The Economics of Payday Lending

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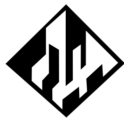
Prepared for the Center for Credit Union Research



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Filene Research Institute and Center for Credit Union Research

The Filene Research Institute is a non-profit organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance and credit unions. It supports research efforts that will ultimately enhance the well-being of consumers and will assist credit unions in adapting to rapidly changing economic, legal, and social environments.

Deeply imbedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members and the general public. Credit unions, like other democratic institutions, make great progress when they welcome and carefully consider high-quality research, new perspectives, and innovative, sometimes controversial, proposals. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process. In this spirit, the Filene Research Institute grants researchers considerable latitude in their studies of high-priority consumer finance issues and encourages them to candidly communicate their findings and recommendations.

The name of the institute honors Edward A. Filene, the "father of the U.S. credit union movement." He was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

The Center for Credit Union Research is an independent academic research center located in the School of Business at the University of Wisconsin–Madison. The Center conducts research and evaluates academic research proposals on subjects determined to be priority issues by the Research Council of the Filene Research Institute. The Center also supervises Filene Research Institute projects at other universities and institutions. The purpose of the Center's research is to provide independent analysis of key issues faced by the credit union movement, thus assisting credit unions and public policymakers in their long-term planning.

Progress is the constant replacing of the best there is with something still better!

— Edward A. Filene

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Executive Summary

This paper draws on a variety of sources to establish what we know about the operations of payday lenders, who uses payday loans and why they choose to do so, and the extent to which customers become frequent users of these loans. It also discusses how credit unions might respond to the rise of the payday loan industry.

KEY FINDINGS

What is payday lending?

Payday lending is a relatively new business that has grown explosively over the past decade. At the beginning of the 1990s, there were probably fewer than two hundred payday loan offices nationally. By mid-2001, that number had risen to about 10,000, many of which operate as part of large multi-state chains.

In a traditional payday loan, a customer writes a personal check made out to the lender. The lender agrees to hold the check for a specified period of time, usually until the customer's next payday or for up to about two weeks, before depositing it. In exchange, the lender advances a cash payment to the customer that is somewhat less than the amount of the check. The difference, which is the "finance charge," in combination with the maturity of the loan determines the annualized interest rate. In a typical transaction, for example, a borrower might write a check for $235 that the lender agrees to hold for two weeks. The lender provides the borrower with a $200 cash advance.

Prior to the maturity of the loan, the borrower can pay the lender the face value of the check in cash. If the borrower does not repay the loan prior to its maturity, the lender deposits the customer's check. Assuming the check clears, the loan is fully repaid and the transaction is complete.

In many cases, borrowers can renew their loans rather than paying them off. One method is a "rollover." In a rollover, the borrower pays the lender the finance charge due at maturity and the lender agrees to hold the check for another specified period of time, usually about two weeks.

Interest on payday loans is paid with each renewal, so there is no compounding of interest. This makes the calculation of the annual percentage rate simple. For example, the annual percentage interest rate on a two-week $200 loan for which the lender charges $35 is 455 percent (17.5% for two weeks multiplied by 26). Given the short maturity of the loans and the size of the finance charge relative to the size of the loan, the annual percentage interest rates on payday loans are frequently 400 percent or more.

Who are payday loan customers?

Surveys of payday loan customers find that most are from lower-middle to middle-income households. In one survey, about half of the customers reported household incomes of between $25,000 and $50,000. The remaining customers were almost equally divided between those with household incomes under $25,000 and those with incomes over $50,000. This survey also found that payday loan customers tend to be younger than the general adult population and are more likely to have children. They are substantially less likely to have a college degree, although relatively few have less than a high school degree. Over 40 percent of customers report that they own their homes and 57 percent report that they have a bank credit card. Other data sources indicate that somewhat over half of payday loan customers are female.

Why do people borrow from payday lenders?

Interviews with payday lenders and data from surveys suggest that people borrow from payday lenders because they believe that this is the best way to meet an immediate need for a cash advance of $100 to $500. Many payday loan customers apparently do not have access to lower cost credit from banks or credit unions because they have already reached the limit of the credit available from these sources. They have “maxed out” their credit cards and other lines of credit. Others do not have access to lower cost credit because they have severely impaired credit histories. They do not want to ask family members or friends for a cash advance because they might be judged harshly for doing so, or because they have exhausted their access to such informal alternatives. They could address their cash shortfall by making payments using checks that they know will bounce or by delaying paying some bills. But

because of substantial fees for late payments, over-limit charges, and NSF and returned check charges, such steps can be even more costly than a payday loan.

As an alternative or supplemental explanation for the use of payday loans, some critics of the product argue that many customers may not understand just how expensive payday loans are. Survey data indicate that at least three quarters of payday loan customers remember to a reasonably accurate degree the dollar cost of the most recent cash advance they received. The vast majority of payday loan customers, however, either report that they do not know the annual percentage rate on their loans, or they report unrealistically low rates.

Does payday lending trap borrowers?

Defenders of payday lending argue that the industry provides a beneficial service to people who have no better alternatives. Imagine, for example, someone who has no savings and no quick access to comparatively low-cost credit. Suppose this person's car breaks down and she might lose her job if she cannot get it repaired quickly. It is perfectly reasonable for her to pay $35 to take out a two-week $200 loan to fix the car rather than lose her job, write checks that bounce, or incur late payment fees on a variety of other bills. Payday lenders acknowledge that their loans appear to be outrageously expensive when stated in terms of the annual percentage rate. But they argue that this is misleading because payday advances are intended to be very short-term loans.

Critics of payday lending argue that most customers do not use payday loans as an occasional short-term emergency source of credit. A customer may borrow initially to meet an unexpected emergency. In many cases, however, when the next pay period comes the customer faces a difficult choice. He can use his available cash to repay the loan. If he does, given his limited income for discretionary expenditures, he is likely to run short of funds before the next pay period, and returns to the payday lender to seek a new loan. Alternatively, upon the maturity of the loan he can simply pay the finance charge in cash and extend the term of the loan until his next pay period. Under either approach, when the next pay period arrives he faces the same set of choices. In this way, a short-term emergency loan evolves into a persistent debt.

Critics of payday loans allege that such an outcome is inherent in the design of the product. They argue that people who use payday loans have modest incomes, almost all of which goes for necessities and the service of previous debts. If a person in this situation has car trouble and must obtain a $200 loan for repairs, she is unlikely to be able to repay the loan plus finance charges out of one paycheck. Rather, she would need to repay the principal in small amounts from several future paychecks. But since payday loans are structured as “balloon” payments, where all principal is repaid at once, they do not facilitate this process. Thus, the critics view payday loans as providing short-term help, but frequently at the cost of trapping the borrower in a long-series of costly debt payments.

While advocates for the industry and its critics disagree about the benefits of payday loans, the data indicate that most loan customers are frequent users of the product. Data from payday lenders in North Carolina, for example, show that almost 35 percent of their customers had more than ten payday loan transactions over the course of 1999. Somewhat more than 50 percent of the customers of a typical payday loan office had more than 7 transactions. My analysis of data from a random sample of the loan files of 322 payday loan customers gathered by regulatory authorities in Wisconsin found that the average customer had 12 loan transactions over the course of a year; 26 percent of the clients had fewer than six loan transactions and 18 percent had more than 20.

These data likely understate the average number of loan transactions among payday loan customers, for two reasons. First, survey data indicate that about half of the customers use more than one payday loan firm over the course of a year. So, while a customer of any one lender may have borrowed 10 to 12 times from that lender, the customer may have also borrowed from other lenders in the same year. Second, my analysis of the data from Wisconsin indicates that many of the customers who used a payday lender infrequently took out their first loan from the payday lender only a few months prior to the time state regulators gathered the data. Thus, borrowers who took out five or fewer loans over the previous year are primarily short-term customers, not long-term customers who borrowed infrequently. In fact, of the 127 customers in the data set who were customers at least once 10 months or more prior to their most recent loan, only four took

out five or fewer loans over the course of the year. But 56 (44 percent) of these long-term customers had more than 20 loan transactions within one year.

Will payday lending continue to grow?

Since payday lending is new in many states and is offered by only a handful of offices in some very large states, one would expect continued rapid growth for the industry. The major factor that could interfere with this forecast is the regulatory and legal environment. In states where payday lenders can charge $15 or more for every $100 they advance, payday lending can thrive under state laws. Currently, somewhat over half of the states meet this threshold. In some other states, payday lenders avoid state usury ceilings by making an agreement with banks or thrifts located in permissive states. The payday lenders in the restrictive states function as agents for the banks. They gather the loan application information and they handle the collection process, but the banks technically make the loans. The lenders argue that the relevant usury ceiling is that of the state in which the bank is located since, like banks that offer credit cards across state lines, the bank can "export" its interest rates to customers in other states.

Payday lenders operating under state laws must worry about their future. A state that has permissive usury laws can always change the laws to mandate lower payday loan finance charges or to make payday lending illegal. There are also threats facing lenders that use a bank located in a permissive state in order to offer payday loans in states with restrictive usury laws. In recent lawsuits filed against payday lenders and banks, plaintiffs argued that the banks are not truly making the loans and, therefore, should not be able to export their interest rates. The lawsuits point out that the local payday loan office collects the loan application material, distributes the loan to the borrower, and monitors and works to collect the loan. In some cases, the payday lender immediately purchases a substantial share of the loan from the bank. These lawsuits challenging bank affiliations are still in the courts and the outcome is uncertain. If the courts uphold the plaintiff's challenge, this will threaten the ability of payday lenders to by-pass state usury laws and could reverse or slow the growth of the industry.

