Payday Loans, Inc.: Short on Credit, Long on Debt

Executive Summary

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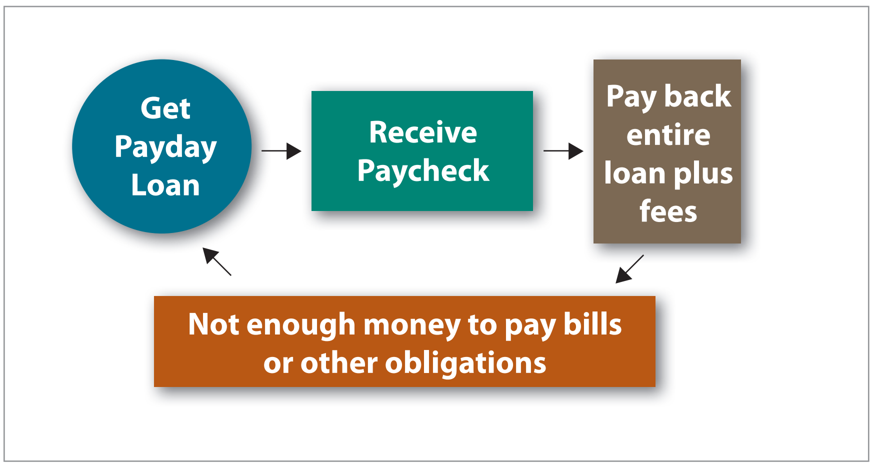
CENTER FOR RESPONSIBLE LENDING

www.responsiblelending.org

EXECUTIVE SUMMARY

Payday loans—small, short-term loans due on a borrower's next payday—are marketed as a quick solution to a financial shortfall. Despite the contention that these loans are intended to be used only on an occasional basis, the typical payday borrower has multiple payday transactions per year, usually taking one after the other and paying a new fee each time. This "debt treadmill" on which borrowers commonly find themselves is created by the nature of the loan itself—the loan must be repaid in full from a single paycheck, a tall order for a household already living close to the edge. Borrowers routinely find themselves short of cash soon after paying one loan back, and then must take out another to meet their ongoing obligations, as the chart below illustrates.

Payday Lending Debt Treadmill



Many of CRL's previous studies of payday borrowing activity have been derived from annual reports from regulators in the states in which payday lenders operate. While these reports provide valuable summary statistics, they do not tell the full story of the experience of borrowers over time. This report fills part of this gap by tracking the transactions of the 11,000 borrowers in Oklahoma who took out their first loans in either March, June, or September of 2006 for the subsequent 24 months.

Oklahoma was one of few states where this type of analysis was possible. We compared the findings from this analysis with other available information and studies, including regulator data from Colorado, Florida and other states, as well as findings from borrower interviews conducted in New Mexico and California, and an analysis of transactions from a large Texas-based payday lender. These supplement and confirm our findings.

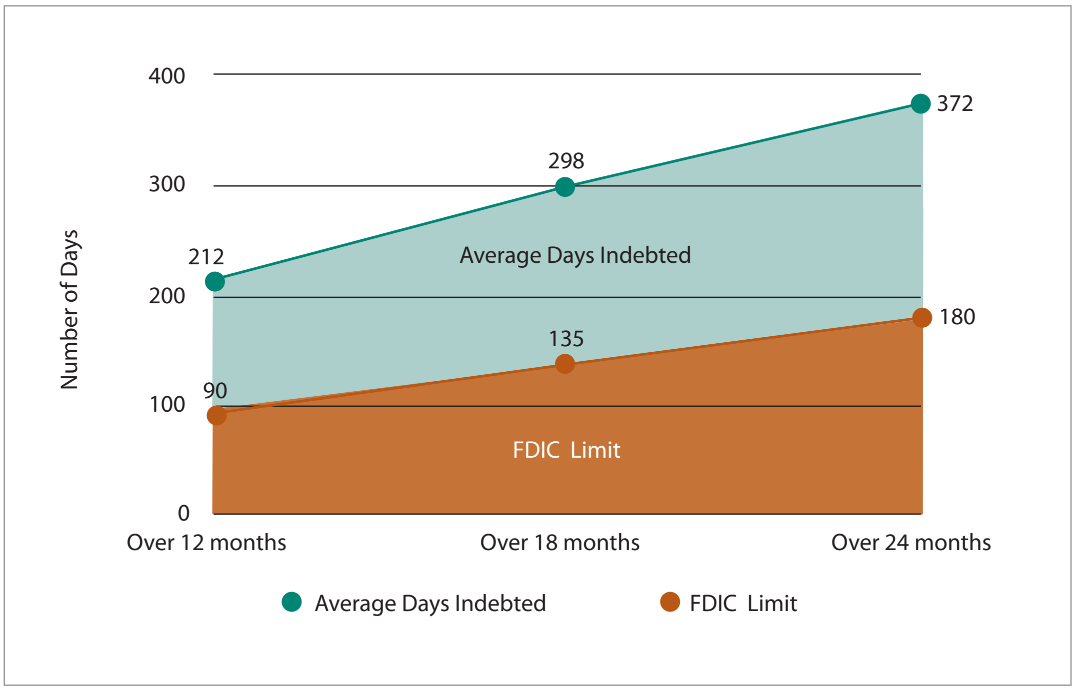
It should also be noted that because this analysis took place before the worst impacts of the financial crisis hit households across the country, our findings are not affected by more recent financial and employment conditions.

