Payday Lenders Pose as Brokers to Evade Interest Rate Caps

The next chapter in payday lender subterfuge

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Payday lenders repeatedly attempt to dodge reforms

In recent years, a growing number of states have enacted interest rate caps and other protections to eliminate abusive payday lending practices that trap consumers in long term debt.[1] Despite industry claims that "the Law is there to protect us and consumers,"[2] payday lenders repeatedly evade these rules, finding new ways to maintain business as usual and continue to offer short term loans with triple-digit interest rates.

The latest form of subterfuge is one in which the payday lenders position themselves as brokers, seeking licensure under state-level laws designed to regulate credit repair organizations. Under this scheme, payday lenders charge the maximum interest rate allowed on the underlying loan plus an additional "broker" fee, typically ranging from $20 to $25 per $100, resulting in loans with an effective annual percent interest (APR) in excess of 500%. See table below.

Payday Lender	Cost of Brokered Loan[3]
Ace Cash Express	**792% APR**
Advance America	**533% APR**
Cash America	**533% APR**
CashNetUSA	**664% APR**
Check N Go	**662% APR**

The emergence of this brokering subterfuge through the use of credit repair laws increased exponentially after 2005.[4] In that year, federal regulators cracked down on payday lenders' tactic of partnering with national banks to evade state consumer protection laws.[5] Meanwhile, payday lenders have experienced a more general contraction in the number of states in which they are permitted to make high-cost loans. Since 2005, no state has granted payday lenders authorization to lend at triple-digit rates and an additional six states, the District of Columbia, and Congress have all taken affirmative steps to roll back existing authorization.[6]

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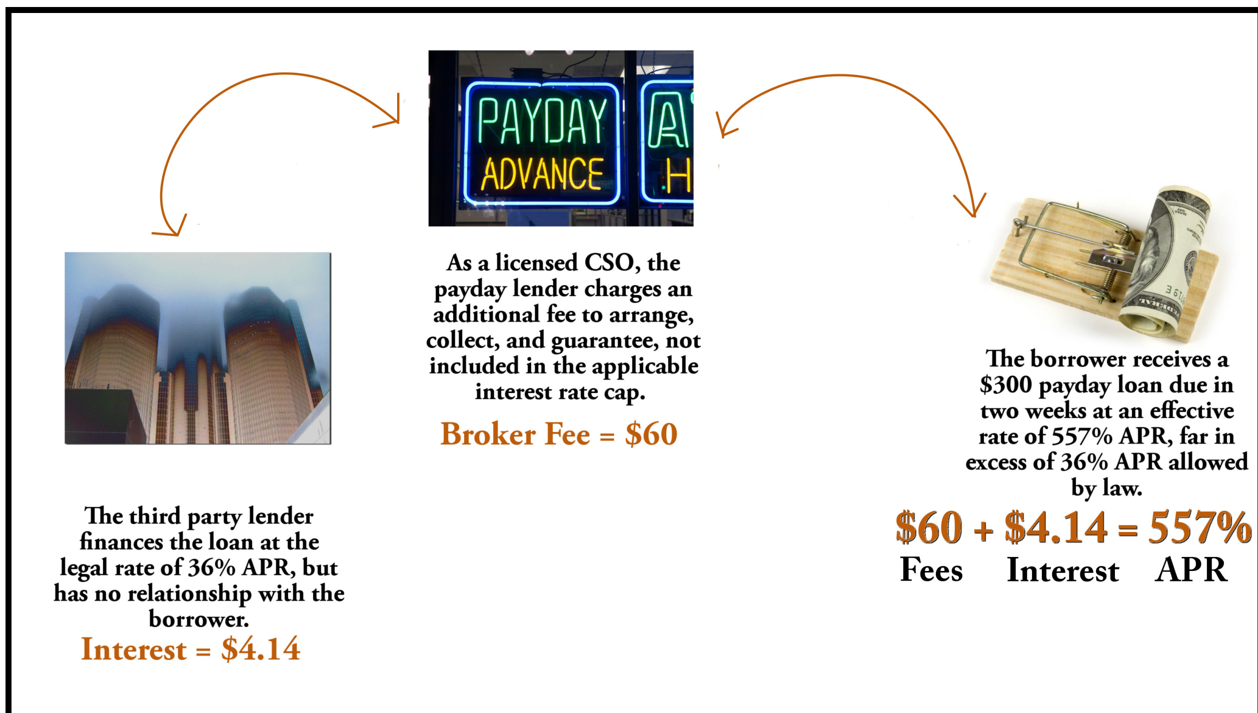
In response to these efforts, several national payday lending companies have become registered as credit service organizations (CSOs), using broker fees to preserve a defective product, and with it triple digit effective interest rates.[7] The table on page one shows the cost of a typical $300 loan with a 14-day term offered by large national payday companies operating under state credit repair laws, as disclosed by the companies themselves pursuant to the Federal Truth in Lending Act.[8]