In addition to the regulatory and legal challenges facing the payday loan industry, in the long run payday lenders may find other businesses encroaching on their customer base. Banks in particular may begin to offer payday loans directly to their depositors, especially if regulatory and product image issues are resolved in favor of payday lenders.

How should credit unions respond to the rise of payday lending?

Advocates for payday lending argue that these loans are the best quick solution to the short-term financial crises payday loan customers face. That may well be true considering the alternatives realistically available to most customers. But it is also true that payday loans are not an attractive solution to financial emergencies. They are far more costly than credit available to people with relatively clean credit histories. Moreover, many payday loan customers, perhaps a majority, are frequent customers who pay well more in finance charges over the course of a year than their average cash advance.

It is natural for credit unions to want to address this issue. The earliest credit unions were founded so that people could build savings and avoid high-cost lenders, and many credit unions still place a high priority on those goals. The question is: What should they do?

Some credit unions may decide that their most important contribution is to become involved in advocating changes in regulations governing payday lending. In advocating regulatory changes, however, credit unions should proceed cautiously. If a credit union backs regulatory or legal changes that would make payday lending illegal or unprofitable, it should do so only after it becomes convinced that most or all payday loan customers would truly be better off without legal access to these loans.

Another possible approach to the rise of payday lending is for credit unions to undercut payday lenders by offering low-cost small-value loans to payday loan customers. But this approach is unlikely to be successful. If a credit union were to charge payday loan customers its top loan rate of 18% APR for a short-term small-value loan, it would not be able to cover its costs. For example, a $200 two-week loan at 18% APR would generate $1.38

in interest, not enough to cover even the origination cost. The high annual interest rates on payday loans is a result of the cost of making small-value, short-term loans.

Credit unions recognize this reality by providing most small consumer loans in the form of revolving lines of credit attached to checking accounts or credit cards. But credit unions can offer such products only to individuals with acceptable credit-risk profiles. And many, probably most, payday loan customers are not able to meet this criterion. Although credit union loan products and risk-screening methods have changed over time as a result of technology and labor costs, they have always used risk-screening standards to enable them to remain financially healthy while offering low-cost consumer loans. Even during the Great Depression, typical loan charge-off rates at credit unions were less than one tenth of one percent.[1]

Although credit unions cannot prudently make loans to individuals beyond a particular credit-risk threshold, they can help these individuals in other ways. Credit unions can offer savings products designed to help members, especially those living paycheck to paycheck, build savings. As indicated in previous studies published by the Filene Research Institute, many credit unions already make special efforts in this regard, and other credit unions can learn from these initiatives.[2] A household that maintains even only a few hundred dollars of savings at the end of each pay period has a financial margin of safety that can eliminate or greatly reduce its need for payday loans. More important, households with modest cushions of savings are less likely to miss

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[1] See Kelly, William A., Jr., and Judith F. Karofsky, *Federal Credit Unions Without Share Insurance: Implications for the Future,* (Filene Research Institute: Madison, WI) 1999, page 10. The reason for the emphasis on a pre-existing common bond for members of a credit union when they were founded was to have good knowledge of which members were likely or unlikely to discharge their financial obligations faithfully. Loan decisions were made by a credit committee of members who often knew the loan applicants personally. Not repaying a loan meant taking money from other members' pockets. Today, this purpose of the common bond has been superceded by the availability of detailed credit records available at very low cost.

[2] See, for example, John P. Caskey, and David B. Humphrey, *Credit Unions and Asset Accumulation by Lower-Income Households,* (Filene Research Institute: Madison, WI) 1999, and Albert E. Burger and Mary Zellmer, *Strategic Opportunities in Serving Low to Moderate Income Individuals,* Filene Research Institute, Madison, WI, 1995.

paying bills or engaging in other behavior that creates seriously impaired credit records, so they remain eligible for lower-cost sources of credit.

A second measure that credit unions can take is to promote consumer education initiatives that help people address credit problems, set savings goals, and adopt good personal financial management practices. Many credit unions already have programs in this area or work closely with groups that do. Studies by the Filene Research Institute provide information on some of the programs offered by credit unions across the country.[3] Credit unions that do not yet offer such services should investigate cost-effective ways to do so.

[3] See Wendy Culler and Sam White, "Alleviating Financial Distress: An Alternative to Bankruptcy", in *Fresh Approaches to Bankruptcy and Distress–Volume II: Working with Members in Financial Distress,* (Filene Research Institute: Madison, WI) 2000.

Section I: Introduction

This paper analyzes payday lending. A payday loan is an uncollateralized closed-end loan intended to help a person meet financial needs prior to the borrower's next payday.[4] Payday lenders commonly advance $100 to $500 that borrowers agree to repay within about two weeks or on their next payday. Annualized interest rates on these loans are typically 400 percent or more.

Payday lending deserves scrutiny for a number of reasons. The industry first became formalized in the early 1990s and has grown explosively since that time. The business is highly contentious. Advocates argue that it provides an important source of short-term emergency liquidity for people with no better alternatives. Critics charge that it entraps modest income households in a series of high-cost debts. Not surprisingly, in recent years there has been much litigation related to the business, bitter fights over whether or not the business should be legal and, in cases where it is legal, how it should be regulated.

There have been previous studies of payday lending. While several are high quality, they are almost all by groups that take strong advocacy positions either in favor of the industry or in opposition. This paper does not seek to make a case in support of, or in opposition to, payday lending. Instead, it uses available data to establish what we know about the operations of payday lenders, who uses payday loans and why they choose to do so, and the extent to which customers become frequent users of the loans. This paper also discusses how credit unions might respond to the rise of payday lending.

In Section II, I explain the key features of payday loan contracts and the underwriting process. In describing payday lending, I do not attempt to be encyclopedic. I omit detailed discussion of several problems that were endemic to payday lending in its early years and still plague it to some extent, such as the failure of some payday lenders to comply with Truth-in-Lending statutes and the use of coercive collection tactics. This allows me to keep the paper reasonably brief and to focus on payday lending as it functions under the highest standards in the industry. In Section III, I review data profiling customers for payday loans. In Section IV, I examine why people use these high-cost loans. Section V provides data on

[4] Payday lending goes by a variety of names, including payday advance lending, deferred deposit, and postdated check loans.

the frequency with which customers use payday loans, addressing the charge that people become entrapped in a revolving series of short-term debts. Section VI surveys regulatory and competitive challenges that could threaten the payday loan industry. And Section VII briefly discusses the implications of payday lending for credit unions.

Section II: What Do Payday Lenders Do?

Payday lending is a relatively new business that has grown explosively over the past decade. At the beginning of the 1990s, there were probably fewer than two hundred payday loan offices nationally. The exact number is uncertain since, at that time, most payday lenders were commercial check-cashing outlets (CCOs) that made payday loans as a casual extension of their core business, and no one tracked them (Caskey, 1994). By mid-2001, there were about 10,000 payday loan offices nationally, about half of which also function as CCOs (Robinson, 2001). About 4,400 of these belong to firms that operate 200 or more offices in multiple states.

The number of payday loan outlets has grown from fewer than two hundred in 1990 to about 10,000 in 2001.

Payday loan offices are found in all but a few states. In states where usury laws are not restrictive, many operate under state laws.[5] Other payday lenders have business agreements with banks located in states with permissive usury rules whereby the banks technically make the loans. Under these arrangements, although the payday loan offices may be located in states with restrictive usury laws, the payday lenders claim that the laws in the states in which the banks are located are the relevant usury laws for the transaction.

A payday loan is a relatively simple transaction. In its traditional form, a customer writes a personal check made out to the lender.[6] The lender agrees to hold the check for a specified period of time, usually until the customer's next payday or for up to about two weeks, before depositing it.[7] In exchange, the lender advances a cash payment to the customer that is somewhat less than the amount of the check.[8] The difference, which is the "finance charge," in combination with the maturity of the loan, determines

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[5] Jean Ann Fox and Edmund Mierzwinski (2001) provide an overview of state laws concerning payday lending.

[6] Rather than write a personal check, some payday lenders have the borrower sign an agreement giving the lender the right to debit the borrower's account electronically at the maturity of the loan.

[7] In 1999 in North Carolina, state law allowed payday lenders to set the maturity of the loan for any time up to 31 days. The North Carolina Commissioner of Banks (2001) reported that the 142 licensed lenders in the state originated or renewed 2.9 million payday loans in 1999. Of these, 10 percent matured in 1 to 7 days, 63 percent matured in 8 to 14 days, 20 percent matured in 15 to 21 days, and 7 percent matured in 22 to 31 days.

[8] Some lenders provide the borrower with a check rather than cash. Others transfer funds electronically to the borrower's checking account or to a deposit account that the lender opens in the name of the borrower. In the latter case, the lender may issue an ATM/debit card to the borrower that is linked to that account.

the annualized interest rate. In the states where payday lending thrives, lenders typically charge $15 to $25 for each $100 that they advance with a two-week maturity.[9] That is, in a typical transaction, a borrower might write a check for $235 that the lender agrees to hold for two weeks. The lender provides the borrower with a $200 cash advance. Most lenders limit their loans to under $500.[10]

Lenders strive to make the loan process speedy. In most cases, a first-time borrower who arrives with the necessary information (a check, recent pay stub, copies of recent bank statements, identification, and a series of utility bills or other evidence of a stable place of residence) can walk out with his cash in less than thirty minutes.