FINDINGS

An analysis of this data documents the size of these borrowers' initial loans, how many transactions they conduct, how long they remain indebted, and how many of them default.

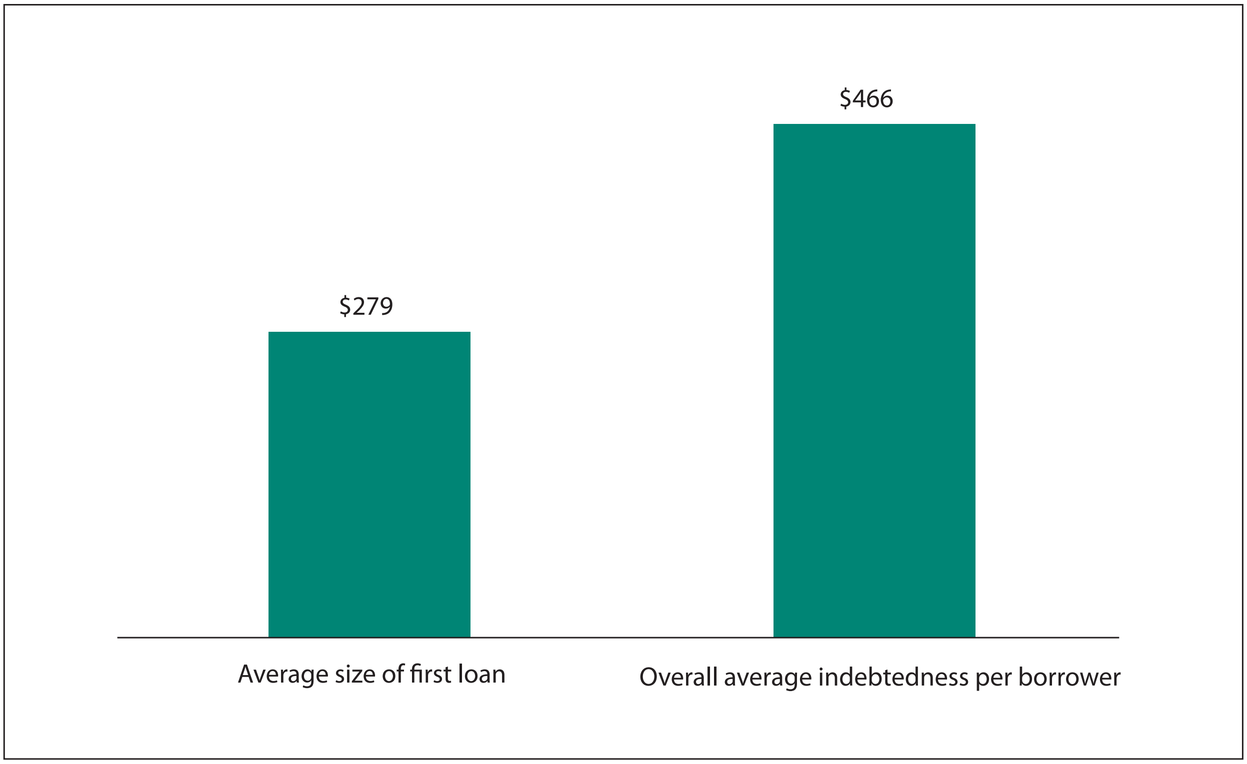
The typical payday borrower remains in payday loan debt for much of the year, and many borrowers remain indebted in payday loans for even greater periods of time. Payday lenders were granted exemptions to existing annualized interest rate caps because of their assertion that borrowers would use these loans on a short-term basis. The industry's trade group, the Community Financial Services Association (CFSA), acknowledges in its consumer guide that payday loans are "…not a long-term solution" and that "[r]epeated or frequent use of payday advances can cause serious financial hardship." Federal banking regulators agree with this assessment. For example, while the Federal Deposit Insurance Corporation (FDIC) has ruled that it is inappropriate for payday borrowers to remain indebted for more than 90 days in any 12 month period, we find that borrowers are indebted for more than double this limit on average. In their first year of payday loan use, borrowers are indebted an average of 212 days. Over the full two-year period, borrowers are indebted a total of 372 days on average.

