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Introduction

The payday lending industry has grown substantially in recent years and increasingly exists in maturing consumer and regulatory environments. Thousands of consumers now use payday loans every day. While traditional financial products receive a great deal of professional, industry and academic inquiry, payday lending has been the interest of relatively few, but knowledgeable, scholars. These researchers include John P. Caskey of Swarthmore College, Gregory Elliehausen of Georgetown University, and Ronald A. Wirtz and Robert W. Snarr of the Federal Reserve Board.

With the rapid rise of payday lending and growing consumer demand, the need for a clear discussion about this form of lending is apparent. As economists, we have been drawn to this inquiry and have together assembled this overview of payday lending. This analysis summarizes what payday loans are, how they work, and who typically uses them; it also clarifies why payday loans are increasingly utilized by consumers in need of short-term credit. Our work also addresses the need for terms that are understood by consumers who are increasingly turning to this form of credit.

This document is intended to offer a clear, readable summary of payday lending. In the interest of improving understanding within as diverse a group as possible, this collaboration relies on plain language to explain concepts and practices.

We hope it will serve as common ground from which further discussions can spring. We look forward to participating in those deliberations.

William O. Brown, Jr., Ph.D.
David W. Findlay, Ph.D.
Thomas E. Lehman, Ph.D.
Michael T. Maloney, Ph.D.
James W. Meehan Jr., Ph.D.

This guide was made possible by the Consumer Credit Research Foundation.[1]

[1] Consumer Credit Research Foundation. See: www.consumercreditresearchfoundation.com.

How Payday Loans Work

Payday loans are small, short-term loans that help people manage their expenses. Payday loans are also known as:

- Payday advances
- Cash advances
- Deferred presentment services
- Postdated check loans
- Deferred deposit check loans[2]

In most situations, obtaining a payday loan works like this:

- The borrower and lender agree on the amount of the loan and the fee for the loan;
- The borrower presents identification (typically two forms, one with a photograph), the most recent bank statement, and the latest pay stub; all are typically required to obtain a loan;
- The lender verifies the borrower's information and makes a decision on the creditworthiness of the borrower;[3]
- If the risk is acceptable, and the loan is approved, the lender gives the borrower the cash;
- The borrower writes a personal check for the amount borrowed plus a finance charge and post-dates the check for his or her next payday;
- On or before payday, the borrower repays the lender in cash, or the lender deposits the borrower's check (or makes an authorized electronic withdrawal from the borrower's bank account); and
- The typical loan is for around $200 to $300 and usually costs $15 to $20 per $100 borrowed, although the fees can be much greater.[4]

It is also noteworthy that payday lenders do *not* have the capacity to garnish wages, collateralize or otherwise secure their business risk; in this regard, payday loans are unsecured, personal obligations. The industry also does not require an application fee or prepayment fees, which can occur in other forms of credit. These simplifications have been part of the reason behind the growth of payday loans. With this growth has come the industry's share of critics. We examine some of these issues in detail throughout the text.

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[2] Elliehausen and Lawrence, p.1; Thomas Lehman, In Defense of Payday Lending, The Free Market, The Mises Institute monthly, Vol. 23, No. 9, Sept. 2003, http://www.mises.org/freemarket_detail.asp?control=454&sortorder=articledate.

[3] Many payday lenders use database companies, such as TeleCheck Recovery Services, to check credit records for high-risk borrowers.

[4] "Banking on the Fringe" by Joe Mahon, http://minneapolisfed.org/pubs/fedgaz/04-07/banking.cfm.

History

Before organized consumer credit (roughly in the period 1800–1900), there were five major consumer lending sources: pawnbrokers, illegal small-loan lenders, retailers, friends and family, and mortgage lenders.[5]

Roughly 100 years ago, Americans had few places to obtain cash in emergencies. Pawnbrokers emerged as the "poor man's banker." Many people became longstanding, repeat borrowers and paid interest rates as high as 300 percent on small loans, usually of five dollars or less.