Payday lenders monitor loans carefully and contact borrowers immediately when checks are returned unpaid because of insufficient funds.

Prior to the maturity of the loan, the borrower can pay the lender the face value of the check in cash. In this case, the lender returns the check to the borrower and the transaction is concluded.[11] If the borrower does not repay the loan prior to maturity, the lender deposits the customer's check. Assuming that the check clears, the loan is fully repaid and the transaction is complete. If the check is returned unpaid because of insufficient funds in the account, the payday lender immediately contacts the borrower to negotiate a satisfactory solution. The lender typically telephones the borrower at home or at work and urges him to repay the loan in cash promptly or to renew the loan. Under either approach, a borrower whose check bounced must also usually pay the lender a "returned check" fee, commonly about $20.

A borrower can renew a loan in two ways. The method used depends on the policies of the lender and the regulations in the state in which the lender operates. One method is a "rollover." In

[9] In a 2001 survey of 235 payday loan offices in 20 states and the District of Columbia, Fox and Mierzwinski (2001) found that 30 percent of the offices charged $15 for each $100 they advanced, making this the most common charge. Less than 4 percent of the loan offices cited finance charges of less than $15 per $100 advance, and the lowest fee reported was $10 per $100 advance. About 14 percent of the loan offices reported fees of over $20 per $100 advance.

[10] Under Colorado statutes, deferred deposit lenders can extend loans up to $500. The Colorado Supervised Lenders' Annual Report (2000) indicates an average loan amount of $198. In Tennessee, the maximum cash advance is $415. According to the Tennessee Department of Financial Institutions (2000), in fiscal year 2000 the average cash advance was about $143 (borrowers wrote checks that averaged $168 which includes a $25 finance charge).

[11] Some lenders rebate a pro-rata share of the finance charge when borrowers repay their loan prior to maturity.

a rollover, the borrower pays the lender the finance charge due at maturity and the lender agrees to hold the check for another specified period. Imagine, for example, that a borrower originally receives a cash advance of $200 and gives the lender a check for $235 that the lender agrees to hold for two weeks. At the end of two weeks, the lender may allow the borrower to pay $35 in cash and agree to hold the check for another two weeks.

The second way to extend the maturity of a loan is a "same-day" advance. Under a same day advance, the borrower repays an existing loan with its finance charge and, on the same day, takes out a new cash advance equivalent to the previous cash advance. The same-day advance is nearly equivalent to the rollover but, in this example, it does require the borrower to pay $235 for at least a brief period prior to receiving the second $200 cash advance.

Under either method of renewing a loan, the interest on the loan is paid with each renewal. There is no compounding of interest. This makes the calculation of the annual percentage rate simple. For example, the annual percentage interest rate on a two-week $200 loan for which the lender charges $35 is 455 percent (17.5% for two weeks multiplied by 26). Given the short maturity of the loans and the size of the finance charge relative to the size of the loan, the annual percentage interest rate on payday loans commonly falls between 350 and 1,000 percent.

Some states set limits on the number of times a payday lender can renew a loan.[12] Even in states that do not set such limits, some payday lenders set their own limits on renewals.[13] But limitations on renewals are difficult to enforce. If state law, or the lender's policy, only restricts rollovers, a lender can renew the loan with a same-day advance. If same-day advances are not permitted, a borrower can create one by repaying one lender and, on the same

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[12] Four states require "cooling-off" periods between transactions. In Florida, for example, a borrower who repays a loan must wait 24 hours before taking out a new loan.

[13] According to the list of "best practices" for members of the trade association for the payday advance industry (Community Financial Services Association of America, 2001) in states where rollovers are permitted, "…a member will limit rollovers to four or the State limit, whichever is less." The CFSA is only a few years old. The CFSA list of best practices does not discuss same-day advances. The organization's largest members are "monoline" firms that only make payday loans. Several large "multi-product" firms that offer payday loans through check-cashing outlets and many small independent payday lenders are not members of the CFSA.

day, going to another lender to take out a new loan. Finally, a borrower can repay one lender, wait a few days, and borrow again from the same lender or a different one. Because payday loans are often structured to fall due on a person's payday, even financially-pressed people are likely to have sufficient funds to repay a loan on that day. The problem is that they may not have enough money remaining after repaying the loan to meet necessary expenses until the next payday. Thus, they may take out a new payday loan several days after repaying an old one. Such a pattern is similar to a loan renewal even though the person is completely out of debt to the payday lender for a period of several days.

In discussions with borrowers who do not have sufficient funds in their accounts to cover their checks at loan maturity, lenders frequently encourage the borrowers to repay or renew the loan by emphasizing possible penalties from a failure to do so. A lender, for example, may emphasize that, if he deposits the check and it bounces, it will result in a "non-sufficient funds" (NSF) fee from the borrower's bank and a returned check charge from the lender. In addition, the bank may force a borrower to close her account if she has a history of writing NSF checks.[14] Since the NSF and returned check fees commonly aggregate to $45 or more, the borrower has an incentive to renew the loan or to find a way to repay it.[15] Payday lenders also generally report a borrower who defaults to "TeleTrack," a credit reporting agency that specializes in subprime credit transactions. This makes it difficult for a borrower to obtain future payday loans.

[14] If the borrower fails to pay the NSF charges, the bank may report her to "ChexSystems," a company that maintains records of individuals' deposit account management histories. Since most banks subscribe to this service, an adverse report with ChexSystems can make it difficult for someone to open an account at another bank.

[15] In states where it is permitted, some payday lenders seek civil damages that exceed the face value of checks that are returned unpaid. In addition, some payday lenders have told borrowers in default that they will ask law enforcement agencies to prosecute the borrowers for writing bad checks. Plaintiffs' lawyers have successfully sued several of these lenders, however, by arguing that default on a loan is purely a civil matter. They argue that the borrowers wrote checks to repay their loans at the same time as they received cash advances because lenders insisted on it. The code of conduct of the national trade association of payday lenders states that its members "…will not threaten or pursue criminal action against a customer as a result of the customer's check being returned unpaid or the customer's account not being paid."

Payday lenders face substantial risks in making uncollateralized loans to financially-pressed individuals.

Despite these measures, payday lenders face substantial risks in making uncollateralized loans to financially-pressed individuals. Most payday lenders reduce this risk by lending only to loan applicants with steady employment records who have maintained checking accounts in good standing for six months or longer. Many lenders only lend to applicants whose salaries are directly deposited into their bank accounts. Many lenders limit first-time customers to loans of $200 or less, but gradually increase the size of cash advances to customers who develop a history of repaying or renewing loans reasonably promptly. Lenders commonly limit the size of loans to even well-established customers to under $500 or about one-third of a customer's net paycheck, whichever is less.

With first-time loan applicants, many lenders will pay a fee to verify whether the person has an adverse report in the TeleTrack system. The TeleTrack service also tells them whether or not the loan applicant has other outstanding payday loans. The lenders do not run traditional credit checks, since this costs money and they are willing to lend to people with traditionally impaired credit histories. In addition to such underwriting criteria, lenders further reduce their risk by closely monitoring their borrowers and by responding quickly to any developing problems. Many lenders, for example, telephone borrowers a day or two prior to loan maturity to remind them that the loan is due and, if appropriate, urge them to take actions to prevent default.

This review of the product and operations of payday lenders explains why payday loans carry such high interest rates. Payday lending is labor intensive because borrowers have face-to-face interactions with lenders each time they borrow or extend a loan. In addition, lenders devote substantial time to monitoring the status of the loans and working to minimize defaults. Payday loans are generally originated and serviced from local loan offices, so the lenders must price the loans to cover both labor and office occupancy expenses. Because the loans are small, dividing these

expenses across each loan results in a high cost per loan.[16] The finance charge must be set sufficiently high to cover these expenses.[17]

In addition to labor costs and office occupancy expenses, payday lenders must cover their loan losses.[18] Available data suggest that unpaid obligations to payday lenders amount to about 10 to 20 percent of the finance charges they levy over the course of a year. A report by the North Carolina Commissioner of Banks (2001, p. 4), the agency that oversees payday lenders in that state, indicated that in 1999, 142 licensed lenders in the state originated or renewed 2.9 million loans.[19] The aggregate value of these loan originations and renewals was $552.9 million, on which lenders charged $96.6 million in fees. Of an unreported number of checks that the lenders submitted for payment, 166,558 with a face value

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[16] A lender could lower some of the cost-per-loan if it could conduct a very high volume of lending from one office. But because borrowers factor in transportation costs and convenience, they would probably select a somewhat more expensive local lender over a lower-cost distant lender. Thus payday lenders do not achieve the economies of scale necessary to significantly reduce their cost-per-loan. Some payday lenders offer loans over the Internet and do not maintain local offices. They function by debiting and crediting a borrower's checking account electronically. My informal review of their posted finance charges indicates that they are not less expensive than payday lenders with local offices. Indeed, many are more expensive. My guess is that loss rates on Internet payday loans are higher than those on loans made from local offices.

