

How Bad Are Payday Loans?

Donald Rieck, July 18, 2008

Do payday loans sink people into inescapable debt, forcing them to pay many times more the original borrowed amount in interest?

Whether or not we are technically in a recession, a severe economic downturn looks likely, given the recent cascade of external shocks to our economy. One such shock is the crisis roiling the credit and financial markets. Widely described as a “credit crunch,” this crisis has narrowed the options of the typical consumer who needs quick access to cash to help manage household debt.

For many households with little or no savings to fall back on, an economic shock such as an unexpected home or car repair can produce a sudden short term need for extra cash. What are the options for households and individuals in these unpleasant circumstances? Recent reports in the media suggest that the worst possible option is to take a so-called payday loan. A Factiva search of newspapers across the country shows that there were over five thousand stories on payday loans in 2007 alone, generally deriding the industry for what were described as exorbitant fees and interest rates.

According to the [Center for Responsible Lending](#) (CRL), payday loans are the poster boy for financial predation. Their 2006 report “Financial Quicksand” argued that these loans catch consumers in a “debt trap,” which results in the “typical” payday borrower paying back \$793 for a \$325 loan. [\(note 1\)](#). They also argue that the fees for these two-week loans extrapolate to annual percentage rates (APR) as high as 390 percent. These alarming numbers have been repeated [frequently](#) in news media accounts; however, on closer inspection, they conceal more than they reveal.

A payday loan (also called a paycheck advance or payday advance) is a small, short-term loan that is intended to cover a borrower's expenses until the next payday. Payday lenders typically charge \$15 for every \$100 borrowed. According to the [Community Financial Services Association of America \(CFSA\)](#), the payday loan industry trade association, all that a customer needs is proof of income and a checking account.

CFSA argues that the claim of “APR as high as 390 percent” disguises some important caveats. They point out that these loans are not annual loans. To reach this APR, the consumer would have to roll the loan over repeatedly. This scenario is unlikely, it says, since rolling over these loans is illegal in 22 states and severely restricted in eight others.

The notion that \$793 is paid back for every \$325 loaned is even more deceptive. It suggests that an individual takes out a single loan of \$325 and pays it off along with an additional \$468 interest. In fact this number is based on CRL's assumption that a borrower receives a \$325 loan and pays a fee of \$52 (16 percent of the loan amount) nine consecutive times, piling up \$468 in interest before the borrower is able to pay off the principal. This is precisely the type of “rolling over” that is widely limited or prohibited by law.

[A 2007 study](#) by Veritec (a government contractor that provides program management to state agencies which regulate this industry) rebutted the notion of a “typical” payback of \$793 for a \$325 loan as a misrepresentation of Veritec's own previously published data. After examining payday loan usage in Florida and Oklahoma, Veritec concluded that the data “simply does not support the CRL conclusion about fees paid.”

“The CRL conclusion is based on an assumption that borrowers in these states never pay off their first payday loan and that the loan is somehow “extended” by the lender for the entire year. This activity is effectively prevented in states that have centralized databases that enforce related consumer protections in real-time. The CRL Report apparently assumes that the fees for subsequent loans are added to initial principle amount and mistakenly concludes that \$793 is the amount due for a single \$325 loan made to the borrower. The Florida statute specifically allows for an advance fee of up to \$10 per one hundred borrowed up to a maximum single loan amount of \$500, plus a verification fee of up to \$5. The total finance charge for a \$500 loan can not exceed

\$55. The Oklahoma statute provides a tiered rate and under no circumstances can the borrower be charged \$793 per loan under states law.” [\(note 2 \)](#).

Veritec also noted that by statute Florida provides a 60-day grace period on every loan, during which additional fees cannot be charged. Oklahoma provides a repayment plan option to the borrower on “every third and subsequent consecutive loan.” Both states have statewide databases preventing borrowers from taking out additional loans from any licensed lender during the period of a repayment plan or grace period.

According to research by Dr. Pat Cirillo of Cyprus Research, a statistical consulting firm that looks at the small loan market, the average payday borrower generally takes one loan to deal with an out of pocket emergency, pays it off, and then needs another loan for a different reason a few paychecks later.

