

Banking for the Poor: Payday Loans

A “payday loan” is a relatively small amount of money—say, \$300—borrowed for a short period, usually about two weeks, by lower-income people who have a checking account, a job, and direct deposit of their paycheck. For example, the borrower writes a post-dated check for \$300 to the payday lender, and gets \$255 in cash. The lender holds onto the check until the next payday, two weeks later, then cashes it, netting \$45 on the transaction. Or the borrower can decide to rollover the loan by paying the lender another \$45 to hold the check for two more weeks. Most borrowers roll over their loans more than once. The implied annual rate of interest is at least 400 percent.

Payday lending began in Arizona in 2000 and peaked at 715 stores there. Nationally, payday lender stores reached into the tens of thousands. Here are some questions: Do payday loans benefit an underserved population by providing ready access to short-term credit, albeit at a high cost? Or do payday loans trap customers into habitual borrowing at steep interest rates with no way out? Should government regulators protect borrowers from the bad consequences of their own choices? Or would a ban simply force such borrowers into even less attractive options?

Some earlier research using geographical differences in regulation across the country suggested that payday loans, despite their high interest rates, may provide benefits to borrowers and their communities. For example, although this may sound odd, according to one argument, some people may deliberately borrow at such costly rates so they will have more incentive to repay the loan quickly. But more recent research raises some troubling questions about payday loans. For example, Brian Melzer of Northwestern University finds no evidence that having access to payday loans alleviates economic hardship. On the contrary, access to payday lenders leads to more difficulty paying mortgages, rent, and utilities; a greater chance of losing one’s home; and an increased tendency to put off needed medical care, dental care, and prescription drug purchases.

Using a database of 145,000 payday loan applicants from a large lender in Texas, Paige Skiba of Vanderbilt and Jeremy Tobacman of the University of Pennsylvania compare payday borrowers with similarly situated applicants who were denied payday loans to determine whether payday borrowing affects the likelihood of bankruptcy. They find that, for first-time applicants with below average credit scores, access to payday loans doubles the chances of filing for bankruptcy during the following two years (compared to first-time applicants with below average credit scores who were denied payday loans). Seemingly small loans cause such a large effect because borrowers are already financially strapped when they begin with a payday loan. In addition, many payday borrowers take out multiple loans, so the interest burden piles up.

Finally, a study by the North Carolina bank commissioner analyzes how families fared after payday lenders were forced from that state in 2006. A survey of payday borrowers found that most knew the dollar cost per \$100, but only one in six had any idea about the implied annual percentage rate. Some said they were glad they no longer were tempted by what they viewed as a costly product—easy to get into, but hard to get out of. About three quarters of the fees collected by payday lenders come from rollovers of existing loans. Many payday lenders offer half-off discounts to new customers.

Arizona, where it all started, imposed a 36 percent cap on payday loans effective July 2010, the same ceiling placed on other lenders, such as banks. Altogether 16 states have imposed interest rate caps. Payday lenders claim they can’t survive at such low rates, and many leave those states. Some payday lenders switch to using auto titles as collateral, but interest caps still apply. Research into the impact of payday loans is ongoing, but recent evidence suggests this option could make borrowers worse off, not better off.

Sources: “North Carolina Consumers After Payday Lending,” University of North Carolina, (November 2007); Paige Skiba and Jeremy Tobacman, “Do Payday Loans Cause Bankruptcy?” Unpublished manuscript, (November 9, 2009); Ryan Randazzo, “Payday Lender to Close 47 Stores, Leave State,” *Arizona Republic*, 12 July 2010; and Brian T. Melzer, “The Real Cost of Credit Access: Evidence from Payday Lending,” Northwestern University, (January 3, 2009) at http://www.kellogg.northwestern.edu/faculty/melzer/realcosts_melzer_01_03_09.pdf.

Payday lenders seemingly have few friends in high places.

They've been banned in 10 states and the District of Columbia. State attorneys general have gone after them over complaints about deceptive practices and the targeting of vulnerable populations. Federal regulators have even worked to push payday loan stores out of the market by encouraging small-dollar loan programs at banks and credit unions.

But the payday loan business-or the "deferred deposit" trade, as the industry prefers to call it-recently found sympathy in a surprising place. The Federal Reserve Bank of Kansas City has issued a controversial report by a senior economist supporting some of the payday loan industry's long-standing contentions that short-term, high-interest loans bring benefits to low-income populations.

In particular, Fed economist Kelly D. Edmiston found evidence that, in states that ban or restrict payday loans, consumers have lower credit scores and make less use of traditional credit.

"I'm arguing that they either lose access to credit, or are using less healthy forms" of short-term borrowing, such as bounced checks, overdraft loans or even illegal loan sharks, says Edmiston, who presented his research in May at a Kansas City Fed forum about the impact of payday lending restrictions.

Edmiston's research included statistics showing the drop-off in traditional credit usage in Georgia after its 2004 ban on payday loans, as well as national credit bureau data that found that credit scores suffered.

Edmiston's conclusion-that "a lack of payday lending is associated with lower scores"-counters the work of economists and consumer watchdog activists who have found that much of the economic harm in low-income communities is created, rather than mitigated, by the \$38.5 billion in loans made each year to 19 million households through payday lending outfits.

An influential research paper two years ago by Brian Melzer, an assistant finance professor at Northwestern University's Kellogg School of Management, laid out a case nearly the opposite of Edmiston's, finding that high-risk borrowers actually exacerbate their financial problems by taking on short-term loans that turn into a "debt spiral" of recurring fees and bulging principal.

Likewise, the Center for Responsible Lending asserts that payday loans are cement shoes for consumers. According to the group, the average \$300 payday loan costs \$800 in fees each year (which works out to a nearly 400 percent annual interest rate), and still leaves most borrowers with a \$300 balance to carry over.

Josh Frank, a CRL senior researcher who took part in the Kansas City Fed's discussion panel, said Edmiston's study was inconclusive, if not misguided. By focusing on isolated data that looks at no other explanation for lower scores or use of credit, the Fed has not proven any correlation, he argues.

"These things associated with payday lending may not have anything to do with payday lending, and they probably do not," he says.

Frank suggests that researchers just as easily could have linked anti-payday loan policies to racial or cultural demographics to argue that "restricting payday loans changes the race makeup of a state ... or changes the religious composition of a state" versus states with no restrictions. "Those things obviously aren't true, but you could easily do that using this methodology," he says.

Sharing the debate panel with Frank and with Darrin Anderson, an executive from payday lender QC Holdings, Edmiston defended his research, pointing out that the results were not intended as an argument against bans but as a starting point for discussions on payday loan restrictions, which he says haven't been examined enough. "The evidence is mixed," he says with a shrug.

Anderson, QC Holdings' president and chief operating officer, sharply attacked the CRL for its claims on high-default rates for payday loan customers who churn through multiple loans. As for Edmiston's paper, Anderson says he was heartened by the "new evidence that consumers in counties where payday loans are offered have higher credit scores and fewer late-bill payment penalties than those in counties without access to payday loans."

Anderson also boasts about the payday lending industry's high satisfaction rate (92 percent is the figure he cites) among a customer base that averages \$40,000 in annual income.