[17] In its 2001 10K filing, ACE Cash Express, whose stores cash paychecks for a fee and make payday loans, reported that the average annual operating costs for one of its stores is $146,100. About 36 percent of this cost comes from employee compensation, 18 percent from occupancy costs, and 17 percent from loan loss provisions. Audited expense reports are not publicly available for monoline payday lenders, but their per-store costs should be somewhat lower. Industry insiders have told me that a typical mature monoline store makes about 4,000 advances or renewals a year, with much variation around this average. Assuming that the average cash advance is $250 with an average finance charge of $45, this implies per store annual revenues of $180,000.

[18] Reporting losses from uncollected payments as a fraction of loan originations can be misleading. Consider a lender who advances $100 for two weeks in exchange for a $120 check. Imagine that the borrower renews this loan five times, paying $20 in cash each time. The sixth time the loan falls due the lender deposits the check and it is returned unpaid. If the lender cannot collect on the check, he writes-off $120 as a loss. Although the reported loss exceeds the $100 loan, what the lender collected in finance charges ($100) equals the loan amount. In addition, the difference between a renewal and an origination is often blurred. Many payday lenders allow a borrower to pay a fee to rollover a loan or permit a borrower to repay one loan and then take out a new one the same day or a few days afterwards. Although the second set of transactions may count as two originations, it can function as a renewal.

[19] In 1999, North Carolina permitted payday lenders to charge $17.65 per $100 advance. The maximum cash advance permitted under the law was approximately $255.

of $36.5 million were returned unpaid. After collection efforts, the lenders wrote off $9.9 million in losses, about 10 percent of the gross finance charges on the loans.

In Colorado, the Colorado Supervised Lenders' Annual Report (2000) indicates that 186 licensed payday lenders originated or renewed 536,375 loans in 2000 totaling $106.1 million. Out of an unreported number of checks that the lenders submitted for payment, 40,733 with a face value of $8.6 million were returned unpaid. After collection efforts, the lenders wrote off $2.4 million in losses, about 13 percent of the gross finance charges on the loans.

Critics charge that payday lenders have undue market power in dealing with borrowers who have no alternative sources of credit.

ACE Cash Express is a publicly-held payday loan and check-cashing firm that provides audited data on its business operations. It makes payday loans with maturities of up to two weeks, charging $17 for each $100 it advances.[20] In its 10-K filing covering the fiscal year ending June 30, 2001, ACE reported that its average payday cash advance was $269 (ACE 2001). Its average finance charge for this advance was $42.30. Over the course of the year, ACE made 1.5 million payday loans totaling $397 million dollars. It charged off $13 million in loan losses for the year, or about 21 percent of the aggregate finance charges on its loans.[21]

Some critics of payday lending have argued that payday loans are costly because the lenders have significant market power. There is an asymmetry of power when a lender does business with a financially-pressed borrower who either has no alternative source for credit or cannot or does not shop for alternatives. According to the critics, payday lenders use this power to set the price on the loans well above the cost of providing them, thereby achieving unusually high rates of profit.

[20] As explained later, ACE does not technically make payday loans. ACE processes loan applications and Goleta National Bank decides whether or not to make the loans. If Goleta makes the loan, ACE immediately buys a substantial participation in the loan from Goleta. ACE monitors the loan performance and works to ensure the repayment of the loan.

[21] Reported loan losses are not a simple indication of the risks in payday lending. A lender can reduce defaults by staying in close personal contact with borrowers, reminding them of the costs associated with default when necessary, and promoting the various ways that default can be avoided. In other words, a moderate level of loan losses may not mean that payday lending is only moderately risky. It may simply mean significant effort and expense goes into reducing the risk.

No one denies that payday lending has been highly profitable during the 1990s.[22] In states where payday lenders can charge $15 or more for each two-week $100 cash advance, the reported returns from the business fed the growth of the industry as existing firms added more offices and new firms entered the field. In addition, as the industry grew, it organized to lobby states to preserve or create a legal and regulatory environment that permits payday lenders to flourish (Fox and Mierzwinski, 2000). But as long as barriers to entry into payday lending are low, the high profits associated with the business are likely to diminish over time. According to economic theory, and as played out in many other industries, high profits attract new entrants. The new entrants attract business from existing operators, driving down their returns.[23] The process eventually stabilizes when so many offices have opened that most lenders only make normal rates of return.[24]

Making this point about the long-run effects of competition on profits is not equivalent to arguing that interest rates on payday loans should be unregulated. If one believes that payday lending is pernicious, for example, it is perfectly reasonable to advocate that governments set fee ceilings so low that payday lenders are forced out of business. Even people who believe that there is a useful role for payday loans can favor fee ceilings and other regulations to prevent an unscrupulous lender from taking advantage of particularly vulnerable customers. Advocates for payday lending

[22] The Annual Report of the Tennessee Department of Financial Institutions (2000) provides summary information from the unaudited data the Department gathered from 358 payday loan companies operating 846 branch offices in the state. The Report indicates that over the course of the Department's fiscal year, these firms originated or renewed about 2.5 million loans. According to the Department, "As of June 30, 2000, the industry made a return on assets of 14.8% based on total assets and a return on equity of 20.6%." However, given the lack of standardized accounting procedures for the firms, these numbers could be significantly biased in either direction.

[23] One lender told me that between 1996 and 2001, there was a ten-fold increase in the number of payday loan stores operating in his city. He said that several of his competitors had told him that "…because of heightened competition, their volume is less than half what it was a few years ago."

[24] People commonly assume that competition should drive down finance charges. This might happen, but it need not. Firms can compete across many dimensions, and they tend to vary those to which customers are most responsive at the lowest cost to the firms. Payday lenders, for example, could compete with each other based on which one is willing to make the largest cash advance to customers in similar situations or based on which one has the most convenient locations.

favor fee ceilings high enough to enable payday lenders to survive in sufficient quantities to be reasonably convenient for most customers.

Section III: Who Uses Payday Loans?

Survey information on the characteristics of payday loan customers is limited but broadly consistent. One survey, funded by the payday lender trade association, the Community Financial Service Association of America (CFSA), was conducted by the Credit Research Center at Georgetown University. Participating lender-members of the CFSA provided the Credit Research Center (CRC) with a random sample of 5,430 customer names and telephone numbers. The CRC hired a firm to conduct a telephone survey of these customers, with a goal to complete 500 interviews. Of the 5,430 names on the list, the surveyors could not reach 3,168, mainly because the phone had been disconnected or the borrower was never at home when the survey organization called. Of the 2,196 people the organization reached, 858 refused to be interviewed, 726 denied that they had ever taken out a payday loan (although the lenders' records clearly indicated that they had), and 185 began but refused to complete the interviews. The organization was able to complete 427 interviews from the original 5,430 names. One cannot assume that this selection is representative of payday loan customers generally. Nevertheless, the data from these 427 respondents are interesting.

As shown in Table 1, the Credit Research Center survey found that slightly over half of the responding payday loan customers reported household incomes of between $25,000 and $50,000.[25] The remaining customers were almost equally divided between those with household incomes under $25,000 and those with incomes over $50,000. In addition, payday loan customers tend to be younger than the general adult population and they are more likely to have children. They are substantially less likely to have a college degree, although relatively few have less than a high school degree. Finally, 42 percent report that they own their homes while 66 percent of the general adult population does; and 56.5 percent of the surveyed payday advance customers report that they have a bank credit card versus 72.5 percent of the general adult population.

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[25] In its 2001 10-K filing, Dollar Financial (2001, p. 8) reported that, of the customers at its monoline payday loan stores, "…approximately 62% have household incomes between $15,000 and $40,000 and 16% have household incomes greater than $50,000."

Table 1
Socioeconomic Characteristics of Payday Loan Customers

	Surveyed Payday Advance Customers	All adults[26]
Family income		
Less than $25,000	23.0%	31.5%
$25,000 to $49,999	51.5%	29.0%
$50,000 or more	25.4%	39.6%
Age		
Less than 35 years	36.4%	28.7%
35 to 44 years	31.9%	22.5%
45 to 54 years	21.7%	17.3%
55 to 64	6.5%	12.0%
Over 65 years	3.5%	19.5%
Family structure		
Married with children	40.2%	28%
Married without children	16.6%	32.9%
Unmarried with children	23.3%	12.4%
Unmarried without children	20.0%	26.7%
Education		
No high school diploma	6.2%	9.7%
High school diploma	38.3%	34.3%
Some college	36.1%	21.1%
College degree	19.4%	34.9%
Own home		
	41.7%	66.3%
Has bank credit card		
	56.5%	72.5%

Source: Elliehausen and Lawrence (2001)

[26] Based on responses from January 2000 Survey of Consumer Attitudes.

The information available from state regulatory agencies, reviewed below, is broadly consistent with this portrait, except that it suggests a lower percentage of homeowners and, perhaps, somewhat lower household incomes. This latter point is uncertain since the data from the state regulatory agencies only reports the individual incomes of the borrowers, not their household incomes.[27] In addition, the data from the state agencies suggest that somewhat over half of payday loan customers are female.

The Wisconsin Department of Financial Institutions (2001) reviewed the loan files of 321 customers who patronized at least one of 14 payday loan offices that the Department selected to sample out of the 202 offices open in the state in 2000. The Department found that 53 percent of the borrowers are women. The average age of the customers is 39. The average annualized take-home pay for the customers is $18,675. For 54 of the customers, rather than reporting net income, the loan files report gross income. For these customers, their average annualized gross income is $24,673. Of those who report whether or not they own or rent their home, 74 percent say that they rent.

