NCLC®
NATIONAL CONSUMER LAW CENTER®

MISALIGNED INCENTIVES

WHY HIGH-RATE INSTALLMENT LENDERS WANT BORROWERS WHO WILL DEFAULT

EXECUTIVE SUMMARY

Lenders normally want borrowers who will pay back their loans in full. This seems obvious—otherwise, won't the lender lose money?

Yet in the high-rate installment loan market, the normal incentive to make affordable loans does not work. When loans have high interest rates, lenders may seek out and can profit from borrowers who will default in significant numbers. The gap between lender and borrower success can encourage business models that harm numerous consumers.

This report analyzes the inherently dysfunctional and harmful dynamics of high-rate installment loans. In a responsible loan market, the lenders' profits are closely aligned to the successful repayment of the credit. Borrowers and lenders have parallel incentives and share the same goals of successful repayment. But high-rate lending can lead to asymmetrical incentives:

- **As long as the borrower pays long enough before defaulting, a high-rate installment loan will be profitable.** If the borrower makes even half the payments on a longer-term high-rate installment loan, the lender may receive sufficient cash flow to recover the amount loaned and another 50% or more, likely more than enough to turn a profit.
- **A borrower who defaults later can be a more profitable customer than one who prepays the loan in full too early.** Tighter underwriting can lead to borrowers who are able to repay early, generating less revenue than a consumer who struggles for months or years to make payments and then ultimately defaults.
- **While the lender may have a successful experience, default causes a cascade of devastating consequences that are likely to plague the consumer for a lifetime.**

It is not our purpose to evaluate whether high-rate lenders have excessive profits. High rates tend to encourage inefficient operations. Thus, high-rate lenders may or may not be highly profitable.

Instead, our goal is to show that loans that default can be a desirable component of a high-rate lender's portfolio and part of its business plan despite the harms those loans cause to consumers. **The problem is a business model that is callous about defaults and the devastating impacts they have on consumers.**

This report first illustrates a dysfunctional loan through an analysis of a $2,600, 42-month loan with 96% annual interest. **After 20 months of payments, less than halfway through the loan, the consumer has paid over $4,331 yet reduced the loan balance by only $391.** If the consumer defaults at this point, the lender will have recovered its principal and another $1,731, likely enough to cover expenses and generate a profit. The yawning gap between lender success at 20 months and borrower success at 42 months creates enormous peril for consumers.

A smaller, $500 loan with a 2-year term and 231% interest can be equally dysfunctional. A borrower could make $45 biweekly payments for a year—the same amount they would pay to roll over a traditional balloon payment payday loan—with similar results: over $1,000 in payments with the loan amount reduced by less than $50. The lender can easily turn a profit even if the consumer does not make it into the second year.

We then show that large potential gaps between lender and borrower success characterize several high-rate installment loans on the market today. Even assuming that these lenders have extremely high expenses amounting to 50% of the loan amount, each of these loans has a large gap between the lender's likely profit point and the borrower's successful repayment of the loan:

- CashCall starts making a profit after only about 14 monthly payments on its 47-month, 135%, $2,600 loan in California. CashCall targets a 35% to 40% default rate.
- On Elevate's Rise $2,250 loan at 274% in Alabama, lender success could require only 14 of 26 biweekly payments.
- Cash Central (a subsidiary of Community Choice Financial) could begin turning profits after 10 months of payments on a 2-year loan of $2,000 at 185% in Missouri.
- Advance America recovers 150% of the amount loaned after only 16 of 26 biweekly payments on its $2,550, 196% loan in California.

These loans have the potential for misaligned incentives leading to profits for lenders and great harm for many borrowers.

Skewed incentives are most pronounced in larger, longer-term loans. But a misalignment of lender and borrower success can also occur with smaller or shorter loans, especially those with high rates, disproportionately long terms, or a pattern of refinancing:

- On shorter 6-month loans, triple-digit lenders can often recover the amount loaned if the borrower makes only half of the payments.
- A Speedy Cash $300 loan at 430% in Missouri requires 18 months of $50 biweekly payments, but the lender might profit if the borrower defaults after little more than 4 months of payments.
- If a Cash Store loan in Texas is refinanced three times with $81 cash out each time, the consumer must make $2,210 in additional payments. The time to repay the 6-month loan stretches to nearly 10 months, but the lender might make a profit after less than 4 months of payments.

- With loans from ACE Cash Express, Advance America, Elevate (Rise), and CashNetUSA (a subsidiary of Enova), a refinancing that gives the consumer barely enough cash to cover one payment can add three, four, or even six payments to the time in debt, increasing the possibility that the consumer will default before reaching the end.

Not surprisingly, high default rates are common among high-rate installment lenders. The Consumer Financial Protection Bureau found a 24% per-loan default rate for payday installment loans, with high defaults even when payments are limited to only 5% of the borrower's monthly income. Data collected by California reveal default rates from 20% to 40% or even higher among high-rate installment lenders, compared to default rates of 2% to 9% for companies that make lower interest rate loans to California consumers with subprime credit scores. The charge-off rates for high-rate lenders in California are 1,000% to 2,000% higher than national credit card charge-off rates.

Defaults are just the tip of the iceberg of borrower pain caused by unaffordable lending. When delinquencies are added to defaults, the "struggling index" for some lenders in California rises to 30% or even 80% or higher. Even loans that do not default can be a destructive experience for struggling borrowers.

Legislators, regulators and enforcement authorities should take action to change these misaligned incentives and narrow the gap between lender and borrower success:

- **The easiest and most effective way to align the interests of lenders and borrowers and to minimize defaults is to cap interest rates (including fees) at 36% (lower for larger loans, such as those over $1,000).** At lower interest rates, the lender and borrower together will benefit from a successful loan and feel pain from an unsuccessful one. Rate caps should apply to all consumer and small business loans regardless of size.
- **Lenders should be prohibited from making loans that borrowers cannot afford to repay on the loan's original terms while meeting other expenses without reborrowing.**
- **Regulators should monitor and collect data on default rates and other indicators of unaffordable lending.** Data should be collected on default rates on a per-consumer and loan-cohort basis, as well as on rates of refinancing, late fees, delinquencies, and bounced or missed payments.
- **Default rates above 10% (or lower for auto title, payroll deduction, and other loans with strongly coercive repayment mechanisms) should face scrutiny.** The lender's interest rates, as well as the leniency or aggressiveness of its collection practices, should factor into what level of defaults reflects unfair, deceptive or abusive practices.
- **Lenders with high default rates should be found to be in violation of rules prohibiting unfair, deceptive, or abusive practices.**

Lenders should not be allowed to profit from a business model that imposes harm on a significant number of borrowers. Instead, interest rate caps and front-end underwriting requirements will steer the market towards loans that borrowers can afford to repay. Keeping an eye on how loans perform in practice is also critical to ensuring responsible lending that not only turns a profit for lenders but also is a positive experience for the vast majority of borrowers.