Fiscal Note & Local Impact Statement

127 th General Assembly of Ohio

Ohio Legislative Service Commission
77 South High Street, 9th Floor, Columbus, OH 43215-6136 ✧ Phone: (614) 466-3615
✧ *Internet Web Site:* http://www.lsc.state.oh.us/

BILL: **H.B. 358** DATE: **January 22, 2008**

STATUS: **As Introduced** SPONSOR: **Rep. Yates**

LOCAL IMPACT STATEMENT REQUIRED: **No — Minimal cost**

CONTENTS: **Modifies the provisions for making a loan under the Check-Cashing Business Loan Law**

State Fiscal Highlights

STATE FUND	FY 2008	FY 2009	FUTURE YEARS
General Revenue Fund			
Revenues	- 0 -	Potential negligible gain	Potential negligible gain
Expenditures	- 0 -	- 0 -	- 0 -
Consumer Finance Fund (Fund 553) – Department of Commerce			
Revenues	- 0 -	Potential loss from license fees	Potential loss from license fees
Expenditures	- 0 -	Potential decrease in administrative expenses	Potential decrease in administrative expenses
Victims of Crime/Reparations Fund (Fund 402)			
Revenues	- 0 -	Potential negligible gain	Potential negligible gain
Expenditures	- 0 -	- 0 -	- 0 -

Note: The state fiscal year is July 1 through June 30. For example, FY 2008 is July 1, 2007 – June 30, 2008.

- ***Potential decrease in licenses*.** If, as a result of the bill's limits on origination fees and interest rates, check-cashers or check-casher lenders opt out of payday lending, license fee revenue to the Consumer Finance Fund (Fund 553) may decrease. While it is uncertain how many check-casher and check-casher lenders would opt out, the maximum revenue loss would be approximately $1.6 million annually. This figure is based on the revenue generated by the check-casher and check-casher lender license fees in FY 2007. If these licensees were to shift to another licensure category, such as to small loan companies, the potential revenue loss would be reduced.

- ***Potential administrative cost reductions*.** Also offsetting any revenue loss would be a potential reduction in administrative costs from issuing and renewing fewer licenses. Check-cashers and check-casher lenders make up about 22% of the active consumer finance licenses Department of Financial Institutions (DFI) oversees. The magnitude of any decrease will depend upon how licensed check-cashers and check-casher lenders respond to the bill.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 2008	FY 2009	FUTURE YEARS
Counties and Municipalities			
Revenues	Potential minimal gain	Potential minimal gain	Potential minimal gain
Expenditures	Potential minimal increase	Potential minimal increase	Potential minimal increase

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- ***Civil justice considerations*.** Current law, unchanged by the bill, makes a violation of the prohibitions against payday lenders a violation of the Consumer Sales Practice Act (CSPA), which makes available civil remedies to the Attorney General and to consumers. While the bill contains new prohibitions and requirements on check-casher lenders, very few payday lenders currently violate the law. In view of this and the potential of the bill to significantly decrease check-casher lender licensure activity, it is unlikely that the overall impact of the new prohibitions and requirements on local civil justice costs would be any more than minimal annually.

- ***Local criminal justice costs*.** In addition to the civil remedies available for violations by payday lenders, current law also imposes a first-degree misdemeanor (M1) criminal penalty for such violations. As a result of the new requirements, some persons who may not have been successfully prosecuted and convicted under existing law, could be prosecuted and sanctioned. This could in turn increase local criminal justice expenditures related to investigating, prosecuting, adjudicating, and sanctioning offenders. Accordingly, local fine and court cost revenue may increase, offsetting some or all of any additional criminal justice costs.

Detailed Fiscal Analysis

Background

In order to originate what are commonly referred to as "payday loans" in Ohio, a check-casher lender must be licensed by the Superintendent of Financial Institutions. There is a two-tiered system of licensing for check-cashing businesses in Ohio. A licensed check-casher may cash checks and pay customers the full amount of the check less any charges permitted by law. In order to make loans, a check-cashing business must obtain a second license. Current law requires the loans be made under a written contract, not to exceed $800, and not have a duration of more than six months. Licensees are permitted to charge a loan origination fee and interest at not more than 5% per month or fraction of a month on the unpaid principal balance of the loan. Licensees may also charge check-collection fees in instances where a check has been dishonored or returned for insufficient funds.