In 1999, the Illinois Department of Financial Institutions (1999) conducted a similar survey of the records at payday lenders located in that state. Based on data drawn from over 600 different customers from 60 payday loan offices, it found that 60 percent of the borrowers are women. The average age for borrowers is 37. Their average annualized income (not specified whether recorded

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[27] Payday loan customers in general may have somewhat lower household incomes than those indicated by the Credit Research Center survey for a variety of reasons. It is reasonable to think that the CRC survey reached customers who have more stable residential patterns, and these may be higher-income customers. In addition, the CRC drew its customer list from members of the CFSA, which is dominated by monoline payday lenders. Several payday lenders have told me that customers who obtain their loans at check-cashing outlets (CCOs) have on average somewhat lower household incomes than do those who patronize monoline payday loan stores. This is true for two reasons. First, CCOs are located to be convenient for people who do not have bank accounts, meaning that they tend to be in lower-income neighborhoods. Second, many higher-income payday loan customers would feel uncomfortable lining up with check-cashing customers to obtain a cash advance from a teller standing behind bullet-proof glass. Dollar Financial (2001, p. 7), which opened monoline payday loan stores in addition to offering payday loans through its check-cashing outlets, explained that its monoline payday loan stores offer "…unsecured short-term loans in a friendly office-like environment. [This]… appeals to a broader market segment than that which currently utilizes the Company's check cashing stores." This implies that payday loan customers in states where CCOs provide most payday loans are likely to have somewhat lower incomes than in states where monoline lenders provide most of the loans.

on a net or gross basis) for the borrowers is $25,131. About 75 percent report that they rent their home, 15 percent own their home, and 10 percent either did not report their status or are in some other category. Using the data provided by the Department, the Woodstock Institute (2000) constructed a chart (reproduced as Table 2 below) indicating the distribution of income among the payday loan customers.

Table 2
Distribution of Income of Payday Loan Customers in Illinois

Reported Annual Earnings of Borrowers	Percent of Borrowers in this Category
Less than $15,000	19%
$15,000 to $24,999	38%
$25,000 to 39,999	31%
$40,000 and over	12%

Source: Woodstock Institute (2000)

Section IV: Why do People Borrow from Payday Lenders?

In analyzing why people borrow from payday lenders, there are two separate questions. First, why do people want to borrow $100 to $500 on short notice prior to their next payday? Second, given this desire, why do people patronize payday lenders rather than an alternative?

Information on why people want to take out small loans prior to their payday is very limited. In informal discussions, payday lenders say that most of their clients have almost no money in their bank accounts and they have pressing expenditure needs. Such a situation may arise because of an unexpected expense, an unexpected income shortfall, or poor budgeting habits. In addition, as critics of payday lending emphasize, once someone has borrowed from a payday lender, the person may have to borrow for several more pay periods before having the resources to repay the principal and meet other obligations.

The Credit Research Center survey asked payday loan customers why they borrowed money. As shown in Table 3, 47 percent of customers said their most recent payday loan was to meet an unplanned expense, 19 percent said that it was to address a temporary reduction in income, 12 percent said that it was to meet a planned expense, and 23 percent said that it was for some other reason. It is difficult to know what the respondents had in mind when they classified their loans by these reasons, so the information in the table is only suggestive. Respondents were not asked if they had taken out a payday loan in the previous pay period, so the table does not tell us the extent to which a new payday loan may be used to help address budgeting problems related to previous payday loans.

Table 3
Purpose of Most Recent Payday Loan

	Percent of Responding Payday Loan Customers
Emergencies	
Unplanned expenses	47.2
Temporary income reduction	18.5
Discretionary uses	
Planned expenses	11.9
Other	22.5

Source: Elliehausen and Lawrence (2001)

Payday lenders often explain that their customers come to them for loans because they have no better alternatives. Borrowers are seeking to solve an immediate need for about $200, and banks do not make such small closed-end loans. Many credit unions do, but generally only for members able to pass traditional credit risk screening criteria. Almost all banks and credit unions offer small loans through credit card advances or lines of credit on a checking account. But these options are not open to people who do not have credit cards or overdraft protection, and payday lenders report that many of their customers do not because of flawed credit histories. Even among payday loan customers with credit cards or lines of credit attached to their checking accounts, many have reached their credit limit and cannot obtain additional funds through these means. Some payday loan customers with minimally adequate credit histories or who own their own home might be able to obtain an unsecured personal loan or home equity loan from a bank or credit union. But such loans may be larger than the payday loan customer wants, and may take several days to process.

A second alternative for someone facing a shortfall of two to three hundred dollars is to seek such an advance from a family member or friend. Payday lenders report that their customers often prefer to pay for the advance from a payday lender rather than reveal their financial situation to friends or family members. In addition, some customers may have exhausted their access to such informal alternatives.

A third alternative for someone facing a cash shortfall is to make payments using checks that the person knows will bounce, or to delay meeting some payment obligations, such as rent or utility bills. These alternatives can also be costly. Banks commonly charge $20 to $30 for each check that bounces, and firms to which the checks are written also typically impose "returned check" charges, often around $20.[28] Even if the bank honors the check, it commonly levies an overdraft fee, and many banks close the accounts of customers who frequently overdraw their checking

[28] According to a recent PIRG survey of 521 banks across the country, fees that banks charge their customers who write checks that bounce average between $26 for "big" banks and $22 for "small" banks (Mierzwinski, 2001). In addition, some banks increase bounced check fees, and by processing the highest-value checks first, make it more likely that a customer will bounce several small-value checks rather than one large-value check (Brooks, 1999).

accounts. Utility companies, landlords, and other firms commonly impose financial penalties for late payments.

The limited data available on payday loan customers supports the notion that many have impaired credit histories or have reached the limit of credit available through lower-cost lenders. In the Credit Research Center telephone survey of payday loan customers shown in Table 4, 61 percent reported that they refrain from using a credit card at some point in the previous year because of concerns that they would exceed their credit limit. In addition, much higher percentages among the payday loan customers compared to the general adult population reported that at some point in the previous five years:

- they were turned down for credit or not given as much credit as they applied for
- they did not apply for credit because they thought that they would be turned down
- they filed for bankruptcy.

Table 4
Indicators of Impaired Credit Histories Among Payday Loan Customers

Percentage Among Surveyed Payday	Loan Customers	Percentage Among Adult Population[29]
Refrained from using bank credit card in past year because credit limit would have been exceeded	60.8	n.a.
In the past 5 years, you…		
were turned down or not given as much credit as you applied for	73.0	21.8
considered applying for credit but did not because you thought you would be turned down	67.7	14.3
filed for bankruptcy	15.4	3.7

Source: Elliehausen and Lawrence (2001)

[29] Based on data in the January 2000 Survey of Consumer Attitudes as reported by Elliehausen and Lawrence (2001).

The Credit Research Center telephone survey also asked payday loan customers' about their perceived cost of bouncing checks or making late payments compared to the cost of a payday loan. As shown in Table 5, about half the customers thought that the cost of a payday loan was the same as or lower than the cost of returned check fees, late fees on rent or mortgage payments, or late fees on consumer debt payment obligations.

Table 5
Customers Perceptions of Costs of Payday Loans
Compared to Fees on Bounced Checks or Late Payments

Perceived Cost of Payday Advance Relative to:	Higher	Same	Lower	Don't know
Returned check fees	43.6	27.6	22.3	6.6
Late fees on rent or mortgage	40.8	22.0	21.6	15.7
Late fees on credit card or other consumer debt	33.5	29.0	24.4	13.1

Source: Elliehausen and Lawrence (2001)

Finally, the Credit Research Center survey of payday loan customers asked about their consideration of credit alternatives. As shown in Table 6, only 38 percent of the respondents indicated that they considered alternative sources of credit. Of these, about half said that they considered a bank, 16 percent considered a credit union, and 30 percent considered a finance company. Only 5 percent considered borrowing from a family member or friend. Among those who considered using an alternative source of credit, 60 percent reported that they chose to use a payday lender primarily because of the speed and ease of the transaction. Another 11 percent cited the convenient location of the payday lender relative to alternatives, and 9 percent chose the payday lender because the loan would not be reported to a traditional credit agency.

Table 6 **Payday Loan Customers Consideration of Other Sources of Credit**	
	Percentage Among Surveyed Payday Loan Customers
Did you consider other credit sources besides payday lenders?	38.0
If so, which did you consider? (Respondents could name more than one option)	
Bank	48.5
Credit union	15.5
Finance company	29.8
Credit card company	6.2
Friend or relative	5.0
Among those considering alternatives, most important reason for choosing a payday advance loan	
Quick easy process, fast approval, less paper work	59.0
More convenient location	10.9
Advance provides more privacy, not included in credit history	9.0
No other alternative	6.4
Other	13.6

Source: Elliehausen and Lawrence (2001)

Some critics of payday lending have alleged that many customers of payday lenders may not understand just how expensive this source of credit is, and that their ignorance could explain some of the demand for payday loans. Data from the telephone survey provides mixed support for this hypothesis. The survey asked payday loan customers to report the size of their most recent cash advance transaction, whether or not it was a new loan or a renewal, and to report the finance charge on the transaction. As shown in top half of Table 7, almost 70 percent of respondents gave replies indicating that they paid between $15 and $24 per $100 borrowed. Another 6 percent reported paying $25 or more per $100. Since the vast majority of payday lenders levy finance charges in these ranges, it appears that at least three quarters of the borrowers remembered to a reasonably accurate degree the dollar cost of the cash advance they received.

