Phantom Demand:

Short-term due date generates need for repeat payday loans, accounting for 76% of total volume

Executive Summary

By Leslie Parrish and Uriah King
Center for Responsible Lending

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CENTER FOR RESPONSIBLE LENDING

www.responsiblelending.org

North Carolina
302 West Main Street
Durham, NC 27701
Ph (919) 313-8500
Fax (919) 313-8595

California
1330 Broadway
Suite 604
Oakland, CA 94612
Ph (510) 379-5500
Fax (510) 893-9300

District of Columbia
910 17th Street NW
Suite 500
Washington, DC 20006
Ph (202) 349-1850
Fax (202) 289-9009

EXECUTIVE SUMMARY

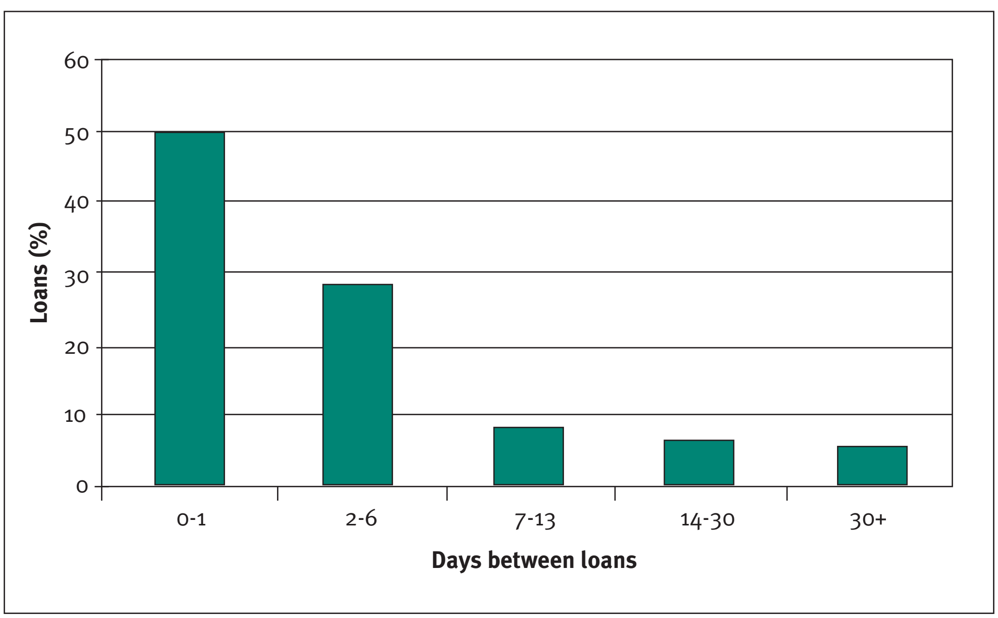
Since its inception in the 1990s, the payday lending industry has established over 22,000 locations which originate an estimated $27 billion in annual loan volume. The amount of payday lending, while small relative to other unsecured loan products like credit cards, is often said to reflect a strong demand for the payday loan product. Further analysis, however, reveals that a sizeable majority of payday lending volume is generated by payday debt itself—borrowers need to open a new loan shortly after repaying a previous loan because repayment left them with inadequate funds for other needs.

The data show that half of new loans are taken out at the borrower's first opportunity upon paying a previous loan back.

The payday loan product, which routinely comes with a 400 percent annual percentage rate (APR) sticker, requires a short-term balloon payment that can account for 25-50 percent of a borrower's entire take-home income. Devoting this substantial share of a paycheck to repaying a payday loan, it appears, leaves most borrowers inadequate funds for their other obligations, compelling them to take a new payday loan almost immediately. In fact, the most common period of time between payday loans—one day or less—is consistent with the explanation that payday borrowers, unable to both repay their payday loan and meet other expenses, are effectively locked in a cycle of debt.

Using tabulations of loan-level data obtained through public records requests, this report examines the loan activity of the more than 80 percent of borrowers who take out more than one payday loan a year. These borrowers generally open new loans in rapid succession, with 87 percent of all new loans to these borrowers occurring during the very next pay period. In fact, the data show that half of new loans are taken out at the borrower's first opportunity upon paying a previous loan back.

Figure 1: Days between payday loan transactions for borrowers with multiple payday lending transactions



Note: Over 80 percent of borrowers have more than one payday lending transaction per year.

This "churning" of existing borrowers' loans every two weeks accounts for three-fourths of all payday loan volume. Nearly 59 million loans totaling more than $20 billion are a product of this churning. In contrast, loans to non-repeat borrowers account for just two percent of loan volume, and subsequent loans to repeat borrowers originated a month or longer after a previous loan was closed account for five percent of all loans.

