CFA Consumer Federation of America

FAX and Mailed Copy

July 5, 2000

Mr. James A. Whitehead
Supervisor of the Bureau of Loans
State Banking Department
301 Adams Avenue, Ste-680
Montgomery, AL 36130

Re: Rule No. & Title: 155-2-2-.15(4) Refinancing – Alabama Consumer Credit Act

Dear Mr. Whitehead:

Consumer Federation of America (CFA)[1] appreciates the opportunity to comment on a proposed rule change that impacts on high-cost small loans. The Alabama State Banking Department requested public comments on a proposal to amend an existing regulation regarding the interest surcharge for consumer credit contracts under the Alabama Consumer Credit Act "Mini-code." The proposed amendment to Section 155-2-2-15(4) states that an interest surcharge is not considered a duplicate fee or expense under Section 5-19-7 "unless the subsequent pre-computed consumer credit transaction contract is made 30 days or less after the prior existing pre-computed consumer credit transaction contract is executed." The apparent reason for the proposed rule change is a proposal by companies previously engaged in Payday Lending to make loans under the Mini Code for a period of five (5) days.

Typical payday loans (short-term loans based on personal checks held for future deposit) are made for terms of a few days up to two weeks, or the borrower's next payday. The finance charge imposed tends to be $15 to $33 per $100 loaned with the resulting Annual Percentage Rate for a two-week loan 390% and up. A $15 fee on a $100 advance repayable in one week is 780% APR. Payday loans are closed-end, single-payment transactions, not installment debt.

Payday lending finds its roots in short-term, high-cost loans made in the past. One such practice, from more than 50 years ago, is the "salary loan," where a borrower would receive five dollars in exchange for repaying six dollars at payday. CFA

[1] Consumer Federation of America is a pro-consumer association of about 260 organizations that represent 50 million consumers. CFA was founded in 1966 to advocate for consumers. CFA has published a series of reports on the payday loan industry available at www.consumerfed.org.

testimony before a United States Senate forum on payday lending provides a thorough discussion of historical practices that mirror payday lending practices of today. This discussion is included as Attachment A to these comments.

Alabama protects consumers from usurious interest through two consumer finance statutes: The Ala. Mini-Code (Alabama's abbreviated version of the Uniform Consumer Credit Code) at Ala. Code sec. 5-19-1 and the Ala. Small Loan Act at sec. 5-18-1. The proposed regulation change applies only to the Mini-Code. The maximum allowable interest rate under the Mini-Code is 15% per year for loans up to $750 and 10% per year for that portion of the loan greater than $750 but less than $2000. (Ala. Code 5-19-3) The Interest Surcharge authorized by Ala. Code sec. 8-8-14(a) is 6% per consumer loan, in addition to the Mini-Code interest rate. It is our understanding that there is no stated purpose for the surcharge in the statute and no legislative history to explain what the Alabama legislature intended for the surcharge to cover.

The Alabama Mini-Code does not specify a minimum term for the loan to which the 6% surcharge may be imposed. At the time the surcharge was adopted, payday loans and other forms of very short-term small loans were not common. Based upon the Department's proposed rule change, when the Mini-Code interest rate and the surcharge are applied to a one-month loan, the interest rate is 7.25% per month or 87% per annum (uncompounded). While less costly to borrowers than the typical payday loan, the proposed rule change will produce very expensive short-term loans to Alabama consumers.

It is arguable that the legislature did not intend for the 6% surcharge to be imposed on a monthly basis. Note that Ala. Code section 8-8-14(a) provides for a rebate of unearned interest surcharge if the loan is prepaid in full by any means within 90 days of the date of the contract. It is reasonable to infer that the Alabama legislature intended the surcharge to apply to loans for at least a 90-day term. The resulting annual interest rate (uncompounded) for a 90-day Mini-Code loan with the interest surcharge is 39% APR. This rate is very close to the maximum 36% annual rate for loans of $200 or less subject to the Alabama Small Loan Act (Ala. Code 5-18-15(a). A 90-day minimum term for very small loans gives borrowers several paydays to successfully make installment payments rather than the single balloon payments required by payday lenders.

The Alabama legislature also must not have intended the 6% interest surcharge to apply to very small loans. Section 8-8-14(a) permits lenders to retain $25 when surcharged loans are prepaid. It takes a prepaid loan balance of almost $420 to produce a $25 surcharge while the typical payday loan is less than $200.

The Alabama Banking Department should amend its proposed rule to read "(c) unless the subsequent pre-computed consumer credit transaction contract is made 90 days or less after the prior existing pre-computed consumer credit transaction contract is executed."