Most surveyed payday loan customers, however, did not know the annual percentage rate on their loan. Even among those who claimed to know the rate, most had a very inaccurate notion. As shown in table 7, although 78 percent of customers said that they recalled that the lender provided them with the APR on the loan, 72 percent said that they did not know the APR on their most

recent loan. Of those who claimed to know the APR, 41 percent thought that it was less than 30 percent and another 16 percent thought that it was between 30 and 200 percent. Less than half the customers who claimed to know the APR stated a range that is credible for a payday loan. The obvious conclusion is that most payday loan customers know the dollar cost of their loans. They do not know the annualized interest rate on the loans.

Table 7
Payday Loan Customer Reports on the Cost of Their Loans

	Percentage Among Surveyed Payday Loan Customers
Reported finance charge per $100 advance for most recent loan or renewal	
Less than $10	4.1
$10 to $11	6.5
$12 to $14	9.4
$15 to $19	49.8
$20 to $24	20.0
$25 or more	6.0
Don't know	4.3
Remember that the lender provided information on the APR of the loan	78.0
Don't know APR on most recent loan	72.0
Among those claiming to know approximate APR on most recent loan, stated amount:	
Less than 30%	40.8
30 to 199%	15.8
200 to 399%	20.8
400 to 599%	18.3
600% or higher	4.2

Source: Elliehausen and Lawrence (2001)

Section V: Does Payday Lending Entrap Borrowers?

People strongly disagree over whether or not payday lending provides a useful service for most customers. Defenders of the industry argue that payday lenders provide a form of short-term emergency liquidity insurance to people who have no better alternatives. This is an expensive service, but one that benefits most customers. They cite hypothetical situations to make their point. Imagine the case of someone who has no savings and no quick access to comparatively low-cost credit. Suppose this person's car breaks down and she might lose her job if she cannot get it repaired quickly. It is perfectly reasonable for her to pay $35 to take out a two-week $200 loan to fix the car rather than lose her job, write checks that bounce, or incur late payment fees on other bills. If this individual were to face such situations numerous times over the course of a year and turn to a payday lender each time, then the service is all the more important.

Payday lenders acknowledge that their loans appear to be outrageously expensive when stated in terms of the annual percentage rate. But they argue that this is misleading because payday advances are intended to be very short-term loans. To clarify this point, payday lenders commonly make the following analogy. Many people in urban areas occasionally take taxi trips, thinking that the benefit of the service is worth the price. Suppose a new law required taxis to post their prices based on the cost of a one-thousand-mile taxi trip. The posted price would make taxis appear to be an outrageously expensive form of transportation. But this would be misleading, since taxi prices are set on the assumption that people will use them only for short local trips.

Payday lenders argue that their rates are justified by the very short-term character of the loans.

Critics of payday lending argue that most customers do not use payday loans as an occasional short-term emergency source of credit. A customer may borrow initially to meet an unexpected emergency or to meet cash shortfalls caused by careless budgeting. In many cases, however, when the next pay period comes he faces a difficult choice. He can use his available cash to repay the loan. If he does, given his limited resources for discretionary expenditures, he is likely to run short of funds before the next pay period, and must return to the payday lender for a new loan. Alternatively, upon the maturity of the loan the borrower can simply pay the finance charge in cash and extend the term of the loan until his next pay period, or "rollover" the loan. Under either

approach, when the next pay period arrives he is likely to face the same set of choices. In this way, a short-term emergency loan becomes a persistent debt.

Critics of payday lending allege that such an outcome is inherent in the design of the product. They argue that people who use payday loans have modest incomes, almost all of which goes to necessities and the service of previous debt. If a person in this situation has car trouble and she must obtain a $200 loan to repair it, she is unlikely to repay the loan plus finance charges out of one paycheck. Rather, she needs to repay the principal in small amounts out of a series of future paychecks. But since payday loans are structured as "balloon" payments, with the entire principal due at once, they do not facilitate this process. In theory, she could pay down the principal in a small number of renewals, paying the finance charge as well as a significant share of the principal with each renewal. But if she were to renew more than once or twice, she would quickly pay almost as much or more in finance charges as she borrowed in principal. In addition, critics argue, it is unrealistic to expect a borrower to repay the principal in just one or two installments given the substantial bite the finance charge takes out of most borrowers' limited discretionary income.[30] Thus, the critics view payday loans as providing short-term help, but frequently at the cost of entrapping the borrower in a long-series of costly debt payments.

While advocates for the industry and its critics disagree about the benefits of payday loans, the data show that most loan customers are frequent users of the product. Because customers can borrow from different payday lenders over time, the records of any one lender may underestimate the number of times an individual customer borrows. Nevertheless, data from individual lenders indicate that many of their customers borrow frequently.

The North Carolina Office of the Commissioner of Banking is responsible for the oversight of payday lenders in that state. The Office requested each loan office in the state to report the number of customers over the course of 1999 who took out payday loans in varying frequencies. Table 8 presents results from the report of the

[30] Data from payday lenders in Wisconsin indicate that in 79 percent of 1,947 loan renewals, the outstanding principal either stayed the same or increased. In 21 percent of the renewals, the outstanding principal decreased.

Office (North Carolina Office of the Commissioner of Banking, 2001). As indicated in the table, almost 35 percent of customers of a typical payday lender had more than ten payday loan transactions with that lender in 1999. More than 50 percent of customers of a typical payday loan office had more than seven transactions. These results are striking, since this underestimates the aggregate number of payday loans taken out by customers who borrowed from more than one lender. Available data indicate that about half of payday loan customers borrow from more than one lender over the course of a year.

Table 8
Frequency of Customer Use of Payday Loans at Individual Loan Offices In North Carolina in 1999

Customer Usage	Number of Customers in this Category of Usage	Percentage of Customers
1 to 3 times	124,663	29.7%
4 to 6 times	76,793	18.4%
7 to 10 times	73,949	17.6%
11 to 14 times	52,273	12.5%
15 to 18 times	32,941	7.9%
19 or more times	58,982	14.1%
Total	419,601	100.0%

Source: North Carolina Office of the Commissioner of Banking (2001)

Data from three other states provide additional evidence that most payday loan customers are frequent users of the service. In 1999, the Indiana Department of Financial Institutions (2000) examined the loan files of 1,434 customers of 36 payday loan offices. It found that the average customer took out 11.9 loans over the previous 12 months. Over 90 percent of customers renewed a loan at least once. The typical customer had 10 loan renewals, not necessary in sequence, over the course of the year.

In the summer of 1999, the Illinois Department of Financial Institutions collected data on the loan transactions of 340 randomly selected customers at 32 payday loan offices in the state (Woodstock Institute, 2000). The offices had been open for more than one year but less than two. For each customer, examiners from the Department recorded all loan transactions between that customer and the loan office. The Department found that 18

percent of the customers had three or fewer loan contracts, 52 percent had more than 10 transactions, and 21 percent had more than 20. The average number of contracts per borrower was 12.6.

In the fall of 2000, examiners from the State of Wisconsin's Department of Financial Institutions collected data from 17 payday loan offices in the state. At each of the offices, the Department attempted to gather information from 20 randomly selected active loan files and from five closed loan files. It asked lenders to provide a history of all transactions for the selected borrowers over the previous year. The active loan files were outstanding loans that were not in arrears at the time of the examination. The closed loan files were loans that matured prior to the time of the examination. Whether these loans were paid off in full was not specified. In some cases, the closed loan files included loans that fell due only within the month previous to the examination. In cleaning the data, the Department eliminated the data from three lenders because the lenders were too young to have data going back a full year. Not all of the lenders provided data on 25 clients, so the Department's report was based on data from 321 clients of 14 firms (Wisconsin Department of Financial Institutions, 2001).

After eliminating all information that could possibly identify a particular lender or borrower, the Department provided its raw data to me. After cleaning it, I retained the records for 322 loan clients, 283 with active accounts and 39 with closed accounts. I am unsure why the Department's analysis was based on 321 clients and my own on 322, but my own estimates using the data are nearly identical to those in the Department's report. Here I report my own estimates, since they include information beyond that included in the Department's report.

The 322 loan customers had a total of 3,832 reported loan transactions (originations or renewals), or about 11.9 each. The average term for the loan originations and renewals was 14 days. Nearly 90 percent were for between 12 and 16 days. The average cash advance was $245.03 and the average finance charge was $49.37, implying an average APR of 528 percent. Table 9 shows the distribution of customers by number of loan transactions. The distribution looks broadly similar to that reported for Illinois and North Carolina. About 26 percent of the clients had fewer than six

transactions over the previous year and 18 percent had more than 20 loan transactions. The greatest number of loan transactions entered into by one person over a year was 30.

Table 9
Distribution of Wisconsin Payday Loan Customers by Number of Transactions

Number of Loans per Borrower Within Previous Year	Number Borrowers in Category	Percentage Borrowers in Category
1 to 5	84	26.1
6 to 10	79	24.5
11 to 15	58	18.0
16 to 20	43	13.4
21 to 25	39	12.1
More than 25	19	5.9

Source: Wisconsin Department of Financial Institutions (2001)

The data in such tables can be misleading. As noted earlier, 283 (88 percent) of the borrowers in the data set had active accounts at the time of the data collection. What is not shown in the table is that 16 percent of the active borrowers took out their first loan from the payday lender within only two months prior to the examination date. Another 61 percent of the active borrowers initiated their first loan between two and six months prior to the examination date. These relatively new customers are bound to take out fewer loans over the previous year. Thus, the borrowers in the first category of Table 9, those taking out five or fewer loans over the previous year are primarily short-term customers, not long-term customers who borrowed infrequently.[31] In fact, of the 127 customers in the data set who were customers at least once 10 months or more prior to their most recent loan, only four took out five or fewer loans over the course of the year. But 56 (44 percent) of these long-term customers had more than 20 loan transactions within one year.

