



## Payday Loans Put Families in the Red

*Research refutes industry claim that payday loans prevent overdraft fees*

CRL Issue Brief

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### ***Payday loans create a cycle of debt that diminishes the income of vulnerable households***

Marketed as short-term relief for a cash crunch, payday loans carry annual interest rates of 400 percent and are designed to catch working people – or those with a steady source of income such as Social Security or a disability check – in a long-term debt trap.

The terms are set so that borrowers most often cannot pay off the loan on payday when it's due without leaving a large gap in their budget, often forcing them to immediately take out a new loan after paying the first one back.<sup>1</sup> One recent study found that people who took out payday loans nearly doubled their chances of filing for bankruptcy. These households' higher bankruptcy risk exists even when compared to households with similar financial status who were denied a payday loan.<sup>2</sup>

Overdraft fees burden the same people: those living paycheck-to-paycheck. Banks and credit unions routinely approve uncovered transactions without warning their customers of a negative account balance, and charge an average \$34 fee for each incident, even when the uncovered purchase amounts to just a few dollars.

### ***Do borrowers pay more in overdraft fees when payday loans aren't available?***

Payday lenders argue that working people are better off getting a payday loan than overdrawing their account, and claim that meaningful curbs on abusive payday lending, such as a 36% rate cap, will only increase the number of overdrafts incurred by cash-strapped families.<sup>3</sup> This does not bear out—payday loans and overdrafts are not substitutes for each other. Rather, as shown in a University of North Carolina study of low- and moderate-income families—and the industry's own surveys—payday borrowers tend to have a variety of options besides a taking payday loan or incurring an overdraft fee.<sup>4</sup>

In reality, most overdrafts are accidentally caused by small debit card purchases of about \$20, not larger checks which might be used to pay an important bill.<sup>5</sup> Very few bank customers knowingly overdraw their account—in a 2006 CRL survey, only five percent of accountholders reported ever using their debit card or writing a check when they knew there were not enough funds in their account to cover the transaction.<sup>6</sup>

*Payday lending increases the odds that households will repeatedly overdraft and ultimately lose their checking accounts.*

*-Harvard Business School Study*

*Only five percent of accountholders have ever intentionally overdrawn their bank account to conduct a transaction.*

*-2006 ORC Caravan Survey for CRL*

*A study of OD/NSF fees by state provides no evidence of a connection between the presence of payday lending and OD/NSF fees incurred by households.*

*-Bretton Woods NSF/OD Fee Analysis*

Additionally, a new study by Bretton Woods, a private consulting firm which lists the payday lenders' trade association as a client, shows no evidence that households in states without payday lending incur greater overdraft or NSF fees than households in other states. For example, two-thirds of the states without payday lending pay less than the national average in overdraft/NSF fees, and the share of household income spent on overdraft/NSF fees is the same or greater in states with payday lending, as compared to states without the product.<sup>7</sup>

***Payday loans don't prevent overdrafts – they increase them***

Not surprisingly, because payday loans are secured by a borrower's personal check or automatic electronic access to a borrower's bank, much of the available data suggests that payday lending may actually *increase* involuntary bank fees. Because one-quarter to half of all payday borrowers default in a twelve-month period, payday lending can actually spur overdraft fees.<sup>8</sup>

In North Carolina, payday borrowers paid over \$2 million in NSF fees to payday lenders in addition to the fees assessed by their banks in the last year their practice was legal.<sup>9</sup> Moreover, a new report from Harvard Business School researchers finds that payday lending can increase the odds that households will repeatedly overdraft and ultimately have their banks close their checking accounts.<sup>10</sup> Therefore, rather than lessening the impact of overdraft fees on a family's budget, payday lending can actually increase them.

