



REINVESTMENT ALERT

Woodstock Institute

March 2000

Number 14

Unregulated Payday Lending Pulls Vulnerable Consumers Into Spiraling Debt

In recent years, there have been growing concerns about the ability of lower-income people to accumulate financial assets. Because of the strong economy, new welfare regulations, and continuing immigration, an increasing number of lower-income people are entering the workforce and receiving paychecks regularly. However, lower-income people remain at a disadvantage for building wealth. High-cost credit is one obstacle to asset development for lower-income people, and the payday loan is one example of high-cost credit.

This report provides a new analysis of the payday lending industry and its customers. Using data obtained from the Illinois Department of Financial Institutions (DFI) and various other sources, it finds major faults in the key defenses that the industry has used against stronger consumer regulation.

Background

The payday loan industry is a young one that has experienced explosive growth in recent years. Businesses making the loans began to emerge in the early 1990s, and the number of stores nationwide is now estimated to be between 8,000 to 10,000.¹ Non-existent in Illinois until 1995, payday lenders now number over 500 in the state. The nature of the industry is changing as national chains dominate the smaller independent companies and national banks are lured into the business by the potential to make extraordinary profits. An investment report on the payday loan industry estimates that the number of payday lenders may grow to 25,000 when it reaches maturity in two to three years.²

Payday loan borrowers, by definition, have cash management problems, and payday loans often exacerbate those problems. Due in part to the high cost of these loans, many borrowers are unable to repay them as they become due. Instead, the borrowers extend the loan period, which doubles the cost of the loan. Extensions are common among borrowers and may occur multiple times for each loan. Other borrowers manage to repay a payday loan only to experience another cash shortage after a short time and then return to the lender for a new loan. Similar to continuous extensions, regular borrowing results in a rapid build-up of financing charges and traps the borrower in a cycle of debt.

¹Robinson, J.L. and Lewis, G.L. *The Developing Payday Advance Business: The Next Innings: From Emergence to Development*. Stephens Inc., 1999.

²Robinson, J.L. and Lewis, G.L., 1999.

In the last decade, there have been some advances in access to credit for lower-income homebuyers and consumers. However, not all extensions of credit benefit consumers. The Federal Reserve Bank of St. Louis found that in 1998, household debt was growing at an annual rate of 8.3 percent, and the total--\$5.8 trillion--was an all-time high.³ While debt has increased, personal savings have decreased. More than 40 percent of households had less than \$1,000 of liquid assets in 1995, a figure that is progressively worsening.⁴ With debt levels rising and personal savings falling, bankruptcy rates are near all-time highs. More than 1.4 million bankruptcy petitions were filed in the U.S. in 1998. Poor households possess more credit cards on average than ever before, and the typical monthly balance carried on those cards has nearly doubled since 1983.⁵ And now, unregulated payday lending is providing another barrier to asset-building for lower-income people.

What is a Payday Loan?

A payday loan is a small, extremely high interest rate loan with an initial term of approximately two weeks. The cost of payday loans varies by state. In Illinois, where no usury laws exist, the cost of the payday loan is typically 20 percent of the amount borrowed. The annual percentage rate (APR) of this loan is 521 percent.

An example of the loan process, as explained by a customer service representative of a national lender operating in Illinois, is described in the adjacent box.

The consumer of a payday loan is often in a desperate financial situation with few other options. Lenders exploit vulnerable borrowers by grossly overpricing the loans and deceptively using threats of criminal prosecution to collect repayment. What may seem like an easy solution to a cash shortfall begins a cycle of accumulating and insurmountable debt for many borrowers.

In order to obtain a loan, a person must provide to the loan company a pay stub, a current bank statement, a current phone bill, and a photo ID. If the amount requested is \$200, then the borrower will give the loan company a check for \$240. The loan period is two weeks. At the end of two weeks (or shortly before the period ends), the borrower will receive a courtesy call from the company. Either the borrower's original check for \$240 will be deposited, or the borrower can refinance the loan by paying \$40 (the finance charge) in cash. When the loan is cleared, the company reports to the credit bureau. (In the Yellow Pages, this company markets itself as a way to rebuild credit through the credit bureau.)

Industry Claims

The payday loan industry has used questionable defenses to justify its practices and to deter increased regulatory oversight. This report will analyze the major four defenses of existing industry rates and practices:

1. Payday loans are used as occasional short-term loans.
2. The typical payday loan borrower is an average middle-income person who is not in a vulnerable position.