The Department's data permits an examination of patterns with respect to loan renewals. In its report, the Department defined a renewal to include rollovers (customers pay the finance charge at

[31] Similar problems arise with respect to closed accounts. In several cases, data on these accounts did not go back one year but, rather, one year from the date of the examination. Thus, if the examination was in November of 2000 and the account closed in March of 2000, data on the account may only be available for November 1999 through March 2000.

or before maturity and the lender extends the term of the loan) and same-day advances (customers take out a new loan on the same day that they pay off an old loan). Of the 322 customers, 20.2 percent never renewed a loan in the relevant time period, 38.5 percent had four or more sequential renewals, and 15.5 percent had seven or more sequential renewals. In 66 percent of the renewal transactions, the outstanding principal balance stayed the same. In 21 percent, the outstanding principal balance decreased, and in 13 percent it increased.

As in the previous case, these data on renewals can be somewhat misleading. First, customers who started to borrow only one or two months prior to the examination date have not had enough time to accumulate many renewals. In fact, if we limit the analysis to customers who took out at least one loan ten or more months prior to their most recent loan, the results are very different. Among these 127 customers, 8.7 percent never renewed a loan, 40.1 percent had four or more sequential renewals, and 17.4 percent had seven or more sequential renewals. Second, some customers consistently repay their loans on the due dates but take out new loans prior to their next payday, remaining out of debt only a few days between paydays. Of the 3,832 transactions by the 322 customers, 53 percent were rollovers or same-day advances. But an additional 26 percent were loan originations made within one to 13 days of the termination of the previous loan.

In a study of Wisconsin payday lenders, 40.1 percent of borrowers had four or more renewals, and 17.4 percent had seven or more renewals.

The advantage of the data analyzed above is that they come from the official records of the payday loan offices themselves and do not rely upon the memory of customers. A disadvantage is that they underestimate the number of transactions among customers who patronize more than one loan office in a given time period. In order to obtain information on such behavior, one would have to combine data from all loan offices in a region – a challenging task for state oversight agencies – or obtain the information from customer surveys. The danger with the second approach is that one may not reach a representative sample of customers, the customers may not remember how many loans they originated or renewed, or they may misrepresent the numbers that they do remember.

The Credit Research Center telephone survey of payday loan customers asked them about their use of different payday advance companies within the previous year.[32] As shown in Table 10, about half of customers reported using more than one payday loan firm in the previous year and 6 percent reported using four or more. About 17 percent said that they used a loan from one company to pay off another company.

Table 10
Use of Different Payday Loan Companies Within Previous Year

	Percentage of Surveyed Payday Loan Customers
Used more than one company in previous year	47.0
Number of companies used	
Two	30.0
Three	11.1
Four or more	5.9
Paid off one company with the loan proceeds from another company	16.5

Source: Elliehausen and Lawrence (2001)

The CRC survey also asked customers about the frequency with which they used payday loans over the previous year. As Elliehausen and Lawrence (2001) report, 48 percent of customers reported that they entered into seven or more loan transactions during the previous year and 22.5 percent reported 14 or more. Three quarters of the borrowers reported that they renewed a loan at least once; 29 percent reported seven or more renewals. Fifty-seven percent of borrowers reported that their longest sequence of consecutive advances was less than four weeks, 33 percent reported consecutive advances of seven weeks or more, and 10 percent reported that their longest consecutive loan sequence was 14 weeks or more.

Despite the diversity of contexts and sources for the data on the use of payday loans, there is a general consistency in the findings. All studies find that 50 to 80 percent of payday loan customers

[32] To be clear, the survey should have asked about use of multiple offices, since sometimes the same company operates more than one office in a region. It seems likely, however, that most respondents would understand “company” to mean “office.”

entered into seven or more loan transactions over the course of a year and 20 to 30 percent of customers entered into 14 or more. In addition, two of the studies examine the prevalence of uninterrupted sequences of loans. The Wisconsin Department of Financial Institutions finds that 38.5 percent of customers renewed a loan more than three times in a row. Since this mean that the customer remains in debt to the payday lender for eight weeks or more, this finding roughly agrees with the data from the Credit Research Center. In the CRC survey, 33 percent of borrowers reported that their longest period of consecutive advances was seven weeks or more.

These findings are shaped by the methodologies of the studies. In selecting a group of payday loan customers and tracking their transactions over the previous year one necessarily includes very recent customers who cannot have had many transactions or renewals. As the data from Wisconsin suggests, a large share of customers who used payday loans a small number of times consists of such clients, for whom there is only a short time period of data. It does not include long-term customers who use payday loans only once every few months.

The data discussed in this and the previous section support both the views of advocates for payday lending and its critics. Payday loans may well be the best immediate alternative available to borrowers without access to mainstream lenders, and who need to remedy a pressing financial shortfall. At the same time, the data are consistent with the charge that most payday loan customers are frequent borrowers who may be trapped in a persistent and costly debt cycle. Over 40 percent of the longer-term payday loan customers in Wisconsin, for example, had 20 or more loan transactions over the course of a year. Assuming that they borrowed the average amount for Wisconsin customers ($245) and that they paid an average finance charge ($49) with each transaction, they would have each spent at least $980 in finance charges in order to keep a $245 loan outstanding for most of a year.

Section VI: Regulatory, Legal, and Competitive Threats to Payday Lending

Since payday lending is new in many states and is offered by only a handful of offices in some large states such as New York and Pennsylvania, one would expect continued rapid growth for the industry. The major factor that could interfere with this forecast is the regulatory and legal environment. As noted earlier, in states where payday lenders can charge $15 or more for every $100 they advance, payday lending thrives under state laws. Currently, somewhat over half of the states meet this threshold (Fox and Mierzwinski, 2001). In some other states, payday lenders avoid state usury ceilings by making an agreement with banks or thrifts located in permissive states. The payday lenders in the restrictive states function as agents for the banks. They gather loan application information and handle the collection process, but the banks technically make the loans. Lenders argue that the relevant usury ceiling is that of the state in which the bank is located since, like banks that offer credit cards across state lines, the bank can "export" its interest rates to customers in other states.

States with permissive usury laws could change their laws to lower finance charges or make payday lending illegal.

Payday lenders operating under state laws must worry about their future. A state that has permissive usury laws can always change its laws to lower ceilings on payday loan finance charges, or to make payday lending illegal. Critics of the industry have advocated such measures. In North Carolina they were successful. North Carolina allowed its payday lending law to expire on August 31, 2001. The law formerly allowed payday lenders to charge $17.65 for each $100 they advanced. After August 31, the state had no statute authorizing payday lending. As a result of this change, payday lenders in the state have rapidly begun to affiliate with out-of-state banks located in permissive states, or to sell their stores to payday lenders that have such affiliations.

There are also threats facing the lenders that use a bank located in a permissive state in order to offer payday loans in states with laws that are unfavorable to the business. A small number of states have laws that restrict offices from functioning as agents of banks whose loan terms violate state usury ceilings or other consumer protection legislation. Lenders have challenged these laws in courts, and the outcome is uncertain.

In addition, lawyers have filed suits against payday lenders using bank alliances to avoid state usury laws, arguing that the banks are not truly making the loans.[33] Rather, they function as a façade to enable payday lenders to evade state laws. Lawyers bringing these suits point out that local payday loan offices collect the loan application material, distribute the loan to the borrower, and monitor and work to collect the loan. Moreover, in many cases, in exchange for the interest payments on the loans, the payday lender agrees to reimburse the bank for substantially all of the loan losses, or the payday lender purchases a substantial share of the loan from the bank. ACE Cash Express uses a bank for its payday lending, partnering with Goleta National Bank in California. In its 10-K filing (ACE, 2001, p. 13), it explains:

> *"Under the Goleta Agreement, the Company must purchase from Goleta a participation in all Bank Loans made on the previous day or previous days. That participation entitles the Company to substantially all of the interest received by Goleta from the borrowers, and subjects the Company to substantially all of the risk of nonpayment by the borrowers. The Company must pay Goleta a participation fee for Goleta's originating the Bank Loans."*

Lawsuits challenging bank affiliations are still in the courts and the outcome is uncertain. If the courts uphold the plaintiff's challenge, this will threaten the ability of payday lenders to by-pass state usury laws and could reverse or slow the growth of the industry.[34]

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[33] The Office of the Comptroller of the Currency (OCC), the chartering and regulatory agency for national banks, has tried to discourage national banks from participating in payday lending by issuing directives stating that it will closely examine the operations of any national bank that makes payday loans. In January 2002, the OCC required Eagle National Bank to exit the business, claiming that Eagle did not exercise proper oversight of the activities of the payday loan firm that functioned as its agent.

[34] Some legal advisors to payday lenders and their partnering banks have encouraged the banks to provide payday loan customers with credit cards. For example, a customer receiving a $200 cash advance would be given a credit card with a $200 credit limit. The customer could use this to obtain a $200 cash advance. The payment on the card would fall due every two weeks, rather than each month, and the finance charge and other fees could total $40 on a biweekly basis. In other words, the terms associated with the credit card could mimic those of traditional payday loans. From the perspective of the bank and payday lender, such an arrangement may be more resilient to legal and political challenges, because the law and political interests supporting the export of national bank interest rates in the case of credit cards are quite powerful.

