Application for the
2017 NLPES Excellence in Research Methods Award
Submitted by the
Office of the Utah Legislative Auditor General

We are pleased to submit for your consideration our report titled *A Performance Audit of the Department of Financial Institution's Regulation of the Payday Loan Industry*. We are applying under the **"exceptional breath, depth, and scope of fieldwork"** criteria. We believe this report demonstrates how program evaluators, by applying sound research methodology, can overcome challenges in data collection, and use newly gathered comprehensive data to answer a difficult public policy question for the Legislature. Specifically, to determine whether state regulations are adequate to prevent payday loan customers from overextending themselves with multiple payday loans. The contact information requested for this application is James Behunin, Audit Supervisor. He can be reached at (801) 326-1724 or jbehunin@le.utah.gov.

Report Background and Summary

Though very expensive, payday loans are offered as a short-term solution to an individual's financial emergency between paydays. However, the loans offer serious risk to borrowers who may be tempted to overuse the product. Just as a cab ride, through expensive, can be a reasonable solution to a short-term transportation need, payday loans are only reasonable when used to address a short term financial emergency. The concern is that some borrowers, once they obtain a payday loan, have difficulty paying them off. Borrowers may use one payday to pay the interest on another payday loan. This long-term use of payday loans would be the equivalent of using a cab service for a cross country trip.

To prevent borrowers from overusing the product, the Utah Legislature has approved several limits on the length of payday loans. To test the effectiveness of these laws and the regulators who oversee the payday lending industry, we conducted a study of the borrowing habits of all payday customers located in five separate Utah communities. Our study revealed that 32 percent of borrowers in our study population can be described as chronic users. The report recommends that the Legislature consider adopting some of the same regulations used by other states to prevent the overuse of payday loans. In addition, the report recommends that the regulatory agency, Department of Financial Institutions (DFI), gather a more complete set of industry data to monitor overuse of payday loans as well as the rate of default.

1. Methodology Usefulness/Design

Research Objective

In recent years, the Utah State Legislatures has been presented with two very different views regarding the practice of payday lending. The industry claims the state's 70-day limit on the duration of payday loans assures that loans are paid off with minimal impact on a customer's finances. In contrast, the critics of payday loans claim that customers can quickly become overextended to the point that they are taking out new loans simply to pay the interest on old loans. We were asked to find out whether the state's 70-day limit on the duration of a payday loan, as well as other limits, were adequate to prevent overuse of the product.

Methodologies Considered

To assess the adequacy of Utah's payday loan laws, our audit team determined that we needed to examine the complete loan history for a sample of actual payday loan customers. Initially, we determined that payday loan customers would be a difficult population to study. We considered the following methodologies:

- First, we considered conducting a survey of payday loan customers statewide. The challenge was identifying the total study population from which to pull a sample. We estimated there could be as many as 90,000 payday loan customers in the state, with records from some 63 different lenders. Contacting the customers would be difficult.

- Second, we considered conducting a survey of customers as they entered or left a payday loan store. However, as we tested this approach, we found some customers were reluctant to share information and some lenders were reluctant to allow us to interview their customers.

- Third, we also considered testing customer records from a sample payday lending stores. However, our initial tests revealed that some customers were visiting multiple lenders at the same time. We feared that a study of the loan histories at one payday lender would not give us information for a customer's total exposure to payday loans.

After determining the limitations of these methods, the methodology that we ultimately selected was a study of a sample of all the borrowers for all payday lenders in five relatively isolated communities within the state.

Each of the five communities (groupings of towns and cities) selected has a sizable population with multiple payday lenders. We selected each of the five communities based on geographic locations within the state wherein we had certainty that we could capture all the different lenders that a borrower would use in our 1-year study (FY 2015). Each community was far enough distant from other communities to minimize the likelihood that borrowers would be obtaining additional loans from outside the geographical area of study, so we could determine the true use of multiple lenders. The sample of borrowers was obtained from all the payday lenders available within those five communities. With this contained design, we were able to create a study population that included about 3,000 customers from 14 different payday lenders in five communities. From that study population, we felt confident that we could obtain a complete loan history for a statistically representative sample of 303 individuals which could be used to infer to the five communities.

2. Methodology Application

Methodology Procedures

The following methodology procedures were used to complete the audit:

1. Create a Study Population of Payday Loan Customers. In our behalf, the Utah Department of Financial Institutions (DFI) asked each payday lender in our five study areas to provide a complete list of all individual who had an active payday loan from July 2014 to June 2015. This was a crucial step because our statutory authority did not allow us to obtain data from private entities—the payday lenders. However, as authorized regulators of the industry, the DFI had statutory authority to obtain any records. We could then legally utilize the data once it was in the possession of a governmental entity: DFI. So, after combining the customers lists from all 14 lenders, we found about 3,000 customers within the population of those five communities. We also found 14 percent of the customers had loans from multiple lenders during that time period.