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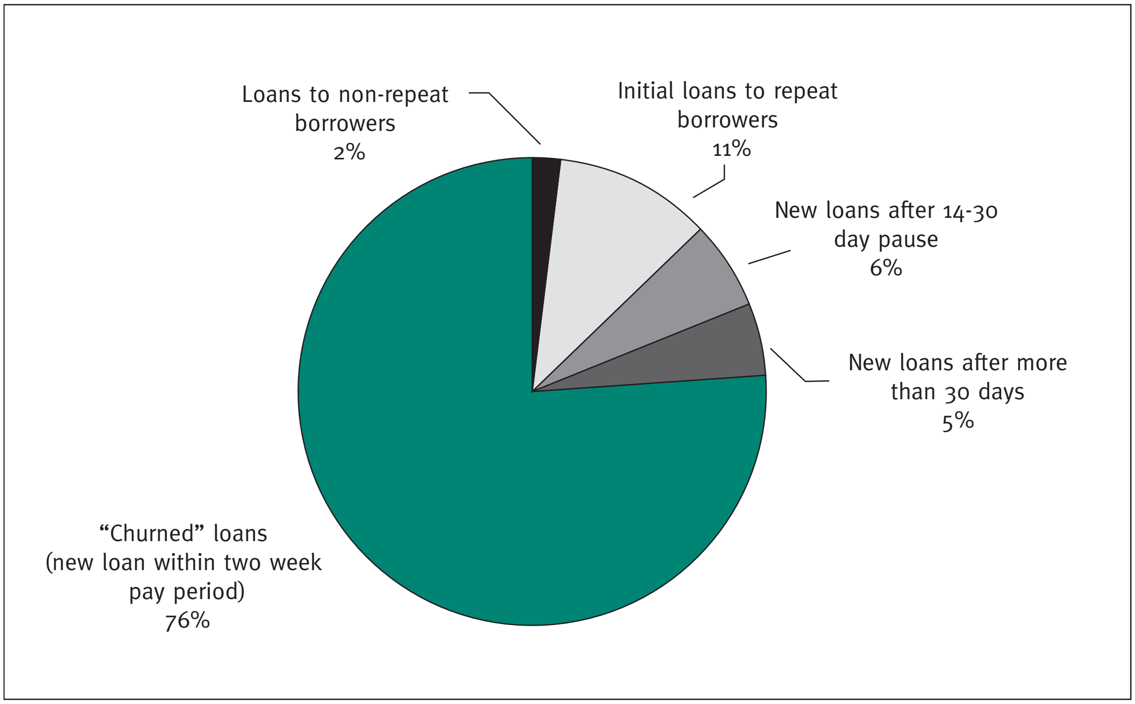
Figure 2: Share of total loan volume attributable to churning



Churned loans result in $3.5 billion in fees each year. The importance of generating these fees by churning borrowers is clearly recognized by payday lenders who frequently offer first loans for free or at highly discounted rates in order to attract new customers and convert them into long-term borrowers.

The unique structure of a payday loan with a short term balloon payment due in two weeks inherently sets borrowers up to need a new loan to fill the financial gap which results by paying off the first in its entirety. While some households may need an occasional small loan, offering loans with such a short repayment term causes financial harm for most payday borrowers.

Policymakers can curtail small loan abuses that trap borrowers in debt by enacting a 36 percent APR cap. A loan's APR reflects both the cost of the loan and the time in which a borrower has to repay this debt. So, a loan carrying a high APR (such as a payday loan) is more difficult to repay because of a high cost, a short term, or both. As the experiences in 15 states and the District of Columbia show, a 36 percent APR rate cap protects families from short-term balloon payment loans, encouraging installment products where a borrower can repay their debt at a more manageable pace.

In addition to this rate cap, regulators and policymakers should also consider (1) establishing a standard similar to that endorsed by the FDIC which would limit the amount of time each year a borrower could be indebted to a payday lender; (2) expanding access to affordable small loan products and emergency savings; and (3) discouraging other abusive loan products such as fee-based overdraft loans that weaken financial security.

Summary Findings:

Finding 1: The great majority of payday loans are originated shortly after a previous loan is paid back, with half of new loans opened at the borrower's first opportunity, and 87 percent opened within two weeks.

Finding 2: Borrower churn inflates payday loan volume by over $20 billion each year, with three of every four loans generated by the debt trap.

Finding 3: This churning of loans to borrowers each pay period costs these households $3.5 billion in extra fees each year.