The outcomes for consumers of differing approaches to the regulation of small dollar lending

Presentation to the Manitoba Public Utility Board

April 12th 2016

Policis

- A London based think-tank focused on evidence-based policy making
- Working for government departments, regulators, UK and internationally
- Independent domain experts and consumer advocates
- Long track record of research and advocacy around financial inclusion, affordable credit, consumer protection and market regulation
- Particular domain expertise in consumer dynamics of high cost credit markets and the provision of financial services to those on low incomes
- Policis was the lead research organisation for the UK Government and the UK financial regulators in framing key credit market legislation for the UK:
  - Consumer Credit Act 2006
  - Financial Services and Markets Act and new regulatory regime for credit (2014)
- In last twelve months Policis have been invited to present to various regulators and commissions on small sum lending in UK (FCA), US (CFPB and CSBS), Australia (SACC) and Japan

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The outcomes for consumers of different approaches to regulating high cost small sum lending

- One of Policis occasional, independent public interest project
- Ongoing international research programme undertaken over a two year period
- Exploring the outcomes for consumers of different approaches to regulating small sum credit
- This presentation largely based on analysis of online small sum credit market in US states but touches also on other international jurisdictions
- Based on highly robust and very large quantitative data sets and extensive interviews with state and federal regulators

The outcomes for consumers of different approaches to regulating small sum credit markets:

The big research questions

- Do regulators achieve outcomes they intend?
- Which approaches are most likely to deliver the outcomes that regulators seek?:
  - Protect consumers from detriment
  - Control and / or reduce cost of credit to consumers
  - Enforce responsible lending and borrowing
  - Prevent problematic debt / over-indebtedness
  - Transparency and fairness in product pricing and terms
  - (and in some cases) reduce/ eliminate small sum high cost lending
- Are unintended effects arising? What do these look like and on what scale are these occurring?
- How can consumers be most effectively protected?

The issues for Canadian consumers and the Manitoba PUB hearing

- Would consumers' interests be best served by reducing the cap rate on payday loans or by adjusting the income to debt restrictions?
- If payday loan supply were further restricted and the number of bricks and mortar stores were to decline further:
  - Will consumers use fewer payday loans or borrow less frequently?
  - Will this reduce or prevent problematic debt and entrenched cycles of debt?
  - Will more consumers borrow online or from unregulated lenders?
- What inferences for Canadian consumers and the regulatory model in Manitoba can be drawn from the experience of other countries and from the US?

Methods, data sources and definitions

Analysis rests on qualitative interviews with US regulators and analysis of robust quantitative data from large transactional databases

- **Quantitative data sources:**
  - Both state-licensed and unlicensed lenders use credit reference agencies to support credit decisions
  - Direct analysis of a representative sample of 9.4 million sub-prime small sum credit transactions 2010–2014 from across the US, drawing on the Clarity Services Inc. database, the leading provider of credit reference analytics for the US online non-prime credit market
  - Aggregated data from a time-series data set of a representative sample of 28.9 million anonymised small sum credit transactions in the period from 2001 to 2011 and drawn from across the US – from Teletrack, the sub-prime credit reference agency
- **Qualitative interviews with regulators**, commissioners and supervisors from across the US:
  - Interviews undertaken on an unattributable, anonymised basis to facilitate frank disclosure and discussion
  - States selected to provide a mix of more or less permissive / restrictive approaches to regulation of small sum credit
  - States with the largest "sub 701" FICO score populations
  - States with notable approaches to lenders that are not state licensed.
  - Urban and rural areas and mix of population types

Definitions of terms

- Throughout we distinguish between lenders that are state-licensed and unlicensed
- State-licensed and unlicensed lending have both been defined in relation to individual loan transactions within the database
- **State-licensed lenders** are defined as those with a licence to lend in the state in which the lending transaction takes place (defined by the residence of the borrower)
- **Unlicensed lenders** are defined as lenders which are not licensed to lend in the state in which the loan is made (defined by the residence of the borrower):
    - Lenders have been classified as offshore if the lender is unlicensed by the state into which they are lending and the lender is based outside the US
    - Lenders have been defined as Tribal if they are unlicensed by the state in which they are lending into and they are also asserting that their authority derives from an affiliation with an Indian tribe on a “sovereign nation” basis
- Throughout “Share of lending” refers to the share of numbers of actual loan transactions
- “Small dollar high cost” loans refers primarily to loans made by payday lenders but includes also some small dollar loans made on an instalment basis
- Cost of credit $ per $100 dollars lent = all payments made the consumer on an individual loan including additional fees for re-financing, penalty fees etc.
- Reference year is 2012 unless otherwise stated

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Regulatory approach categorisations

- “**Banned” states:**
  - Banned small sum high cost lending aka payday loans outright
  - Effectively banned such lending, by setting price caps at a level where licensed lenders cannot operate on a commercially viable basis.
- **“Restrictive”** states, with this categorisation resting on:
  - Relative comprehensiveness and complexity of the regulatory framework and the extent to which a series of restrictions are layered over each other
  - The relative strictness of specific restrictions or price controls and other restrictions
  - The degree to which restrictions are enforced (for example by means of a regulatory database or pro-active court action)
- **“More permissive” states,** with this categorisation resting on:
  - The number of restrictions and the relative simplicity of the regulatory framework
  - Whether price caps or other controls are set at comparatively high levels relative to states taking more restrictive approach

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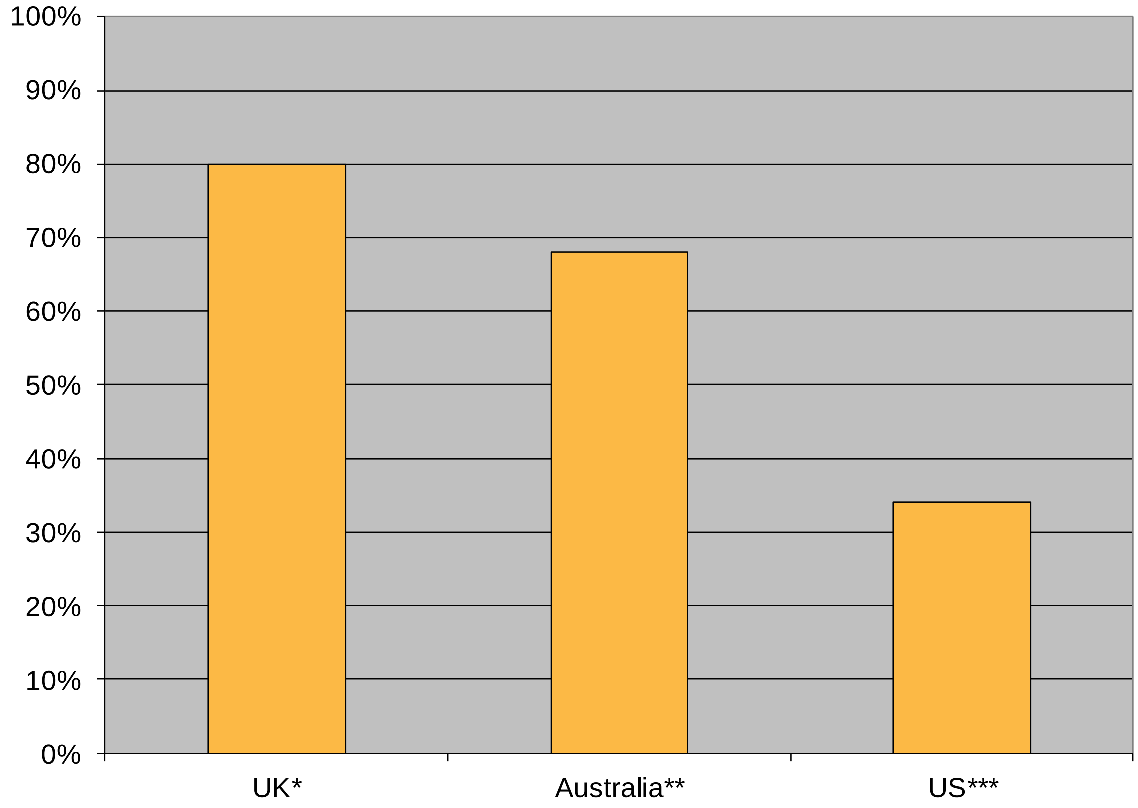
The regulatory framework and the impact on supply and demand

Small sum lending is increasingly transacted online and the shift to online is accelerating

