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Proponent Testimony on H. B. No. 123
Senate Finance Committee
Nick Bourke, Director, Consumer Finance, The Pew Charitable Trusts
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Chairman Oelslager, Vice-Chair Manning, Ranking Member Skindell, and members of the Senate Finance Committee:

Thank you for your effort to address the problems in the payday loan market in Ohio, and for giving us the opportunity to add to prior testimony that my colleague Alex Horowitz and I have submitted. My name is Nick Bourke and I lead the consumer finance project at The Pew Charitable Trusts. I have been a product manager, consultant, legal advisor, and researcher in the consumer finance field for nearly 20 years. My testimony is informed by in-depth research Pew has conducted on the small-loan market since 2011. This research includes four nationally representative surveys of borrowers, 22 focus groups with borrowers of high-cost credit across the country, polls of the public, including in Ohio, extensive analysis of market and regulatory data, and the laws of all 50 states. We have published reports, briefs, and fact sheets available at www.pewtrusts.org/small-loans. I appreciate the opportunity to share these findings.

Pew supports HB 123 because it provides a strong yet simple approach to payday loan reform. It clarifies Ohio's law about small-dollar lending using minimally burdensome yet meaningful guidelines. HB 123 is built around core concepts such as affordable payments, reasonable time to repay, transparency, and pricing that is fair both to borrowers and lenders. Critically, the bill is also carefully designed to be minimally burdensome, with requirements that are simple and easy to implement. Strong rules protect consumers. If the rules are clear and simple, they also keep costs down and promote a vibrant and competitive marketplace. This is what HB 123 will do for Ohio's payday and small-dollar loan market if you pass this bill intact.[1]

Let me give you an example. If HB 123 were law today, and you wanted to make a $500 loan, here is what you would have to do:

- Check the borrower's monthly income, set the monthly payment at 5% or less of that, figure out the interest and fees you will charge, and then divide the total amount to be repaid by the size of the monthly payment to see how long the loan will last. A typical borrower today makes about $2,500 per month, so her monthly payments would be $125 or less and it would take about six months to pay off the loan.

[1] As we have discussed previously, HB 123 enacts a compromise in part by adding a reasonable monthly fee of up to $20 on top of the 28% interest charge authorized in the 2008 law. This significantly increases allowable loan revenue and helps lenders continue to provide credit throughout the state.

- But the loan could last longer if the borrower and lender agree. On the same $500 loan, if the borrower is higher-income, then monthly payments can be larger and the loan duration can be shorter; or for lower-income borrowers, lenders are free to allow more time to repay. HB 123 contains no fixed minimum or maximum loan terms. By simply requiring monthly payments to take no more than 5% of a borrower's income, it automatically lets loan terms adjust depending on the borrower's individual circumstances.[2]

This process takes very little time and requires no information other than what lenders voluntarily collect today in the course of business.

In testimony last week, Senator Huffman proposed substantial changes to the bill, including replacing the core components of HB 123. This would fail to address Ohio's key payday loan problems, encourage the expansion of harmful loans while discouraging safer ones, and give up an extraordinary opportunity to help working Ohioans.[3] The remainder of my testimony will focus on why you should reject proposals to undo this carefully-crafted bill, and how a few simple adjustments to HB 123 could respond to any reasonable concerns.

PROPOSALS TO REDESIGN OR REPLACE THE BILL WOULD HARM OHIO COMMUNITIES AND RESPONSIBLE LENDERS

Senator Huffman's proposals would eliminate the potential for a strong yet simple law that I have just described. Databases, off-ramps, complex or confusing pricing and APR rules, referrals to bankruptcy attorneys and the like will not protect consumers, and they risk burdening lenders with costly, confusing, and time consuming rules. While some who control Ohio's payday loan market today may be willing to accept such terms as the cost of avoiding true reform, others—consumers, communities, and mainstream, responsible lenders alike—would be better off under the framework that HB 123 provides.

I shall briefly review several of these alternative approaches and why the are ineffectual.

- So-called "safety valves" or "off-ramps"—such as no-cost payment plans or a pause on further interest and fees accumulating—may sound like appealing ideas, but they do not solve the problem that loans on the market today take one-third or more of a borrower's next paycheck and are routinely and predictably unaffordable for most borrowers in the first place. Besides, few borrowers become aware of these plans, and lenders discourage their use. In Florida and Michigan, where these plans are part of state law, fewer than 1 percent of loans are converted to them.

- While establishing a database would add cost and reduce privacy, it would do nothing to make loan payments affordable, give consumers reasonable time to repay, protect against hidden or up-front fees, or improve transparency and competition.