The Alabama Banking Department should also amend its proposed rule to add: "The minimum term for such contracts is 90 days." Nothing in the proposed rule change prevents licensed lenders from charging the $15 per $100 annual rate and the 6% per loan surcharge for loans due in one day. While the lender could not roll-over the loan and collect a second surcharge, the needy borrower, unable to repay on such short notice, will likely need to borrow from a second lender in order to repay the first.

Loan roll-overs and renewals occur in the vast majority of payday loans. The Indiana Department of Financial Institutions inspected a sample of licensed lenders in 1999 and found that 77% of payday loans are roll-overs or extensions. Indiana DFI found that the average borrower made more than 10 loans each, with one borrower having made 66 such loans in a year.[2] A recent analysis of data from the Illinois Department of Financial Institutions found that only a small portion of payday loan borrowers were "occasional" borrowers. Eighteen percent of borrowers had three or fewer such loans, but the average Illinois borrower had 12.6. More than half, 52 percent, had more than 10 and more than one-third had more than 15. Twenty-one percent had more than 20 loans.[3]

The benefit to Alabama consumers of setting a 90-day minimum term and of permitting the surcharge to be imposed no more often than once per 90-days is to drastically lower the cost of short-term small loans while extending a loan term over several paydays to enable borrowers to repay loans in installments without resorting to roll-overs or serial loans. It is unconscionable to loan money to consumers who have no expectation of being able to repay under the terms of the loan.

There is no explicit authorization in the Alabama Mini-Code and the Small Loan Act for lenders to advance money on personal checks held for future deposit and is therefore prohibited.[4] In fact, such check-based payday loans meet the Alabama tests for determining what constitutes unconscionable agreements: (1) whether there is an absence of meaningful choice on one party's part; (2) whether contractual terms are unreasonably favorable to one party; (3) whether there was unequal bargaining power among parties; and (4) whether there were oppressive, one-sided, or patently unfair terms in the contract. (Rollins, Inc. v. Foster, 991 F.Supp. 1426 (M.D.Ala.1998)

Holding a personal check as the basis for a small loan is inherently coercive. A borrower unable to repay in full on the due date has the choice of letting the lender deposit the check although insufficient funds are on deposit to cover the check or rolling over the loan by paying a new fee. If the check is deposited with insufficient funds, both the lender and the bank will charge bounced check fees. Some payday lenders require a separate check for each $100 loaned, causing multiple bounced check fees when the borrower is unable to repay on time. The consumer will get a record as a "bad check

[2] Indiana Department of Financial Institutions, Summary of Payday Lender Examinations. Indiana Regulator's Survey of most recent 12 months prior to examination dates 7/99 – 10/99.

[3] Wiles, M. and Immergluck, D., *Unregulated Payday Lending Pulls Vulnerable Consumers Into Spiraling Debt*, Woodstock Institute Reinvestment Alert, Number 14, March, 2000, p. 3.

[4] *See* Singer, Sutherland Statutory Construction § 47.23 (5th Ed.) (*expressio unius est exclusio alterius*)

writer" with the credit reporting companies that are used to screen check-writers and account holders, putting account ownership and the ability to pay retailers by check at risk.

Small loans based on personal checks held for deposit foster coercive collection tactics. Depending on the sophistication of the borrower, the lender may threaten (incorrectly) to file criminal fraudulent check charges or pursue civil bad check penalties. In any case, the defaulting borrower now owes the original loan and finance charge, at least two bounced check fees, and possible fines. The borrower who avoids default by rolling-over the debt or borrowing from another payday lender sets up a debt trap where fees paid soon surpass the original debt.

Small loans based on personal checks held for deposit would give payday lenders an unfair advantage over other small lenders in Alabama. As Stephens Inc., a Little Rock investment firm, reports, payday loans get paid first. In a recent update, Stephens noted that other lenders, such as low-balance credit card issuers, small loan finance companies, and pawn shops will be at risk of becoming subordinated to the payday advance companies in terms of payment priority.[5] If these loans "get paid first" because the lender is holding a personal check, then the risk for payday lenders is less than small loan companies licensed in Alabama.

In conclusion, CFA congratulates the Alabama Banking Department for proposing regulation changes to prevent inappropriate application of the interest surcharge to loans issued under the Alabama Mini-Code by companies seeking to make payday loans in the state. The two changes proposed by CFA (permitting the interest surcharge to be imposed no more often than every 90 days and setting 90 days as the minimum term for loans subject to the Mini-Code) will better accomplish the goal of protecting needy borrowers from usurious lenders.

