Springing the Debt Trap:

Rate caps are only proven payday lending reform

Executive Summary

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Payday lenders in public:

> *"Since a payday advance is a short-term solution to an immediate need, it is not intended for repeated use in carrying an individual from payday to payday. When an immediate need arises, we're here to help. But a payday advance is not a long-term solution for ongoing budget management. Repeated or frequent use can create serious financial hardships."*
>
> Community Financial Services Association, the FACTS about payday advance services information brochure, 2005

Payday lenders in private:

> *"And the theory in the business is you've got to get that customer in, work to turn him into a repetitive customer, long-term customer, because that's really where the profitability is."*
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> Dan Feehan, CEO of Cash America, remarks made at the Jefferies Financial Services Conference (6.20.07)

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EXECUTIVE SUMMARY

Payday lenders argue that charging 400 percent annual interest is the only way their business model can be profitable. Some states have responded by exempting payday lenders from the interest rate caps imposed on small loans in general. Perhaps this special treatment would be justified if payday loans provided a strong public benefit, but the experience of borrowers shows the reverse. The vast majority of families taking out payday loans are ensnared in long-term debt, making them worse off than they would be without high-cost payday lending.

A payday loan typically ranges from $300 to $500 and is secured by a personal check. It is marketed as a short-term advance on the borrower's next paycheck, but the high price and the fact that it must be paid off in one lump sum two short weeks later virtually ensures that cash-strapped borrowers will be unable to pay off their loan with a single paycheck and still meet their basic expenses.

Payday lenders justify the high cost of payday loans by saying they are short-term loans that get borrowers past an immediate shortfall. To give payday lenders the benefit of the doubt in our definition of the debt trap, we assume that a borrower may have one of these shortfalls every quarter—this reasoning would justify four loans per year. When borrowers receive greater than this number, we can assume that the difficulty in repaying the short-term balloon debt has forced the borrower to convert that short-term loan into long-term, high-cost debt. The borrower is therefore caught in a debt trap—a cycle of debt they cannot afford to pay off for good.

States approach payday lending in one of three ways. Some allow payday lenders to operate with virtually no legal restrictions. Others enforce an interest rate cap at or around 36 percent on small loans, inclusive of payday lending. And a third group attempts to create a middle ground where payday lenders can charge triple-digit interest rates with certain restrictions intended to make sure that payday loans don't create a debt trap for borrowers.

In this paper, we evaluate the efficacy of this third approach. We find:

- The debt trap of payday lending persists even in states that have attempted to reform the practice. In these states, 90 percent of payday lending business is generated by trapped borrowers with five or more loans per year.

More evidence that the debt trap persists:

- Over 60 percent of loans go to borrowers with 12 or more transactions per year;
- 24 percent of loans go to borrowers with 21 or more transactions per year;
- One of every seven Colorado borrowers have been in payday debt every day of the past six months; and
- Nearly 90 percent of repeat payday loans are made shortly after a previous loan was paid off.

- As implemented in any state, none of these restrictions have stopped payday lending from trapping borrowers in long-term debt:

  - Renewal bans/cooling-off periods
    Renewal bans and cooling-off periods do not stop the cycle of payday debt, as loans are simply paid off and then re-opened at the borrower's first opportunity, often on the same day. Data from Florida and Oklahoma show that nearly 90 percent of new loans were made during the same two-week pay period as the previous loan was paid off.

  - Limits on number of loans outstanding at any one time
    Even with this provision, borrowers can remain in payday loan debt for the vast majority of the year. Data from three states with limits on loans outstanding—Florida, Michigan, and Oklahoma—show the number of these provisions do not lessen the debt trap.

  - Payment plans
    Few borrowers take advantage of payment plans in states where they are required to be offered. Only one to two percent of transactions eligible for a payment plan take advantage of a longer repayment period. Since lenders make less money if borrowers enter into these plans, they have little incentive to cast them in a positive light and—as the regulator in Colorado has confirmed—many lenders tweak their practices so that borrowers cannot become eligible.

  - Loan amount caps based on a borrower's income
    Even in states that limit the amount a borrower can borrow based on their income, the debt trap continues. This is because these "ability to repay" provisions do not take into account the borrower's other obligations, such as a mortgage or rental payment, car loan, or minimum credit card payments. Without knowing the extent of a borrower's other expenses, it is impossible to truly assess the borrower's ability to repay the loan.

  - Databases which enforce ineffective provisions
    Several states enforce measures by collecting transaction information in a database, but this does nothing when the measures themselves are not effective.

  - Regulations that narrowly target payday loans
    When legislation defines problem loans narrowly, payday lenders tweak the product to avoid interest rate limits and other restrictions.

- Those states which enforce a comprehensive interest rate cap at or around 36 percent for small loans have solved their debt trap problem; realizing a savings of $1.5 billion for their citizens while preserving a more responsible small loan market.

The only proven way for state policymakers to protect their citizens from predatory small loans is to enforce a comprehensive small loan law with an interest rate cap at or around 36 percent.