- Verbal disclosures and referrals to counseling or the assistance of bankruptcy attorneys do nothing to make loans more affordable, provide reasonable time to repay, prevent hidden or up-

[2] Research shows that typical payday loans are structured to take more than one-third of a borrower's paycheck, but most borrowers can afford to spend no more than 5% of their periodic income while still making ends meet.
[3] For a discussion of Ohio's payday loan problems, see our prior testimony to this committee dated June 21, 2018, or our prior testimony to the House Government Affairs and Oversight Committee.

front fees, enhance transparency and competition, or reduce costs. Lenders sometimes promote financial literacy and disclosures as a solution to payday loan problems. While this can be a component of reform, it does not fix deficient laws or bolster consumer protection.[4]

- While it is unobjectionable to propose making it easier for nonprofit organizations to pay off loans on behalf of struggling borrowers, the best way to protect borrowers is to make it unlikely that they will need a bailout in the first place—by making the core terms of the loans safer and more affordable. The vast majority of loans in Ohio are repaid by borrowers themselves.

In his presentation last week, Senator Huffman referred to many of these ideas as a possible replacement of the HB 123 approach to payday loan reform. He also suggested allowing loans up to $2,500 and an 18-month maximum (not minimum) repayment term. He has spoken of a minimum 30-day term for loans, a six-month maximum (not minimum) loan term for loans under $500, and Annual Percentage Rates (APRs) around 360 percent.[5] These ideas are highly prescriptive, yet they are also fragmentary because they do not provide for affordable payments, ensuring that loans fit within borrower budgets, allowing for loan durations to scale appropriately for loan size and cost, or other essential features. In short, these proposals do not add up to a cohesive or effective policy, but it is possible to demonstrate just how expensive and unaffordable loans would be under this approach:

- A $500 loan repaid in 30 days, with an APR of 360%, would cost $150 under this alternative approach. The total payment due after just one month would be $650—approximately 26% of a typical borrower's entire take-home pay before taxes.
    - If this loan were stretched out to the maximum term of 6-months, the cost would swell to $635 on top of the original $500 principal amount.
- A $2,500 loan under the same terms would cost $750 per month under this alternative approach.
    - The proposed maximum repayment term of 18-months and a 360% APR would cost Ohio borrowers $11,121, in addition to the original $2,500 loan amount.
    - Even if the target APR were reduced to 150%, this alternative proposal would cost borrowers $3,892 on top of the $2,500 loan, repaid over 18 months.

By contrast, loans under HB 123 would have monthly payments of about $125 for borrowers with average income. A $500 loan under HB 123 would cost a maximum of $250, but a typical borrower would expect to pay about $160 for a $500 loan over six months, with an APR in the low-100s (see appendix).

There are many problems with the alternative approaches outlined by Senator Huffman. On substance, the approach falls short of the one outlined in HB 123, the carefully crafted, bipartisan bill now before you. Its prescriptive rules, and unusual focus on regulating APRs and borrower behavior rather than core loan

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[4] As we have noted before, the academic research on financial education has found it to be costly and largely ineffective. When consumers have few good options, and when the small-loan market is characterized by weak competition and insufficiently clear legal requirements like in Ohio, the prospects for financial education improving consumers' well-being are dim.

[5] http://radio.wosu.org/post/advocates-say-senate-changes-would-water-down-payday-lending-bill#stream/0

terms, would burden responsible lenders at the same time that its fragmentary approach would fail to protect borrowers and their communities.

MOVING FORWARD WITH HB 123

Assuming that this committee moves forward with HB 123 intact, I shall now summarize several ways that the bill has already incorporated many of the concerns that Senator Huffman and others have raised, and how some simple adjustments to the bill could address other reasonable concerns.

<u>As passed by the House, HB 123 already achieves many of the goals that this committee has heard about from other testimony, including Senator Huffman's</u>.

- HB 123 stops payday lenders from operating as Credit Services Organizations (CSOs) as a way to avoid interest rate limits and other legal requirements.

- HB 123 prevents interest-only loans and balloon payments. Specifically, at lines 146-147, it provides for "substantially equal installments of principal, fees, and interest combined."

- HB 123 lets borrowers choose when and how often to borrow money, without need for government databases or off-ramps.

- HB 123 does not blur the lines between Ohio's Short Term Loan Act and the state's already existing installment loan laws, such as the Consumer Installment Loan Act (CILA). It provides a better alternative to payday loans while leaving consumers free to obtain installment loans of $2,000, $3,000, or more under those acts just like they do today.