2. Request the Loan Histories for a Random Sample of the Study Population. After combining the lists, we pulled a sample of 303 payday loan customers for which we obtained the complete loan history from each lender.

3. Classify Borrowers into One of Four Groups. After studying their loan history, we classified each borrower into one of the following groups based on his or her level of exposure to payday loans: (1) Low-Risk Users, (2) Moderate-Risk Users, (3) Chronic Users, and (4) Defaulters. (See Figure 2.1 on page 8 of the report.) We developed these classifications using prevailing academic research and in consultation with DFI. Our innovative creation of this type of borrower risk categorization was the first time such a level of detail was presented to our Legislature; it had never been considered or presented before even by the regulators.

Efficiency and Effectiveness of the Research Methodology

We believe our methodology was efficient because it included a statistically valid sample that gave our audit team adequate information about the payday lending environment, and allowed us sufficient time to use the data from the sample for in-depth analysis. The five-community sampling method produced accurate and relevant results at a relatively low cost for the Legislature. The methodology was effective because we developed an innovative borrower risk categorization that provided legislators with new information describing the impact of Utah's payday loan regulations on customer's borrowing habits. The data helped them to make policy decisions to better regulate the payday lending industry. In fact, nationwide, only a few studies of the payday loan industry have documented the full extent of a customer's borrowing habits such as we did.

3. Evaluation Results

Contributions to the Audit Findings and Recommendations

Our methodology answered the Legislature's question regarding whether the state's 70-day limit on the duration of a payday loan, as well as other limits, were adequate to prevent overuse of the product. The methodology resulted in identifying the degree to which a population of payday loan customers were overusing the product. Even the payday lending industry warns that "payday advances should be used for short-term financial needs only, not as a long-term financial solution." But we found that a typical chronic user in our sample had a payday loan for more than six months during our one year study period. With one out of three customers classified as chronic users, our results showed Utah's restrictions on payday loans have had a limited effect. The audit made five recommendations to the Legislature, and six recommendations to the DFI to address these concerns.

Conclusions Were Clearly Described for the Reader

Our results were summarized in several easy to understand report figures. Our overall finding, that 32 percent of customers are chronic users of payday loans, was summarized in Figure 2.1 on page 8 of the report. The figure clearly and simply indicated, by category, the extent to which certain individuals are using payday loans wisely and those who were not.

17%	**Low-Risk Users**: Borrowers who used payday loans sparingly. They took out an average of 2.6 loans in a year and repaid their loans on the agreed upon date or after one extension.
37%	**Moderate-Risk Users:** Borrowers who used an average of 4.0 payday loans in a year. These borrowers often extend their loans for several weeks or months.
32%	**Chronic Users**: Borrowers who demonstrated a frequent and sustained use of payday loans, averaging 7.4 loans during fiscal year 2015. Some took out loans from multiple lenders at the same time.
14%	**Defaulters**: Borrowers who defaulted on their payday loans within just a few weeks, some without ever paying interest. They averaged 1.6 loans a year.

One figure of actual users (names withheld) revealed other types of behavior, such as those who take our one payday loan to pay off another. See Figure 2.7 on page 18 of the report:

Figure 2.7 By Continually Rolling One Loan into Another, One Lender Extended a Customer's Debt for 373 days. One payday lender kept rolling a customer's old loan into a new payday loan just before the old loan was about to reach the 70-day limit required by law.

Lender	Loan Numb er	Loan Amount	Interest/ Fees Paid	Initiation Date	Closed Date	Loan Duration
Lender A	Loan 1	$500	$357	6/30/14	8/20/14	51 days
Lender A	Loan 2	500	390	8/20/14	10/20/14	61 days
Lender A	Loan 3	500	410	10/21/14	12/22/14	62 days
Lender A	Loan 4	500	396	12/22/14	2/20/15	60 days
Lender A	Loan 5	500	390	2/20/15	4/20/15	59 days
Lender A	Loan 6	500	416	4/20/15	6/22/15	63 days
Lender A	Loan 7	500	93	6/22/15	7/6/15	14 days
Avg:		**$500**		**Consecutive days in a loan: 370**		
Sum:			**$2,452**	**Average APR: 484%**		

When this report was first presented in public, legislative leaders gave high praise to the report, the methodology, and the quality of the data. The legislature responded by approving House Bill 40 in the 2017 General Session that enacted additional restrictions on when old loans can be rolled into new loans. The legislation also directed DFI to strengthen its review of the lending activities of payday lenders.