³Fed Analyst: People's Debt Grows Faster than Income," *American Banker*. February 1, 1999.

⁴SMR Research quoted in Fickenscher, L., "Bankruptcies Fall, But Expert Says Credit Weakness Persists," *American Banker*. April 15, 1999.

⁵Bird, E.J., Hagstrom, P.A., and Wild, R. "Credit Card Debts of the Poor: High and Rising," *Journal of Policy Analysis and Management*. Vol. 18, Winter 1999, pp. 125-133.

3. The current cost of a payday loan is appropriate based on the risk associated with the loan and the cost of available alternatives and is justified by consumer demand.
4. The industry is highly regulated.

In fact, this report shows the opposite to be the case:

1. For many borrowers payday loans are not occasional short-term loans.
2. Lower-income people are disproportionately represented among payday loan borrowers.
3. The high costs of payday loans are not justified.
4. The payday loan industry lacks adequate and effective regulatory oversight.

The Facts About Payday Loans

1) For Many Borrowers Payday Loans are Not Occasional Short-Term Loans

The industry argues that a payday loan is a short-term loan used for occasional cash shortfalls. Because of the short term and occasional usage, the industry argues that the annual percentage rate of the loan is irrelevant. However, many borrowers use payday loans over much longer periods. Even if a loan is only extended, or rolled over, once or twice, the borrower can return to the lender many more times, allowing the lender to subvert the intent of existing regulations that limit rollovers. Regulations in Illinois limit rollovers to three; however, the regulation is virtually unenforceable. Because a waiting period between loans is not required, a borrower is able to receive a fourth rollover in the form of a “new” loan.

Our analysis examines the borrowing practices of a sample of payday loan borrowers who received loans from lenders in Illinois. These data were collected by the Illinois Department of Financial Institutions between June 21 and July 2, 1999. Data on 485 payday loan borrowers were collected from 46 payday loan operations.

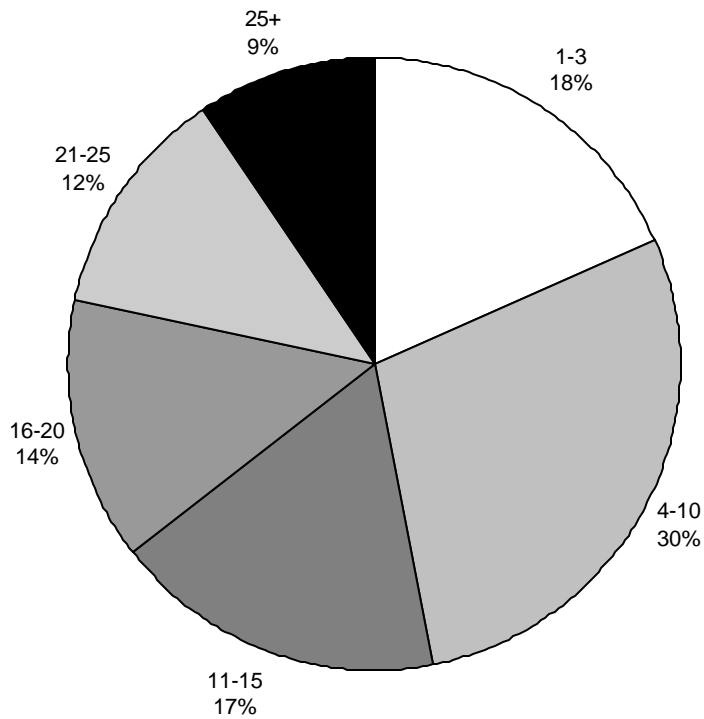
Figure 1 shows the prevalence of multiple contracts per borrower. Because very new lenders could not have clients with large numbers of contracts, 14 lenders (and their 145 borrowers) were not included in the analysis of the number of contracts. No lender in the study was licensed prior to July, 1997. Thus, none of the borrowers in the analysis here could have taken out their first loan prior to two years before the study date, and most began their borrowing significantly later.⁶

Only a small portion of the borrowers surveyed appeared to be occasional users of payday loans. Eighteen percent of the borrowers had three or fewer contracts. However, the average number of contracts per borrower was 12.6.⁷ More than half (52 percent) of the borrowers had more than 10 contracts, and more than one-third of the borrowers had more than 15 contracts. Twenty-one percent had more than 20 contracts. Because the majority of borrowers become frequent users of payday loans, APR is an appropriate measure of the cost of borrowing.