- HB 123 is designed to keep access to small-dollar credit widely available, so concerns about illegal lenders attempting to fill the void are overblown. However, HB 123 will protect against illegal lending by requiring all lenders—including online lenders—to be licensed, and by making loans made without a license void under state law (see lines 71 to 74 of the bill). This will give state authorities a powerful new tool to prevent the collection of improper loans and protect Ohioans from any threat of illegal lending.

- HB 123 minimizes the problems associated with repeat borrowing without limiting borrower choices or rationing credit with databases. It does this by tackling the two biggest drivers of repeat borrowing: unaffordable payments that drive reliance on refinancing or reborrowing to cover other bills, and large up-front fees that incentive loan officers to encourage the taking of new loans. This approach leaves borrowers free to refinance or reborrow whenever they decide it is best for them to do so.

- HB 123 keeps the 28% interest rate cap overwhelmingly approved by voters in 2008 but adds a reasonable monthly fee to help credit flow. Thus it is a compromise between the highly restrictive 2008 law and the harmful status quo in Ohio today. A poll showed that most Ohio voters—Republicans and Democrats alike —support by overwhelming margins the fixes found in the reform bill, as do payday loan borrowers themselves.

- HB 123 avoids government overreach by relying on simple, rules that require no paperwork other than what lenders voluntarily collect today (proof of income).

- HB 123 allows lenders to choose their own procedures for underwriting loans and managing risk as long as the loan itself meets a few simple rules, and compared to every other lending statute in Ohio it lets lenders charge a premium for the risk of lending to those with poor credit histories (see loan examples in appendix).

- HB 123 uses concepts that have worked elsewhere and makes several improvements on them. Like Colorado law, it limits loan sizes to $500 and stretches payments out over time, with typical borrowers experiencing APRs that are about four times lower than what similar borrowers experience from the same companies in other states (in Colorado, this has translated to paying about 40% less than before the law change). Yet it is simpler and more flexible than Colorado's law, and it lets lenders begin earning the monthly maintenance fee on Day 1 of the loan, not on Day 60 like in Colorado. (See appendix.)

- HB 123 provides strong consumer protections. It requires affordable payments that fit within borrowers' budgets and prevents loans from creating debt traps that are common in payday and small-loan markets today.

- HB 123 allows small-dollar credit to continue to flow throughout the state. It provides lenders with ample opportunity to sustain their businesses while earning up to $250 on a $500 loan.

- HB 123 encourages competition by normalizing state law and enacting clear rules that allow for low-cost compliance and fast loan origination.

<u>HB 123 is based on a cohesive and flexible structure that this committee can easily build on.</u>

The provisions in HB 123 as passed by the House work together to ensure core goals for consumer protection, efficiency, and a transparent and competitive marketplace. And HB 123 could be amended to meet reasonable concerns with just a few simple adjustments, as demonstrated below:

- **HB 123 ensures that loans last long enough to fit within borrower budgets, but do not last so long that they become harmful. It does this with two simple rules.** One allows any minimum loan duration so long as the monthly payment takes no more than 5% of the borrower's gross income (or 6% of net income such as deposits to a bank account; lines 92 to 95 of the bill). The other allows any maximum loan duration but discourages loans from lasting too long by capping total fees and interest at 50% of the amount borrowed (lines 201 to 212 of the bill). With these two simple rules in place, there is no need for complex rules about minimum or maximum loan terms for various loan sizes and costs. Otherwise, the bill would have to be much more prescriptive about these terms, adding complexity, limiting choice for borrowers and lenders, and making the law less flexible as borrower incomes increase over time.

- **HB 123 is based on a simple, flexible pricing structure that automatically scales for different loan sizes and durations.** It allows lenders to charge 28% interest plus a monthly fee of five percent of the original loan amount (maximum $20). APRs will automatically vary depending on loan size and duration (see appendix). Other approaches, such as allowing origination fees or introducing tiered pricing structures based on loan size, add unwarranted complexity and create other problems that require the creation of additional legal protections.

- To allow larger loans under HB 123, the committee could simply change the maximum allowable loan size in the Short Term Loan Act and the rest of the provisions would automatically work. If the maximum loan size were increased to $1,000, consumers would remain protected by the core provisions of HB 123 but lenders could earn up to $500 in revenue per loan.

- To better ensure ongoing access to small-dollar credit, the committee could make the business model for lenders richer by raising the maximum allowable monthly fee (line 165 of the bill) and/or increasing the maximum allowable loan size under the Short Term Loan Act.

- To enable competition from state licensed banks and credit unions, the committee could add a new provision explicitly authorizing them to opt in to making loans under HB 123.