Payday loan interest rate and fee changes

The bill modifies the terms and conditions of payday loans in a number of ways by:

- Prohibiting loan origination fees, unless such a fee is included in the calculation of interest rates;
- Limiting the interest rate on payday loans to 25% per annum, which is the criminal usury limit (payday loans are currently exempt from this limit since the rate of interest is otherwise authorized by law), but exempting payday loans from the civil usury limit of 8% per annum;
- Limiting check collection charges to one charge per loan.

The effect of the bill would be to limit the maximum finance charge to approximately $0.96 on a $100 loan for two weeks.[1] The table below illustrates how the finance charge is calculated at various loan amounts both under current law and under the bill under a two-week loan model.

Table 1: Payday Loan Finance Charge Crosswalk		
Loan Amount	**Current Law[2]**	**Proposed Changes in H.B. 358**
$500 or less	$5 loan origination fee for every $50 borrowed plus 5% interest per month or partial month	25% Annual Percentage Rate (includes all fees and charges other than check collection charges for bounced checks)
	Example of $100 loan for two weeks: $100 + $10 loan origination fee + $5 in interest = **$115**	**Example** of $100 loan for two weeks: $100 + $0.96 in finance charges = **$100.96**
	Example of $500 loan for two weeks: $500 + $50 loan origination fee + $25 interest = **$575**	**Example** of $500 loan for two weeks: $500 + $4.81 in finance charges = **$504.81**

[1] This is calculated by dividing the annual percentage rate (APR) by the number of 14-day periods in one year to find the APR's 14-day equivalent. So, 0.25/(365/14) = ~ 0.0096, which equals an interest rate of 0.96% for 14 days.

[2] Ohio Department of Commerce, Office of Consumer Affairs "Payday Loans" publication.

Table 1: Payday Loan Finance Charge Crosswalk		
Loan Amount	**Current Law[2]**	**Proposed Changes in H.B. 358**
More than $500 but up to $800	5% interest + $5 loan origination fee for every $50 for the first $500 and $3.75 loan origination fee for every $50 above $500	25% Annual Percentage Rate (no difference from the rate noted above)
	Example of $800 loan for two weeks: $800 + $72.50 ($50 for the first $500 and $22.50 for the last $300) in loan origination fees + $40 in interest = **$912.50**	Example of $800 loan for two weeks: $800 + $7.69 in finance charges = **$807.69**

Much of the fiscal effect of the interest rate cap will depend on how the industry will react under the new guidelines and thus how many licensed check-casher lenders will stay in or enter the industry and continue to pay license fees. That question may be addressed by examining the current operating costs and profits of payday lenders in view of the revised finance charges allowable under this bill as well as reviewing the experience of other states that have experienced similar rate caps.

Current payday lender costs and profits

There is limited publicly available data in regard to payday lender operating costs and profits. An often-cited source is Flannery and Samolyk's 2005 working paper for the Federal Deposit Insurance Corporation's (FDIC) Center for Financial Research. Their study examined proprietary store-level data from two large payday lending firms to study store costs and profitability.[3] This study included data on a random sample of 600 stores operating in 22 states. The study found a relatively high average cost of originating payday loans. Specifically, Flannery and Samolyk found that average costs for a store open at least one year to loan $100 were between $11 to $14 depending on the age of the store; these are figures the authors contend are not that out of line with the size of advance fees (the average advance fee in the study ranged from $14.32 to $18.30 depending on store age).

Flannery and Samolyk find the average store's operating margin (the ratio of operating income to store revenue which measures how much revenue is left over after store operating costs are deducted) to be 33.2%. However, this margin does not account for shared administrative and interest expenses allocated by the payday lending firm at the corporate level, which, when accounted for, substantially reduces true store profitability. The table below summarizes Flannery and Samolyk's findings for stores open at least one year. As the table demonstrates, the study found that older stores are more profitable due to greater loan activity. In sum, the study's authors concluded that fixed operating costs and high loan loss rates account for a large part of the high APR charged on payday advance loans.

[3] Flannery, Mark and Katherine Samolyk. "Payday Lending: Do the costs justify the price?" FDIC Center for Financial Research Working Paper 2005-09, June 2005.

