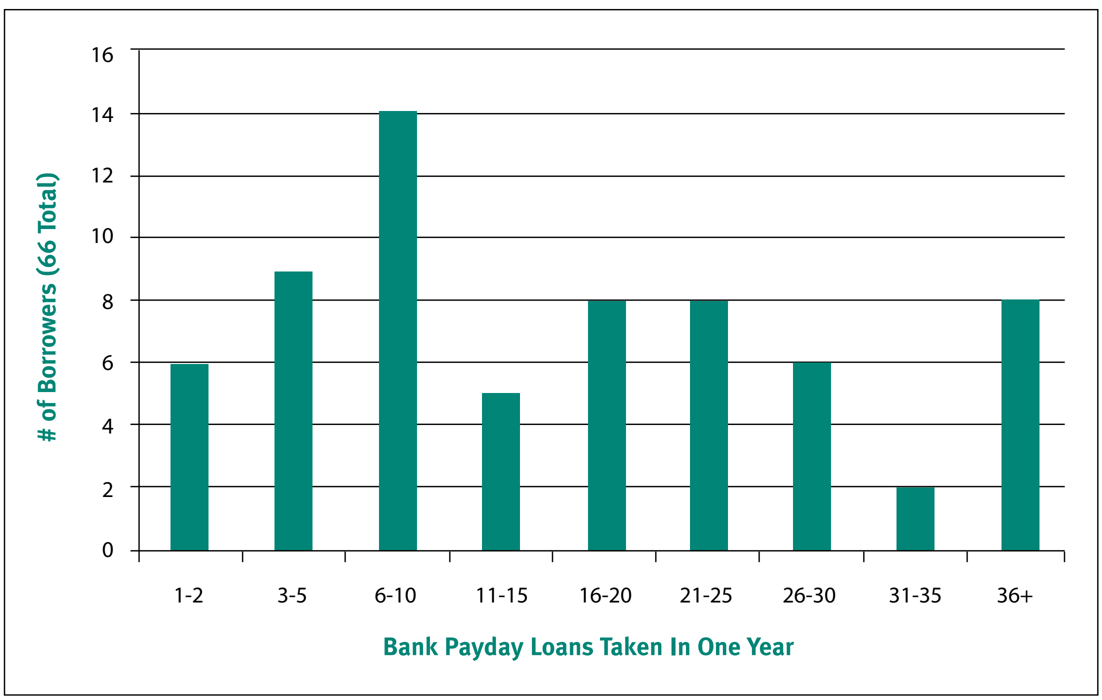
The fundamental structure of payday loans—a very high cost and short loan term with a balloon repayment—coupled with a lack of traditional underwriting makes repeat loans highly likely. Borrowers already struggling with regular expenses or facing an emergency expense with minimal savings are typically unable to repay the entire lump-sum loan and fees and meet ongoing expenses until their next payday. Consequently, the borrower often must take out another loan before the end of the pay period to meet other expenses, paying yet another fee and becoming trapped in a cycle of repeat loans. Indeed, bank payday lenders have little incentive to assess a borrower's ability to repay the loan, as the bank has direct control over the customer's account and can repay itself first.

Our analyses of 2010 and 2011 bank payday lending data quantified the long-term cycle of high-cost payday loan debt (Borné, Frank, Smith & Schloemer, 2011) (Borné & Smith, 2013). We found that the median bank payday borrower took out 13.5 loans in 2011 and was in bank payday loan debt at least part of six months annually—that is, a typical borrower had one or more bank payday loans outstanding at some point during six discrete calendar months during the year (Borné & Smith, 2013).

The mean number of loans was 19, far higher than the median, because over a third of borrowers had more than 20 loans (Borné & Smith, 2013).

