Payday Lending: What We Need to Know

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By Dr. Tom Lehman

There are 606 licensed payday loan locations in Indiana, according to the Indiana Department of Financial Institutions. There were only 30 a decade ago.

The general consensus appears to be that payday lending is a practice that offers few benefits and may do harm to unwitting borrowers, thus necessitating government intervention and regulation. Economics, however, argues against that consensus.

Payday lending is becoming a heavily regulated segment in the financial-services industry. Thirty-nine states, including Indiana, permit regulated payday loan operations, limiting fees that can be charged, setting maximum loan amounts per borrower, and setting limits on the number of times a customer may access multiple or repeated payday loans. Eleven states explicitly outlaw payday loan operations.

A “payday advance” or “deferred deposit” loan is a short-term two- to four-week loan backed by a postdated personal check that a borrower agrees to cover with sufficient funds out of his or her next paycheck. In Indiana, the finance charge is regulated to 15 percent of the first $250, 13 percent of the amount between $250 and $400, and 10 percent of any amount between $400 and $500, with a maximum payday loan limit of $500 and a minimum term of 14 days.

Payday-loan firms appear to compete most vigorously with pawnshops. Payday lenders also compete with the informal small-loan market that generally lies just beneath the level of pawnshops, usually consisting of unsecured loans from family, friends or “acquaintances.” However, this black market is not governed by contract law or enforceable property rights, making such markets potential grounds for abuse between borrowers and lenders.

Payday borrowers, then, may be quite rational in using this financial service given the alternatives they face.

Borrowers sometimes choose payday loans to avoid tapping into savings. Often borrowers are seeking only to solve an immediate emergency need, and banks typically do not make such small closed-end loans. Borrowers may prefer self-imposing financial discipline by obtaining a payday loan, forcing them to avoid revolving credit or the temptation to draw down a savings nest egg.

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One alternative for consumers facing a cash shortfall is to seek a small loan from family or friends. However, borrowers often prefer to obtain the cash advance from a payday lender rather than reveal their financial situation to friends or family, and some borrowers may have exhausted their access to such informal alternatives.

Some critics argue that consumers could opt to forego the intended purchase. In many cases, consumers need quick cash to pay for automobile repairs. Foregoing the auto repair may jeopardize their employment, and a payday loan could provide the only means available to prevent a domino of otherwise unavoidable and undesirable events.

The critics of the payday lending industry raise several objections to cash advance loans, and, on the basis of these objections, push for further industry regulation or banning. The most common objection to payday loans is that they carry a high annual rate of interest. The finance charge on payday loans relative to the small amount borrowed can easily compute to a triple-digit annual interest rate. Looked at from this perspective, the cost of a payday loan appears extreme.

However, this viewpoint is flawed for several reasons. First, a relatively high price for any good or service is not alone an argument that markets have failed or that harm has been done. High prices may be a symptom of monopoly in rare instances, but this certainly does not appear to be the case in the payday loan industry in light of the increased competition in this market in the last decade.

Because payday-lending establishments often deal with a high-risk clientele, the effective annual interest rates charged on these types of small loans are going to reflect increased risk. The entrepreneur in this high-risk industry must find a way to recover their investment and earn a positive rate of return. Because the risk may be higher, the risk premium on the loan would naturally be higher.

Finally, although lenders are required by law to disclose the APR at the time of the loan, it may not be a concern to the borrower. The real price signal to which the borrower responds is the flat fee (i.e., $15 or $20) that is charged to hold the postdated check.

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In sum, justification for further regulation or banning of payday lending cannot be supported on economic grounds. To the contrary, as economists understand, heavy regulation stifles market entry and thus restrains the competitive forces that serve to bring rates down naturally.

Legislated rate caps are a prescription for disaster. State regulations that hold finance charges on payday loans below the market-clearing level will lead inevitably to an excess of demand over supply, creating shortages in the small loan market and preventing marginal borrowers from obtaining credit in emergency circumstances.

Preventing or limiting the use of payday-loan services only encourages borrowers to seek out and utilize less attractive alternatives that put the borrower in an even weaker financial position.

Further regulation or outright banning of payday lending has the adverse and unintended consequence of reducing credit options for those who may have few alternatives to begin with. In an age where the democratization of credit has been widely celebrated due to new technology, it is unwise to single out and restrict relatively new forms of credit.

You do not help marginal borrowers by looking at their list of available options and then eliminating the one they actually choose, something that critics and state legislators should seriously ponder.

Tom Lehman, Ph.D., an associate professor of economics at Indiana Wesleyan University , is an adjunct scholar of the Indiana Policy Review Foundation. Contact him at tlehman@inpolicy.org.