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Payday Loans: The Good, the Bad, and the Ugly

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INTRODUCTION

Numerous industries face the problem of reaching a delicate balance between satisfying industry interests and consumer interests. Frequently, one question that emerges is; how can an industry profit while still promoting the interests of consumers? This question is extremely relevant to the payday loan industry. This comprehensive analysis of payday lending is based on the acts of distinguishing characteristics of payday loans, identifying lenders and borrowers, clarifying evolving legal requirements, and analyzing reasons of support and opposition for payday lending. Based on this comprehensive analysis, recommendations for the future of the payday lending industry are presented and additional research topics will be discussed.

LITERATURE REVIEW

Overview of payday loans

Definition While there is no set definition for a payday loan, according to the Consumer Financial Protection Bureau (2017), a payday loan is "a short-term, high cost loan, generally for $500 or less, that is typically due on your next payday." The Consumer Financial Protection Bureau goes on to explain how borrowers may obtain payday loans through lenders located in physical storefronts or online, depending on the state law where the borrower is seeking the loan. An alternative definition is offered by the Center of Responsible Lending (2013) and describes these loans as "high-cost small loans averaging $350 that usually must be repaid in a single payment after two weeks" (pg. 2).

History In order to analyze the characteristics of payday loans, it is important to understand their history. Starting in the late 1980s to early 1990s, the payday lending industry was created to be a source for working poor individuals with funds such as paychecks or disability checks to receive small, short-term loans (Mayer, as cited in Kirsch et al., 2014, p. 2). Following its formation, the payday lending industry exploded and became more complex over time with the added expansion of banks and online financial providers in the payday loan market (Montezemolo, as cited in Kirsch et al., 2014, p. 2). According to the Consumer Federation of America (n.d) in 2015, there were approximately 15,766 payday loan stores operating in the United States.

How Payday Loans Work The payday loan process is fairly simple, which leads to their attractiveness for consumers. The first step is that borrowers write a post-dated personal check for the amount being borrowed plus a finance charge. After giving the lender their check, the borrower will receive cash, have funds deposited in their account, or receive a prepaid card. The lender will then hold the check until the borrower's next payday. The payday loan frequently must be paid in one lump sum at the end of the borrower's pay period. The borrower will redeem their check by paying the lender with cash and the lender will return the borrower's personal post-dated check (Consumer Federation of America, n.d).

According to the Consumer Financial Protection Bureau (2017), the length of the borrower's pay period frequently ranges from two to four weeks following the origination date of the loan. The due date is stated in the payday loan agreement and if the borrower is unable to pay before the due date, the lender can then cash the borrower's check as it acts as collateral for the loan (Kirsch et al., 2014, p. 2). Because the lender does not generally consider the borrower's ability to pay, this situation happens quite frequently. Some payday lenders will enable the unpaid portion of the loan to be refinanced and rolled over to the next pay period, but this comes at a steep price to the borrower (Kirsch et al., 2014, p. 3).

Types of Payday Loans An important point to highlight is that no two payday loans are alike. There are two main types of payday loans that include balloon payment loans and installment loans. The single balloon payment loan model requires that the entire loan balance (amount borrowed in addition to fees) is due in one lump sum payment (Center for Responsible Lending, 2013, p. 2). The Consumer Financial Protection Bureau (2017) points out that these types of payday loans are structured so the total payment is organized into several smaller installments that are payable over a longer time period. Unfortunately for consumers, installment loans can be incredibly costly because they are "the equivalent of a payday loan with multiple renewals effectively incorporated into the product" (Center for Responsible Lending, 2013, p. 12).

Lenders And Borrowers

Major Payday Lenders Characteristics of lenders and borrowers are presented to further understand the conflicting interests between the two groups. The payday lending industry is an industry of impressive scope resulting in considerable customer impact. Payday lenders generate about $3.6 billion a year in revenue, according to a study by the Consumer Bureau (Epley, 2017). With such a large stream of revenue, it comes as no surprise that payday lenders oppose attempts at government regulation.

Data regarding lenders with physical storefronts is much easier to track than data from online lenders. Nearly 50% of all payday loan physical storefronts in the United States are run by nine major companies (Center for Responsible Lending, 2013, p. 9). One of the most recognizable names is Texas-based Cash America, which was created 35 years ago as a pawn shop but entered the payday lending industry in 2000. Cash America currently offers more than 660 locations nationwide. Additional names include Pennsylvania-based DFC Global (Money

Mart), Texas-based EZCORP (EZ Money), First Cash Financial Services (First Cash Advance and Cash and Go), and Kansas-based QC Holdings (Quik Cash) (Center for Responsible Lending, 2013, p. 9).