As Figure 1 illustrates, many borrowers take out twenty, thirty, or more loans annually (Borné & Smith, 2013):

Figure 1: Bank Payday Loans Taken in One Year

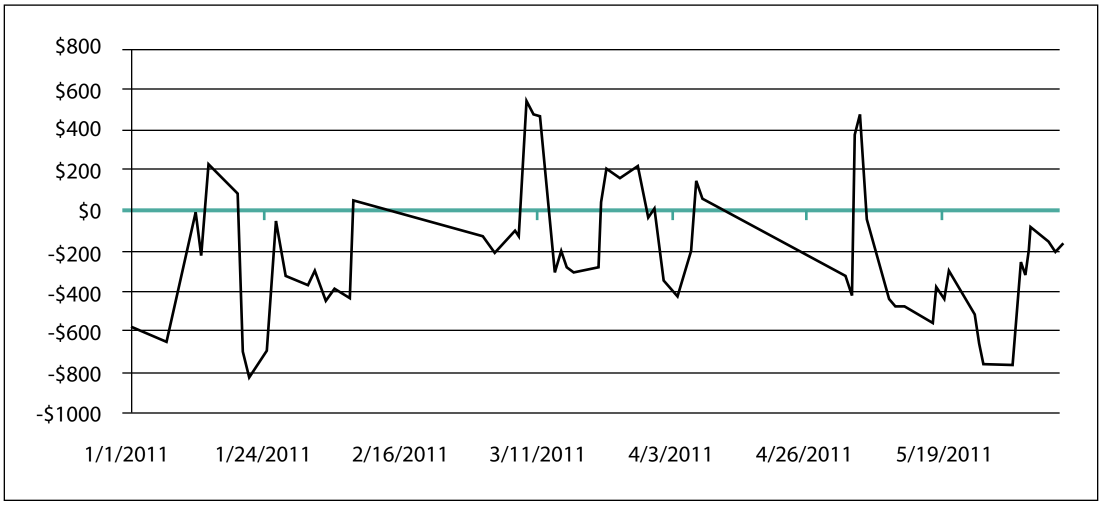


Similarly, the CFPB recently found a median number of 14 advances per borrower, amounting to an average of 112 days of indebtedness per borrower during the year (CFPB, 2013). Further, a sizeable portion of borrowers (14 percent) took out a median of 38 advances averaging $200 each, yet paid interest ranging from $570 to $760 (over an average 254 days of debt).

Both CRL's and CFPB's findings demonstrate that bank payday loans trap customers in a cycle of debt, refuting the banks' claim that these products are meant for occasional use to manage a short-term cash shortfall and not as long-term credit.[4]

A real-life case study from our database of bank payday borrowers provides an example of repeat loans to one borrower over the course of a six-month period:

Figure 2: Melinda's Checking Account Balance – January to June 2011



Melinda is a 33-year-old residing in Texas. During the five-and-half-months of account activity CRL was able to observe, Melinda had 19 bank payday loans, typically grouped into clusters of two-to-three loans extended over the course of a few days each month.[5] The median loan size was only $100, yet Melinda paid $233.50 in fees. She also incurred 21 overdraft fees during this period. At the end of the period, her account remained in the red.

Increased likelihood of overdraft fees

Banks have pitched their payday loans as a way for customers to avoid overdrafts and associated fees (Burbach, 2013).[6] But, as noted above, if the customer's direct deposits are not sufficient to repay the loan, the bank typically repays itself anyway within 35 days, even if the repayment overdraws the consumer's account, triggering high overdraft fees for subsequent transactions.

4 Every bank we know of making payday loans tells customers the product is intended for short-term rather than long-term use. For an example from each of these banks, see Appendix B.

5 See Appendix A for discussion of the database we analyzed; Melinda provided her account activity to the database for five-and-a-half months.

6 For example, Wells Fargo Bank's product agreement provides a chart comparing borrowing $300 for 30 days as costing $22.50 with the deposit advance (payday loan) product versus $70 with overdraft (assuming two overdraft items at $35 each) and also states: "If you find yourself in a situation where the funds in your . . . checking account may be insufficient to cover checks or other items that will post to your deposit account, you may choose to advance from [the direct deposit advance] service to avoid the overdraft . . . . The Direct Deposit Advance service is an expensive form of credit, and while the advance fee may be lower than an overdraft or insufficient funds fee, you may want to consider speaking with a banker regarding overdraft protection options that may be available to you" (Wells Fargo, 2013).