***Federal response to overdraft***

Federal regulators and policymakers have recently turned their attention towards overdraft fee regulation. The GAO and FDIC have documented bank and credit union overdraft practices, and the Federal Reserve has proposed rules that would take steps toward reform. Federal legislation has also been proposed that would require that account holders have a clear understanding of the cost of overdraft programs, and that would prohibit banks from engaging in unfair practices such as clearing the day's transactions from the highest to the lowest in order to increase the number of fees they can charge.<sup>11</sup>

***State policy-makers can alleviate the overdraft problem – by addressing payday lending***

A 36 percent interest rate cap for high-cost loans eliminates the predatory practice of charging 400 percent for loans to working people and will reduce the bank fees unnecessarily assessed because of faulty payday loans. A two-digit interest rate cap is already saving 15 states and the District of Columbia nearly \$1.8 billion in predatory payday fees alone, and a federal 36 percent cap on loans to military personnel and their families has stopped the worst payday lender abuses of those serving our country.<sup>12</sup> Our civilian working families are in dire need of the same protections.

Payday lending industry representatives have lobbied for other reforms, such as payment plans and renewal bans, because they understand that these measures have done nothing to slow the rate at which they can flip loans to the same borrowers. But an interest rate cap is the only measure that has proven effective.<sup>13</sup>

Predatory payday lending needs immediate attention, especially in a time where preserving the purchasing power of working families is an essential part of economic recovery.

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<sup>1</sup> Regulator data from Florida and Oklahoma (the only states with this level of detailed data) show that 45 percent and 59 percent of repeat payday transactions, respectively, are opened at the borrower's first opportunity. In addition, 88 percent and 87 percent of subsequent loans are originated before the borrower receives their next paycheck in two weeks. This data is discussed in further detail in *Springing the Debt Trap*, available at [www.responsiblelending.org/issues/payday/reports/springing-the-debt-trap.html](http://www.responsiblelending.org/issues/payday/reports/springing-the-debt-trap.html).

<sup>2</sup> Paige Marta Skiba and Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* Vanderbilt University and the University of Pennsylvania (October 10, 2008). Available at: <http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=2221>

<sup>3</sup> Research heavily quoted by industry representatives assumes payday lending and overdraft fees are perfect substitutes – that is, a decrease in payday lending means an increase in overdraft fees. For examples of two studies that create hypothetical models based on this assumption, see Donald P. Morgan and Michael Strain, *Payday Holiday: How Households Fare after Credit Bans*. (November 2007) and Bart J. Wilson, David W. Findlay, James W. Meehan, Jr., Charissa P. Wellford, and Karl Schurter, *An Experimental Analysis of the Demand for Payday Loans*. (April 1, 2008).

<sup>4</sup> See University of North Carolina Center for Community Capital, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options* (November 2007). for a list of strategies other than payday loans low- and moderate-income households used for a financial short-fall. Pat Cirillo, an industry-provided expert witness, in testimony to the Ohio House Committee on Financial Institutions, Real Estate and Securities, January 31, 2008, stated that over half of payday borrowers have access to a credit card that they could use to address a financial emergency. Transcript on file with CRL.

<sup>5</sup> Officials representing payday loan companies tend to quote APRs for the smallest overdraft transactions and compare to similarly sized payday loans. However, the average payday loan is \$325 while the average overdraft is caused by a \$20 debit card transaction – more evidence that these loans are not substitutes. Moreover, the payday lenders' argument depends on the payday loan borrower only using the product once, but that experience represents only 1 to 2 percent of all transactions – the vast majority are repeat loans. For more details on typical size and triggers of overdraft fees, see Eric Halperin, Lisa James, and Peter Smith, *Debit Card Danger*. Center for Responsible Lending (January 25, 2007). Available at <http://www.responsiblelending.org/pdfs/Debit-Card-Danger-report.pdf>.

<sup>6</sup> For example, a CRL survey found that only five percent of households have intentionally used their debit card or written a check when they knew they did not have enough money in their account to cover the transaction. See Lisa James and Peter Smith, *Overdraft Loans: Survey Finds a Growing Problem for Consumers*. Center for Responsible Lending (April 24, 2006). Available at [http://www.responsiblelending.org/pdfs/ip013-Overdraft\\_Survey-0406.pdf](http://www.responsiblelending.org/pdfs/ip013-Overdraft_Survey-0406.pdf).