Average number of days indebted in payday loans



Payday borrowers' loans increase in size and frequency as they continue to borrow. Those payday borrowers who continue to take out loans over a two year period have 12 payday transactions in their second year of borrowing, up from 9 transactions in the first. While not the subject of this analysis, a previous CRL analysis found that payday borrowers with multiple transactions—including those in Oklahoma—tend to take these loans on a consecutive basis rather than sporadically throughout the year. In addition, evidence suggests that borrowers' loan sizes increase after their initial loan. While borrowers' initial loans averaged under $300, the average Oklahoma borrower owes $466 on payday loans.

Increasing payday loan indebtedness



A significant share of borrowers become late or default on their payday loan, triggering more fees and placing their bank account at risk. Payday lenders say that over 90 percent of the time, borrowers successfully repay their loan. This is consistent with the default rates of around five percent reported by state regulators in Oklahoma and elsewhere, which is similar to that of a credit card. However, a low default rate on a per loan basis should be expected due to two critical factors: (1) the payday loan is timed to be due on the borrower's payday, when the borrower has an infusion of cash that can be used to repay the loan and (2) lenders can repay themselves, since they hold the borrower's personal check for the amount due, or have authorization to withdraw funds from their bank account. In effect, the payday lender guarantees that he will have the first claim on the borrower's funds, potentially causing the borrower to come up short on his or her other obligations.

While payday lenders have very little risk of not getting repaid on any given loan, the typical borrower taking out loan after loan every year has a much higher chance of experiencing an eventual default. Over the first two years of payday loan use, 44 percent of borrowers will experience a "return event" or default placing additional financial stress on borrowers by triggering bounced check fees from the lender and the borrower's bank.

CONCLUSION AND RECOMMENDATIONS

Despite the fact that payday borrowers are likely to continue taking loans for long stretches of time, payday lenders routinely market their loans as short-term credit for emergencies. Borrowers are misled by the promise of a short-term credit product when it is in fact designed and functions to keep them indebted for extended periods.

Repeat borrowing is the norm, not the exception. There are relatively few new borrowers entering the payday loan market, providing a strong incentive for the industry to keep existing customers borrowing on a regular, ongoing basis.

The fundamental flaws of a payday loan are the product's design and weak underwriting. Payday lenders provide loans without giving consideration to a borrower's other obligations and therefore cannot gauge the borrower's ability to repay. They also require that the loan and fees be paid back in full from a single paycheck.

To ensure that available small loans help borrowers cover a financial shortfall without trapping them in long-term debt, **we recommend that states end special exemptions for payday lenders and other providers of high-cost credit that authorize triple-digit annual interest rates.** Seventeen states and the District of Columbia protect their residents by setting interest rate limits for small loans at or around 36 percent annually. Congress has also given this protection to active-duty military and their families on a national basis.

In addition, while the new federal Consumer Financial Protection Bureau (CFPB) cannot limit interest rates on payday loans as states can, both the Bureau and states can take other steps to ensure that payday borrowers' short-term loans do not turn into long-term debt, such as:

Limiting the amount of time a borrower can remain indebted in high-cost payday loans. The FDIC's guidance of limiting indebtedness to no more than 90 days in a given year would help to ensure that lenders are providing these loans only as advertised—on no more than an *occasional* basis.

Ensuring that small loans do not lead to debt traps by requiring sustainable terms and meaningful underwriting. Instead of taking access to a borrower's bank account as security for a loan, borrowers would be better served by responsible underwriting standards that account for their income and other obligations when deciding how much debt they can afford and the amount of time needed to repay.

Facilitating efforts to help low- and moderate-in income households save. All families, and especially those living paycheck-to-paycheck, would benefit from having savings that they could use as an alternative to taking on debt when an unexpected expense occurs.

About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

Visit our website at **www.responsiblelending.org.**

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