Share of payday loan market represented by online channels, UK, Australia, US



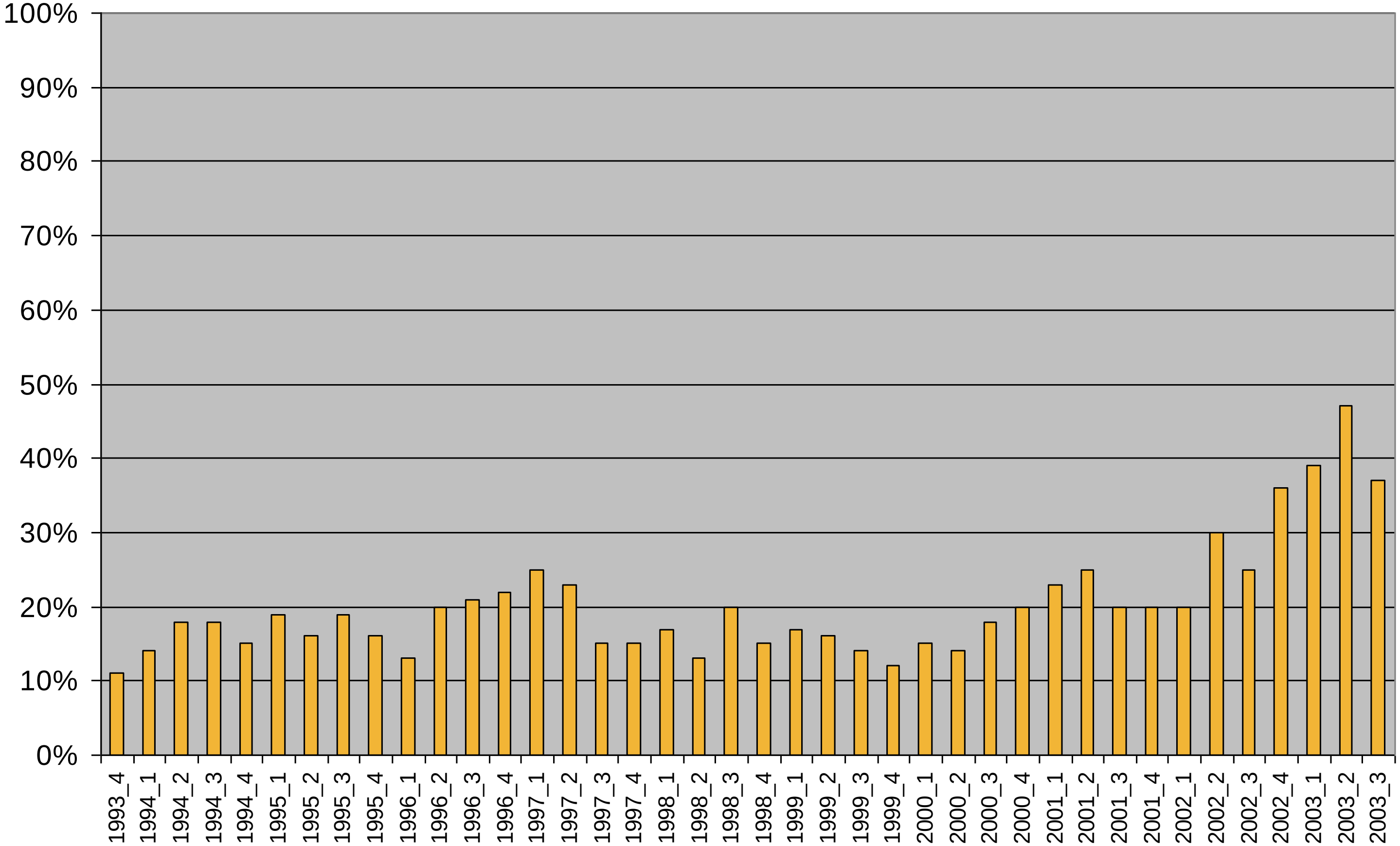
* Source. Competition and Markets Authority Statement 31st Jan 2014, page 11
** Australian Centre for Financial Studies
*** Stephens Inc.

The shift to online payday lending has changed the dynamics of supply and demand – and with it the impact of regulatory intervention

- The emergence of online payday lending over last decade has been game changer – for both lenders and regulators
- Historically regulators have been able to control the supply side end to end
- Critically, however, demand does not go away when supply of small sum restricted
- Prior to the emergence of digital channels, demand was displaced to alternative credit products, typically revolving credit and overdrafts
- In new digital world, restriction of supply creates opportunities for unlicensed, unregulated lenders to fill vacuum created by credit exclusion
- When supply restricted, evidence is that demand is now displaced from storefront to online – and from regulated to unregulated lenders
- US experience demonstrates that an unlicensed credit market can emerge and rapidly acquire critical mass and scale over relatively short period
- It is also clear that different regulatory approaches profoundly influence likelihood of unlicensed lending developing and scale and nature of detriment arising

Displacement effects: prior to the emergence of online credit markets; historically demand was displaced from payday lending to revolving credit and overdraft finance

% by which account delinquency on revolving credit higher in states in which small sum lending restricted, quarterly 1993 – 2003
(Source: Transunion data: 435,000 representative sample of credit users from across US)



In states where small sum loans were restricted, low income, higher risk borrowers shifted to revolving credit and bank overdrafts. Credit card delinquency, unmet debits and unauthorised overdrafts (and associated fees) increased in step. But this long-standing displacement effect broke down 2005 onwards as small sum internet lending takes off…

Where supply is restricted demand is moderated by reduced market stimulus but remains significant because underlying drivers remain

- Restriction of supply appears successful in suppressing “impulse” demand and thus in reducing consumer requirement for small sum loans
- But relatively high proportion of short term borrowing is driven by distress and need to address “emergencies” and cash flow crises
- Applications fall in states where legal lenders (often the largest) not actively soliciting for business and where state lenders primarily storefront
- Where restrictions cause suppliers to withdraw because lending becomes unprofitable:
  - Some of demand falls away – that element that stimulated by advertising and marketing activity of lenders and brokers
  - Underlying demand remains – driven by events, cash flow constraints, uneven earnings and lack of savings safety nets
- In states where legitimate supply more restricted applications tend to shift online where unlicensed lenders a high proportion of overall suppliers

The experience of US regulators is that demand for credit does not go away when supply is restricted

"Well, essentially, what happened is that the legislation got rid of the supply. I should say, got rid of the local supply, but it did nothing to address demand … well they turned to unregulated, you know, unlicensed lenders, primarily internet based. They don't follow the cap rate or anything along that line."

US regulator

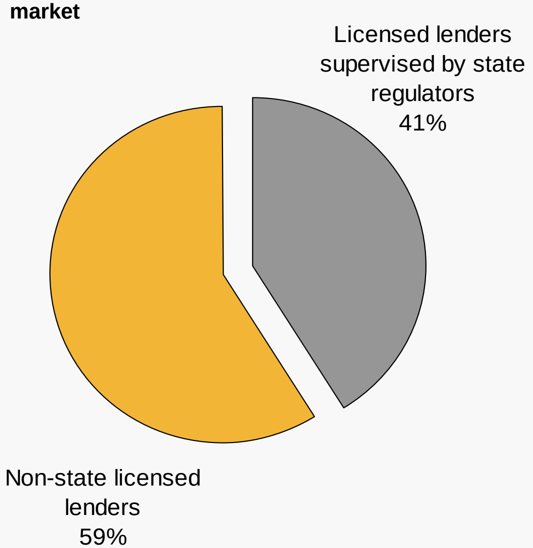
"You talk to the (named state) regulatory, they will probably tell you that they don't have payday lending in their state and everything is just fine. But, guess what, they do have payday lending in their state but it's just unlicensed online payday lending that they have."

US regulator

In US, parallel unlicensed lending market has emerged over ten years to point where unlicensed lenders now dominate online small sum lending in the US

Six in ten online lenders are unlicensed

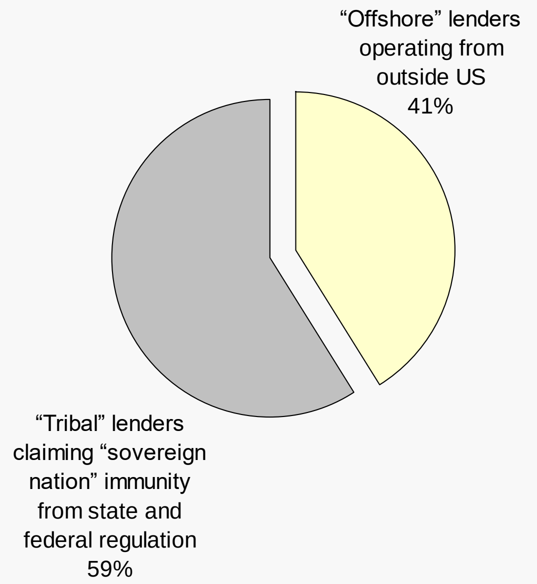
Online small sum lending volumes by regulatory status of lender. % share of the online small loans market



Base: All online small sum loan transactions 2012

Four in ten lenders that are unlicensed operate offshore

Online small sum unlicensed lending volumes by type of unlicensed lender



Base: Online unlicensed HCST loan transactions 2012

Policis estimates based on Clarity Services data

Unlicensed lenders operating online represent a significant sub-set of the US small dollar lending market

- Within US online market, just 41% of all small sum high cost loans were made by lenders with a licence to lend into the state in which borrower lived
- By 2012 6 in 10 (59%) of all online small sum high cost loans were made by lenders with no licence to lend into the state in which borrower lived:
  - 21 million unlicensed loans p.a. representing some $9.7 billion dollars p.a.
  - Online unlicensed lenders used by 2.4 million US consumers, primarily the higher risk and more vulnerable borrowers
- Represents 21% of all payday lending in the US
- Of all online small sum high cost loans, 41% were made by offshore lenders based outside the US

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State regulators report that unlicensed lending now their major challenge

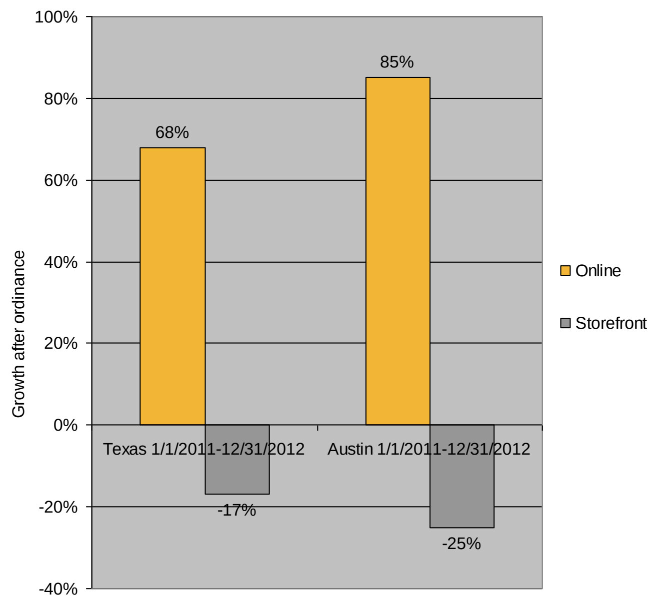
"If you went to Google right now and you typed in payday loans, you'd probably get over a million results. And we licence 1,300. You do the math …The challenge in regulating the lenders and, sort of implementing the regime, is the unlicensed activity that goes on, on the internet and online."