Table 2: Payday Lending Industry Profitability				
	Young Stores (1-4 years) Avg. Loan Size = $257.72		Mature Stores (>4 years old) Avg. Loan Size = $227.54	
	$ per loan	$/$100 advanced	$ per loan	$/$100 advanced
Avg. Total Store Revenue	$45.94	$17.83	$43.82	$19.26
Avg. Total Store Operating Costs	$36.10	$14.01	$25.10	$11.03
Avg. Store Operating Income	**$9.84**	**$3.82**	**$18.72**	**$8.23**
Avg. G&A and Interest Expenses	$12.84	$4.98	$7.47	$3.28
Avg. Pre-tax Store Income	**($3.00)**	**($1.16)**	**$11.26**	**$4.95**

Source: Flannery and Samolyk

Another source of information concerning the profitability of payday lenders comes from the quarterly Securities and Exchange Commission (SEC) filings of seven publicly traded payday lending companies (some of these companies also engage in pawn business). An August 2006 study in the Fordham Journal of Corporate and Financial Law reviewed these documents (which includes data from nearly 8,000 payday lending stores) and came to a similar conclusion as Flannery and Samolyk.[4] Namely, that payday loan firms are not "overly profitable." While average store operating margins were comparable to those reported by Flannery and Samolyk (24.64%), the average profit margin (the percentage of gross revenue that remains after subtracting out all associated costs for the period) was 7.63% when including companies that, while pawn is their primary business, also make payday loans. This study noted that the average profit margin was less than Starbucks (a little over 9%), a company with a similar business model as the payday lending industry.

This study explains that the industry's average profit margin is attributable to high operating costs, which are driven by longer business hours (leading to higher wage costs) and a large number of stores (leading to high occupancy or rent costs) that are needed to drive loan volume and thus profitability.[5] The high cost of loan losses also contribute heavily to a store's operating costs, further reducing profitability (around 25% of store operating costs in both studies); however, the Fordham study indicated that loan losses for payday lenders are not unusual in comparison to commercial lenders.

<u>Case studies</u>

Recent experience of other states with similar payday lending rate caps may also inform what could happen in this state under similar circumstances. An August 2001 Indiana Supreme Court ruling limited payday loan finance charges to 72% APR by applying Indiana's loan-sharking law to payday lenders.[6] After this, the number of entities licensed and the number of branch locations decreased. According to Indiana Department of Financial Institutions (IDFI) annual reports, at the end of CY 2000, Indiana had 119 payday lender companies registered with 463 branch locations. By the end of CY 2003, there were 44 companies registered with 313 branch locations, amounting to a reduction in the number of companies and branch locations of 63.0% and 32.4%, respectively.

[4] Huckstep, Aaron, "Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?" Fordham Journal of Corporate and Financial Law, October 2006, Volume XII, pages 203-232.
[5] Flannery and Samolyk cite another study indicating a high concentration of storefronts is necessary in the payday lending industry since competition appears to revolve around customer convenience rather than price.
[6] Janet Livingston, et al. v. Fast Cash USA, Inc., Case Number 94S00-0010-CQ-609.

An IDFI official noted that most of the larger payday lending companies continued to operate under the 72% rate cap under the industry's expectation that a new law authorizing the practice with sufficient fees would be passed. This occurred in March 2002 through a bill that specifically provided for the existence of payday lending in Indiana after several disputes (including the Indiana Supreme Court case above) about the issue of payday lending in that state. The March 2002 law limited payday loans to $401 and the associated finance charge to $35. This law was updated in July 2004 to revise the allowable finance charges according to a scale that reduced the percentage charged on the loan as the principal amount increased. By the end of CY 2005, the number of companies and branch locations increased to 54 and 547, respectively.

Another more recent example comes from Oregon, which, effective July 1, 2007, changed its payday lending laws to limit origination fees to $10 per $100 advanced (in other words, a 10% origination fee) and interest to 36% APR. The minimum loan term is 31 days. Including the origination fees yields an APR of 153% for a 31-day loan. An LSC review of recent SEC filings by the publicly traded payday lending companies indicated that, in some cases, these firms cited the new law's origination fee and interest caps as reasons for closing some or all of their payday loan outlets in Oregon. For instance, Advance America, the country's largest payday cash advance company, is closing all 45 of its stores in Oregon. QC Holdings has already closed all eight of its stores, and First Cash Financial Services has closed two of its seven stores in the state.

Impact on license fees

Given the recent industry experience in Indiana and Oregon, check-casher lenders licensed in Ohio might not choose to continue business in the state. If so, license fee revenue to the Consumer Finance Fund (Fund 553) from check-casher lenders and check-cashers may decrease. As of January 18, 2008, DFI's license roster listed 1,564 check-casher lender licenses and 1,661 check-casher licenses in Ohio (for a total of 3,225 licenses).[7] Given that over 94% of check-casher licenses also have check-casher lender licenses, revenue from check-casher fees may decrease as well.

