



May 1, 2008

TO: INTERESTED PARTIES

FROM: THE CALIFORNIA BUDGET PROJECT

SUBJECT: RECENT REPORTS ON PAYDAY LENDING IN CALIFORNIA SHOULD BE USED WITH CAUTION

Recent reports released by the Department of Corporations (DOC) provide valuable insights into California's payday lending industry and confirm that repeat borrowers – those who are likely to be caught in a lengthy cycle of debt – account for the vast majority of payday lenders' business. However, due to a major factual error and a methodological flaw, each report highlights data that understate the number of Californians who repeatedly use payday loans. In addition, the DOC report understates, by a large margin, the average number of payday loans per borrower in California. Consequently, these reports should be used with caution.

## What Are Payday Loans?

Payday loans are short-term, high-interest-rate loans that are generally provided to low- and moderate-income individuals who need immediate access to cash prior to receiving their next paycheck.<sup>1</sup> Loans are secured with a personal check that borrowers "postdate" to their next payday, at which time the loan must be repaid. California law allows payday lenders to charge a fee of up to 15 percent of the face value of the check, up to a maximum face value of \$300.<sup>2</sup> A borrower who writes a check for the maximum amount – \$300 – receives a loan of \$255 and pays a fee of \$45.<sup>3</sup> Due to high fees and short repayment periods, payday loans carry high implicit annual percentage rates (APRs), with an average APR of 429 percent for payday loan transactions in California in 2006.<sup>4</sup>

---

<sup>1</sup> Payday loans are also known as "payday advance" and "deferred deposit" loans.

<sup>2</sup> California Financial Code, Sections 23035(a) and 23036(a).

<sup>3</sup> In California, the average payday-loan amount in 2006 was \$254 and loans were repaid in an average of 16 days. In addition, "almost every [lender] charges the maximum fee, with very little fee competition." California Department of Corporations, *California Deferred Deposit Transaction Law* (December 2007), pp. 6 and 15.

<sup>4</sup> California Department of Corporations, *California Deferred Deposit Transaction Law* (December 2007), p. 6. APRs are the "uniform metric" that all mainstream creditors use to compare prices. "Home mortgages, student loans, and automobile loans are all disclosed and regulated with an annual percentage rate terminology. Even other short-term lenders, such as credit card issuers, use annual percentage rates." Steven M. Graves and Christopher L. Peterson, "Predatory Lending and the Military: The Law and Geography of 'Payday' Loans in Military Towns," *Ohio State Law Journal* 66 (2005), p. 662.

## Research Shows That Payday Loans Encourage Chronic Borrowing

Research shows that payday lending is a “business model that encourages chronic borrowing.”<sup>5</sup> Borrowers often do not have enough income to both repay their payday loan and meet their basic expenses until they receive their next paycheck. Therefore, many borrowers repay their existing loan and take out a new payday loan – which triggers a new fee – either immediately or within a few days.<sup>6</sup> Such back-to-back transactions can result in a lengthy cycle of payday loan debt, in which fees “[eat] up a significant portion” of borrowers’ modest incomes.<sup>7</sup> A full 1.1 million Californians took out payday loans during an 18-month period ending in September 2007, averaging approximately 13 loans per borrower.<sup>8</sup> Moreover, California’s payday lenders report that 84 percent of their business is attributable to “repeat customers.”<sup>9</sup>

## Recent Reports Understate the Number of Californians Who Repeatedly Use Payday Loans

In March, the DOC released two reports on payday lending in California – one prepared by Applied Management & Planning Group (AMPG), a Los Angeles-based consulting firm, and the other prepared by the department itself.<sup>10</sup> The reports use numerous data sources, including payday-loan account records and surveys of lenders and borrowers. Overall, the reports provide valuable insights into California’s payday lending industry and confirm that repeat customers account for the vast majority of payday lenders’ business. However, due to a major factual error and a methodological flaw, each report highlights data that understate the number of Californians who repeatedly use payday loans.

### AMPG Report Contains a Major Factual Error

The AMPG report inadvertently understates the number of Californians who are repeat payday-loan borrowers. A key table indicates – incorrectly – that more than 835,000 out of 1.1 million payday-loan customers in California (73.0

---

<sup>5</sup> Michael A. Stegman and Robert Faris, “Payday Lending: A Business Model that Encourages Chronic Borrowing,” *Economic Development Quarterly* 17 (February 2003). See also Sheila Bair, *Low-Cost Payday Loans: Opportunities and Obstacles* (The Annie E. Casey Foundation: June 2005), p. 8.