US regulator

In the US where state-licensed supply has been restricted – demand has been displaced from storefront to online and from state-licensed to unlicensed lenders – with this effect most marked in large cities

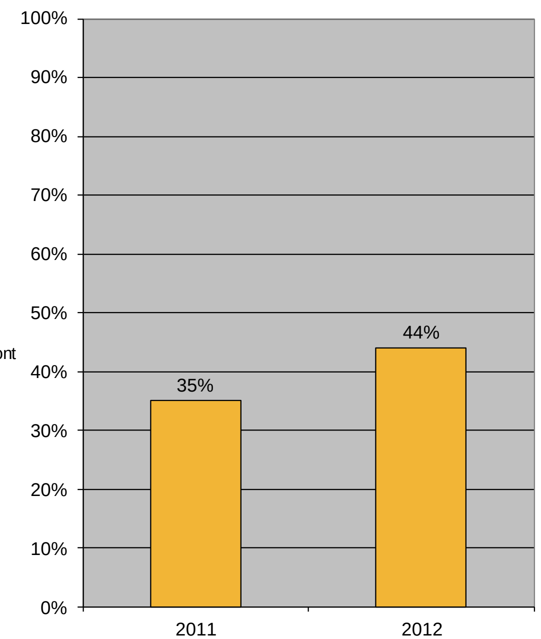
Texas: Following regulatory tightening January 1st 2012 demand was displaced from storefront to online and overall applications to lenders rose

Changes in applications for payday loans by distribution channel Texas YOY 2011/ 2012



Source: Tim Ranney blog Non Prime 101.based Clarity Services inc data.

Share of all online small sum high cost lending in Texas represented by unlicensed lenders 2011 / 2012



Source: Policis estimates based Clarity Services data.

Texas: Following introduction of new regulatory restrictions January 2012 unlicensed lenders increased their share of online lending volumes

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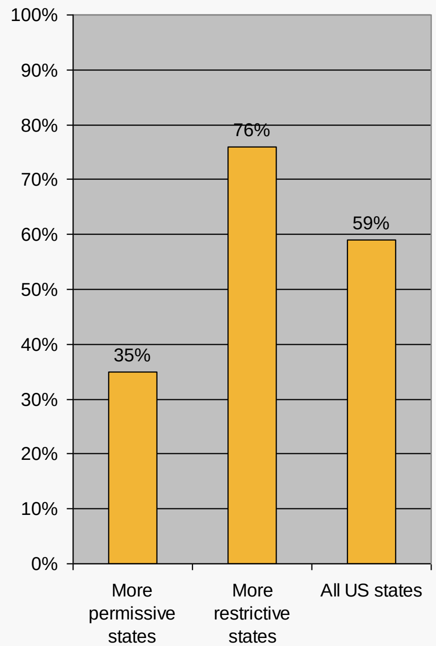
In states with more restrictive regimes online lending is dominated by unlicensed lenders – with a disproportionately high share of online unlicensed lending occurring in states where small sum high interest loans are banned or effectively banned

Unlicensed lending represents a much higher share of online lending in states with more restrictive regimes

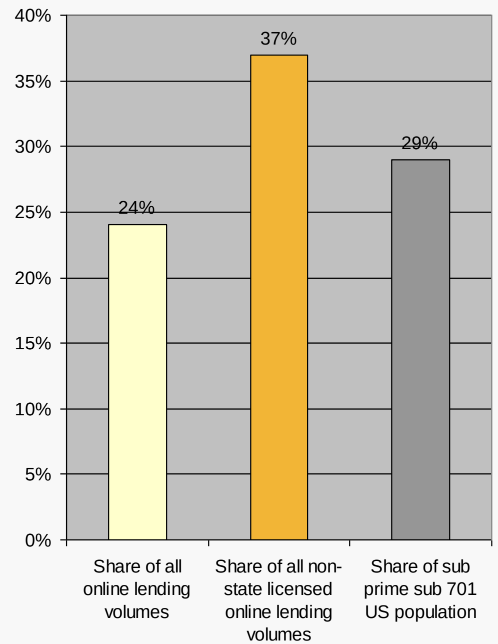
Unlicensed lending as share of all online lending all, US states, more or less permissive / restrictive regulatory regimes



Base for restrictive regimes exclude those states where payday actually or effectively banned
Source: Policis analysis of Clarity Services data

Almost 4 in 10 unlicensed payday loans in US are being made in states where small sum credit actually or effectively banned

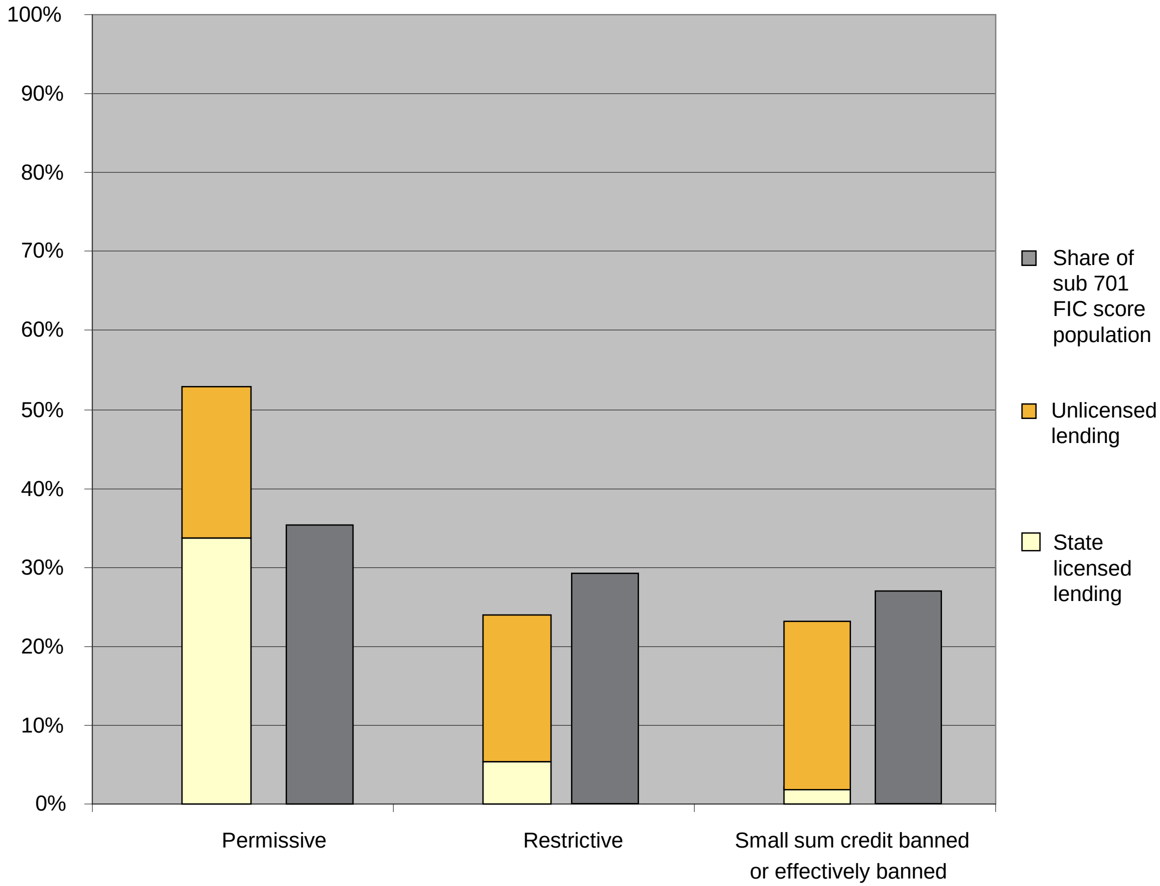
Share of all online and unlicensed online lending in US occurring in 14 US states where payday lending banned or effectively banned



Base: 14 states where payday banned or effectively banned. Source: Policis analysis of Clarity Services data.

The power of demand: In “Restrictive” and “Banned” states, these states’ share of total small sum lending is only slightly lower than these states’ share of the sub prime population – but most is by unlicensed, unregulated lenders

There are higher levels of borrowing in the permissive states – but the share represented by unlicensed lenders is relatively low



Source: Policis estimates based Clarity Services data

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The outcomes for consumers of more or less permissive or restrictive approaches to regulating small sum credit

Balance between licensed and unlicensed lenders is important because it determines consumer outcomes

- State licensed lenders:
  - Lower cost
  - Customers borrow less
  - More responsible lending
  - Lower delinquency
  - Reduced cycle of debt issues
  - Less collateral damage (to bank account, financial well-being)

- Unlicensed, unregulated lenders:
  - Higher cost and price is less transparent
  - Larger loans
  - Less sustainable debt service to income ratios
  - Higher cycle of debt issues
  - Higher collateral damage and greater indicators of financial stress

US state regulators are clear both that significant consumer detriment is occurring and that it is overwhelmingly associated with unlicensed lenders

“The real harm to the consumers is that they take an ACH (Automatic Clearing House payment) with your account and so the money is just removed out of your bank without your control and it’s not a one-time event. They keep grabbing money out of your account. That can be very damaging to consumers and the collections element is very damaging to consumers. If you don’t pay money into your bank then you’re harassed into paying the debt collectors.”

US regulator

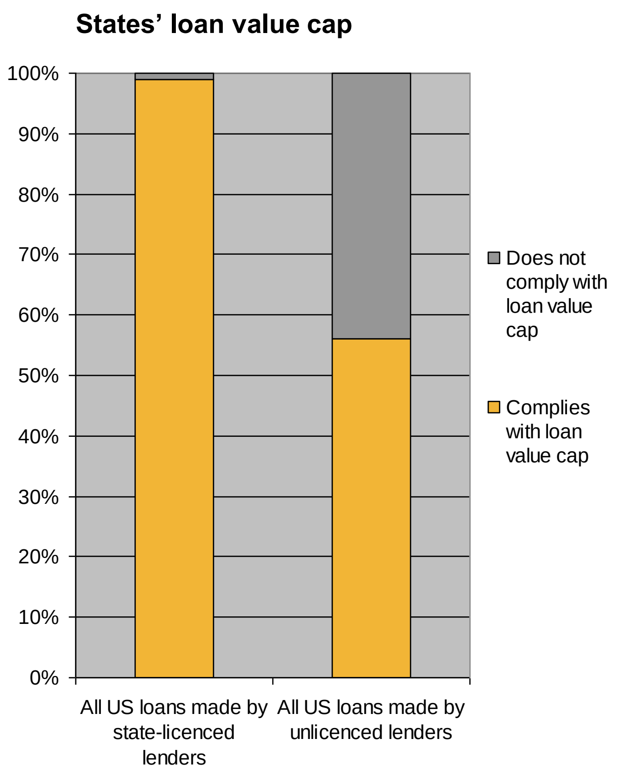
“The ones that are not licensed are just loan sharks. They roll people over, they wipe out bank accounts and they do not respect any legal authority whatsoever.”