CRL analysis finds that nearly two-thirds of bank payday borrowers incurred overdraft fees, and these borrowers were three times as likely to incur overdraft fees as bank customers as a whole.[7]

The CFPB's analysis found similar results, with 65 percent of bank payday borrowers incurring overdraft or non-sufficient funds fees, which was more than three-and-a-half times the portion of customers eligible for a bank payday loan who did not take one out (CFPB, 2013). The CFPB further found that a quarter of the bank payday borrowers most heavily steeped in the cycle of debt incurred an average of 18 or more overdraft or non-sufficient funds fees during the 12-month period (CFPB, 2013).

These findings are consistent with what consultants selling bank payday loan software have promised banks: that payday lending will result in little-to-no "overdraft revenue cannibalization" (Fiserv, 2011b). They also confirm prior research finding that non-bank payday loans often exacerbate overdraft fees, leading to checking account closures (CRL, 2009).

For an illustration of how bank payday loans create a debt trap and cause overdraft fees for a Social Security recipient, see Figure 3 in the "Impact on U.S. Households" section of this chapter.

Ineffective "safeguards" that do not prevent a cycle of debt

Banks often point to "safeguards" they have in place on payday loans to ensure that borrowers do not become mired in a long-term debt trap; these include installment plans and "cooling-off periods," when banks will not extend the customer another payday loan following repayment of one or more loans. The data discussed above demonstrate that these "safeguards," as banks currently design them, are not effective, as borrowers spend large portions of the year in debt.

Banks that permit installment repayment plans make these plans difficult to qualify for or obtain. Wells Fargo Bank's "payment plan" (which allows payments in $100 increments rather than balloon repayments) is available only to customers who have already been in balloon payment loans in three consecutive months and have at least $300 in bank payday debt outstanding (Wells Fargo, 2013). Regions Bank's installment option is available only to borrowers who call the bank prior to taking out the advance and explicitly request an installment plan, while the bank places any borrowers who request a payday loan online, at a branch, or over the phone without specifying the installment option into the default balloon repayment structure (Regions, 2013).

Banks' cooling-off periods allow borrowers to become mired in a cycle of debt before the cooling-off period is triggered. Wells Fargo Bank's cooling-off policy, for example, allows six consecutive months of loans before a one-month cooling-off period is triggered (Wells Fargo, 2013). After six consecutive months with loans, a borrower will typically have paid hundreds of dollars in fees and still owe the original principal on the loan. By contrast, if provided an affordable installment loan at the outset, the borrower would have repaid all or a substantial portion of the loan after six months.

These bank "safeguards" are the same ones that non-bank payday lenders have long touted but that have proven to be ineffective in that context as well (King & Parrish, 2007).[8]

7 The prevalence of overdraft use among bank payday users is 63.6%, compared with 17.2% overall and 20.2% at banks that make payday loans. See Appendix A.

8 CRL examined millions of loans across several states that adopted similar "best practices" to ostensibly reform payday loans. Nevertheless, there was no measurable reduction in repeat borrowing. For example, over 60 percent of all loans from these states go to borrowers with 12 or more transactions in a year (CRL, 2007).

IMPACT ON U.S. HOUSEHOLDS

Research has shown that payday lending often leads to negative financial outcomes for borrowers; these include difficulty paying other bills, difficulty staying in their home or apartment, trouble obtaining health care, increased risk of credit card default, loss of checking accounts, and bankruptcy (Argawal, Skiba & Tobacman, 2009) (Jerez & Tufano, 2011) (Skiba & Tobacman, 2008).

Senior citizens

Senior Americans are particularly at risk. Our recent analysis of bank payday loans made in 2011 finds that more than one-quarter of bank payday borrowers are Social Security recipients. This finding is consistent with the 2010 data, which found that nearly one-quarter of all bank payday borrowers were Social Security recipients (Borné, Frank, Smith, & Schloemer, 2011).