<sup>7</sup> Bretton Woods estimates (1) total NSF/overdraft fees paid by banked households in each state and (2) the share of household income devoted to paying NSF/overdraft fees. There is no significant difference in NSF/overdraft fees charged. In 2008, NSF/overdraft fees amount to an average of 0.6% of household income, regardless of whether payday lending is occurring in the state, if we exclude data for Delaware, Nevada, South Dakota, and Utah which may contain some anomalies (see page 14 of the Bretton Woods report for more details). If included, they show a greater burden in payday states (0.9% of household income) as compared to non-payday states (0.6% of household income). In addition, about two-thirds of states without payday lending pay less than the national average (\$368) per household on NSF/overdraft fees. *2008 Fee Analysis of Bank and Credit Union Non-Sufficient Funds and Overdraft Protection Programs*, Bretton Woods, Inc (January 2009). The study is available at [www.bretton-woods.com/452/18901.html](http://www.bretton-woods.com/452/18901.html).

<sup>8</sup> When a payday loan defaults, the payday borrower is still liable for the triple-digit interest rates to the payday lender plus NSF fees to both the payday lender and the bank. In Paige Marta Skiba and Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* Vanderbilt University and the University of Pennsylvania (October 10, 2008), the authors find that half of borrowers experience a default within the first 12 months of taking a payday loan. This study is available at: <http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=2221>. Regulator data from Florida and Oklahoma reveal that 26 and 25 percent of borrowers, respectively, experience a “return event” or default within a given 12 month reporting period. Regulator data on file with CRL.

<sup>9</sup> As reported in the 2000 Annual Report of the North Carolina Commissioner of Banks, the total amount of NSF fees collected by payday lenders was \$2,000,844. This was the last year payday lenders were authorized to operate in North Carolina. The report is available at [www.nccob.org/NR/rdonlyres/5F7F31CF-2645-4CD2-8EE1-EE349F9F6AE8/0/cccon00.pdf](http://www.nccob.org/NR/rdonlyres/5F7F31CF-2645-4CD2-8EE1-EE349F9F6AE8/0/cccon00.pdf).

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<sup>10</sup> Specifically, an increase in the number of payday lending locations in a particular county is associated with an 11 percent increase of involuntary bank account closures, even after accounting for county per capita income, poverty rate, educational attainment, and a host of other variables. Dennis Campbell, Asis Martinez Jerez, and Peter Tufano (Harvard Business School). *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures*. June 6, 2008. Available at:

[http://www.bos.frb.org/economic/eprg/conferences/payments2008/campbell\\_jerez\\_tufano.pdf](http://www.bos.frb.org/economic/eprg/conferences/payments2008/campbell_jerez_tufano.pdf)

<sup>11</sup> For more information and CRL's policy recommendations regarding bank and credit union overdraft practices, see [www.responsiblelending.org/issues/overdraft](http://www.responsiblelending.org/issues/overdraft).

<sup>12</sup> In a previous CRL report, we reported that households in the 13 states and the District of Columbia saved nearly \$1.5 billion in predatory payday loans fees because of their states' interest rate caps. Since publication, three other states—Arkansas, New Hampshire, and Ohio—have enforced existing or enacted new interest rate caps, bringing the total savings to nearly \$1.8 billion. For more details and methodology, see Appendix 2 of *Springing the Debt Trap*, available at [www.responsiblelending.org/issues/payday/reports/springing-the-debt-trap.html](http://www.responsiblelending.org/issues/payday/reports/springing-the-debt-trap.html).

<sup>13</sup> For more information on how to effectively regulate small loan products, see *Springing the Debt Trap*, available at [www.responsiblelending.org/issues/payday/reports/springing-the-debt-trap.html](http://www.responsiblelending.org/issues/payday/reports/springing-the-debt-trap.html).