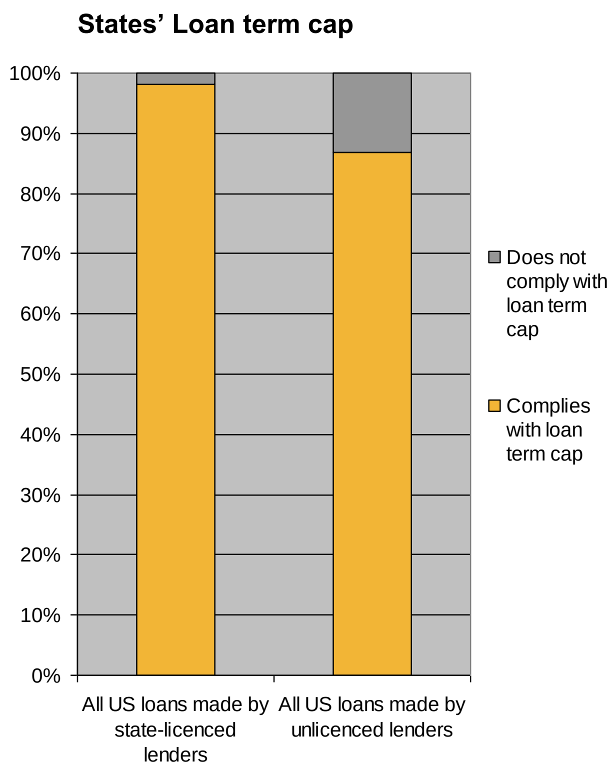
US regulator

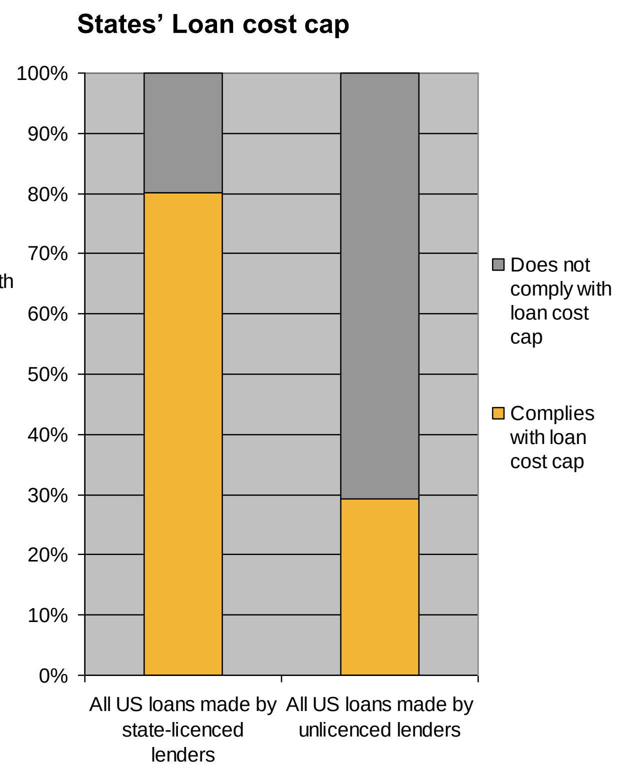
“I would say 99% of the complains that we get from consumers have to do with unlicensed internet lenders.”

US regulator

Many unlicensed lenders do not comply with regulatory regime. Licensed supervised lenders much more likely to be compliant





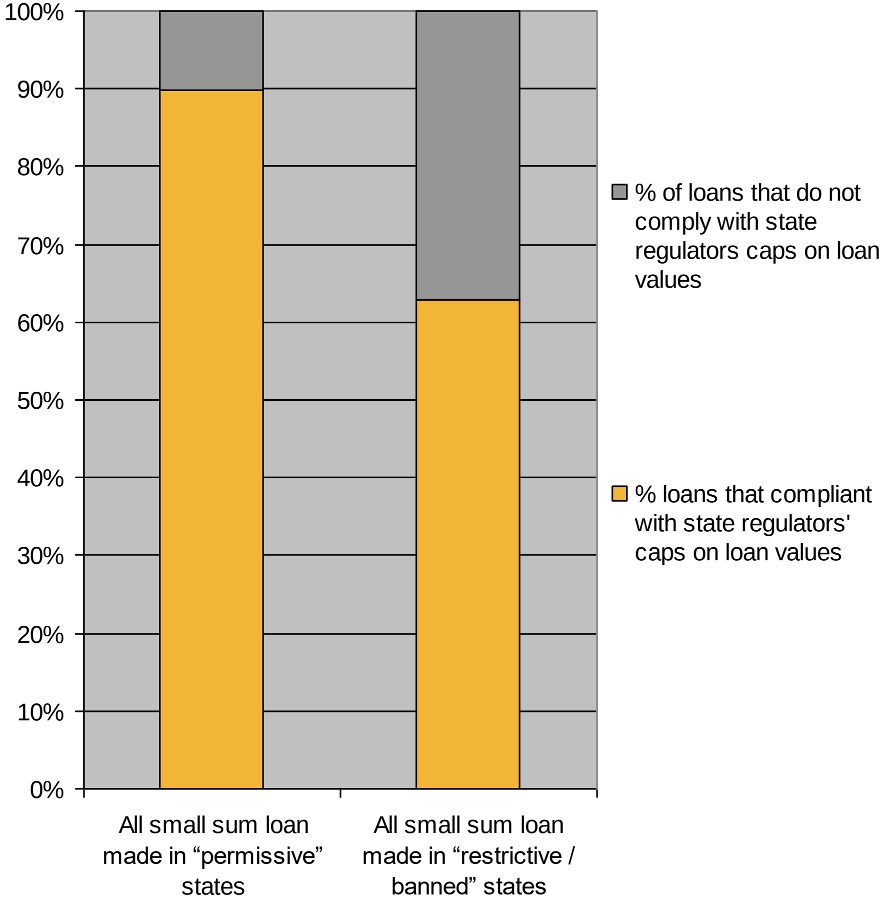


Base: All US online small sum loan transactions 2012
Source: Policis analysis of Clarity Services data

Because permissive states have a higher proportion of licensed lenders , regulators are more likely to achieve their aim on restricting loan values
In permissive states, average loan values are lower than in restrictive states

Average small sum loan values, “permissive” and “restrictive / banned” states

Compliance with state regulators’ loan value caps, “permissive” and “restrictive” / “banned” states



Base: All US small sum online loan transactions 2012*
Source: Policis analysis of Clarity Services data
*for which loan value data available

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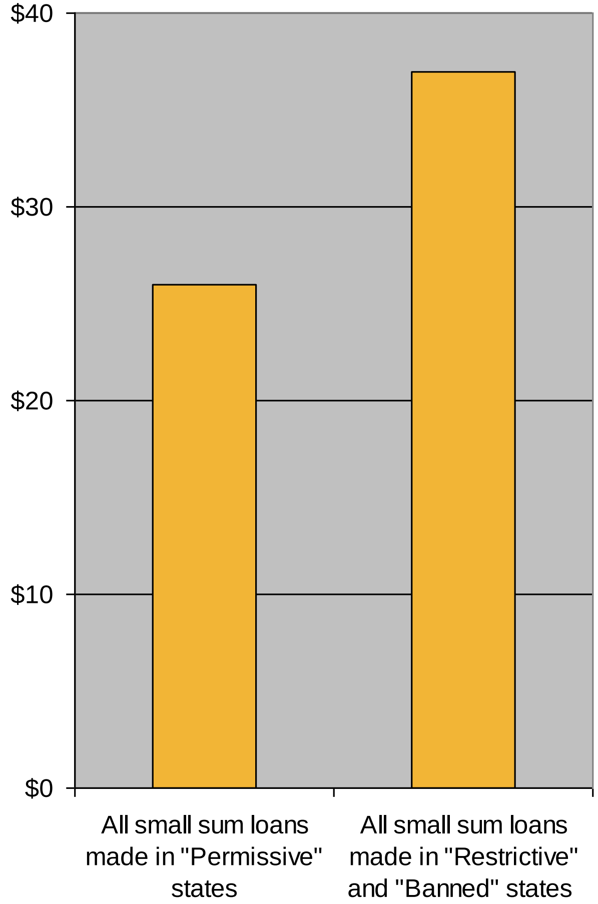
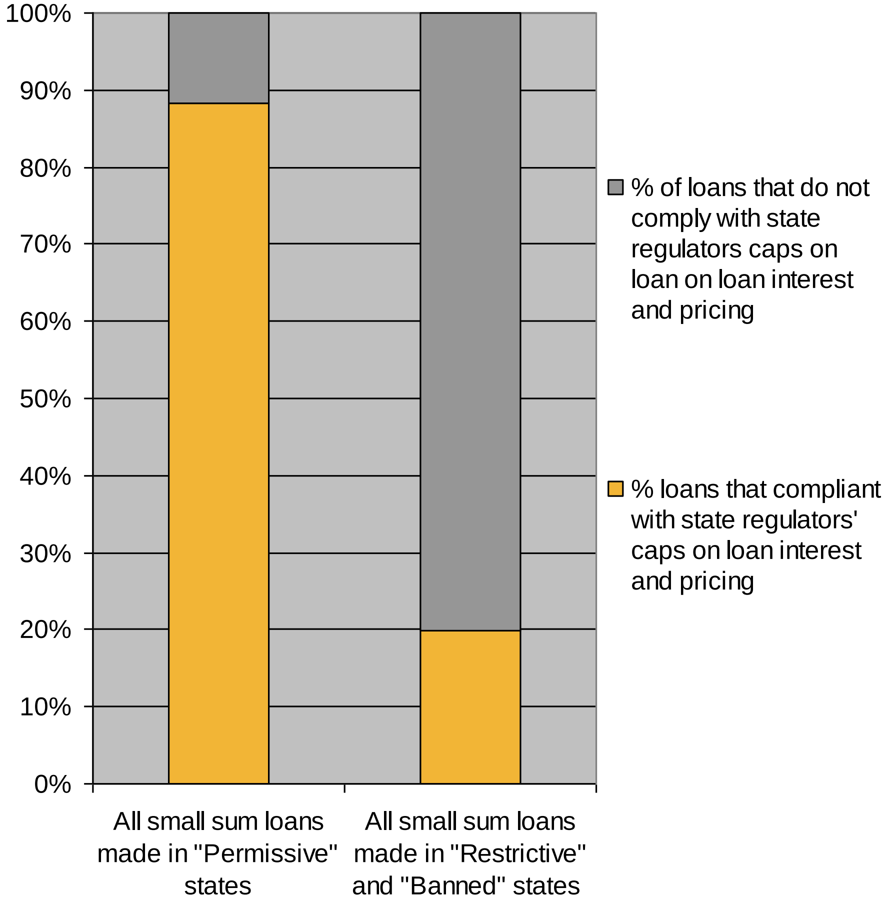
Few loans in the more restrictive states and in states where small sum credit is banned comply with regulators intentions on costs