The early 1990's saw a boom in payday lending. Prof. Caskey has identified a number of factors that gave rise to the check cashing industry in the 1980s and 90s. Bank deregulation compelled many institutions to trim less-profitable products, including small, short-term loans. Retailers moved away from installment loans, opting for credit cards, which some payday borrowers could not or would not access.[7]

Oklahoma City, 1937 [6]

At the beginning of the 1990s, payday lending was primarily the domain of small, independent check-cashing outlets and pawnshops that offered services related to check cashing. These firms specialized in making high-priced loans to borrowers with limited access to credit.

The number of payday lenders has surged in recent years as the high level of consumer demand for short-term, small-denomination credit has brought more suppliers into the marketplace. New providers of payday loans include large regional or national multi-service providers of payday loans, large regional or national payday loan entities, and insured depository institutions.[8] The number of payday loan offices nationwide increased from approximately 300 in 1992 to nearly 10,000 by mid-2001 and continues to grow.[9]

The payday loan industry estimated that about 180 million payday loans were originated throughout the United States during 2002.[10] The Community Financial Services Association of America ("CFSA") represents a large number of America's payday lenders. CFSA members operated over half of the

[5] "The History of Credit and Debt" by Steve Rhode, http://myvesta.org/history/history_index.htm.
[6] Ibid; .http://myvesta.org/history/history_financeco.htm.
[7] Ibid.
[8] FDIC, Payday Lending, January 29, 2003, http://www.fdic.gov/bank/analytical/fyi/2003/012903fyi.html
[9] Federal Reserve Bank of Philadelphia, http://www.phil.frb.org/src/srcinsights/srcinsights/q1cc1.html.
[10] Ibid.

22,000 payday loan locations in the nation. In 2002 the gross volume of all payday loans was estimated to be $45 billion.[11]

Payday loans can cost borrowers more than other forms of short-term, closed-end loans — if such borrowers are able to secure other forms of credit at all. Nonetheless, payday loans are increasingly penetrating the market. These small, short-term loans typically incorporate high finance charges which are designed to reflect the risk of borrower default, the underlying cost of doing business and the necessity of earning a profit.

Some critics of payday lending have proposed limiting interest rates or eliminating these loans altogether. Neither price controls nor credit eradication will help those who need access to capital.[12] We accept that payday borrowers have legitimate needs for credit, and that payday loans are an improvement over pawn lending, loan sharks and wholly unregulated forms of credit that exist within the confines of what has been described as the "informal economy."[13]

As economists, our analysis of payday lending assumes it should not be driven into the informal economy, and that society is best served when:

- Borrowers can access readily available short-term credit;
- Borrowers are fully informed about the costs of securing a payday loan;
- The market is increasingly competitive and appropriately disciplined by competitive forces; and
- Uniform consumer protections, including disclosure and collections standards, exist.

Access to credit is best conducted in the open and competitive marketplace. Although likely always to be costly due to the risk profile of the borrowers it serves, the payday loan industry is increasingly competitive, and a competitive marketplace will no doubt reduce the cost of short-term credit and increase the available options for short-term credit.

[11] Ibid.

[12] The economic effects of price controls are notorious and can lead to credit rationing. The distortion of market forces that occurs with price ceilings in consumer-credit markets will deprive the most desperate of borrowers of the opportunity to borrow from legitimate, regulated borrowers and instead compel marginal borrowers to deal with lenders who are willing to lend illegally and who, more likely than not, will pursue just as illegal collection practices when the loans come due. Rationing and under-the-table payments are common results of regulatory price ceilings. Pricing to the most desirable customers is invariably increased so that the least desirable customers can be subsidized, if they are served at all.

[13] Other economists have measured the informal economy and estimate it to represent between 4.4% and 27% of GDP, with most estimates centering on 10%.; Elaine Edgcomb and Tamara Thetford, The Informal Economy, Making it in Rural America, February, 2004, p.12, http://www.fieldus.org/publications/IE_Rural.pdf.

COMMENT

"The payday lending industry fills a critical market niche in the consumer finance industry between the informal sector on the one hand and less flexible conventional retail loan products on the other."

Thomas Lehman, Ph.D.

Size

Payday loans are typically between $100 and $500. Nearly half of all payday loans are for amounts between $201 and $300, and about a quarter are between $101 and $200.[14]

Most states where payday lending is explicitly authorized impose limits of between $300 and $500 per loan, though some permit loans of up to $1,000.