Who Uses Payday Lending Because of the numerous offerings of payday loans to consumers, the number of consumers who take advantage of such loans is relatively large. According to the Pew Safe Small-Dollar Loans Research Project (2012), nearly 12 million American adults (5.1% of the total population) used a payday loan in 2010 (Center for Responsible Lending, 2013, pg. 7). This figure may be attributed to the fact that it is relatively easy for an individual to receive a payday loan. The Consumer Federation of America (n.d.) explains that the only requirements for most payday loans is that the borrower has identification, a source of income, and has an open bank account. Lenders infrequently perform a credit check or determine if the borrower will be able to repay the loan (Consumer Federation of America, n.d.).

In terms of borrower demographics, the financial status of the individual plays a large role in determining whether they will take out a payday loan. Nearly 18% of payday loan borrowers received some sort of income from benefits and public assistance programs (Center for Responsible Lending, 2013, p. 7). According to Kirsch et al., (2014), "Many payday borrowers have impaired credit histories and would be ineligible to borrow commercially under traditional credit standards" (pg. 2).

Additional borrower demographics reveal that most borrowers are 22 to 44-year-old females who are Caucasian (Center for Responsible Lending, 2013, p. 7). In addition to the above demographics, there are five groups that are more likely to have used a payday loan in the past. These five groups include "those without a four-year college degree; home renters; African

Americans; those earning below $40,000 annually; and those who are separated or divorced" (Center for Responsible Lending, 2013, p. 7).

There is commonly a significant amount of targeting that occurs by payday lenders when locating stores. A 2009 study conducted by the Center for Responsible Lending found that despite controlling for factors such as income, "payday lenders were 2.4 times more concentrated in neighborhoods of color" (2013, p. 7). According to Howarth, Davis, and Wolff, "bank payday loans that jeopardize their bank accounts can leave these communities even more disproportionately underserved by the banking mainstream" (as cited in Responsible Lending, 2018).

Additional areas targeted by physical payday loan stores were historically right outside military bases, becoming an attractive option for military members. This changed when the Military Lending Act (MLA) was enacted in October 1, 2007 and was expanded on October 3, 2016. Under the MLA, "payday loans are not permitted for active-duty service members and their dependents" (Consumer Federation of America, n.d.).

Uses of Payday Loans The proceeds from payday loans are used to cover a variety of expenses. A 2012 study conducted by the Pew Research Survey found that approximately 50% of payday loan proceeds went to pay for recurring expenses such as rent, utilities, mortgage payments, food, clothing, and credit card bills. Sixteen percent of proceeds were used for unexpected emergencies such as car repairs and emergency medical expenses. Finally, 8% of proceeds were used for "something special and 2% for "other" (Kirsch et al., 2014, p. 8).

Court Cases

Tucker and Muir Because of the sheer magnitude of the payday lending industry and historic lack of regulations, there have been numerous court cases involving illegal payday lending. One of the more recent cases involved Kansas native and competitive race car driver Scott Tucker. Scott Tucker and his business partner Timothy Muir were online payday lenders from 1997 to until 2013. Over this period of time, their payday loan offerings frequently ranged from 600% APR to 700% APR, and sometimes even exceeded 1,000% APR. The extent of their lending impacted more than 4.5 million borrowers in the United States (US Justice Department, 2017).

The reason the interest rates charges were so high was because Tucker and Muir would automatically withdraw finance fees payday after payday, "applying none of the money toward repayment of principal, until at least the fifth payday, when they began to withdraw an additional $50 per payday to apply to the principal balance of the loan." Consumers were unaware of how high the interest rates actually were because Tucker and Muir violated the Truth in Lending Act (TILA), a federal statute that requires lenders to disclose the terms of the loan to the consumer in a clear and understandable way (US Justice Department, 2017).

The interest rates that Tucker and Muir were charging was a clear violation of state usury laws, which are laws that "set rate caps or usury limits" (Consumer Federation of America, n.d.). Tucker and Muir attempted to evade such state usury laws by claiming that their business was operated and owned by several Native American tribes. They claimed that since the business was "owned" by the tribes, they were protected by sovereign immunity, which is "a legal doctrine that, among other things, generally prevents states from enforcing their laws against Native American tribes" (US Justice Department, 2017). In 2013 and the three years beyond, Tucker paid off the Miami Tribe of Oklahoma, and the Modoc Tribe of Oklahoma, and the Santee Sioux Tribe of Nebraska in exchange for them to claim that they owned the payday lending business.