Regulators achieve much lower costs for consumers in permissive states

Cost of credit per $100 borrowed, based all payments made on loan, permissive and restrictive states



Compliance with state regulators cost of credit caps, permissive and restrictive states



Base: All US small sum online loan transactions 2012*
Source: Policis analysis of Clarity Services data
*for which loan value data available

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The impact of selected regulatory models: California and Florida

Two US states share similar consumer protection goals but adopt differing approaches to regulatory complexity

- **California**
  - Categorised as “permissive” state – simple regulatory regime
  - Relatively low price cap (at an effective $17.5 per $100 borrowed)
  - Relatively strict controls on roll-overs (only 1 allowed per loan) with no fees allowed for extensions. NSF (insufficient funds for payments) charges of $15 are allowed.
  - Only one loan is allowed from the same lender at any one time.
- **Florida**
  - Categorised as “restrictive” state because of complexity of process and protocols around lending and enforcement by regulatory database
  - $16.11 per $100 dollar loan), verification fee $5 per loan
  - Only one loan is allowed at any one time from any lender, no roll-overs
  - Mandatory 24 hour cooling off period
  - Mandated series of validations of borrower eligibility for loan
  - Enforced by regulatory database

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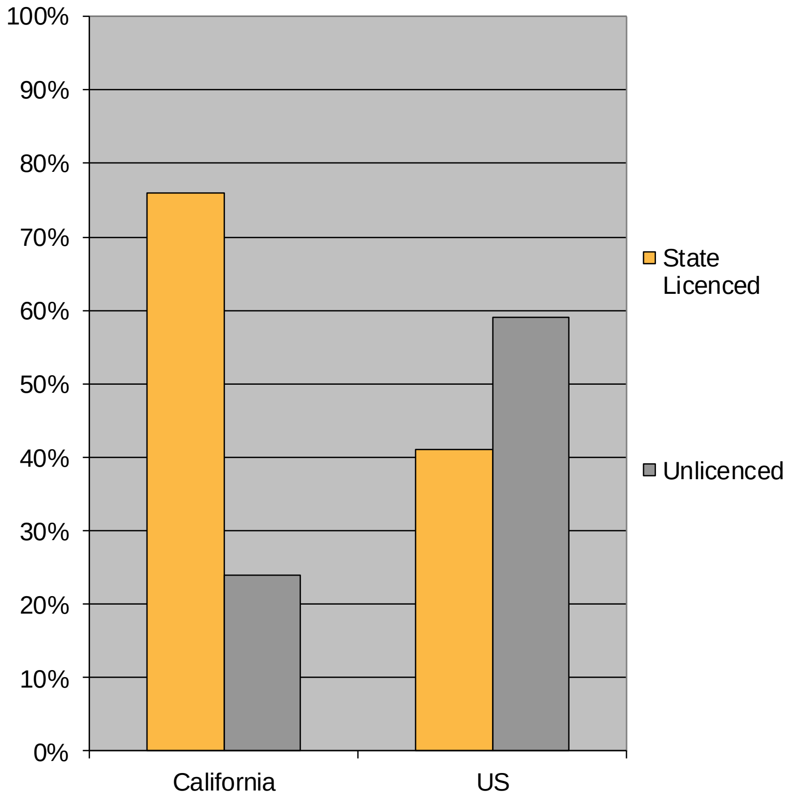
California among most successful regulators in US; high lender compliance, low cost of credit, lower value loans, low problematic debt, low debt service over-stretch, regulators largely achieve goals

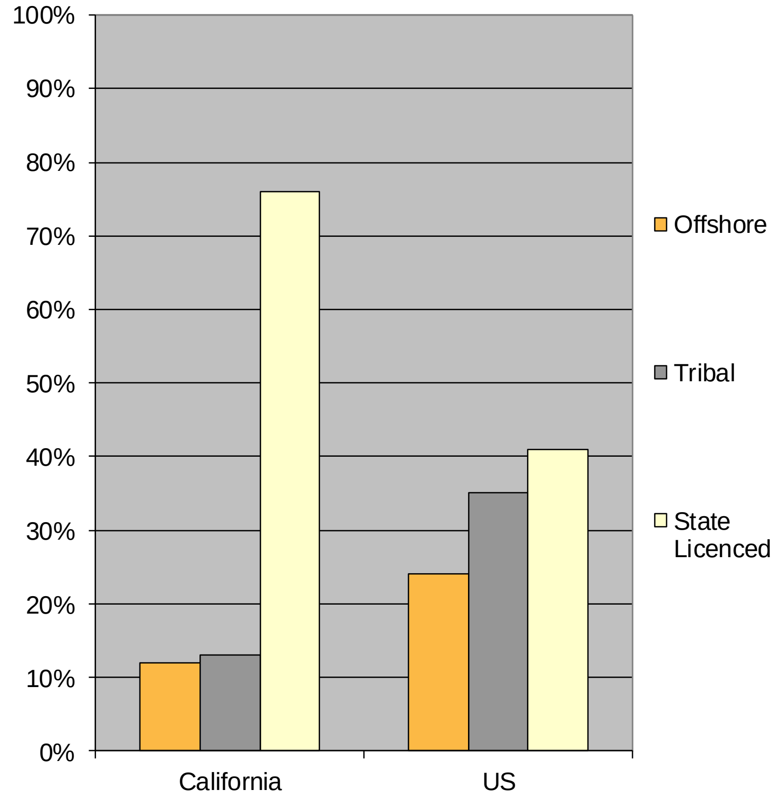
California has lowest incidence of unlicensed lenders of any US state – forcing unlicensed lenders to compete on price

The balance of state licensed and non state licensed lenders in the online small dollar lending market, California and US



Source: Clarity Services

The lender mix in the online small dollar lending market by regulatory status, California and US



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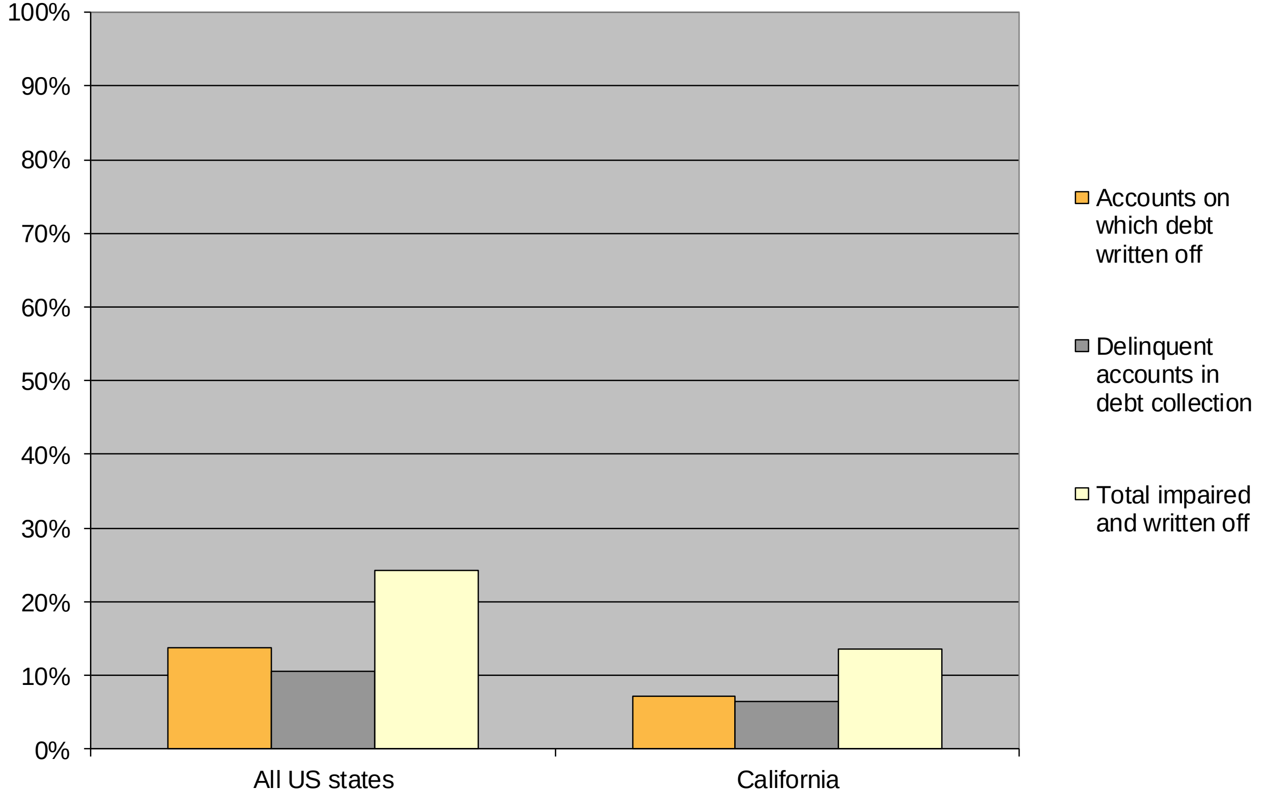
Californian regulators have achieved high standards of responsible lending and delivered low incidence of problematic debt