> While operating as a registered CSO in Texas, Check 'n Go includes the following disclaimer in all contracts with borrowers, **"Check 'n Go is not providing you with any advice or counseling as to your personal financial situation or credit needs."**

To the consumer, whether the payday lenders operate free of state restrictions or use a brokering model to evade existing protections, the result is the same: loans with triple-digit interest rates and balloon payments due by their next payday, collateralized by direct access to the borrower's checking account.[9] We have no evidence that payday lenders are offering legitimate credit repair services. The bottom line is that in exploiting credit repair laws – typically CSO Acts at the state level – payday lenders are perpetuating the same old debt trap.

How Payday Lenders "Operate" as Credit Repair Organizations:
A Typical $300 Two-Week Loan Transaction



Payday loans brokered through credit repair laws perpetuate the debt trap

Payday loans are typically marketed as a quick, easy emergency loan product that helps working families address short-term financial hardships.[10] However, because of the predatory design of these products the vast majority of borrowers cannot walk away after the initial loan, but must continue borrowing every pay period to pay off the previous payday loan. The typical borrower is stuck in the payday debt trap for nine pay periods, and ultimately pays $822.50 in principal and interest for a $350 loan.[11] Payday lenders' ability to churn borrowers in this manner continues unabated as they operate under state credit repair laws.

The destruction to families' financial security stems not from the license or label which payday lenders carry, but rather from the terms of the product itself: high fees, and balloon payments due in full on a borrower's next payday. By posing as brokers, payday lenders continue to offer payday loans on the same terms, protecting their triple-digit interest rates and leaving consumers worse off than when they started. Research shows that because of their high costs and terms, payday loans leave borrowers unable to pay other bills, more likely to file for bankruptcy, and exhibiting decreased productivity at work due to the resulting stress.[12]

Payday lenders are exploiting laws intended to address very different practices

Many of the state statutes used as havens by payday lenders were modeled after the Federal Credit Repair Organizations Act, passed by Congress in 1996 in response to the proliferation of credit repair scams. The act was intended "to protect the public from unfair and deceptive advertising and business practices by credit repair organizations."[13]

Of the thirty-seven states that have adopted a CSO Act, twenty-six currently allow entities licensed under these statutes to offer the service of obtaining credit from a third-party lender in exchange for a fee paid by the borrower. In the absence of other protections, this subset of states is vulnerable to this particular form of brokering subterfuge; however, the same model could easily be applied to other brokering statutes. See Appendix A (Vulnerability Assessment of CSO Laws by State).

Because credit repair acts were originally designed to regulate actors offering debt relief services, not lending services, these statutes do not limit the fees and fail to incorporate such fees into the cost of the underlying credit. In addition, actors licensed under CSO statutes are not necessarily subject to the restrictions that apply to other small-dollar consumer lenders.