Many senior Americans are financially vulnerable. From 2005 to 2010, the Great Recession led to a 13 percent decrease in net worth for households headed by someone age 65 or older (U.S. Census Bureau, 2005 and 2010). Coupled with declines in the value of their largest assets—homes and retirement assets—many older Americans struggle with limited incomes. More than 13 million older adults are considered economically insecure, living on $21,800 a year or less (National Council of Aging, 2011). People over age 55 make up the fastest-growing segment of people seeking bankruptcy protection (Brandon, 2010).

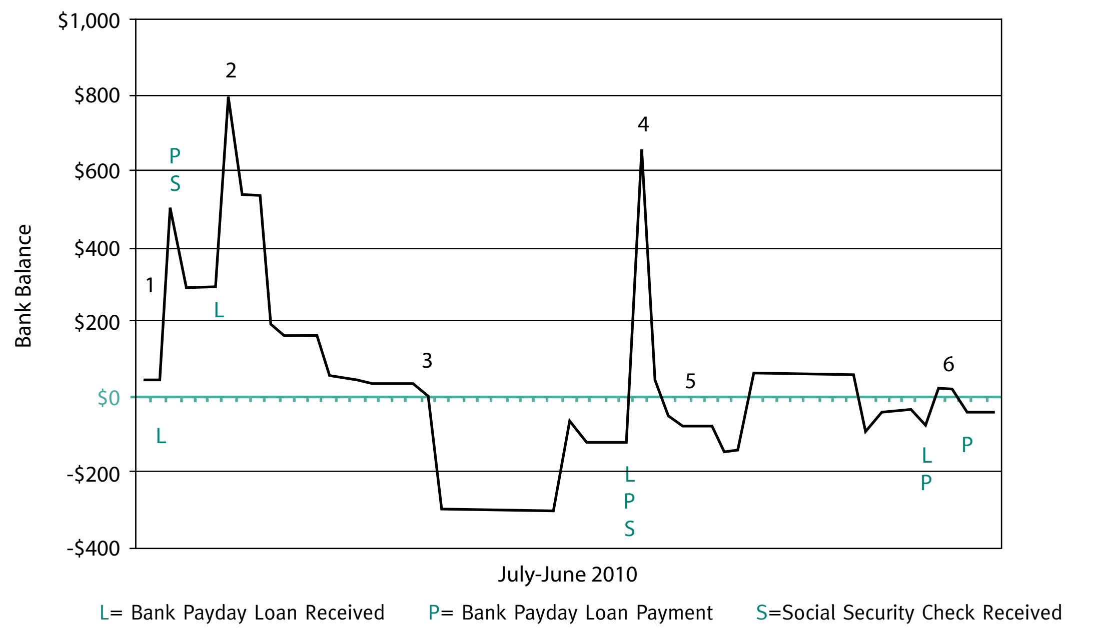
The threat bank payday loans pose to Social Security recipients became more pronounced on March 1 of this year, when electronic distribution of government benefits became mandatory (Dept. of Treasury, 2010). Benefits that have been distributed by paper check, often to those most financially vulnerable, are now directly deposited to checking accounts or prepaid cards. As part of the new rule, the Treasury Department prohibited government deposits to prepaid cards that allow payday loans out of concern that these credit products would siphon off exempt benefits.[9] However, benefits deposited into traditional checking accounts remain at risk to bank payday loans, where banks repay themselves the loan amount before any other expense or creditor.[10]

Figure 3 below demonstrates the impact that bank payday loans have on a Social Security recipient, an account holder in CRL's 2010 database whom we call Alice. Alice's primary source of income is Social Security. The figure maps two months of her checking account activity. The line on the graph represents Alice's account balance. It goes up when she receives a direct deposit or other deposit or when a payday loan or overdraft loan are extended on her account. It goes down when checks, bill payments, debit card transactions, or other withdrawals are posted to the account, or when the bank collects the payday loans (after a direct deposit is received) or overdrafts and related fees.

9 "In order to prevent Federal payments from being delivered to prepaid cards that have payday lending or 'account advance' features, we are prohibiting prepaid cards from having an attached line of credit if the credit agreement allows for automatic repayment of a loan from a card account triggered by the delivery of the Federal payment into the account. Our intention is that this restriction will prevent arrangements in which a bank or creditor 'advances' funds to a cardholder's account, and then repays itself for the advance and any related fees by taking some or all of the cardholder's next deposit." 75 Fed. Reg. at 80338.