<sup>6</sup> Uriah King and Leslie Parrish, *Springing the Debt Trap: Rate caps are only proven payday lending reform* (Center for Responsible Lending: December 13, 2007), p. 5. California law prohibits lenders from “rolling over” payday loans; lenders may extend a loan’s due date, but may not charge additional fees for doing so. In addition, state law prohibits borrowers from paying off all or a portion of one payday loan with the proceeds of another loan issued by the same lender, and prohibits a lender from issuing more than one payday loan at a time to a borrower. California Financial Code, Sections 23036(b) and (c) and 23037(a).

<sup>7</sup> Michael S. Barr, *Banking the Poor: Policies to Bring Low-Income Americans Into the Financial Mainstream* (The Brookings Institution: September 2004), p. 2.

<sup>8</sup> A study prepared by a consulting team for the DOC reports that 1,144,032 Californians took out payday loans between April 15, 2006 and September 11, 2007. This study does not report the total number of payday loan transactions during this period. However, a separate DOC study reports that payday lenders in California made 10,048,422 loans in 2006 – equivalent to 15,072,633 payday loans over 18 months (10,048,422 \* 1.5). Combined, these data indicate that payday-loan borrowers in California take out an average of 13.2 loans over an 18-month period (15,072,633 / 1,144,032). Applied Management & Planning Group, *2007 Department of Corporations Payday Loan Study* (prepared for the California Department of Corporations: December 2007), p. x; California Department of Corporations, *California Deferred Deposit Transaction Law* (December 2007), p. 6; and California Department of Corporations, *2007 Department of Corporations Payday Loan Study: Errata*, Table 1, downloaded from <http://www.corp.ca.gov/pub/errata.asp> on April 28, 2008.

<sup>9</sup> Applied Management & Planning Group, *2007 Department of Corporations Payday Loan Study* (prepared for the California Department of Corporations: December 2007), p. 30.

<sup>10</sup> Applied Management & Planning Group, *2007 Department of Corporations Payday Loan Study* (prepared for the California Department of Corporations: December 2007) and California Department of Corporations, *California Deferred Deposit Transaction Law* (December 2007). Both reports were posted on the DOC’s website on March 10, 2008.

percent) received *only a single payday loan* during an 18-month period ending in September 2007.<sup>11</sup> This flawed “finding” appears to contradict research showing that payday loans tend to trap borrowers in lengthy cycles of debt.

AMPG has acknowledged that it incorrectly labeled the table.<sup>12</sup> AMPG intended to show that more than 835,000 payday loan borrowers *visited only a single payday lender* during an 18-month period, regardless of how many loans they received. Instead, because AMPG mislabeled the table, the report erroneously suggests that California has relatively few repeat payday-loan borrowers. In addition, the mislabeled table led to errors in several bullets in the report’s “key findings” section, indicating that AMPG misinterpreted its own data.<sup>13</sup> Although the DOC had been aware of these errors at least since late March, state officials did not post an “errata” notice on the DOC website until late April. However, the notice attempted to correct only one of the erroneous bullets in the key findings section – and even the revised bullet contained two errors because it continued to misinterpret data included in the AMPG report.<sup>14</sup>

## DOC Report Contains a Methodological Flaw

The DOC report contains a methodological flaw that understates the number of Californians who are repeat payday-loan borrowers. The DOC reports that nearly three-quarters of borrowers (73.0 percent) took out multiple payday loans during 2006, and that approximately 387,000 borrowers (27.0 percent) received a single payday loan during that period.<sup>15</sup> However, the DOC’s methodology almost certainly *inflates* the number of borrowers who took out a *single* payday loan, and thus *understates* the number of borrowers who received *multiple* payday loans. For example, a Californian who took out one payday loan in January 2006 and five consecutive payday loans later in the year from a single lender is included in *two* categories in the DOC report: a single-loan category and a separate category for borrowers who took out between two and five payday loans in 2006 (the “2-to-5 loan” category).<sup>16</sup> A more accurate, more transparent, and less complex approach would include this borrower in a single category that encompasses *six or more* loans, rather than including the borrower in two seemingly mutually exclusive categories. In short, the DOC’s finding that repeat borrowers make up 73 percent of all payday-loan borrowers in California is an understatement.