Tucker and Muir underwent a trial that lasted five weeks and they were convicted on all 14 counts of the indictment on charges that included, "one count of conspiring to commit racketeering through the collection of unlawful debt, three counts of participating in a racketeering enterprise through the collection of unlawful debt, one count of conspiring to commit wire fraud, one count of wire fraud, one count of conspiring to commit money laundering, two counts of money laundering, and five counts of violating TILA." Tucker received a prison sentence of 16 years and 8 months (US Justice Department, 2017).

Legal Aspects

Regulatory Agencies As exemplified by the Tucker and Muir court case, due to the potential of abusive lending practices, regulatory agencies are of vital importance for consumer protection. There are three main Federal regulatory agencies that includes the Consumer Financial Protection Bureau (CFPB), the Federal Deposit Insurance Corporation (FDIC), and the Federal Trade Commission (FTC). The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) created the CFPB in 2011, which set the stage for Federal regulation of payday lenders (Center for Responsible Lending, 2013, p. 18)

Before the creation of the CFPB, states had the reserved power to regulate storefront payday lenders (Kirsch et al., 2014, p. 3). According to the Center for Responsible Lending (2013), "the CFPB has the power to, bring enforcement actions, and regulate all payday lenders, regardless of size or type" (p. 20). This is a positive for those in favor of lending regulations because actions can be brought against payday lenders who receive little to no state regulation (p. 20). Recent rulings passed by the CFPB identifies that it is "unfair and abusive practice for a lender to make covered short-term or longer-term balloon-payment loans, without reasonably determining that consumers have the ability to repay the loans according to their term"("Payday loans", 2017, p.1)

The Federal Deposit Insurance Corporation (FDIC) is an additional Federal regulatory body. The FDIC issued a series of guidelines in 2005 for the payday industry which highlighted the risks that borrowers as well as other financial institutions face because of risky payday loans (Center for Responsible Lending, 2013, p. 11). While the guidelines only apply to FDIC banks, they still stress the importance that banks should "ensure that payday loans are not provided to customers who had payday loans outstanding at any lender for a total of three months during the previous 12 months (p. 11).

Lastly, the Federal Trade Commission (FTC) is another Federal regulatory body. The FTC has recently cracked down on illegal behaviors of online lenders. Because online payday lenders are a relatively new practice, there has been increasingly tight monitoring. Payday Financial, also known as Western Sky Financial felt the pressure of the FTC's monitoring when in 2011 enforcement action was taken against them by the FTC. It was alleged that Payday Financial "charged undisclosed and inflated fees and collected on loans by illegally threatening borrowers with arrests and lawsuits (Center for Responsible Lending, 2013, p. 19).

State Laws Over the last 15 years, state laws have been created to produce more inspection and regulation of all forms of payday loans (Center for Responsible Lending, 2013, p. 13). States such as Connecticut, Maryland, Massachusetts, Pennsylvania, Vermont, and West Virginia do not allow payday loans (Consumer Federation of America, 2017). Additional states do not ban payday loans, but instead place limits on the amount that can be borrowed or the fees that can be paid. A common maximum amount for payday loan fees ranges from $10 to $30 for every $100 borrowed and $500 is a common loan limit (Consumer Financial Protection Bureau,

2017) The Center for Responsible Lending (2013) states that "voters have consistently supported ballot initiatives aimed at eliminating high-cost payday lending" (pg. 13).

Payday Lending in Nebraska Historically, the payday lending industry in Nebraska has been largely unregulated and has permitted high-cost lending. Until April of 2018, the maximum loan amount allowed was $500 and the maximum finance fee was "$15 per $100 or pro rata for any part thereof on amount of check" which created an APR of 459% (Consumer Federation of America, 2017). On April 18, 2018 L.B. 194 was passed by the Nebraska Unicameral, which will limit the interest charged on payday loans (Nebraska Department of Banking and Finance, 2018).

Support for and Opposition Against

The most important piece of analysis for payday loans comes from an in-depth inspection of points of support for payday lending in addition to opposition against it. Because of the stark division between the two opinions, it is critical to observe both sides from a neutral perspective, before forming opinions about the payday industry for oneself.

Support for Payday Loans One of the biggest points of support for payday loans is the easy access to quick cash. According to Kirsch et al., (2014), payday loans "empower consumers by giving them a way of meeting short-term cash needs and thereby avoiding far more expensive late fees and credit delinquencies" (p. 4). Additionally, Elliehausen contends that according to supporters of payday lending, "the vast majority of borrowers are quite satisfied with their experience with the industry (as cited in Kirsch et al., 2014, pg. 4).