In particular, the absence of provisions incorporating brokering fees into the calculation of interest has been seen by payday lenders as an invitation for fee-packing. This loophole has resulted in a migration of payday lenders to CSO Acts in several states for the sole purpose of perpetuating their usurious business model, evading rate caps that would otherwise prevent the payday debt trap.[14]

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Recent state developments

Today, sixteen states plus the District of Columbia prohibit the issuance of triple-digit interest rate payday loans.[15] This trend signals a return to the commonsense, small dollar usury laws that protected consumers from triple-digit interest rates for the better part of 60 years. Since 2005, as states have rolled back the special exemptions that authorized payday lending, there has also been action taken to close brokering loopholes in CSO Acts, through both legislative and regulatory efforts.

Regulatory Activity

- In 2006, the Michigan Department of Labor and Economic Growth found that broker fees charged by payday lenders operating as credit repair organizations are a "deceptive subterfuge designed to extract impermissible fees from a borrower" and evade the state's applicable usury law.[16]

> **"The purpose of [the CSO] business model appears to be to avoid the interest rate limits… as well as the fee limitations placed on… payday loans."**
> - Linda Watters, Michigan Commissioner of Financial and Insurance Services

- In 2008, Florida's Office of Financial Regulation brought an action against a payday lender operating as a licensed credit repair organization, finding that its broker fees must count toward the loan's interest rate because the entity's structure as a credit repair organization was a legal form without economic substance.[17]

Legislative Activity

- In 2007, California's statute was amended to prohibit credit repair organizations from obtaining an extension of credit from a third-party lender for whom the organization provides underwriting, billing, payment processing, or debt collection services.[18]

- In 2010, Maryland passed a bill incorporating broker fees assessed by credit repair organizations in the calculation of interest and therefore subject to the rate cap.[19]

Recommendations

As payday lenders are increasingly excluded from markets throughout the country, states must ensure that they are not left vulnerable to brokering subterfuge. A comprehensive interest rate cap is the proven way to spring borrowers from the payday lending debt trap.[20] Despite the payday industry's claims to the contrary, both borrowers and communities benefit when high-cost lending is banned.[21]

State regulators and enforcement officials should examine their statutes to determine whether they could preemptively address this abuse by issuing of a clarifying opinion related to the

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treatment of credit repair organizations' broker fees as interest. Regardless of the approach, whether initiated by the regulator or the legislature, it is imperative that states ensure that broker fees, like those imposed by licensed credit repair organizations, are treated as interest.[22] In addition, states should consider affirmatively barring payday lenders from operating as licensed credit repair organizations, either by prohibiting brokering conduct within CSO Acts[23] or by excluding actors who broker loans from licensing under these Acts.[24]

Credit repair statutes were not designed with payday lenders in mind, and refusing to license and legitimate them as credit repair organizations would preserve the original intent of these laws, while closing the book on this form of brokering subterfuge.

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Appendix A: Vulnerability Assessment of CSO Laws by State

The table below provides a state-by-state summary of limits on payday lenders' ability to operate as credit repair organizations, based solely on an assessment of each state's CSO Act. Shaded states have potentially high vulnerability to this form of subterfuge.[25] Their actual vulnerability would depend on the range of lending and brokering laws in place, and the extent to which they reach loans brokered by credit repair organizations.

			CSO Act permits CSOs to obtain loans	
	No CSO Act	CSO Act does not permit CSOs to obtain loans	CSO fees included as interest	Other protections apply
Alabama	●			
Alaska	●			
Arizona				
Arkansas				
California				●[26]
Colorado		●		
Connecticut		●		
Delaware				
District of Columbia				
Florida			●[27]	
Georgia		●		
Hawaii		●		
Idaho		●		
Illinois				
Indiana				
Iowa		●		
Kansas		●		
Kentucky	●			
Louisiana		●		
Maine				
Maryland			●	
Massachusetts				
Michigan			●[27]	
Minnesota				
Mississippi	●			
Missouri				
Montana	●			
Nebraska				
Nevada				
New Hampshire				