10 In its discussion, Treasury cited Regulation E's prohibition on compulsory electronic repayments as the comparable protection on traditional checking accounts, id., but this prohibition is typically not read to apply to single-payment loans, as bank payday loans typically are. Thus, federal benefits direct deposited to traditional checking accounts remain vulnerable to bank payday loans.

Figure 3. Bank Payday on a Fixed Income



1: Bank payday loan takes balance up to $500.

2: Alice receives June Social Security Check, and bank uses deposit to pay off first bank payday loan. Alice then takes out second bank payday loan, reaching her highest balance for the two-month period.

3: Several large bills and payments put Alice on the verge of overdraft, and the payday loan is about to come due.

4: July's Social Security Check and a new bank payday loan bring Alice's account balance to positive for only a few days.

5: More bills and the payday loan repayment take her right back into overdraft.

6: Small bills and payday loan fees and repayments offset small deposits, transfers, and bank payday loans, and Alice begins August in the red.

This graph demonstrates that bank payday loans only briefly increase Alice's account balance. Several days later, when the principal and fees (in this case $10 per $100 borrowed) are collected in one lump sum, Alice's account balance drops dramatically and overdraft fees soon follow. At the end of a two-month period, during which Alice spent 47 of 61 days in payday loan debt, she is again left with a negative balance, in an immediate crisis.

Military service members

Members of the military are also vulnerable to bank payday lending, even though they are protected by law from other payday loans. In 2006, the Department of Defense and base commanders expressed concern that troops were incurring high levels of high-cost payday loan debt, which was threatening security clearances and military readiness (Department of Defense, 2006). Congress then prohibited making payday loans to service members and their families, but banks structure their loans in a way that attempts to evade this law,[11] even making payday loans on military bases (Fox, 2012).

"This problem with . . . payday lending is the most serious single financial problem that we have encountered in [a] hundred years."

–Admiral Charles Abbot, US (Ret.), President of Navy-Marine Corps Relief Society (Senate Testimony, 2006)

11 The regulation under the law covers only "closed-end" loans. 32 CFR 232.3(b). Banks categorize their payday loans as "open-end," even though the due date for the loan, much like a closed-end loan, is fixed as the next deposit date or, at the latest, after 35 days.

As of August 2013, CRL has documented that the following banks are making payday loans: Wells Fargo Bank, U.S. Bank, Regions Bank, Fifth Third Bank, Bank of Oklahoma and its bank affiliates, and Guaranty Bank.

Though the number of banks making these loans remains small, there are clear signals that bank payday lending may grow rapidly. Fiserv, Inc., a provider of software systems to the financial industry, has actively promoted a bank payday software product it calls "Relationship Advance." Fiserv has reported significant interest in the product: "The pipeline is extremely strong. We've had some very nice mid-tier signings over the last three, four months and we see this as an interesting driver of … high-quality recurring revenue . . ." (Fiserv, 2011a).

Fiserv's marketing of the Relationship Advance product has included promises that a bank's revenue from the product "will be greater than all ancillary fee revenue combined" within two years (Fiserv, 2011b).

"Payday loans are like a consumer needing a life preserver being thrown an anvil."

–North Carolina Attorney General Roy Cooper, discussing Regions Bank's payday loan product (Ranii, 2012)

A widespread public outcry against bank payday lending, along with regulatory action discussed below, appears to have slowed its expansion recently.[12] We are not aware of any large banks that have begun making payday loans since early 2011. In fact, Regions Bank recently ceased making payday loans in North Carolina—a state that does not permit storefront payday lending—in response to public and state attorney general opposition (Ranii, 2013).

12 CRL documented much of the media coverage of bank payday lending and public concerns expressed about the product in an issue brief published in March 2013 (CRL, 2013a).

LEGISLATION AND REGULATION

Nearly half of all states prohibit or significantly restrict payday lending. However, banks are making payday loans not only in states that permit payday lending but also, through the doctrine of federal preemption, in states that prohibit or meaningfully limit the product from non-bank lenders.