Another point of support is the immaterial difference between the concept of payday lending and credit cards. Payday lending industry attorney Hilary Miller makes the assertion of payday loans as being no different, in material ways, than credit cards. Her reasoning is that while interest and fees are common to both credit cards and payday loans, there are fewer complaints about credit cards than there are regarding payday loans (Kirsch et al., 2014, p. 7). Greenberg points out that law experts within the payday industry argue that the “adverse ‘cycle of borrowing’(a.k.a. “debt trap”) and the significant levels of fees and costs incurred by borrower’s overtime should be attributed to consumer behavior and product misuse” rather than the business model of payday lending (as cited in Kirsch et al., 2014, p. 6).

Opposition Against Payday Loans While there is a significant number of references of support for payday loans, there is equal, if not more, opposition to payday loans. The three main arguments against payday loans include high interest rates, difficulty repaying loans, and a concept known as the “debt treadmill.” In addition to these three arguments, there are also additional negative consequences of payday lending.

Just like any other business, payday lenders are looking to earn the largest possible profit. This leads to payday lenders typically charging the maximum possible interest rate on the loan as is allowed in the state they are operating in (Center for Responsible Lending, 2013, p. 2). Finance charges are how payday lenders profit. Finance charges on payday loans average around $15 to $30 to borrow $100. According to the Consumer Federation of America (2017), “for two-week loans, these finance charges result in interest rates from 390 to 780% APR.” Shorter term loans have even higher APRs. These high interest rates can be debilitating for cash-strapped consumers.

Because high interest rates create high costs for borrowers, there is a significant chance that the borrower will default. The payday loan model only succeeds when borrowers are unable to pay their loan (Center for Responsible Lending, 2013, p. 47). A 2012 Pew Charitable Trusts survey found that “only 14% of payday borrowers thought they would be able to repay their loan when it fell due" (Bourke, Horowitz, and Roche as cited in Kirsch et al., 2014 p.3). Defaulting on loan payments is a serious concern for many payday loan borrowers. The Consumer Federation of America (n.d) reveals that borrowers "default on one in five payday loans." The rate of default is even higher for online borrowers. The Consumer Financial Protection Bureau found that more than 50% of all online installment loan payments are defaulted on (as cited in Consumer Federation of America, n.d).

The debt treadmill arises because most borrowers struggle with repaying their payday loan as well as covering their living expenses, often resulting in failing to pay off their loan. This leads borrowers to obtain multiple loans within a short period of time to cover their other loans and expenses. As summarized by the Center for Responsible Lending (2013), "Payday loans create a debt treadmill that makes struggling families worse off than they were before they received a payday loan" (pg. 4). When borrowers get caught in this cycle of repeat borrowing, it can trap them in long-term debt. An even more alarming statistic is that "active borrowers (those taking out at least one loan in each six-month period of the second year) took out an average of nine loans in the first year and 12 loans in the second year" (Center for Responsible Lending, 2013, pg. 5).

In addition to the three main reasons of opposition against payday loans, there are a number of additional consequences of payday lending that can harm the borrower. Examples include "losing bank accounts, becoming delinquent on other debts, filing for bankruptcy, additional financial stress, legal ramifications (wage garnishment and potential court action), and having debt sold to a collection agency" (Center for Responsible Lending, 2013, p. 6)

RECOMMENDATIONS

Based upon the aforementioned research, a variety of recommendations may be made. The first recommendation is that states should continue to regulate APR limits in the payday industry and should continue to follow suit with other states that have set 36% APR limits. This is for the protection of the consumer because it gives them a larger likelihood of being able to pay back their loan on time. A second recommendation is for payday lenders. Per the suggestions of Kirsch et al., lenders should be required to “carry out financial underwriting that takes into account ability to repay and to meet routine household expenses” (pg. 8).

A third and final recommendation deals with the conflicting interests of consumers, state and Federal regulatory bodies, and the payday loan industry. The payday loan model profits off the inability of borrowers to pay. This warrants the protection of consumers, but also comes at a cost to the lending industry. For this reason, there are two very opposing sides that “fight back” against one another. May it be suggested that payday lenders and Federal regulators progressively work to meet in the middle, to protect both the interests of lenders and borrowers. Whether this is possible would require additional research, which is outside the scope of this paper.

CONCLUSION

Payday loans are short-term, low dollar loans that are offered to individuals at high interest rates resulting in high costs. Because of these characteristics and an extensive analysis of payday lending, individuals should research the pros and cons of payday loans before obtaining them. Individuals should understand the state regulations implemented in the state that they are obtaining the payday loan and should analyze all their options before proceeding into a payday loan agreement.

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