⁶Information on when the borrowers became customers was not collected. The age of lenders (study date minus license date) in this part of the analysis ranges from 14 to 24 months, with the average borrower going to a lender that had been in business for 18.2 months. Moreover, 53 percent of borrowers were sampled from lenders less than 18 months old, so many borrowers were likely to have initiated their borrowing well into 1998.

⁷Even relatively new lenders among this set had large numbers of contracts. The 53 percent of lenders less than 18 months old had an average of 12.6 contracts, the same as the overall sample.

Figure 1. Percent of Payday Loan Borrowers by Number of Contracts

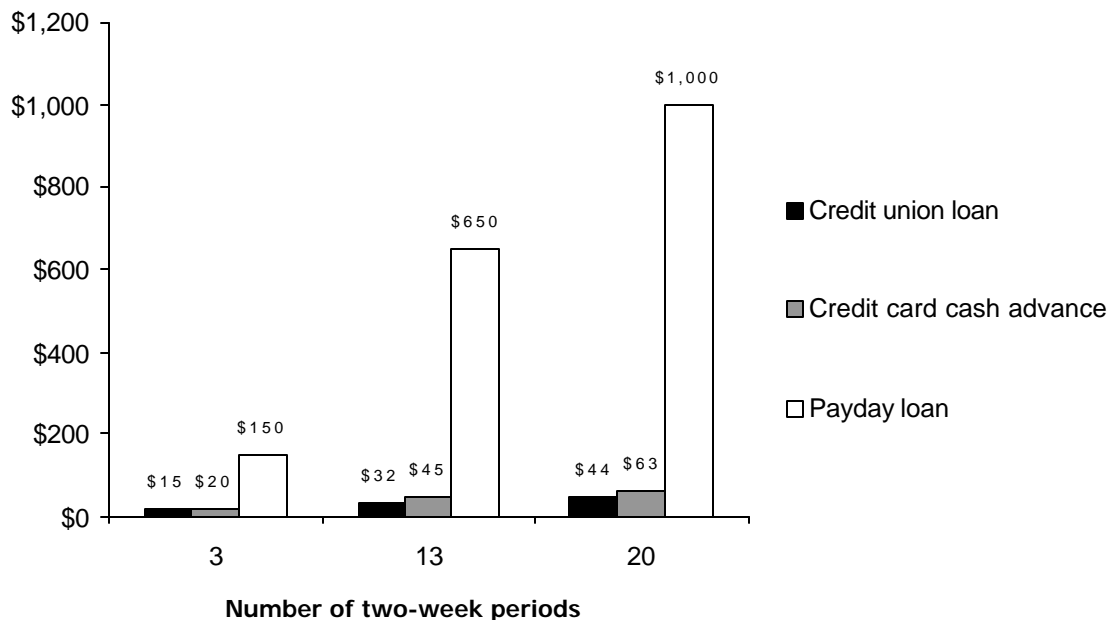


Source: Calculated from data collected by Illinois Department of Financial Institutions, 1999.

As the number of transactions (loans or rollovers) grows, the cost of the loans increases, as does the difference between the costs of the payday loan and alternative sources. Figure 2 shows the increasing cost of borrowing \$250 as the duration of the outstanding debt increases. The figure also compares the cost of payday borrowing to two other types of credit—a credit card cash advance and a credit union loan. The cost of \$250 of payday credit held for six weeks (either continuously or not) is \$150. The cost of borrowing \$250 rises to \$650 for 26 weeks and \$1,000 for 40 weeks.

The comparable costs of the other two types of credit are a decreasing fraction of the costs of the payday loan. Although these options may not be available to all payday loan borrowers or may not provide such rapid turn-around, the ease of access to payday loans does not justify their cost when borrowers become habitual users of the product. For borrowers using the product once or twice, there is little concern of excessive harm. But for those using the product regularly, the magnitude of the costs becomes very large, and it is much more likely that some form of alternative could be identified. The cost comparison demonstrates the exorbitant price of the payday loan, especially when used over a long period of time. The credit union example, in particular, also suggests that the price structure of the payday loan is far beyond the costs of delivering the product.