Loan impairment and write off, All US states and California



Base: All US small sum online loans 2012 / All small sum loans in California 2012
Source: Policis analysis of Clarity Services data

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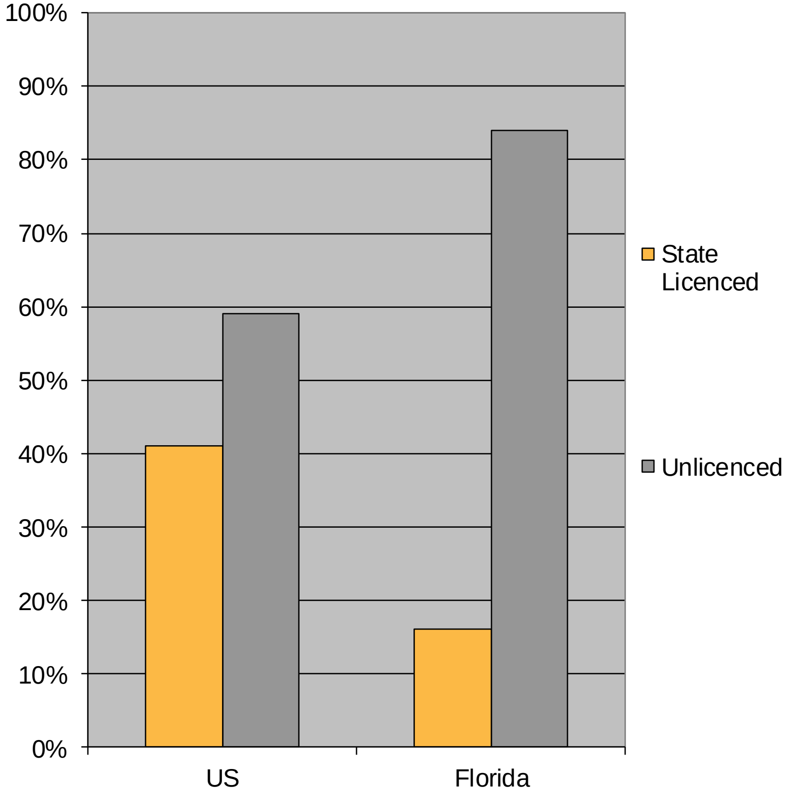
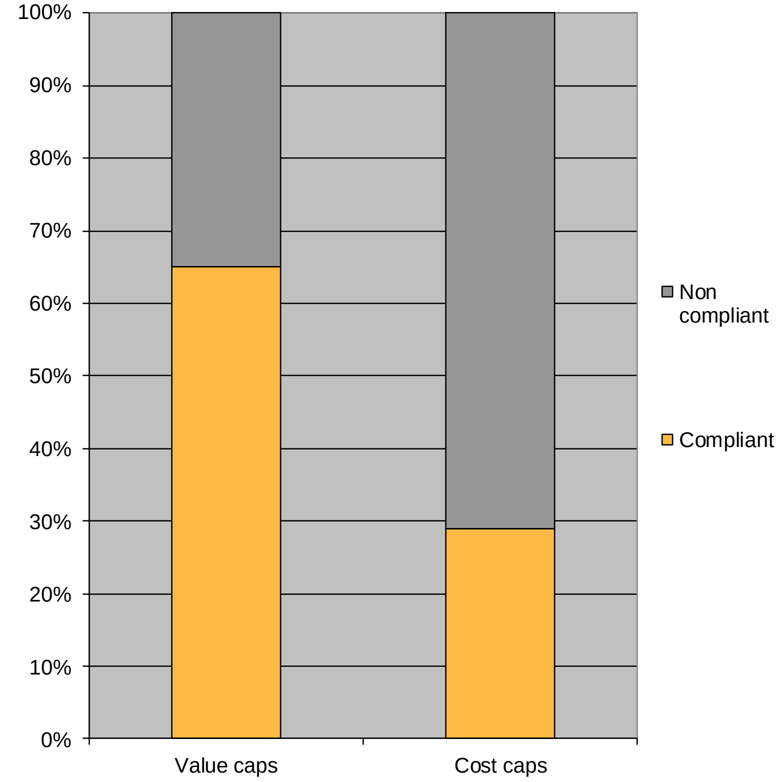
In Florida the small dollar lending market is dominated by unlicensed lenders and consumer outcomes are poor across all dimensions

Florida and All US: balance of state licensed and unlicensed lenders



Source: Clarity Services

Florida compliance with state value and cost caps

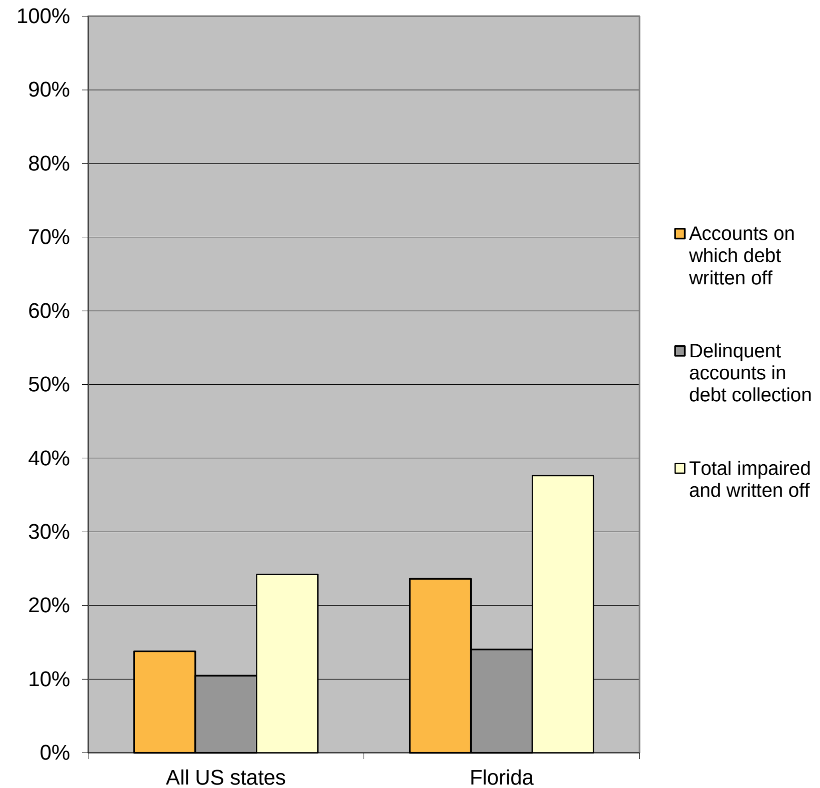


Base: All online loans Florida 2012

Florida borrowers face high cost of credit and suffer high levels of problematic debt and stretched affordability on debt service

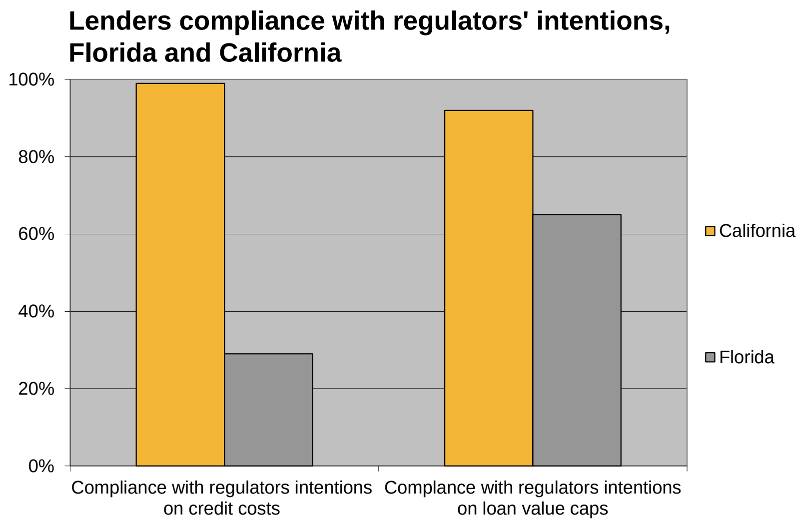
Florida and all US: cost of credit per $100 borrowed

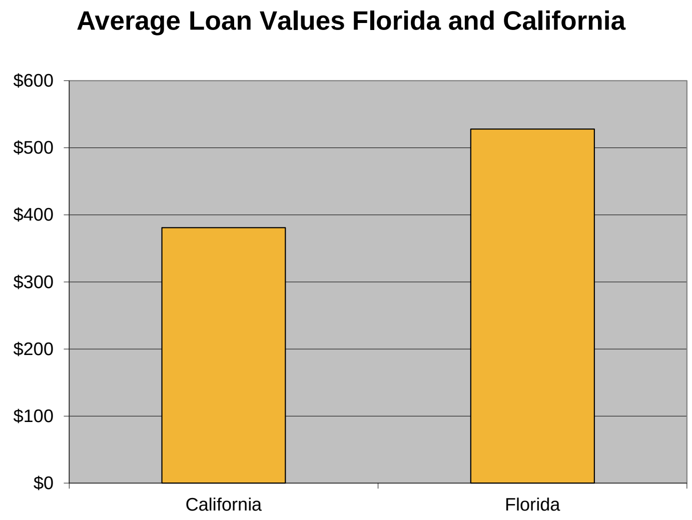
Loan impairment and write off, All US states and Florida