Fees

Lenders apply a fee (or "finance charge") that varies with the amount of the payday loan. Typically this fee is between $15 and $20 for every $100 borrowed.[15]

In complying with the Truth in Lending Act, payday lenders must tell borrowers what the finance charge is, expressed as an annual percentage rate ("APR"). If, for example, the lender's finance charge is $15 per $100 borrowed for a two-week loan — and were it to be hypothetically extended (or rolled over) for 26 two-week increments — the resulting APR becomes 391% (15% x 26 increments = 391%).

Duration

Payday loans are very short-term credit instruments. They are typically taken out less than two weeks before a borrower's next payday. The duration of an individual loan may range, however, from one to four weeks. A Georgetown University analysis found that most borrowers use payday loans infrequently or moderately.[16]

Rollovers

The risk of entering into a cycle of renewals of a payday loan, due to its short term and high cost, represents one of the most controversial features of payday loans. There is debate between payday lenders and their critics over the extent to which customers should be allowed to engage in rollovers or loan renewals.

[14] Elliehausen and Lawrence, p.48.
[15] Ibid., p.49.
[16] Ibid., p.39.

Several terms are used to describe the process of paying off and quickly reentering into a new payday loan. "Consecutive loan," "extension," "refinance" and "same day transaction" are effectively equivalent to the term "rollover." While a variety of terms describe the transaction, two basic types of rollovers exist:

1. **A "consecutive" loan or "same day transaction"** occurs when a borrower returns to a payday lender by the loan's maturity date, pays the entire amount due, and secures a new loan within the same business day. The essential element of a "consecutive" loan transaction is that the entire amount due (principal and interest) is repaid prior to securing a new loan. The borrower pays the total amount due rather than just a finance charge. An example transaction follows (see Example A):

Example A: "Consecutive" or "Same Day Transaction"

Loan #1	
Cash advanced to borrower (loan amount)	$300
Finance Charge	45
Total Due and Payable in 14 days:	$345
Borrower returns on/before 14 days and pays	$345
Loan #1 is closed — Remaining Balance Due:	0
The borrower requests and obtains a new payday loan, typically after the lender screens for other rollovers and makes a new creditworthiness determination.	
Loan #2 is created	
Loan Amount	$300
Finance charge	45
Total due and payable in 14 days (next payday):	$345
Cumulative amount due and payable over the 28 days	**$690**

2. **Alternatively, the other form of rollover is referred to as a "refinance" or "extension."** This kind of rollover occurs when a borrower returns to a payday lender by the loan's maturity date and requests a deferral or extension of the existing loan, generally until the next payday. In this instance, a borrower pays only the finance charge of the maturing loan and enters into a new loan agreement with the lender.

   The essential component of this transaction is that the borrower pays only the finance charge of the previous loan — not the entire principal and finance charge. Payday lenders generally charge the same rate for a rollover as they do for a new loan, although some may discount the refinance transaction (see Example B).

Example B: "Refinance" or "Extension"

Loan #1

Cash advanced to borrower (loan amount)	$300
Finance Charge	45
Total Due and Payable in 14 days:	$345

Borrower writes a check for $345, dated 14 days into the future, which the lender agrees to hold for the agreed-upon time.

Borrower returns on/before 14 days and extends or "rolls over" the loan	$345
Borrower pays previous finance charge on Loan #1	45

Loan #2 (an entirely new loan is created)

Additional cash advanced to borrower:	None
Loan amount carried over:	$300
Borrower agrees to pay an additional finance charge in exchange for a two-week extension (Loan #2)	45
Total due and payable in 14 days	$345
Cumulative amount due and payable over 28 days	**$390**

A "refinance" or "extension" triggers two actions. One is the borrower's immediate payment of $45 for the prior two-week loan finance charge. The other is the lender's agreement to hold the original $345 check for an additional 14 days into the future. The lender deposits the $45 and retains the check until the borrower's next payday.

In either of these examples, the finance charge paid by the borrower over a 28-day (two-payday) interval for a $300 loan is the same: $90. The interest calculation is not compounded, but amounts to 30% over the two-payday interval. If one were hypothetically to repeat this process over the span of 26 paydays in a year, the effective APR for a $300 payday loan becomes 391%— or $1,173; however, such a scenario is not realistic because Federal Deposit Insurance Corporation ("FDIC"), state regulation, industry best practices and common sense prevent such a circumstance from occurring, although the effective APR is accurate nonetheless.