Sincerely,

Jean Ann Fox
Director of Consumer Protection

Enclosed: Attachment A

[5] Gerald Lewis, "Non-bank Financial Services Industry Notes," Stephens, Inc., March 23, 20000, p. 7.

Attachment A

Excerpt from Testimony of Jean Ann Fox, Consumer Federation of America, before the Forum on Payday Lending, Senator Joseph I. Lieberman, December 15, 1999.

The emergence of payday lending in the 1990's is not a new story. The debate about the ethics, economics, and the socio-economic consequences of this kind of lending was held in the first half of the century. The prior wave of salary-lending triggered an earlier reform movement which took place over roughly 50 years between the late 1800s and World War II.

Salary-lending grew up in the late 19th century, as more households began to rely on wages and as the level of those wages was increased enough to give people some margin of income over the bare necessities from which debts could be repaid. As one observer noted fifty years ago, the business of salary-buying thrived upon higher wages and rising standards of living, not upon "abject poverty."[6] "Midget loans" were advanced in anticipation of the next payday. Terms were short – a week, two weeks, or a month – and the price tag was steep. The "5 for 6 boys" lent $5, to be repaid by $6 in one or two weeks, a 522% APR for two weeks. One 1941 study reported effective APRs on low-end, short-term loans ranging from 279% to 559%.[7] (In a survey of payday lenders last year, CFA member groups found rates ranging from 261% to 625% APR.[8]) The form of these early loans varied. "Salary buyers" would "buy" the next wage packet at a discount, for example advancing $22.50 on January 15 in exchange for the "sale" of the $25 paycheck due January 28, an effective 311% APR. Other lenders took wage assignments, chattel mortgages on household goods, or unsecured notes.[9]

There is another direct antecedent of today's post-dated check loan. One of the collection techniques of some early salary lenders was to have the borrower sign a bank

[6] Rolf Nugent, The Loan Shark Problem 3, 4, 8 Law and Contemporary Social Problems (1941). The article was part of a series published collectively in a symposium entitled *Combating the Loan Shark* in that issue. The historical information in these comments is taken from this symposium, referred to as *1941 Symposium.*

[7] William Hays Simpson, *Cost of Loans to Borrowers Under Unregulated Lending,* 73, 74-75 1941 Symposium.

[8] "The Growth of Legal Loan-Sharking: A Report on the Payday Loan Industry," (Consumer Federation of America, November, 1998, Appendix.)

[9] See Jackson R. Collins, *Evasions and Avoidance of Usury Laws,* 54, 55, 58: Nugent, p. 5 (*1941 Symposium.*) Threats of garnishment and confession of judgments also facilitated collection.

A later reform movement curtailed the use of these devices, after the abusive use of them and their consequences became apparent. States had prohibited or curtailed them by the 1960s. A series of hearings was held around the country by the Federal Trade Commission in the mid-1970s in which problems with these and other overreaching contract terms were documented. Based on that record, the use of such terms in consumer credit contracts was curtailed at the federal level by the FTC Credit Practices Rules, 16 C.F.R. 444. Garnishment abuses, and the negative impact on whole families resulting from garnishment, was addressed both by state legislation and by the federal garnishment act, 15 U.S.C. § 1671 et seq., and the Fair Debt Collection Practices Act, 15 U.S.C. § 1692.

check in the amount of the principal and interest, though those borrowers had no bank accounts. The lender explained the check as "security." In the event of default, the lender deposited the check, which, of course, bounced. The lender then threatened criminal prosecution as a collection tactic.[10] This use of criminal prosecution for bad checks is a problem in this second wave of salary lender, discussed later in this testimony.

Then, as now, the real distress created by midget loans with giant price tags came with renewals (often encouraged by the lender, as therein lies the profitability), and the related problem of trying to juggle the debt, "borrowing from Peter to pay Paul."[11] Compare these stories:

- *One borrower, making $35 a week, borrowed a total $83 from four different lenders as a result of family sickness. To service that $83 loan, he paid those four lenders $16 per month. At the end of the year, he had paid $192 in interest, but still owed the $83.*
- *A mill employee, with a $25 a week salary, borrowed a total of $55 from four different loan companies. After paying $69.40 in interest for a year, he still owed the original $55.*
- *After borrowing $150, and paying $1000 in fees for 6 months, a Kentucky borrower still owes the $150.*
- *Paying $1,364 in fees over 15 months, another consumer only reduced the principal balance on $400 loan to $248.*

The first two borrowers' experiences are from 1939 studies; the second two are reported in CFA's 1998 study.[12]