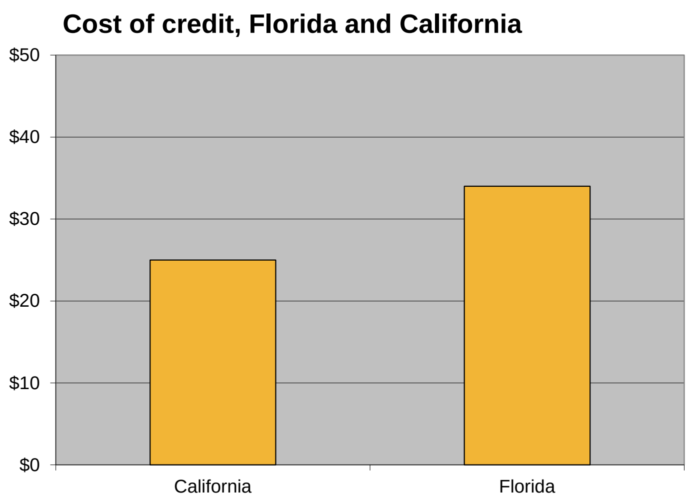


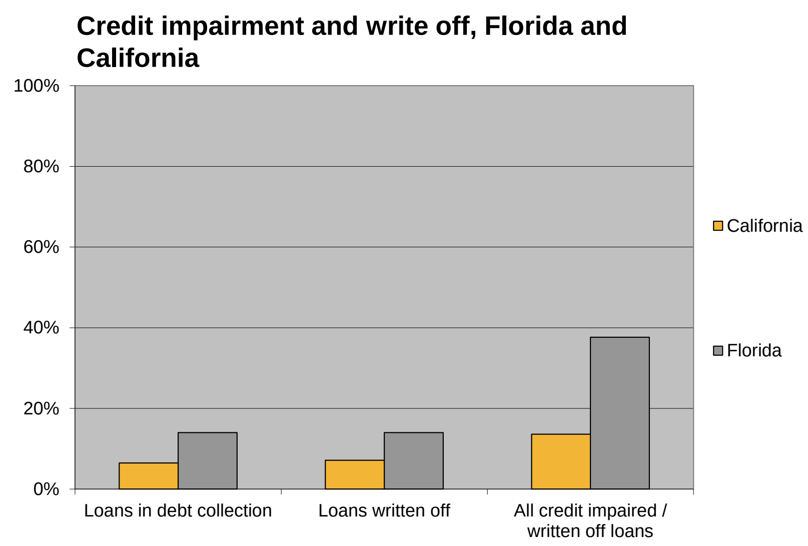
Base: All US small sum online loans 2012 / All small sum loans in California 2012
Source: Policis analysis of Clarity Services data

The outcomes for consumers overall are clearly superior in California than in Florida









Base: All small sums loans in Florida / California 2012
Source: Policis analysis of Clarity Services data

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Tackling unlicensed lending

US experience that unlicensed lending very difficult to tackle. Even material, coordinated effort by state and federal regulators has had limited success

- The federal regulators and some state regulators have made some determined efforts to address unlicensed lending
- Some state regulators have pursued tribal lenders claiming sovereign nation immunity from state laws through the courts, with some success
- Few state regulators have resource or will to do so effectively
- CFPB and DOJ “Operation Choke Point” 2013 which sought to cut lenders off from the payment system had significant impact initially
- In months following Choke Point unlicensed lenders volumes fell significantly and licensed lenders also impacted
- Early signs are that offshore lenders adapting business models, tribal lenders rebuilding market share
- 2015 CFPB has pursued through the courts a number of offshore lenders lending to US borrowers and using aggressive means to collect debt:
    - It is worth noting that all but 2 of the offshore lenders being sued by CFPB for unlicensed lending are Canadian corporations

Cease and desist actions are frequently ineffective – and require prohibitive resource. Publication of enforcement action appears to deter few consumers

"Maybe 25% of the time they respond to us and take notice. Most of the time they don't."

US regulator

"We sent out cease and desist letters to these institutions asking them to stop. You're breaking the law, so basically don't do it anymore … Some of them said they have stopped. Some of them say they won't stop and some of them just said 'we don't have to listen to you because you don't, you can't do anything to us."

US regulator

"We try to keep track of them as best we can … in terms of you know serving them and subpoenaing them and that kind of thing, and auditing them. We are limited because of the lack of resources to go after them. But in doing that, what we do as well is we publish our actions and so what we hope is that people have enough presence of mind to just even Google the company that they're looking at and they'll see that there's a caution alert or even an enforcement action from our department and they might think twice about using them…you may maybe prevent a few hundred from getting into some kind of debt trap."

US regulator

US regulators report that, when challenged, unlicensed lenders mutate identities and are frequently effectively beyond the reach of the law

"It's like 'Whack-A-Mole'. Some of these folks they operate under several different business names and, you know, you may close down one and open up another and it's as easy as just getting a web-site."

US regulator

"They open as Cash Ferry today and ABC lending tomorrow. You don't even know where they are operating from, Dubai, China …"

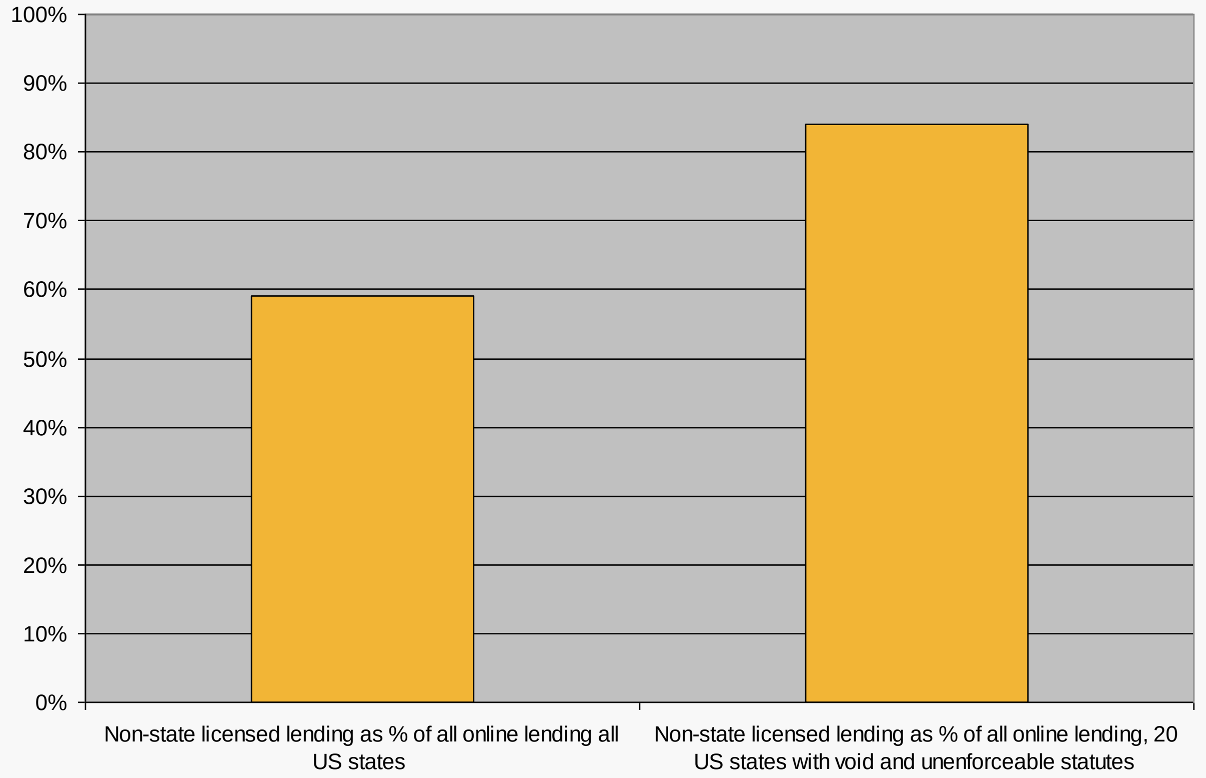
US regulator

"It's been very ineffective with tackling the online payday lending and it's not from lack of trying … by the time you file the charges the company just kills that website and opens a new one … you can't get to the person who owns it and, if they're outside the country, it's beyond, you know, the long arm of the law."

US regulator

Even "void and unenforceable" provisions have not deterred unlicensed lenders

States where debt owed to unlicensed lenders is void and uncollectable are among those with the highest incidence of unlicensed lending