## DOC Report Understates the Average Number of Payday Loans Per Borrower

The DOC report also understates, by a large margin, the average number of payday loans per borrower in California. The DOC indicates that 1.4 million Californians took out 10.0 million payday loans during 2006 – which the DOC reports as an average of 7.01 payday loans per borrower.<sup>17</sup> However, the DOC double counts borrowers who took out

---

<sup>11</sup> This claim appears on pp. ix and x. This report analyzed payday-loan borrower accounts from active lenders for all locations statewide between April 15, 2006 and September 11, 2007.

<sup>12</sup> Maisha N. Hudson, Applied Management & Planning Group, email message to various recipients (March 25, 2008). The DOC provided this email message to the CBP on April 18, 2008.

<sup>13</sup> Applied Management & Planning Group, *2007 Department of Corporations Payday Loan Study* (prepared for the California Department of Corporations: December 2007), p. ix.

<sup>14</sup> The “corrected” bullet claimed that approximately 835,000 borrowers “only had one loan” and that approximately 300,000 borrowers had “more than one loan,” even though the AMPG report did not include data on the number of payday loans that borrowers received. As noted above, these data refer to the number of payday lenders that borrowers visited, rather than to the number of payday loans that borrowers took out.

<sup>15</sup> California Department of Corporations, *California Deferred Deposit Transaction Law* (December 2007), p. 13.

<sup>16</sup> This result occurs because the DOC attempts to distinguish between “intermittent” and “consecutive” payday loans. An individual can be included in multiple loan categories because of how these terms are defined. In addition, borrowers can be counted *multiple times in the same loan category*. For example, a borrower who took out two consecutive loans on three separate occasions would be counted *three times* in the 2-to-5 loan category, rather than *once* in the 6-to-12 loan category. As a result, the DOC report likely exaggerates the number of borrowers in the 2-to-5 loan category and understates the share of borrowers in the loan categories that reflect six or more loans.

<sup>17</sup> California Department of Corporations, *California Deferred Deposit Transaction Law* (December 2007), p. 6.

loans from more than one payday-loan company.<sup>18</sup> AMPG, by comparison, reported a substantially lower number of “unique” payday-loan borrowers in California – 1.1 million – during the 18-month period covered in its study.<sup>19</sup> Because the number of borrowers reported by the DOC is substantially inflated, the DOC’s estimate of the number of loans per borrower is misleadingly low. In fact, a CBP analysis of data included in the AMPG and DOC reports suggests that there were roughly 10 payday loans per borrower in California in 2006.<sup>20</sup>

## Conclusion

The AMPG and DOC reports provide valuable insights into payday lending in California and confirm that repeat borrowers account for the bulk of payday lenders’ business. Due to a major factual error and a methodological flaw, however, each report highlights data that understate the number of Californians who repeatedly use payday loans. In addition, the DOC report understates the average number of payday loans per borrower. Therefore, these reports should be used with caution.

If you have any questions about this analysis, please do not hesitate to contact Senior Policy Analyst Scott Graves at (916) 444-0500 or at [sgraves@cbp.org](mailto:sgraves@cbp.org).

---

<sup>18</sup> See *Review of Department of Corporations Reports on the Payday Loan Law*, background paper prepared for a state Senate informational hearing convened by the Committee on Banking, Finance and Insurance and the Committee on Judiciary (March 26, 2008), p. 5.

<sup>19</sup> AMPG adjusted the account data provided by payday lenders to ensure, to the extent possible, that borrowers who appeared multiple times in the records were counted only once.

<sup>20</sup> Of the 1.7 million payday-loan accounts submitted by lenders for the AMPG study, AMPG determined that 1.1 million represented “unique” borrowers, equivalent to 67.2 percent of the 1.7 million original accounts. This finding suggests that the total number of payday-loan borrowers reported by the DOC – which double counts borrowers who took out loans from multiple lenders – could be overstated by a similar magnitude. Adjusting the DOC data by 67.2 percent reduces the total number of payday-loan borrowers in 2006 from 1.4 million to approximately 963,000 ( $1,432,844 * 0.672 = 962,871$ ). This adjustment, in turn, results in a rough estimate of 10 payday loans per borrower ( $10,048,422$  payday loans /  $962,871$  estimated borrowers = 10.4 payday loans per borrower).