"[L]oans that have been accessed repeatedly or for extended periods of time are evidence of 'churning' and inadequate underwriting."

–OCC, 2013; FDIC, 2013

Bank payday lending clearly falls within the purview of both the prudential banking regulators (the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC) and Federal Reserve Board (the Board)), which are responsible for the safety and soundness of the banks they supervise, and the Consumer Financial Protection Bureau, responsible for consumer financial protection generally. Indeed, bank payday loans pose serious safety and soundness concerns, including that they violate the basic safety and soundness principle of lending based on the borrower's ability to repay a loan; they pose severe reputational risk, as evidenced by sweeping negative reaction to these products (CRL, 2013a); and they risk violation of consumer protection laws, which itself poses safety and soundness risk (CRL, 2013b).

In April 2013, the OCC and the FDIC proposed supervisory guidance addressing bank payday lending (OCC, 2013) (FDIC, 2013). These proposals focus on a fundamental problem with payday lending: the lender's failure to determine the borrower's ability to repay the loan, and meet other expenses, without reborrowing. The proposals would require that banks assess the borrower's ability to repay based on a borrower's inflows and outflows over a six-month period. They also would impose a limit on the number and frequency of payday loans banks can make.

Public comments on the proposed guidance were due June 30, 2013; as of August 2013, the proposed guidance had not been finalized.

The Federal Reserve Board, which supervises Fifth Third Bank and Regions Bank, did not propose supervisory guidance with explicit underwriting guidelines as the OCC and the FDIC did. The Board did, however, issue a supervisory statement emphasizing the "significant consumer risks" bank payday lending poses (Federal Reserve Board, 2013). The Board highlighted the CFPB's recent findings of sustained and harmful repeat usage and underscored that examiners should thoroughly review bank payday products for compliance with laws prohibiting unfair and deceptive practices. The Board also underscored that the product is subject to state law.

These supervisory developments are indeed warranted, particularly in light of the analysis of payday loan data CFPB released in April 2013. Based on that data, CFPB concluded that there is "substantial probability" that consumers will be indebted for longer than anticipated, that "the potential consumer harm is persuasive that further attention is warranted," and that CFPB "expects to use its authorities" to address payday lending.

The prudential regulators' recent supervisory steps are also consistent with concerns they have expressed about payday lending for many years. In the early 2000s, payday lenders were partnering with banks to use bank preemption law to skirt state restrictions on payday loans. The federal banking regulators, noting safety and soundness and consumer protection risks stemming from payday lending, put an end to this so called "rent-a-bank" practice. The OCC's 2000 response to rent-a-bank highlighted concerns about abusive lending practices associated with payday lending, including multiple renewals (OCC, 2000). The FDIC's guidelines addressing payday lending raised similar concerns, and they further urged that no customer should be in such high-cost debt for more than three months in any 12-month period (FDIC, 2005).

"This guidance is necessitated by the high risk nature of payday lending . . . (also known as deferred deposit advances)."

–FDIC, 2005

Payday lending is "unsafe and unsound and unfair to consumers."

–OCC, 2012

More recently, the FDIC had announced that it was "deeply concerned" about payday lending by banks and was investigating the practice (FDIC, 2012). And in July of 2012, the OCC testified before the House of Representatives that payday lending is "unsafe and unsound and unfair to consumers" and that the profitability of payday loans "is dependent on effectively trapping consumers in a cycle of repeat credit transactions, high fees, and unsustainable debt" (OCC Congressional testimony, 2012). The agency further noted the importance of the protections that the Military Lending Act provides members of the military and their dependents by "restricting the cost and terms of . . . abusive credit products" (OCC Congressional testimony, 2012).

POLICY RECOMMENDATIONS

1. The OCC and FDIC should finalize their proposed supervisory guidance, preserving in particular the proposed underwriting requirements that aim to ensure borrowers have the ability to repay their loan without reborrowing, and the limit on the number and frequency of payday loans. The guidance should also clarify that safe and sound banking principles require that interest and fees be reasonable; consistent with the FDIC's affordable small loan guidelines, cost should equate to no more than 36 percent in annualized interest rate terms, subject to more restrictive state usury laws.

