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What is Payday Lending?

Payday loans are high cost, small dollar loans – in Indiana, typically around $300 at 382% APR – that are repaid in a lump sum on the borrower's next payday.[i] As collateral, lenders require borrowers to either authorize lenders to withdraw the amount due directly from the borrower's bank account or provide a post-dated check for the principal and finance charges. By securing a preferred repayment position, lenders can withdraw funds before the borrower pays for other regularly occurring expenses, often leading to repeated reborrowing.[ii] The Pew Charitable Trusts Safe Small Dollar Loan Research Project found that nationwide, the typical payday borrower is in debt for five months and pays $520 in finance charges to repeatedly borrow $375.[iii] Using a different data set, the Consumer Financial Protection Bureau (CFPB) found similar results: among payday borrowers, the median number of loans per year is 10 with $458 in fees paid and 199 days of indebtedness. The CFPB also finds that the median borrower income is $22,476/year.[iv] In other words, payday loans are high-cost loans made repeatedly to predominantly lower-income borrowers.

Payday Lending in Indiana

Payday lenders have a deep and wide footprint across Indiana. As of December 2015, there were 35 active small loan lenders licensed with the State of Indiana operating 333 storefront branches.[v] A 2013 Center for Responsible Lending report estimated there were 4,220 originated loans per store in Indiana, averaging $317 per loan.[vi] The total estimated payday loan volume for the state was $502.9 million, with $70.6 million in finance charges. Indiana also allows online payday lenders to operate in the state, which must follow the same laws as storefront lenders. Unlike a number of other states, Indiana does not permit vehicle title loans – small dollar loans that use vehicle titles as collateral.

Even though Indiana's regulatory framework attempts to address some of the abuses associated with the payday lending industry, it has significant room for improvement. Key features of Indiana's payday lending regulatory framework include:[vii]

- **Borrowing limits** – Lenders can make loans between $50 and $605,[1] not exceeding 20% of the borrower's monthly gross income. The upper borrowing limit is regularly adjusted to keep up with inflation. Borrowers may have two outstanding loans at a given time, but the loans must be made by different lenders and cannot exceed the borrowing limit.
- **Finance charges** – 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 charge structure essentially caps APR at approximately 391%. For the typical loan in Indiana, the APR is 382%.[viii]
- **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 four 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."[ix] To receive another loan from the same lender, the borrower must pay the principal and finance charges of the outstanding loan in full. After paying the loan in full, the borrower may take out another loan. Following six consecutive loans, a borrower must wait seven days to receive a seventh loan.

Problems with Indiana's Small Loans Law

Indiana's small loans law allows low-income borrowers to become trapped in a very costly cycle of debt. This is not only damaging to borrowers, but it has ripple effects on families, communities, and employers.

The cost and structure of payday loans acts as a disincentive to responsible lending practices. When lenders can "cut the line" and collect a significant fee on the day a borrower's paycheck arrives, they have little incentive to ensure that the borrower can both pay the loan and meet their other basic needs. In fact, the opposite is true. Lenders are more likely to be profitable if they make loans to individuals who will need to borrow again in order to make it until their next paycheck.

The ban on renewals and 7-day cooling off period are insufficient to prevent repeated reborrowing. Even though Indiana's statute requires that a payday loan be paid in full prior to taking out a subsequent loan with the same lender, this does not prevent immediate reborrowing. The Consumer Financial Protection Bureau found that in Indiana, the vast majority of payday borrowers have taken out a new payday loan before their next paycheck.[x] Sixty percent of payday borrowers take out a new loan *the same day* they pay off the old one.

[1] This amount will increase on July 1, 2018. The new amount will be based on December's CPI.

Table 1. Reborrowing rates in Indiana[xi]

	Same Day	Within 7 Days	Within 14 Days	Within 30 Days
Indiana	60%	68%	77%	82%

Indiana law also requires a 7-day cooling off period after the 6th consecutive loan, meaning that a borrower repeating a $300 loan will have paid $264 in fees before the cooling off period takes effect.
The short length of this cooling off period makes it possible for most borrowers to repay a loan on his or her payday and then take out another loan before their next paycheck (for those paid biweekly or monthly) and before large, monthly 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.