In addition to the regulatory and legal challenges currently facing the payday loan industry, in the long run payday lenders may find other businesses encroaching on their customer base. Banks might begin to offer payday loans directly to their depositors, especially if regulatory and product image issues are resolved in favor of payday lenders. In fact, some banks are already tiptoeing into the market with "payday loan-like" products.

Wells Fargo Bank, one of the ten largest banks in the country, offers a "Direct Deposit Advance" in all states in which it has branches, except Texas and Wisconsin. As the name implies, Wells Fargo offers this loan only to customers who have their wages or government support payments directly deposited to their accounts at the bank. For those customers, the bank will automatically advance up to half the value of their next deposit, up to a maximum of $300, or $500 in California. The bank deducts loan repayment and finance charges from the customer's next direct deposit. The finance charge on the advance is $5 for each $100 that the bank advances, significantly less than traditional payday lenders. The lower finance charge could reflect lower risk and lower loan-monitoring costs associated with lending only to the bank's own direct deposit customers. The lower charge could also reflect an unwillingness of the bank's management to expose the bank to potential public criticisms that could result if it were to charge higher fees. The bank has kept the Direct Deposit Advance program low-key. It has not provided information on the number of advances it makes, the type of customers who use the product, how many customers are repeat users of the product, and whether or not the product is profitable. If the bank were to widely publicize its Direct Deposit Advance or if other banks were to introduce similar products, this might reduce significantly the customer base of traditional payday lenders.

Wells Fargo Bank offers Direct Deposit Advances only to customers who have wages deposited directly to their accounts at the bank.

A number of community banks have also begun to offer a payday loan-like product which they call "Bounce Protection" or "Automated Overdraft Privilege." A bank that offers an overdraft privilege informs selected customers that it will honor checks that the customer writes without sufficient funds in an account as long as the account is not overdrawn by more than a specified amount, such as $300. Each time the bank honors an overdraft check, it charges its standard "overdraft fee," typically around $20. There are, however, two differences between an overdraft privilege and

a bank's standard overdraft policy. First, the bank generally requires the customer with an overdraft privilege to return the account to a positive balance within two weeks to a month, rather than in a matter of days. Second and more important, the bank does not characterize overdrawn accounts as "bad" behavior. Indeed, the bank encourages its eligible customers to make use of the service whenever they need it.

Banks encourage customers to use overdraft services, rather than viewing it as "bad" behavior.

An overdraft privilege functions like a line of credit attached to a checking account, but the banks offering the service claim that it is not a credit product. They claim that there is no finance charge, just an overdraft fee. The overdraft fee is much higher than a bank earns in finance charges on a line of credit, and they presumably market the product to customers whose credit histories make them ineligible for credit lines. A customer might, for example, write an NSF check for $100 that the bank honors, charging a $20 overdraft fee. If the customer has two weeks to return the account to a positive balance, this is similar to charging a 520 percent annualized interest rate.

The Truth-in-Lending Regulations of the Federal Reserve state that some bank charges are not finance charges, including "Charges imposed by a financial institution for paying items that overdraw an account, unless the payment of such items and the imposition of the charge were previously agreed upon in writing" (Regulation Z of Federal Reserve Regulations, 12 CFR 226.4 (c) (3)). Banks offering overdraft coverage typically state that they will pay the overdrafts as a favor to the customer, but that they are not obligated to do so. Apparently, by stating that they are not obligated to pay overdrafts, banks hope to avoid having the overdraft fees categorized as finance charges with the associated Truth-in-Lending disclosures (Cheatham, 2000).

Banks may be reluctant to reveal an interest rate on the overdraft coverage for fear that they will be criticized for charging triple digit interest rates on loans to some of their customers. But one can imagine legal or regulatory challenges arguing that an overdraft privilege is a credit product and that banks that offer the service should treat it as such.

Most payday lenders with whom I have spoken say they do not see the entry of banks into this market as a threat. In the case of overdraft privileges, the lenders argue that their finance charges

are often lower than bank overdraft fees. In theory, someone with a $300 limit on his overdraft privilege could write one overdraft check for $280 and incur only a $20 fee. Most payday lenders would charge somewhat over $45 for a $280 cash advance. In practice, however, many customers may overdraw their accounts by writing several smaller checks, such as three checks for $65 each. In this case, the fee for the overdraft privilege would aggregate to $60 for a $195 advance, well over what payday lenders charge.

In addition, payday lenders voice skepticism that Wells Fargo Bank's Direct Deposit Advance product is profitable, given the Bank's current finance charge, unless it is restricted to customers with better credit-risk profiles than most payday loan customers. Finally, some payday lenders believe that banks that offer payday loans may be able to undercut payday lenders because they deal directly with their own depositors. But payday lenders also argue that banks are likely to suffer large losses unless they monitor their payday loans very closely and use person-to-person persuasion to reduce defaults. Since banks generally do not have these skills, some payday lenders predict that that banks that enter the market will seek to acquire existing payday loan organizations rather than compete with them. Naturally, the owners of these organizations would welcome such overtures.

Section VII: How Should Credit Unions Respond to Payday Lending?

Advocates for payday lending argue that these loans are the best quick solution to the short-term financial crises payday loan customers face. That may be true, considering the alternatives realistically available to most payday loan customers. But it is also true that payday loans are not an attractive solution to financial emergencies. They are far more costly than credit available to people with relatively clean credit histories. Many payday loan customers, perhaps a majority, are frequent customers who pay more in finance charges over the course of a year than their average cash advance. If these individuals could build the savings to avoid frequent personal financial crises or could develop a credit history making them eligible for lower-cost sources of credit, they could free themselves from dependence on payday lenders. Given the modest incomes of most payday loan customers, saving $500 to $1,000 in annual finance charges could make significant changes in their quality of life.

Credit unions must carefully weigh the alternatives before advocating regulatory changes to payday lending.

It is natural for credit unions to seek to address this issue. The earliest credit unions were founded to help people build savings and avoid high-cost lenders, and many credit unions still place a high priority on these goals. The question is: What should they do?

Some credit unions may decide that their most important contribution is to become involved in advocating changes in the regulations governing payday lending. Even many payday lenders, out of a desire to ensure that customers are treated fairly or a desire to improve the image of their industry, advocate limits on loan and collection policies of their competitors. But in advocating regulatory changes, credit unions should proceed cautiously. If a credit union backs regulatory or legal changes that would make payday lending illegal or unprofitable, it should do so only after it becomes convinced that most or all payday loan customers would be better off without access to these loans. This means thinking carefully about the alternatives available to loan customers. If a credit union thinks that the main problem is with the subset of payday loan customers who borrow frequently, it must weigh carefully the advantages and disadvantages of any proposed regulatory or consumer education initiatives intended to address the problem.

Another possible approach to the rise of payday lending would be for credit unions to undercut payday lenders by offering low-cost small-value loans to payday loan customers. But this approach

raises serious challenges. If a credit union were to find good loan candidates and charge them its top loan rate of 18% APR for a short-term small-value loan, it would not cover its costs.[35] For example, a $200 two-week loan at 18% APR would generate $1.38 in interest, not enough to cover origination costs. The high cost of payday loans reflects the high cost of making small-value, short-term loans.

Credit unions recognize this reality by providing most small consumer loans in the form of revolving lines of credit attached to checking accounts or credit cards. Using automated loan decision and other technologies, credit unions may be able to reduce loan origination and monitoring costs so that closed-end smaller-value loans become cost-effective. But credit unions can offer such products only to individuals with acceptable credit-risk profiles. And many payday loan customers would not be able to meet this criterion.

Positive responses by credit unions include offering products to help members build savings, and educating members in good financial management.

Although credit unions cannot prudently make loans to individuals beyond a particular credit-risk threshold, they can help these individuals in other ways. Credit unions can offer savings products designed to help members, especially those living paycheck-to-paycheck, build savings. Previous studies published by the Filene Research Institute demonstrate that many credit unions already make special efforts in this area, and other credit unions can learn from these initiatives (Caskey and Humphrey, 2002). A household that maintains even only a few hundred dollars of savings at the end of each pay period has a financial margin of safety that eliminates or reduces the need for payday loans. More important, households with modest savings cushions are less likely to miss paying bills or engaging in other behavior that creates seriously impaired credit records. As a result, they remain eligible for lower-cost sources of credit.

A second measure credit unions can employ is to promote consumer education initiatives that help members and potential members address existing credit problems, set savings goals, and adopt good personal financial management practices. Many credit

[35] Theoretically, credit unions could, as some community banks have done, use checking account overdraft fees to create a payday loan-like product. But this would be subject to legal and regulatory challenges and would be counter to most credit unions' commitment to help their members understand and compare the cost of credit.

unions already have strong programs in this area or work closely with other groups that do (Culler and White, 2000). Credit unions that do not yet offer such services should investigate cost-effective ways to do so.

Realistically, if all credit unions were to implement the measures outlined above, there would likely be only a modest reduction in the use of payday loans. Nevertheless, given that several million people use payday lenders, such measures could help ten of thousands of financially-stressed households to raise their standards of living by reducing their dependence on high-cost sources of credit and creating a measure of financial security. This is the historic mission of credit unions.

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