Figure 2. Cost Comparison of a \$250 Consumer Loan from Alternative Sources for Different Durations⁸



A report issued by a payday loan industry association states that “deferred deposit service businesses do not want to do business with customers engaged in excessive rollovers”.⁹ However, DFI found that repeat business is the main source of revenue for short-term lenders.¹⁰ It is possible for a borrower to receive loans from more than one payday lender at a time. In fact, some lenders elect not to subscribe to a service that would inform them when a customer has payday loans outstanding with another lender, because they do not want to have to exclude any potential customers.

2) Lower-Income People are Disproportionately Represented Among Payday Loan Borrowers

One representative of the industry has stated that payday lenders “are not as an industry looking to do business with poor people who find themselves in financial stress.”¹¹ Representatives of the payday loan industry often describe their borrowers as members of the middle class. Instead, our analysis indicates that payday loans are often made to lower-income borrowers and may create a greater burden for minority borrowers.

⁸Credit union loan assumes a \$10 application fee and 16.5 percent interest. The loan amortizes over one year, but that is not assumed here to make it comparable to payday loans, which do not amortize. It requires a one-year membership in the credit union but no credit check. Credit card cash advance assumes a 5 percent fee and 24 percent interest rate. This is a card designed for people with less-established or imperfect credit. The payday loan assumes a 20 percent fee per two-week loan.

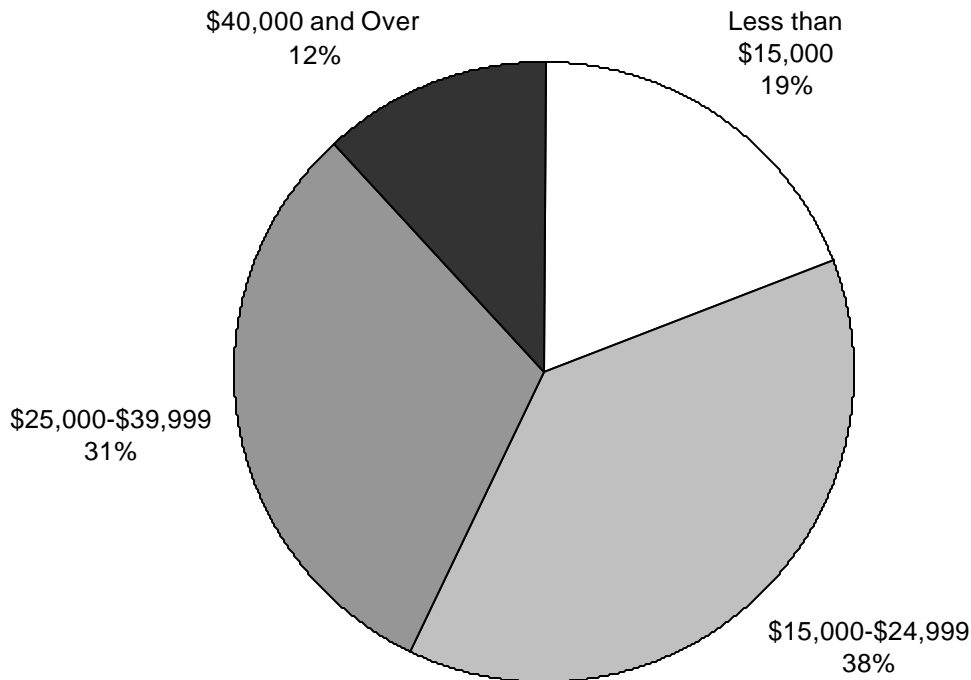
⁹Freedom of Choice for Consumers: The Truth About Deferred Deposit Services. National Check Cashers Association, Inc., 1999.

¹⁰Illinois Department of Financial Institutions, 1999.

¹¹Report of the Proceedings of the Pay Day Loan Review Commission, Pursuant to House Resolution 164, State of Illinois, February 1, 2000, p.52.

Our analysis finds that the typical borrower is a low- to moderate-income person. The median annual income of the borrowers surveyed was \$23,690. Figure 3 shows the distribution of borrowers' annual earnings. Nineteen percent of the borrowers earned less than \$15,000. Only 12 percent of the borrowers earned \$40,000 or more annually.