As the prior reform movement recognized, it is too simplistic to answer the policy issues with a mantra that this is a matter of personal choice. With the experience of many years of salary lending behind them, the first wave of reformers knew that such "choices" have consequences on entire families and the larger community.[13] Complaints to regulators today indicate that renewals and the Peter to Paul phenomenon may result in **monthly** debt service of $500 to $600 on midget loans. Given the average annual household income of around $25,000 for the current payday loan customer reported in some independent surveys, this kind of debt burden for what is typically consumption

[10] Joe B. Birkhead, *Collection Tactics of Illegal Lenders, Symposium*, 78, 86. A salary lender in Kansas City used this system. One of the earliest reports of the modern payday lenders using the post-dated check scheme to try to evade usury and credit disclosure laws came from Kansas City. "Postdated check firms may violate usury laws," Kansas City Star, p. 1A (October 23, 1988.) See also George Gisler, Organization of Public Opinion for Effective Measures Against Loan Sharks, 183, 187-194 (1941 *Symposium*) for a discussion of the Missouri reform effort.

[11] See, e.g. Nugent, p. 5 (1941 *Symposium*)

[12] Simpson, p. 74-75 (1941 *Symposium*); "The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry," p. 6 (Consumer Federation of America, November, 1998.)

[13] Nugent, 13; Robert W. Kelso, *Social and Economic Background of the Small Loan Problem,* 14, 15 (1941 *Symposium*). See also Charles S. Kelly, *Legal Techniques for Combating Loan Sharks,* 88, 89-91 (1941 *Symposium.)*

debt (as opposed to investment debt, or asset-building debt), obviously will have a major impact on households, as well as on other economic players in the community.[14]

The effort to "combat the loan-sharks" began at the dawn of this century, and over the next four decades was anchored to a large extent around the Russell Sage Foundation's deliberative, broad-based studies and efforts. The result was the Uniform Small Loan Act, crafted and re-crafted, widely adopted by states, which gave rise to the commercial small loan or finance company industry.[15] From the description, it appears that then, as now, there was a discrepancy between what the economic theorists posited would be the result, and the real world consequences that the reformers actually saw. The economic theorists argued that legal restrictions were inappropriate: without them, supply, demand, and competition would assure equity and pricing in accordance with risks and costs.[16] But then, as now, theory and reality are two different things. That theory ignores the fact that opportunistic pricing can and does occur in market sectors where there are imperfect market conditions. And small loans were – and still are – "an excellent example of imperfect competition." The borrower's need, the lender's advertising, unequal bargaining position, misleading representations concerning the real costs for fear of "sticker shock," the absence of meaningful choice are as real today as they were at the beginning of the century.[17]

America is facing the second wave of salary-lending in a century.[18] Salary-lenders' "midget loans" were the catalyst for states to adopt small loan laws and, as a result, these loans were outlawed. Not surprisingly, on the heels of financial deregulation in the latter half of the century, the same abuses have resurfaced. Once again, effective regulations and consumer protections are the answer.

[14] Consumers Union analyzed occupations disclosed in 1741 letters sent by California payday loan borrowers in opposition to SB 834. Using the Major Occupation Groups of the Bureau of Labor Statistics, CU computed the average income of payday loan customers. For the 83.35% of payday loan patrons who participate in the paid labor market, the average annual income was $25,416.97. The 1999 Illinois Department of Financial Institutions study of Short Term Loans found payday loan customers had an average income of $25,131.

[15] The first draft appeared in 1916, the seventh draft was revised in 1942. Though not without problems, that largely served the credit needs of the small borrower until the '80s, when the siren call of higher-margin, deregulated, home-equity secured loans lured much of the finance company sector upstream. In the meantime, the explosion of credit cards supplied and expanded the short-term, small sum credit market.

[16] Nugent, 12.

[17] For discussion of why and how certain segments of the consumer credit marketplace remain today a good example of an "imperfect market," see generally National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges,* § 11.1 (1995).

[18] Courts uniformly hold that payday loans are loans. *Turner v. E-Z Check Cashing, Inc.*, 35 F. Supp. 2d 1042 (M.D. Tenn. 1999); *Burden v. York,* Civil Action No. 98-268 (E.D. Ky., Sept. 29, 1999); *Hamilton v. HLT Check Exchange,* 987 F. Supp. 953 (E.D. Ky. 1997); *White v. Check Holders, Inc.* 996 S.W.2d 496 (Ky. 1999); *Commonwealth v. Allstate Express Check Cashing,* No. HD-44-1 (Cir. Ct. Richmond, Va., Oct. 20, 1993).