Why is it so important to distinguish between a single loan rolled over several times and a series of separate loans? If you look at this as nine separate transactions, then the borrower has gained access to \$2925 in capital over the course of a year; paying a cumulative total of \$468 interest for nine loans totaling nearly \$3000 doesn't seem nearly as steep a interest burden as paying \$468 to finance a single \$325 loan. The latter interpretation allows critics to portray payday lenders as duping borrowers into taking loans that extract enormous returns and profits. But if the nine interest payments are aggregated into an annual total, why shouldn't the nine loans also be aggregated as well?

Given the widely diverging conclusions that these two assumptions produce, one might evaluate the payday industry's charges to borrowers by posing a different question – compared to what? How do the costs of these loans stack up against other options for cash-strapped consumers looking for a temporary infusion of money to tide them over in a rough patch?

One widely used option is to skip a credit card payment. But that triggers an average late payment fee of \$35, according to [indexcreditcards.com](#). Similarly, the average “over-the-limit” fee for credit cards is \$36. In addition, both options will damage a borrower's credit rating and likely cause the credit card company to increase the APR on future uses of the card.

Another option is to try a little creative accounting with a checkbook, otherwise known as kiting. But if a check bounces, it will cost an average penalty per bounced check of \$28.23, according to [bankrate.com](#). Research by Moebs Services, an economic research firm, finds that credit unions and banks are highly dependent on bounced check fees. These fees represent 18 percent of the net operating income of banks and an eye-catching 60 percent of credit unions' operating income. [\(note 3 \)](#).

Consumers can purchase “overdraft protection” against this eventuality. But that too is costly. It is also highly profitable to financial service institutions. In a report for the Federal Reserve Bank of New York, Donald P. Morgan and Michael R. Strain cite a survey by The Woodstock Institute, a Chicago-based nonprofit group that promotes economic development in lower-income and minority communities. The survey studied the overdraft protection plans at eight large Chicago banks. It estimated that the implicit APR for bounced check “protection” averaged 2400 percent!

Sheila Bair, the current chairman of the board of directors of the Federal Deposit Insurance Corporation (FDIC), observed during a 2005 speech that the “enormous” fees earned on these programs discourage credit unions and banks from offering payday loans. In other words, since they reap such enormous revenue from overdraft protection and bounced check fees, credit unions and banks have a vested financial interest in limiting consumer options and having payday loans removed from the marketplace. She warned that customers were “catching on” and turning to payday credit for their “cheaper product” [\(note 4 \)](#).

This point leads us back to the Center for Responsible Lending (CRL), which has led the charge against payday loans. On March 18, 2008, [Forbes.com](#) published an article on CRL founder and Self-Help Credit Union CEO Martin Eakes, titled [“Subprime's Mr. Clean: Martin Eakes' Campaign to Straighten Out Subprime Lending Has Some Wrinkles.”](#) The article argues that Eakes's leadership of a credit union creates a conflict of interest with regard to CRL's activities. The article cites quotes economist Donald Morgan:

“Who then benefits from payday loan bans? Credit unions, for one, notes Morgan. He says interest rates on overdrafts charged by credit unions and banks can exceed 2,000 percent, dwarfing the

high interest rates on payday loans. Credit unions, he adds, have been especially hurt by payday lenders cutting into their overdraft fees.”

Forbes.com notes that in payday-loan free North Carolina, a state in which CRL and Eakes were instrumental in outlawing payday loans, Self-Help has thrived. Its assets have jumped from \$114 million in 2003 to \$292 million in September 2007 and its return on average assets was 1.4 percent, versus the industry average of 1.1 percent.” [\(note 5\)](#). This casts a new light on CRL’s positioning as a public interest group that engaged in consumer protection activities. Journalists may have difficulty in calculating implied interest rates, but a conflict of interest is something they can understand.