While it is uncertain how many check-cashers and check-casher lenders would discontinue operations, the following table provides a rough estimate of the revenue losses to the Consumer Finance Fund (Fund 553) under various scenarios. Within these scenarios, it is assumed that check-casher and check-casher lender licensees give up their licenses in the same proportions, and that the Consumer Finance Fund receives approximately $500 annually from each licensee. Any offsetting gains in revenue from the potential for increased licensure of small loan companies are not factored in to the estimates. Revenue from license fees from check-cashers and check-casher lenders was approximately $1.6 million in FY 2007.

[7] Accessed through the Ohio eLicense Center at http://www.com.state.oh.us/dfi/elicense.aspx.

Table 3: Consumer Finance Fund (Fund 553) Potential Revenue Loss Scenarios		
% of Licensees Ceasing Operations	**Number of Licensees Leaving**	**Estimated Annual Revenue Loss**
25%	806	$403,000
50%	1,613	$806,500
75%	2,419	$1,209,500
90%	2,903	$1,451,500

However, as the growth in the payday lending industry would seem to show, there is a high demand for the short-term, small dollar loan products these businesses provide. If the interest rate caps in the bill make payday lending in its current form an unprofitable venture, Ohio licensees may instead develop alternative, short term loan products in some way to remain profitable while keeping a check-casher/check-casher lender license.

Other industry operators might simply seek licensure under another licensure category, such as Ohio's Small Loan Act, which allows lenders to offer higher principal loan products, including open-ended lines of credit. Small loan licensees also pay license fees into the Consumer Finance Fund (Fund 553). To the degree that an increase in small loan licensure occurs, this might limit potential revenue losses to Fund 553. Small loan companies pay annual license fees of $300.

Potential cost reductions

The Division of Financial Institutions (DFI) in the Department of Commerce oversees the administrative work of approximately 15,000 active consumer finance licenses with check-cashers and check-casher lenders comprising about 22% of that amount. DFI's Consumer Finance program, which currently employs 39 people, also regulates other consumer finance occupations and companies such as mortgage brokers, loan officers, second mortgage companies, and small loan companies. None of these employees work exclusively on check-casher or check-casher lender issues. Rather, DFI assigns these employees by function. So, field examiners perform examinations of mortgage brokers, check-cashers/check-casher lenders, pawnbrokers, and so forth while licensing staff work on all license types.

If a significant number of licensees were to surrender their licenses, payroll, and other costs from the Financial Institutions Fund (Fund 4X2), which pays for a portion of the Consumer Finance program, and the Consumer Finance Fund (Fund 553) may decrease due to a reduction in licenses to oversee. The magnitude of any decrease will depend upon how licensed check- cashers and check-casher lenders respond to the bill.

Civil and criminal justice considerations

Current law, unchanged by the bill, makes a violation of the prohibitions against payday lenders a violation of the Consumer Sales Practice Act (CSPA), which provides civil remedies to the Attorney General and/or the consumer for handling consumer protection law violations. The bill includes a provision that prevents a check-casher lender from accepting a check or other method of access to a deposit account maintained by the borrower or the title of a vehicle as security for the loan.

While the bill prohibits these methods of payment and changes the permissible terms and conditions of payday loans, DFI records show that there have been few enforcement actions against check-casher lenders since August 2006. According to the Department of Commerce, most violations are minor and are immediately corrected or are handled through DFI enforcement actions, meaning that the Attorney General's office is rarely involved in payday lender violations. In view of this and the potential of the bill to significantly decrease check-casher lender licensure, it is unlikely that the overall impact of the new prohibitions and requirements on local civil justice costs would be any more than minimal annually.

In addition to the civil remedies available, current law also imposes a first-degree misdemeanor (M1) criminal penalty for such violations, which carries a maximum jail term of 180 days and a maximum fine of $1,000. As a result of the new requirements, some persons who may not have been successfully prosecuted and convicted under existing law, could be prosecuted and sanctioned. This could in turn increase local criminal justice expenditures related to investigating, prosecuting, adjudicating, and sanctioning offenders. Accordingly, local fine and court cost revenue may increase, offsetting some or all of any additional criminal justice costs.

If additional criminal cases are created, there is also the possibility that the state may gain a negligible amount of state court cost revenue to the GRF and the Victims of Crime/Reparations Fund (Fund 402). For misdemeanors, the GRF receives $15 per case and the Victims of Crime/Reparations Fund (Fund 402) receives $9 per case.

LSC fiscal staff: Jason Phillips, Budget Analyst

HB0358IN/lb