The ability-to-repay requirement allows borrowers to take out much more than they can afford. 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. This is a much higher percentage than most borrowers can afford, and 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.[xii] And even the five percent benchmark that Pew Charitable Trusts recommends has been called into question because it 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.

The Federal Payday Rule is a Positive Step, but Insufficient

The Consumer Financial Protection Bureau (CFPB), the federal agency responsible for researching, developing rules for, and enforcing regulations around financial products, released a rule in October 2017 intended to reduce the payday loan debt cycle. The rule mandates that lenders conduct an ability-to-repay test before issuing a small dollar loan. The full-payment test requires lenders to evaluate whether the borrower can afford the loan payments while meeting basic living expenses and major financial obligations. However, lenders can circumvent the rule in certain cases. The principal-payoff option allows lenders to issue loans up to $500 without conducting a full-payment test so long as subsequent loans made in quick succession are smaller. The lender cannot issue principal-payoff option loans if a borrower has already had more than six short-term loans or been in debt on short-term loans for more than 90 consecutive days in a 12-month period. The rule also caps the number of loans that can be made in quick succession at three for both full-payment test and principal-payoff options.

The Consumer Financial Protection Bureau's rule provides important protections to consumers that utilize small dollar loans. The full-payment test is a common-sense practice to which mainstream financial institutions have long adhered, yet payday lenders and other alternative financial services have eschewed the practice. Though full-payment tests offer protection to borrowers, the problem of usurious interest rates remains. The Consumer Financial Protection Bureau does not have authority to cap interest rates; rather, this vital protection demands action by state lawmakers.

Recommendations

Indiana should cap the maximum allowable APR at 36%. This rate has been long been recognized as a limit at which lenders still have incentives to seek borrowers with an ability to repay the loans while still providing broad access to credit.[xiii,xiv] 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.[xv] Several states have rescinded their decision to allow payday lenders to charge higher rates through caps at 36% APR or below.[xvi] 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.

Support products and tools that promote financial capability. Some payday borrowers have access to alternative forms of credit that are far less costly, including credit cards and bank loans.[xvii] Others can turn to friends and family, their church, or other forms of assistance – often, the sources they turn to in order to get out of payday debt – to meet their needs. However, the state can and should consider ways to expand access to savings vehicles, credit counseling, financial coaching and responsible credit products.

Conclusions

One third of Hoosiers are struggling to make ends meet. When they experience budget shortfalls, they need meaningful sources of assistance, not high-cost debt. Payday lenders drain an estimated 70 million dollars in fees from low-income communities. Indiana should stop this usurious practice and bolster the many reasonable alternatives that exist here and in other states.

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[iii] The Pew Charitable Trusts. *How Borrowers Choose and Repay Payday Loans*: http://bit.ly/1HF6Qyz
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[vii] IC 24-4.5-7

[viii] Pew Charitable Trusts. How State Rate Limits Affect Payday Loan Prices. http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/stateratelimitsfactsheetpdf.pdf

[ix] IC 24-4.5-7-107

[x] Consumer Financial Protection Bureau. Supplemental Findings on Payday, Payday Installment, and Vehicle Title Loans, And Deposit Advance Products: http://files.consumerfinance.gov/f/documents/Supplemental_Report_060116.pdf

[xi] Consumer Financial Protection Bureau. Supplemental Findings on Payday, Payday Installment, and Vehicle Title Loans, And Deposit Advance Products: http://files.consumerfinance.gov/f/documents/Supplemental_Report_060116.pdf

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

[xiii] S. Montezemolo, "Payday Lending Abuses and Predatory Practices," Accessed December 12, 2017, http://bit.ly/1Cqs4zy

[xiv] L. Saunders, "Why 36%? The History Use, and Purpose of the 36% Interest Rate Cap," *National Consumer Law Center* (2013), Accessed December 12, 2017, http://bit.ly/1iRiGPu

[xv] *Ibid*

[xvi] Center for Responsible Lending, "Shark-free waters: States are better off without payday lending," (2016), Accessed December 12, 2017, http://www.responsiblelending.org/research-publication/shark-free-waters-states-are-better-without-payday-lending

[xvii] Ibid.