Historically, state and federal regulators have viewed the "consecutive" loan model more favorably than the "refinance" or "extension" model because it required a borrower to be debt-free, albeit for a short time period. However, the FDIC effectively eliminated the distinction between the two processes in 2003 with respect to payday loans made by federally insured, state-chartered banks. The FDIC determined that the term rollover encompassed both processes, regardless of the mechanics involved. As a result, FDIC-regulated banks that originate payday loans must limit the number of rollovers and adhere to cooling off periods between loans.

States that regulate payday loans are split between the two models. For example, California, Oklahoma and Virginia allow "consecutive transactions" but prohibit "refinance" or "extension" loans. Examples of states permitting "refinance" or "extension" (and the number of times they allow the practice) are Colorado (1), Louisiana (3 – requires a 25% paydown on each refinance) and Oregon (3). The chart on pages 22 & 23, entitled *States Permitting Payday Loans, and Important Measures of How They Are Regulated*, provides an overview of other states' practices.

In states that do not regulate the permissible number of rollovers, almost all payday lenders and loan originators restrict the number of times they will extend or renew a payday loan. Industry "best practice" guidelines call for a limit of four rollovers.[17]

On average, three quarters of payday-loan borrowers pay exactly on time. Of the remainder (those who do not make payments on time), most are reportedly late only once.[18]

Critics have expressed concern that payday-loan borrowers can bypass regulatory or industry "best practices" on rollover limits. They note that borrowers can obtain loans from multiple lenders. With the maturation of the payday lending industry, an increasing number of lenders now subscribe to electronic databases designed to screen for and minimize such behavior. Additionally, some states require such screening. Further, Florida and Oklahoma enforce limits on payday borrowing by means of databases they actually operate. Government databases designed to limit credit and to accrue ongoing personal financial information on citizens, while perhaps well-intentioned, raise compelling privacy concerns. We believe these effects warrant additional inquiry. We know of no other financial services that are so monitored by a governmental agency and, perhaps more interestingly, where a consumer's right to obtain services from a supplier is conditioned on his not having an existing relationship with one of the supplier's competitors.

It is not in the best interest of either consumers or payday lenders to permit an excessive number of payday loan rollovers. By their very acceptance in the marketplace, consumers have signaled comfort with the benefits of payday loans. Although payday loans are appropriate for short-term use, consumers with sufficient credit histories and financial wherewithal are likely to pursue other options for longer-term loans. In other cases, consumers may simply not have a choice for an alternative loan. Additionally, lenders too, are compelled by market discipline. Because their loans are unsecured, payday lenders are less likely than secured lenders to make loans they believe will not be repaid from the borrower's cash flow.

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[17] CFSA, http://www.cfsa.net/genfo/egeninf.html.

[18] Approximately 24% of borrowers made one or more payments late over the course of 12 months. Of those customers, more than half were late with payment only once. Overall, 75.9% of payday loan borrowers repaid the amounts they owed exactly on time. Elliehausen and Lawrence, p.40.

Collection

Payday lenders either collect the amount owed from the borrower in cash, or they deposit the borrower's check (or electronically debit the borrower's bank account). Depositing the check or debiting the account does not ensure that the lender is actually paid, as there may be insufficient funds in the borrower's account.

However, the fact that the lender is holding the personal check or has borrower approval to debit the bank account provides the borrower with an incentive to make timely repayment. If a check is presented against an account with insufficient funds, the account holder will inevitably incur bounced-check fees from the depository bank. Bounced-check bank fees average $30.[19] This amount excludes additional fees that may also be imposed by the recipient of such a check.[20]

COMMENT

"The prevailing fee of $15 per $100 borrowed and the most common duration of two weeks translates to an APR of about 390% — but these are short term loans. Even with four rollovers (the likely maximum in most situations) the fee is effectively limited to a fraction of that APR, as the loan is very unlikely to last more than eight weeks…."

William Brown, Ph.D.

[19] Shannon Buggs, "Loss of Float Means You Have to Swim," *Houston Chronicle*, Aug. 8, 2004.