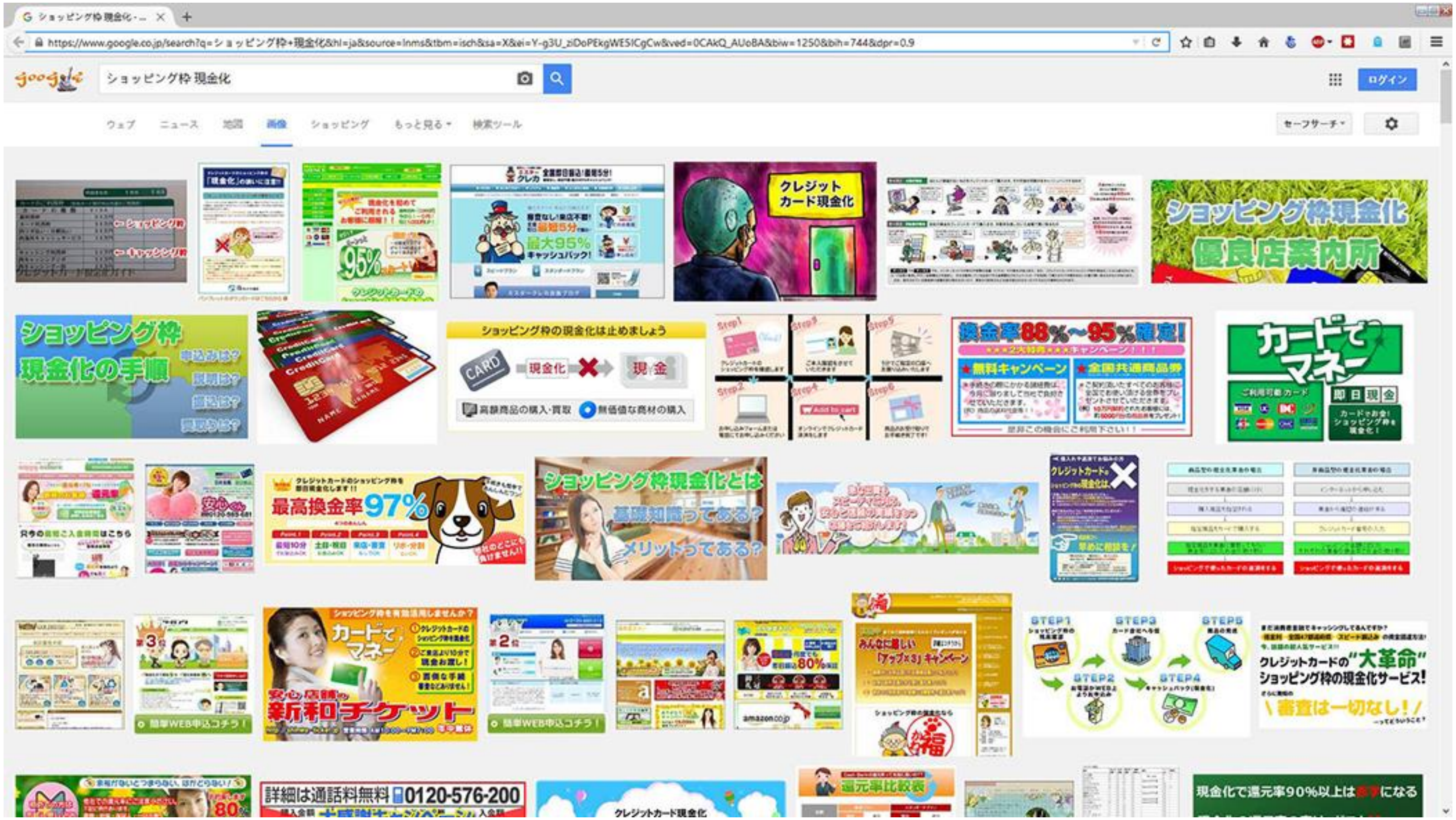


Proportion of online lending volumes which sourced from unlicensed lenders
All US states and 20 states with statutes whereby unlicensed lending debt void and unenforceable

Unlicensed lending outside the US

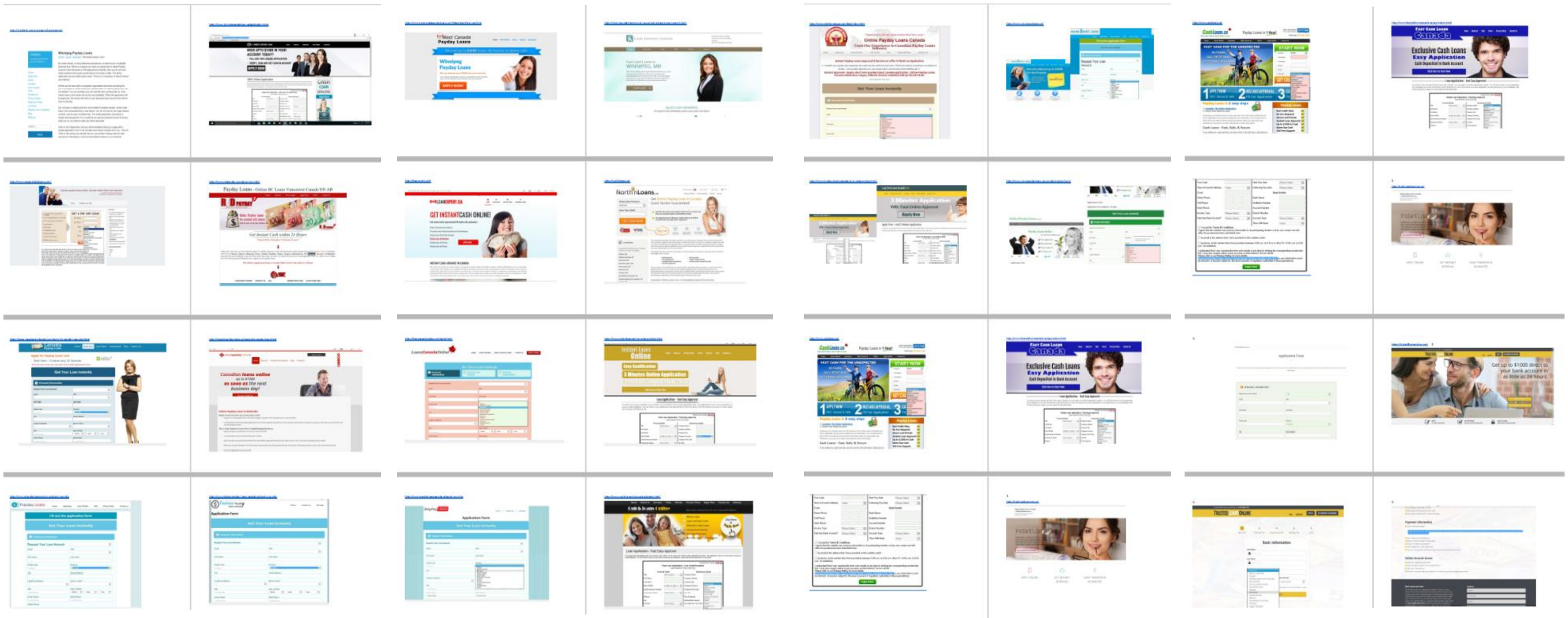
The same phenomena can be observed in other markets where regulatory intervention has significantly reduced legitimate supply

A selection of "Credit card monetising" web-sites, in Japan, a popular business model for unlicensed lenders
The original Japanese phrase used to generate this Google search is ショッピング枠 現金化 (Shoppingu waku genkinka)



https://www.google.co.jp/search?q=%E3%82%B7%E3%83%A7%E3%83%83%E3%83%94%E3%83%B3%E3%82%B0%E6%9E%A0+%E7%8F%BE%E9%87%91%E5%8C%96&hl=ja&source=lnms&tbm=isch&sa=X&ei=Y-g3U_ziDoPEkgWE5ICgCw&ved=0CAkQ_AUoBA&biw=1250&bih=744&dpr=0.9

Unlicensed lenders are active in Canadian markets and in Manitoba



Key take outs

- Demand does not go away when supply restricted
- Demand displaced from storefront to online
- Online environment creates opportunity for unlicensed, unregulated lenders to fill any credit exclusion vacuum
- Unregulated lenders able to take competitive advantage in number of ways:
  - Offer lower (upfront) prices to best repeat customers than can be achieved by compliant lenders (but higher cost overall once other charges taken into account)
  - Serve more vulnerable high risk customers that compliant lenders can not serve at prices not constrained by cost ceilings
  - Deliver rapid decision making and “instant” funds when licensed lenders observing compliance-related process delays cannot do so
  - Lend more and more frequently at debt to income ratios compliant, responsible lenders will not consider and entrench cycle of debt
- Overall outcome that regulatory regimes that overly restrict supply produce poor outcomes for consumers, high cost of credit and problematic debt

The emergence of online lending has changed the dynamics of what regulators can achieve and how best to protect consumers

- The uncomfortable new truth may be that regulators are no longer able to control supply end to end
- In crafting interventions, regulators need to consider the potential for contributing to unregulated lenders gaining competitive advantage
- In particular it will be important to avoid creating the market conditions which appear to cause the greatest damage to consumers:
  - Credit exclusion
  - Protocols which cause process delays for compliant lenders / consumers
- Complex, highly specified, prescriptive regulatory frameworks can be counter-productive and work against consumer interests and regulator intentions
- The most positive outcomes for consumers are achieve with a simple, focused regulatory framework which allows lenders to operate profitably and at scale
- Current direction of regulatory travel appears likely to result in unintended and perverse effects and to worsen outcomes for consumers, particularly the more vulnerable

The implications for Canada and for Manitoba

- Reducing an already comparatively restrictive cost cap or tightening debt to income ratios would seem likely to lead to further restriction of supply and credit exclusion
- This in turn would seem likely to provide stimulus to what appears to be an already active online unlicensed lending market in Manitoba
- Outcome of such moves would be to create unintended effects in the form of consumer detriment for those diverted to unlicensed lenders online
- Those most likely to be diverted to unregulated lenders likely to be the more vulnerable borrowers which compliant lenders will no longer serve
- Real potential to worsen cycle of debt issues and drive up cost burden of servicing loans for these borrowers
- Process delays – such as extended cooling off periods of requirement for online loans to be validated physically likely to be profoundly counter-productive
- Manitoba consumers would seem best protected not by further tightening restrictions but by creating environment which supports high conduct standards but enables legitimate compliant lenders to operate at scale

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Appendix

Appendix 1. US state classification for more or less permissive / restrictive approaches to regulation

Permissive States

AK	ALASKA
AL	ALABAMA
CA	CALIFORNIA
DE	DELAWARE
HI	HAWAII
ID	IDAHO
KS	KANSAS
LA	LOUISIANA
ME	MAINE
MO	MISSOURI
MS	MISSISSIPPI
ND	NORTH DAKOTA
NV	NEVADA
OH	OHIO
RI	RHODE ISLAND
SD	SOUTH DAKOTA
TX	TEXAS
UT	UTAH
WI	WISCONSIN
WY	WYOMING

Restricted States

CO	COLORADO
DC	DISTRICT OF COLUMBIA
FL	FLORIDA
IA	IOWA
IL	ILLINOIS
IN	INDIANA
KY	KENTUCKY
MI	MICHIGAN
MN	MINNESOTA
MT	MONTANA
NE	NEBRASKA
NH	NEW HAMPSHIRE
NM	NEW MEXICO
OK	OKLAHOMA
OR	OREGON
SC	SOUTH CAROLINA
TN	TENNESSEE
VA	VIRGINIA

State where banned or effectively banned

AR	ARKANSAS
AZ	ARIZONA
CT	CONNECTICUT
GA	GEORGIA
MA	MASSACHUSETTS
MD	MARYLAND
NC	NORTH CAROLINA
NJ	NEW JERSEY
NY	NEW YORK
PA	PENNSYLVANIA
VT	VERMONT
WA	WASHINGTON
WV	WEST VIRGINIA