Other than helping credit unions, what other implications does banning payday loans have for consumer welfare? Morgan and Strain’s study looked at how households fared in Georgia and North Carolina after payday loans were prohibited by their respective state legislatures:

“Compared to households in states where payday lending is permitted, households in Georgia have bounced more checks, complained more to the Federal Trade Commission about lenders and debt collectors, and filed for Chapter 7 bankruptcy protection at a higher rate. North Carolina households have fared about the same. This negative correlation- reduced payday credit supply, increased credit problems- contradicts the debt trap critique of payday lending, but is consistent with the hypothesis that payday credit is preferable to substitutes such as the bounced check “protection” sold by credit unions and banks or loans from pawn shops.” [\(note 6\)](#).

Similarly, relaxing restrictions on payday lending can actually increase consumer welfare. In Hawaii, where payday loan limits were eased from \$300 to \$600, borrowers’ problems with household debt and Hawaii rate of bankruptcy filing decline markedly. [\(note 7\)](#).

To underscore the effect of banning payday loans on the incidences of bounced checks, Morgan and Strain note:

“On average, the Federal Reserve check processing center in Atlanta returned 1.2 million more checks per year after the ban. At \$30 per item, depositors paid an extra \$36 million per year in bounced check fees after the ban.” [\(note 8\)](#).

If banks and credit unions are making big profits off overdraft protection and bounced check fees, one would assume that payday lenders, who charge an average of \$15 per \$100 borrowed, are also making a killing off the financial transactions they offer. The industry argues that this isn’t so, pointing to high overhead cost, long operating hours, and large write-offs of defaulted loans.

However self-interested, this position receives some support from a recent overview of the current state of research on the payday lending industry, which appeared in [Fordham Law School’s Journal of Corporate and Financial Law](#). Author Aaron Huckstep concludes:

“Calls for regulating the [payday] industry are based partially on an assumption that payday lenders generate enormous profits from the high cost of borrowing. High profits for payday lenders, however, may be more myth than reality. Consistent with industry explanations, operating expenses for payday lenders are high. Wages, occupancy costs, and loan losses account for a majority of these high operating costs. These expenses are incurred to promote customer convenience....payday lenders choose to keep longer business hours and operate a higher density of stores than traditional lenders such as banks. The cost of convenience is lower profitability.” [\(note 9\)](#).

This analysis raises questions about the popular image of payday loans as a usurious burden on hard working Americans beset by hard times. Regulators and policy makers should certainly be concerned about households that are barely scraping by and the financial predators who take advantage of their plight. And there is a natural tendency for journalists to take up this cause, in the honorable tradition of a watchdog press that “comforts the afflicted and afflicts the comfortable.” But sympathy needs to be based on solid information, and [hype](#) is no substitute for homework.

Recent coverage of payday loans illustrates a broader tendency by the media to deal with social problems by [fixating](#) on a “villain” instead of examining the complex interaction of actors, social problems and trends. In this case, these include such factors as a lack of financial education and the ability to manage household spending and debt, as well as the broader social consequences of a political culture and economic system that emphasize individual opportunity and competition over equality and community.

Every industry contains malefactors who deserve to be exposed. But every industry is also based on incentives that need to be explained, in order to understand how consumers are the beneficiaries of business, not just its victims. It is here that the media are often sadly lacking, as the case of payday loans illustrates only too well.

Donald Rieck is Executive Director of STATS. He holds an MA in political science and an MBA from Temple University.

1. King, Uriah, Parrish, Leslie, and Tanik, Ozlem; Center for Responsible Lending, “Financial Quicksand”, Executive Summary

2. Veritec, “White Paper Analysis of CRL Report: Financial Quicksand” p. 8

3. [“Importance of “overdraft protection” services to financial institutions”](#)

4. Morgan, Donald and Strain, Michel: Federal Reserve Bank of New York Staff Report no. 309 November 2007 “Payday Holiday: How Households Fare after Payday Credit Bans” p. 4

5. Fitch, Stephanie and Woolsey, Matthew: Forbes.com, “Subprime’s Mr. Clean: Martin Eakes’ campaign to straighten out subprime lending has some wrinkles.” March 10, 2008, p. 1

6. Morgan, Donald and Strain, Michel, report abstract.

7. Fitch, Stephanie and Woolsey, Matthew, p. 1

*8. *ibid.*, p. 3*

9. Huckstep, Aaron, Fordham Law Journal of Corporate and Financial Law, Volume XII, October 2006, pgs. 230-231