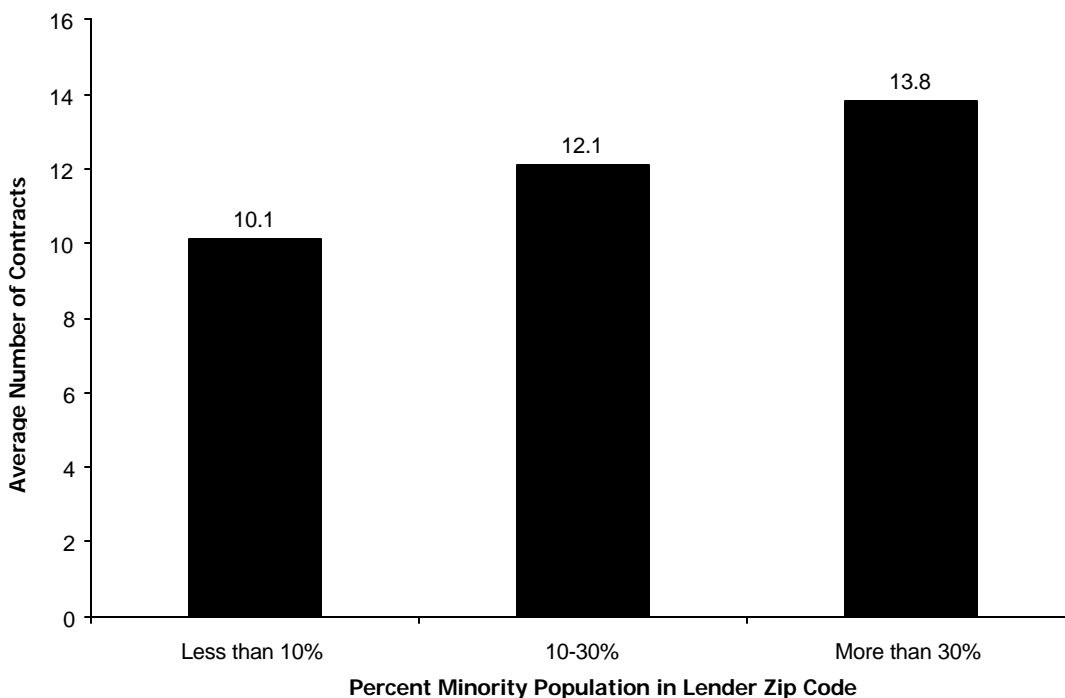
Figure 3. Annual Earnings of Payday Borrowers



Information on family income and size was not collected, but some assumptions can be made based on other information collected. Most of the borrowers were female (62 percent) and renting their home (68 percent). Because renters are more likely to be single, annual earnings equal family income for many borrowers. A family income of \$23,690 was 40 percent of the median family income for the Chicago metropolitan area in 1998. (Low-income is classified as less than 50 percent of the area's median family income.) Even if a family income includes a second earner with equivalent earnings of the borrower, the family income would be just under 80 percent of the median family income of the Chicago area, which is classified as moderate-income.

Our analysis also finds that borrowers from lenders located in zip code areas with higher minority populations had more contracts than borrowers in mostly white areas. Figure 4 shows that in areas where the population is greater than 30 percent minority the average number of

Figure 4. Average Number of Contracts Per Borrower by Minority Composition of Lender Zip Code



contracts per borrower was 13.8. This is 37 percent higher than the average number of contracts per borrower for lenders located in predominantly white zip code areas (10.1).¹²

3) The High Costs of Payday Loans are Not Justified

Lenders justify the high cost of a payday loan in three ways. They cite the high level of risk associated with the loans; they compare the cost of a payday loan to that of bounced checks, which they propose as a comparable alternative; and they argue that consumer demand is an endorsement of the cost.

However, payday lenders do not have extremely high default rates. Recently, an investment analysis reported that the industry's losses have stabilized at 1.0 percent to 1.3 percent of the receivables, barely above bank default rates.¹³

Lenders often suggest that payday loans are more affordable than any alternatives. The alternative usually chosen by the industry is writing bad checks, which is not only illegal, but also not likely to be the alternative most often chosen by potential payday loan borrowers.

¹²This might be explained by lenders in minority tracts being in business longer than those in white tracts. But this is not the case. The average ages of all three groups of lenders are almost identical, with lenders in white tracts being 555 days old on average, while the other two groups have average lender ages of 553 days.

¹³Robinson, J.L. and Lewis, G.L., 1999.

Other alternatives, including credit card advances or credit union loans, can be much less costly than payday loans as shown in Figure 2.