2. The Federal Reserve Board should likewise issue supervisory guidance addressing bank payday loans that clarifies appropriate underwriting procedures, limits the number of loans, and requires that fees be reasonable.

3. The CFPB should use its authority to ensure lenders are not trapping borrowers in a cycle of payday loans. It should also make improvements to existing consumer regulations, including the APR disclosure under the Truth in Lending Act and protections against mandatory automatic repayment under the Electronic Fund Transfer Act.

APPENDIX A

For our analyses of 2010 and 2011 data, we used checking account data from a nationwide sample of U.S. credit card holders, generally representative across geography, household income, and credit scores, tracked by Lightspeed Research Inc. (Lightspeed).[13] Participating account holders provide Lightspeed access to all of their checking account activity occurring during their period of participation, including deposits, paper checks, electronic bill payments, debit card purchases, fees, and miscellaneous charges or credits that are posted to the account.

Bank Payday Loan Statistics

The following figure shows the key statistics from our 2011 and 2010 analyses of bank payday loan data, using Lightspeed's checking account data from 66 and 55 American checking account holders, respectively, who received bank payday loans.

	2011	2010
Mean Bank Payday (BP) loan size	$185	$201
Median BP loan size	$100	$140
Mean BP loan repayment time	14 days	10.7 days
Median BP loan repayment time	12 days	10 days
Mean number of BP loans per year	19.2 loans	16.4 loans
Median number of BP loans per year	13.5 loans	14 loans

To determine the number of months during 2011 during which a typical borrower had a bank payday loan outstanding, we manually computed the number of discrete calendar months during which each bank payday borrower in our Lightspeed database had a bank payday loan outstanding for any portion of the calendar month. From those figures we computed the median, arriving at six months.

Likelihood of Overdraft Fees Calculation

The following chart demonstrates our calculation that borrowers taking out bank payday loans are three times as likely to incur an overdraft fee as bank customers as a whole:

Panelists from banks making bank payday loans	N=742
Panelists from banks making bank payday loans that paid overdraft fees	N=150 (20.2%)
Panelists that received bank payday loans	N=66 (8.9%)
Panelists that received bank payday loans and paid overdraft fees	N=42 (63.6% of bank payday borrowers)
Increased likelihood of overdraft fees for bank payday borrowers	63.6%/20.2% = 3.15x as likely

13 Lightspeed requires that participants have internet access, which may lead to selection bias. A survey conducted by the Pew Internet & American Life Project from November 14-December 8, 2012, reveals higher internet usage among younger Americans versus older Americans and among higher income Americans versus lower income Americans (Pew, 2012).

APPENDIX B

Every bank CRL knows of making payday loans tells customers the product is intended for short-term rather than long-term use:

Wells Fargo Bank: "Advances are intended to assist with short-term cash needs and are not recommended as a solution for your long-term financial needs" (Wells Fargo, 2013).

US Bank: "Checking Account Advance is a loan product designed for short-term credit needs. We do not recommend ongoing use of the Checking Account Advance service" (U.S. Bank, 2013).

Fifth Third Bank: "[Early Access is a] line of credit used to assist our customers with short-term, financial emergencies or unexpected financial needs" (Fifth Third, 2013).

Regions Bank: "Ready Advance is an open-end credit plan that is designed to provide you with funds when you have an emergency or other unexpected expense. Ready Advance is not intended for customers who need to repay an extension of credit over an extended period of time. Ready Advance should not be used for planned purchases, discretionary spending, or regular monthly expenses" (Regions, 2013).

Bank of Oklahoma: "The service is designed to help our customers meet their short-term borrowing needs, but is not intended to provide a solution for longer-term financial needs" (Bank of Oklahoma, 2011).

Guaranty Bank: "This service . . . is designed to help our customers meet their short term needs and is not intended to provide a solution for longer-term financial needs or recurring expenses that you can plan for" (Guaranty Bank, 2013).

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