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			CSO Act permits CSOs to obtain loans	
	No CSO Act	CSO Act does not permit CSOs to obtain loans	CSO fees included as interest	Other protections apply
New Jersey	●			
New Mexico	●			
New York		●		
North Carolina		●		
North Dakota	●			
Ohio				●[28]
Oklahoma			●[29]	
Oregon	●			
Pennsylvania				
Rhode Island	●			
South Carolina	●			
South Dakota	●			
Tennessee				●[28]
Texas				
Utah		●		
Vermont	●			
Virginia				●[28]
Washington				
West Virginia				
Wisconsin				
Wyoming	●			

Notes

[1] See Uriah King and Leslie Parrish, *Springing the Debt Trap*, Center for Responsible Lending (December 2007), available at http://www.responsiblelending.org/payday-lending/research-analysis/springing-the-debt-trap.pdf.

[2] Advance America Company Creed, "About Advance America," www.advanceamerica.net. See also, Consumer Financial Services Association, "Industry Best Practices," available at http://www.cfsa.net/industry_best_practices.html ("A member will comply with all applicable laws. A member will not charge a fee or rate for a payday advance that is not authorized by state or federal law.").

[3] APR calculations for each payday lender come directly from each payday lenders' website: Advance America, available at http://www.advanceamerica.net/apply-for-a-loan/fees/TX; Ace Cash Express, http://www.acecashexpress.com/paydayloan/docs/TX_Fee_Schedule_1-07.pdf; Cash America, Official Website, available at http://www.cashamerica.com/LoanOptions/CashAdvances/RatesandFees.aspx; CashNetUSA, Official Website, available at http://www.cashnetusa.com/fee-schedule-texas.html (this rate reflects CashNetUSA's rates Texas, where the company operates as a CSO; in Ohio and Maryland, where the company also engages in payday lending through state credit repair laws, the rates are 683% and 682%, respectively); Check N Go, Official Website, available at http://www.checkngo.com/resources/state-center/states/tx.rates#schedule (this rate reflects Check N Go's rates in Texas, where it operates as a CSO; in Ohio and Maryland, where the company also engages in payday lending through state credit repair laws, the rates are 677% and 676% APR, respectively).

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[4] See, e.g., American Banker, "A Surprising Contrarian in Payday Trend", 2005 ("Since federal guidelines that went into effect in July seriously curtailed payday lending, most of the publicly traded specialists in the field have turned to an alternative model: the credit services organization.").

[5] In 2005, the FDIC prohibited payday lenders from partnering with out-of-state banks in order to skirt state level usury laws, through what is often referred to as a "rent-a-charter" ruse. Regulators shut down this relationship between payday lenders and banks out of concern that payday lending "can pose a variety of safety and soundness, compliance, consumer protection, and other risks to banks. (OCC Advisory Letter on Payday Lending, AL 2000-10, Nov. 27, 2000.)

[6] In Colorado, Governor Bill Ritter signed a bill (H.B. 09-1351) that takes effect August 11, 2010, which will reduce the total costs of payday loans in Colorado by two-thirds, and extend the amount of time a borrower has to pay back the loan to at least six months; N.H. Rev. Stat. § 399-A:13 (2008); Ohio Rev. Code Ann. § 1321.40 (2008) (later affirmed by the voters by a margin of 2 to 1); Ariz. Rev. Stat. Ann. § 6-1263 (2000) (sunset of lending cap exemption for payday lenders allowed, with voters rejecting an extension in 2008); Letter from Dustin McDaniel, Atty. Gen. of Ark., to payday lending businesses (March 18, 2008), available at http://www.ag.state.ar.us/newsroom/index.php?do:newsDetail=1&news_id=156 (demanding termination of payday lending in the State of Arkansas); DC ST § 28-3301(a) (2007); Or. Rev. Stat. § 725.622 (2007); Military Lending Act, 10 U.S.C. § 987 (2006) (capping interest on consumer loans to military families at 36% APR).