The fact that consumers use payday loans is also insufficient to justify the high cost. The increased demand corresponds to an increase in lower-income workers, including those coming off welfare and entering the workforce. Some of these workers have limited credit histories, and mainstream financial institutions are increasingly seeking a more affluent customer base. Customers of payday loan companies are, almost by definition, in desperate financial situations and unlikely to shop around for the lowest cost. The demand does not give lenders permission to exploit the desperate borrowers; consumers' demand can still be met (and their interests better served) by charging lower rates. The appropriate price level for payday loans should be based on the costs of operating the business allowing for reasonable but not excessive profits. Because many borrowers in desperate situations do not shop around for better alternatives, the unregulated market does not result in appropriate price levels for the industry.

4) The Payday Loan Industry Lacks Adequate and Effective Regulatory Oversight

Specific payday loan laws or regulations that permit payday loans exist in 23 states and the District of Columbia.¹⁴ Payday lenders operate in seven other states that do not have limits on the fees associated with small loans. Nineteen states limit interest rates on small loans, which effectively prohibits payday lending by making it not profitable to operate in those states.

Illinois is one of the seven states that allow payday lending without limits on interest rates and without laws specific to payday lending. Payday loan companies in Illinois are regulated by DFI through the Consumer Installment Loan Act (CILA). Although few of the provisions of this act apply to the practices of payday lenders, the industry claims to be highly regulated. CILA directs DFI on the procedures for licensing and examining lenders but does not include any restrictions on fees, interest charges, collection practices, term limits, or loan amounts. CILA does limit the number of rollovers to three; however, DFI admits that this limit is regularly violated.¹⁵ Moreover, because there is no cooling-off period between loans, the spirit of the rollover limit can be subverted by the borrower returning immediately to take out a "new" loan. DFI also admits that the division that handles payday lenders has been overwhelmed by the industry's growth in the past two years.

What Should Be Done About Payday Lending?

Despite the industry's claims, the problems with payday loans are clear. Legislation at the state and federal level should contain the following components:

- 1) Rate regulation.** A maximum rate structure for payday lenders should be set based on the cost structure of the industry with allowance for reasonable but not excessive profits.

¹⁴Fox, Jean Ann. Safe Harbor for Usury: Recent Developments in Payday Lending. Washington, DC: Consumer Federation of America. September, 1999.

¹⁵Illinois Department of Financial Institutions, 1999. p.8.

- 2) Limits on continual borrowing.** Payday loan regulations often include a limit on the number of extensions allowed per loan. However, limiting the number of rollovers will not eliminate the detrimental effects of continuous borrowing. Illinois already has a regulation that limits to three the number of rollovers for a payday loan. However, the rollover limit is circumvented by writing a new loan when the limit is reached.

To complement a rollover limit, an effective policy to address the problem of continual borrowing will require a substantial waiting period between loans (at least 30 days). Lenders should be required to enforce the waiting period by conducting a check to ensure that a potential borrower has not had an outstanding loan with any lender during the specified period. The waiting period breaks the repeated borrowing and reduces the amount of time a borrower may be subject to a payday loan. The check for outstanding loans makes the waiting period enforceable and ensures that the borrower is not using proceeds from one lender to pay another.

- 3) Data collection and monitoring.** Information should be collected annually from each payday lender, compiled by the state, and made available to the public. This information should include (for the past year) the number of loans made, the average loan amount, the average annual percentage rate of the loans, the average loan period, and information related to the number, dollar amount, and associated costs of returned checks. Having this information publicly available will allow consumers to make better decisions in the marketplace.

- 4) The need for federal as well as state regulation.** The prospects for substantial regulation of payday lenders are generally strongest at the state level. However, a growing segment of the industry will require regulatory solutions at the federal level. Attracted by sizeable profits, national banks are partnering with payday loan operations in states where interest rate limits effectively prohibit payday lending. U.S. banking laws allow national banks to circumvent state law by exporting interest rates from their less-regulated home states. The current regulations do not prohibit banks from engaging in high-cost payday lending.

The downward spiral of debt that payday lending creates for many low- and moderate-income borrowers is devastating. The industry's chief arguments against any significant regulation of its practices are not supportable. Those least able to pay are providing the excessive profits currently being reaped by lenders. Action at both the state and federal levels is needed to provide real protections to working families struggling to build savings and assets.

Prepared by Marti Wiles
and Daniel Immergluck