The Problem with Payday Lending

While payday loans are marketed as two-week loans, they only work as a one-time quick cash solution about two percent of the time. State regulator data demonstrates that only one to two percent of transactions are made to borrowers who take out one loan, pay it off on time, and do not need to borrow again that year.The high price of a payday loan and the fact that it must be paid off in one lump sum two short weeks later, virtually ensures cash-strapped borrowers will be unable to meet their basic expenses and pay off their loan with a single paycheck. Consequently, they are forced to flip the loan over and over.

As the table below illustrates, a person earning $35,000 a year would be hard-pressed to pay back a typical payday loan and still meet basic expenses during one two-week pay period.

The typical borrower cannot afford to pay off a payday loan after two weeks

	$35,000 Salary
Before tax income (2 weeks)	$1,346
Minus taxes	-$120
After tax income	$1,227
Minus two week essential expenditures on food, housing, transportation, and healthcare	-$962
Money left over after essential expenditures ($1,227–$962)	$265
Payday loan payment due on $325 loan ($325 principal plus $52 fee)	$377
Deficit ($265–$377)	-$112

Source: Expenditure data from the Bureau of Labor Statistics, 2005 Consumer Expenditure Survey

The inability to repay their payday loans and meet basic needs drives consumers to continue to take out loans over the course of multiple pay periods. In fact, regulator data collected in eight states shows that the average payday borrower has more than eight transactions per year (8.7 average). Payday lenders depend on this repeat borrowing for the bulk of their revenues. As demontrated in the table below, the vast majority of payday lenders' revenues generated are from trapped borrowers.

Loans to trapped borrowers generate most payday lending revenue

	Loans to borrowers with five or more transactions per year	Loans to borrowers with 12 or more transactions per year	Loans to borrowers with 21 or more transactions per year
Colorado	N/A	65%	28%
Florida	89%	58%	20%
Michigan*	94%	77%	52%
Oklahoma	91%	64%	27%
Washington State	89%	56%	20%
Average	90%	61%	24%

*Michigan figures are for a 13-month period and are not included in the average.

Nearly half (45 percent) of repeat payday transactions in Florida happen as soon as the 24-hour cooling-off period expires, and 88 percent of these are originated before the typical borrower receives their next paycheck. Data from Oklahoma reveals a similar trend with 87 percent of loans taken out during the pay period in which the previous loan is paid off. So, while a brief pause in lending does occur, the borrower is still flipped into another loan and continues to be in long-term debt. This is despite the renewal ban and a cooling-off period established in these states to attempt to end the debt trap.

Majority of repeat loans taken out within a few days of previous loan

	Florida	Oklahoma
Within one day	45%	59%
Within one week	79%	79%
Within the same two-week pay period	88%	87%
Within thirty days (typical billing cycle and monthly pay period)	96%	94%

The data from Florida and Oklahoma is consistent with data from Advance America that shows 46.5 percent of their transactions were originated on the same date as a previous loan was paid off.

POLICY RECOMMENDATIONS

Enact a comprehensive small loan cap at or around 36 percent.

The only meaningful way to address the debt trap is through a comprehensive small loan law with an interest rate cap. The 12 states and the District of Columbia with reasonable rate caps on small loans can and should serve as a model to states that currently authorize payday lending in any form. In these states and in the District of Columbia, citizens in need of credit to help them through an unexpected expense can access affordable alternatives without sinking into high-cost, long-term debt.

Previous CRL research found that the absence of triple-digit payday lending in eleven states saved their citizens an estimated $1.4 billion per year. With new restrictions on high-cost lending in Oregon and the District of Columbia enacted in 2007, this savings will grow by an estimated $77 million.

Savings achieved by states that enforce interest rate caps

	Savings
Connecticut	$64 million
District of Columbia (new cap)	$12 million
Georgia	$147 million
Maine	$25 million
Maryland	$97 million
Massachusetts	$119 million
New Jersey	$150 million
New York	$345 million
North Carolina	$153 million
Oregon (new cap)	$65 million
Pennsylvania	$234 million
Vermont	$12 million
West Virginia	$36 million
Total	$1.5 billion

Additional Recommendations:

Cap the number of loans a borrower can receive annually. The payday lending industry asserts that its product is intended for occasional, short-term use. Therefore, capping the number of loans a borrower can receive each year would be consistent with the industry's definition of responsible use. Precedence for a loan limit comes from FDIC guidelines for banks that may directly engage in payday lending. The guidelines call for banks to ensure that payday loans would not be made to customers in payday loan debt—from any payday lender—for over three months of any twelve-month period.

Ban the use of the bank account access as collateral. Check holding by payday lenders is the modern day equivalent of wage assignment. Policymakers should follow the lead of the federal law protecting military families and prohibit the practice of holding a check or requiring electronic access to the borrower's bank account as security for a loan. From the borrower's perspective, check holding creates a super lien on their income, because the payday lender is holding a live check to be deposited on the date the borrower is paid. This forces borrowers to address the payday loan first before all other debts and essential obligations.

Increase incentives for small loans and emergency savings. Policymakers can provide incentives to banks and credit unions to craft responsible small loan products, and can also look at ways to encourage savings among low- and moderate-income families so that they can weather financial emergencies without taking on additional debt.