[7] Oral Deposition of Daniel John Wienckoski as Corporate Representative of Cash America Finance Services and Cash America International Inc.; In Chenna Madison vs Bonded Credit Bureau, Inc., d/b/a DRS Bonded Collection Systems, and Travelers Casualty and Surety Company of America, as Defendants, August 24, 2006, page 51, lines 8 - 17 (on file with author). ("There's multiple models for different states. Every state has its laws, and currently, in the state of Texas they're using what's called a CSO model . . . Q: And the different models are used from the lender's perspective in order to avoid what could be problems with usury laws, right? A: Yes.").

[8] Even when companies utilize the brokering model, the Truth in Lending Act requires them to make disclosures that represent the full cost of the loan, including interest and brokering fee, in terms of annual percentage rate (APR). See, e.g., Consumer Service Alliance of Texas, "Consumer Protection Laws: Credit Services Organizations," available at http://www.consumerservicealllianceoftexas.org/CSAT%20Letterhead%20with%20Consumer%20Protection%20Laws.pdf (the Texas trade association for payday lenders posing as CSOs clearly acknowledges that they are subject to TILA disclosures: "Federal Truth in Lending Act (15 USC § 1601 et seq.) and Regulation Z (12 CFR part 226). The CSO fee is included in the Finance Charge and Annual Percentage Rate disclosed by the lender to the consumer before a contract is entered into, not because the CSO fee [in] any way compensates the lender for the use, forbearance or detention of the lender's short-term loan to the consumer, but because it is a cost of the loan for purposes of the federal statute's 'comparison shopping' disclosures.").

[9] See, e.g., Texas Appleseed, "Short Term Cash, Long-Term Debt," available at http://www.appleseeds.net/Portals/0/Documents/Publications/Center%20Pubs/TX%20Payday%20Lending.pdf (a survey of borrowers of payday loans offered by payday lenders posing as credit repair organizations). See also APR Matters on Payday Loans, CRL Issue Brief (June 2009), available at http://www.responsiblelending.org/payday-lending/research-analysis/apr-matters.pdf.

[10] See, e.g., Advance America website, http://www.advanceamerica.net (last visited June 22, 2010) ("Payday advances should be used for short-term financial needs only, not as a long-term financial solution. Customers with credit difficulties should seek credit counseling."); see also, Community Financial Services Association website, http://www.cfsa.net/about_payday_advance_product.html (last visited June 21, 2010) ("[P]ayday advance customers know that this is a convenient and economical service that should be used to meet short-term cash needs. The payday advance service is inappropriate for meeting long-term financial obligations.").

[11] See, Leslie Parrish and Uriah King, *Phantom Demand*, Center for Responsible Lending, at 7 (July 9, 2009), available at http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf ("The great majority of payday loans are originated shortly after a previous loan is paid back, with half of new loans opened at the borrower's first opportunity, and 87 percent opened within two weeks.")(assuming a median loan amount of $350 at a rate of $15 per $100 with an average borrower taking out nine loans in a year, results in $472.50 in fees, which together with repayment of principal, comes to a total of $822.50 due on a $350 loan).

[12] Paige Marta Skiba (Vanderbilt) and Jeremy Tobacman (U. Pennsylvania), *Do Payday Loans Cause Bankruptcy*? (Oct. 10, 2008); Brian T. Melzer (PhD Candidate, Economics, U. of Chicago Business School), *The Real Costs of Credit Access: Evidence from the Payday Lending Market* (Nov. 15, 2007); Dennis Campbell, Asis Martinez Jerez,

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and Peter Tufano (Harvard Business School), *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures* (June 6, 2008).

[13] 15 USC 1679 (a) and (b) (Congress formally found that "certain advertising and business practices of some companies engaged in the business of credit repair services have worked a financial hardship among consumers, particularly those of limited economic means and who are inexperienced in credit matters.").

[14] See, American Banker, "A Surprising Contrarian in Payday Trend", 2005 (quoting North Carolina Attorney General Roy Cooper, who says the model seems like "another situation of a payday lender trying to evade state lending laws and complying with the FDIC regulation as well . . . I would believe this type of activity we would be found to be illegal in North Carolina.").

