

Law Article Finds New Mexico Payday Law Ineffective At Stopping Short-Term Loan Abuses

Highlights from Working Paper:

**“Payday Lending Legislation from the Ground Up:
A Customer’s View of What Works and What Doesn’t”**

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In her March 2010 paper, to be published in the Arizona Law Review next fall, Nathalie Martin analyzes interviews with payday lending customers in New Mexico against the backdrop of regulations enacted in 2007 and an extensive review of existing research of the payday lending industry. Professor Martin concludes that New Mexico’s law, which allows payday loans to carry a 417% annual interest rate amidst a variety of regulations such as a database, loan amount limits, right to rescind and others, have proven largely ineffective in preventing short-term loans from becoming long term debt. The following are key findings from her research:

Results of New Mexico’s 2007 Payday Loan Reform Law:

Provision	Result
Limit fees to \$15.50 per \$100	417% APR for a 2-week payday loan
Narrow Definition of Payday Loan	<ul style="list-style-type: none"> • Majority of short-term loans now evade the law by making loans that fall outside of definition (<\$2,500, 14 to 35 day term, and secured by check or debit authorization) • Most continue to charge higher than 417%
Repayment Plan	Consumers openly dissuaded from using repayment plan, if the plan option is even disclosed at all.
Rollover Ban	Does not prevent back-to-back transactions, i.e. taking out a new loan immediately upon paying off old loan, or taking out new loan before making it to next payday.
Limit Total Loan Amount to 25% of Gross Income	Does not account for other outstanding debts, meaning PDL debt can in fact become much more than 25% of net income.
Database operated by Veritec	<ul style="list-style-type: none"> • Fails to track the vast majority of short-term loans since now most fall outside of the narrow definition of payday loans • Does not stop back-to-back transactions. • Industry says: “The implementation of a state-wide database is of little consequence” as well.
BOTTOM LINE	Law has done little to change short-term lending or high interest rates

Consumers’ Experience: Short-Term Loan, Long-Term Debt:

“One man reported paying over \$2,000 over two years on a \$300 loan. This loan is still unpaid and he does not understand why he hasn’t made a dent in the original \$300 loan.”

- Based on 109 interviews with customers at payday stores, plus 20 one-hour interviews, in 2009
- Borrowers are not infrequent or occasional, and the loans are far from short term
 - 19 of the 20 in-depth interviews revealed that the borrower had been in continuous short-term debt for more than a year
- Customers often had other lower cost or no-cost options:
 - Only a small percentage reported that the payday loan was their last option
 - 30% have credit cards, and many had an available balance but mistakenly thought that credit cards were more expensive than a payday loan.

- 43% said they could go to a friend or family member.
- Other low or no-cost options borrowers said they could use if they didn't have a payday loan: wait until payday, not do the activity they were planning, work overtime, walk for a week instead of driving in order to save gas, entering a repayment plan with other creditors, calling utility company, or pay a bill late.
- Most borrowers are unable to describe APR or predict the total dollar cost of the loan
 - 60% of borrowers didn't know or wouldn't guess the APR on the loan, even though the interview took place at the payday shop immediately after they took out or paid on the loan.
 - 39% of those who attempted to guess thought APR was between 18% and 96%
 - The vast majority could not accurately describe the total dollar cost of the loan.
- Customers do not shop around for short-term loans, but rather make decision based on proximity to home or work
 - 41% reported location as a reason why they chose a particular lender, making this the most frequently cited reason
 - 7% report "competitive prices or discounts" as a reason why they chose a lender
- Some use for emergencies, but most use the loans for recurring expenses or to pay off the previous payday loan
 - 63% used the loan for regular, recurring expenses, i.e. phone, utilities, rent
 - **4% used the loan for an emergency expense**

Business Model Depends on Repeat Borrowers:

- According to Dan Freehan, CEO of Cash America, "*The theory in the business is that you've got to get that customer in, work to turn him into a repetitive customer, long-term customer, because that's really where the profitability is.*"
- According to an ex-employee of a New Mexico payday shop, "*We were trained to encourage customers the day they paid off their loan to make another loan as early as the next day.*"
- Lenders offer special discounts to encourage frequent borrowing, i.e. "pay your interest 5 times in a row, get your 6th interest payment half price." But nothing goes to principal.
- Numerous empirical studies show that repeat customers make up vast majority of borrowers:
 - Colorado: 65% of loan volume due to borrowers with 12 or more loans a year.
 - FDIC: 46% of all loans are renewals or new loans taken out immediately after paying off old loan.
 - Indiana: 91% of customers rolled over loans & average number of renewals was 10
 - Industry-funded Elliehausen study: 75% of national sample renewed loans, with 40% having five or more renewals
- Consumers' limited income, the design of the product, and customers' other monthly expense make it nearly impossible to pay back within the short 14 day term. This is the Payday Loan Debt Trap.

Payday Lending Represents a Classic Failed Market:

- Price competition is not necessary to create market share – most lenders charge the same thing, typically the largest amount by allowed by law
- Consumers' primary choice is driven by factors other than price.
- Market has not driven down prices, nor it is likely to do so, since consumers' deciding factor is not driven by price
- The market failure is exacerbated by the information asymmetry – lenders know far more about the loan costs than do borrowers.

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