In sum, HB 123 is a carefully crafted policy that is based on years of research and analysis with the interests of borrowers, lenders, markets, and communities carefully balanced. The same cannot be said for alternative proposals recently presented to this committee. HB 123 will achieve reasonable reform by preventing payday lenders from using unintended statutes, giving borrowers time to repay in installments, and limiting prices to levels that are affordable for borrowers and profitable for lenders. Its flexible structure can accommodate a few simple adjustments for loan size and monthly fees and will achieve the goals of fixing Ohio's laws, protecting consumers, and improving the transparency and vitality of Ohio's small-loan market.

I urge you to enact HB 123 intact, and would be happy to take any of your questions.

Thank you,

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<u>Appendices:</u>

A. HB 123 sample loans and pricing option
B. HB 123 and the Colorado model

Appendix A: HB 123 Sample Loans and Pricing Option

Pricing: HB123
(28% interest plus monthly fee of 5% of loan amount max. $20)

	Loan Amount							
Term	$100	$200	$300	$400	$500	$750	$1,000	$1,500
2 months	$14 cost 107% APR	$27 107%	$41 107%	$54 107%	-	*	*	*
4 months	$26 119%	$52 119%	$78 119%	$104 119%	$110 101%	$124 77%	*	*
6 months	*	$77 122%	$115 122%	$153 122%	$162 104%	$182 79%	$203 67%	*
9 months	*	-	*	*	$240 104%	$270 80%	$300 67%	$360 54%
12 months	*	-	*	*	*	$358 79%	$398 67%	$477 54%
15 months	*	-	*	*	*	*	$497 66%	$595 54%
18 months	*	-	*	*	*	*	*	$714 54%

Pricing: New Sample Option
(28% plus monthly fee of 5% of loan amount max. $30)

	Loan Amount							
Term	$100	$200	$300	$400	$500	$750	$1,000	$1,500
2 months	$14 cost 107% APR	$27 107%	$41 107%	$54 107%	*	*	*	*
4 months	$26 119%	$52 119%	$78 119%	$104 119%	$130 119%	*	*	*
6 months	*	*	$115 122%	$153 122%	$192 122%	$242 104%	*	*
9 months	*	*	*	*	$250 108%	$360 104%	$390 86%	*
12 months	*	*	*	*	*	$375 82%	$50 82%	$597 67%
15 months	*	*	*	*	*	*	$500 67%	$745 66%
18 months	*	*	*	*	*	*	*	$750 56%

* Loans are possible but most likely will not be offered to most borrowers due to lender incentives to optimize revenue
Note: all loans based on monthly payments- APRs will be slightly higher for biweekly payments
Information in boxes is total cost (excluding principal) & APR
* denotes loans unlikely to be made to typical customers due to affordable payment or max loan revenue provisions. But technically would be allowed under the law.

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Appendix B: HB 123 and the Colorado Model

<u>Building Upon Colorado's Proven Model of Success</u>

HB123 is modeled after successful reform passed by Colorado in 2008, which lowered costs for consumers while allowing payday lenders to continue to operate profitably. However, HB123 improves upon Colorado's approach by offering more flexibility and simpler rules for lenders and consumers alike, along with larger loan sizes, while maintaining similar APRs.

More Flexibility

- Colorado law requires six-month minimum loan terms, which lenders complain is too long, especially for smaller loans.

- HB123 sets no minimum or maximum loan term, rather the lender sets the duration based on a borrower's income, using the same documentation required today.

Simpler Rules

- Colorado law backloads costs; lenders may not begin collecting a monthly maintenance fee until day 60.
    - Loans repaid by consumers within two months are unprofitable for lenders.
    - Loans repaid in six months are unnecessarily expensive for consumers.

- HB123 spreads costs evenly over the life of the loan; lenders may begin collecting a monthly maintenance fee on day 1.
    - Loans are fairer and simpler for consumers and lenders alike.

Larger Loans

- Colorado law sets the maximum loan amount at $500, which lenders say is too low.

- As written, HB123 also sets the maximum loan amount at $500.

    - However, bill sponsors, consumer advocates, researchers, and responsible lenders agree that the bill could be amended (see page 2) to safely increase the loan amount as long as other consumer protections remain intact.

Similar APRs

- The average borrower in Colorado takes out a $400 loan and repays that loan in three months at a cost of $91 (117% APR).

- Under HB123, an identical loan in Ohio would cost $79 (115% APR).

- If a $400 loan is paid back in one month in Colorado the lender earns $20. Under HB123, lenders could earn $29. HB123 enables slightly larger APRs for shorter loans and lower APRs for longer loans than in Colorado, carefully balancing the interests of borrowers and lenders.