[15] Arizona, Arkansas, Connecticut, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Vermont, and West Virginia, as well as the District of Columbia prohibit the issuance of triple-digit interest rate payday loans, accounting for one-third of the U.S. population.

[16] Michigan Department of Labor and Economic Growth Bulletin 2006-06-CF (June 21, 2006), available at http://www.michigan.gov/documents/2006-06-CF_163413_7.pdf.

[17] Office of Fin. Reg. v EZPAWN Florida, Inc. Case No. 07—3953 (Fla. Div. of Admin. Hearings Mar. 25, 2008), available at http://s98001.gridserver.com/images/pdf/unreported/EZPawn_Order.pdf.

[18] Cal. Civ. Code § 1789.13 (2007).

[19] H.B. 79 (Md. 2010), available at http://mlis.state.md.us/2010rs/chapters_noln/Ch_385_hb0079T.pdf. ("A credit services business, its employees, and independent contractors who sell or attempt to sell the services of a credit services business shall not: (7) charge or receive any money or other valuable consideration in connection with an extension of credit that, when combined with any interest charged on the extension of credit, would exceed the interest rate permitted for the extension of credit under the applicable title of this article.")

[20] Uriah King and Leslie Parrish, *Springing the Debt Trap*, Center for Responsible Lending (Dec. 13, 2007)(Many states have enacted legislation to regulate certain aspects of the payday industry. Despite these efforts, consumer protections in these laws, including databases, cooling off periods, and limitations on the numbers of outstanding loans, have been ineffectual in reducing predatory payday loan flipping).

[21] E.g., University of North Carolina Center for Community Capital. *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options*. (Nov. 2007)(In a study conducted in North Carolina after the state's payday authorization statute sunset, former payday borrowers reported they were glad they no longer had the temptation of what they viewed as an expensive product that was easy to get in to, but hard to get out of. Instead, they used a number of strategies, such as borrowing from family, friends, employers or savings, paying bills late, or seeking assistance from charitable institutions.)

[22] Maryland has enacted such a law, to be effective October 1, 2010. H.B. 79 (Md. 2010), available at http://mlis.state.md.us/2010rs/chapters_noln/Ch_385_hb0079T.pdf (Prohibits charges "in connection with an extension of credit that, when combined with any interest charged on the extension of credit, would exceed the interest rate permitted for the extension of credit…")

[23] At least ten states, including Colorado, Connecticut, Hawaii, Idaho, Iowa, Kansas, Maine, New York, North Carolina, and Utah, do not include "obtaining an extension of credit" among the list of activities that qualifies an actor as a CSO. By removing this language, states can ensure that brokering activity is not permissible under CSO Acts. California adopts an alternative approach which limits the services a CSO may provide on a broker loan in an effort to bar payday lenders from brokering loans under their CSO Act, while allowing other organizations to continue arranging loans for clients. In particular, the California CSO Act prohibits CSOs from referring clients to a lender for whom they provide services related to the loan, such as underwriting or payment collection, which are a core piece of the sham payday brokering strategy.

[24] Three states, Ohio, Tennessee, and Virginia, expressly exclude actors who "make, collect, or arrange" loans, despite having language that would otherwise authorize loan brokering within their CSO Acts.

[25] This is based on the ability of CSOs to obtain extensions of credit for consumers, paired with a lack of other protections within the statute itself.

[26] CSOs are prohibited from making referrals to lenders for whom they provide services related to the loan, such as underwriting, billing, or payment collection.

[27] Regulators or administrative law judges have determined that state's other lending laws govern CSO-obtained loans, though not explicit in the statute.

[28] The statute lists obtaining extensions of credit as a CSO activity, but then excludes the activity.

[29] CSO Act explicitly makes CSO-brokered loans subject other state laws that would protect against the brokering model used by payday lenders

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