[20] The member agencies of the Federal Financial Institutions Examination Council (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration) issued proposed interagency guidance on overdraft protection programs on June 7, 2004. Under the proposed guidance, fees assessed against a consumer bank account for overdraft protection generally do not constitute "finance charges" for Truth in Lending Act purposes, and must merely be disclosed as a deposit-account fee.

Borrower Profile

The demographic profile of payday loan borrowers has been an area of intense debate and focus, especially among some critics. There are some useful resources and research on this subject, but we believe it is an area ripe for additional inquiry and study.

About 5% of the U.S. population has had at least one payday loan at some time, and about 10% of surveyed Americans say they are somewhat or very likely to obtain a payday loan in the future.[21] Surveys also suggest that borrowers tend to be high-school educated or more, middle-income and often have young families.[22]

Employment and Income

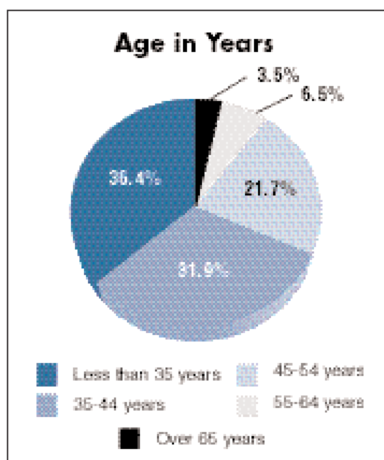
Proof of regular employment is required to obtain a payday loan, and lenders also oblige borrowers to provide a pay stub. Payday borrowers are predominantly middle-income. More than half of borrowers have family incomes of between $25,000 and $49,999.[23]

About a quarter of payday loan borrowers earn less than $25,000, whereas in the general population more than 30% fall into this category. Likewise, about a quarter of payday borrowers earn more than $50,000, whereas in the general population nearly 40% are in this category.[24]

Age and Marital Status

Payday-loan borrowers are predominantly young and married.

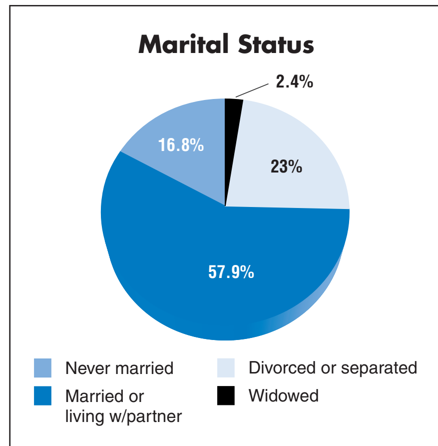
More than a third (36%) are under 35 years old, compared to the overall adult population of about 28% in that age group. Only a small percentage of borrowers (about 3%) are over 65 years of age, compared to the overall adult population of more than 19% in that category.[25]



The majority (about 58%) of payday-loan borrowers are married, which is similar to the overall population figure

[21] Stephens Inc., as reported by Stegman and Faris; 10% figure from CFSA.
[22] Remarks on "Customer Profile and Industry Marketing Practices," Conference of State Banking Supervisors Payday Lending Summit, Chicago, IL, June 6-9, 2004.
[23] Elliehausen and Lawrence, p.29.
[24] Ibid.
[25] Ibid., p.30.

of 61%. About 23% are divorced or separated, compared to the overall population figure of about 14%.[26]



Most payday-loan borrowers have children. About 35% are under the age of 45, married, and have children. A further 23% are unmarried, with children.

Education

The overwhelming majority (about 94%) of payday-loan borrowers have achieved a high school diploma or better. This exceeds the national average of 90%. More than half have been to college.[27]

Awareness of Costs

Payday-loan borrowers are very aware of the actual dollar cost of the credit they have received. According to one survey, fewer than 5% could not recall their most recent payday-loan fees, as expressed in dollars.[28] Borrowers are less able to recall the APR of their loan.

Payday-loan borrowers generally have previous experience with credit. Nearly all (about 92%) also use other types of credit, whether credit cards or closed-end loans.[29] Payday-loan borrowers also recognize the necessity of credit in general; more than 80% agree that "most people benefit from the use of credit."[30]

More specifically, more than 90% of borrowers agree with the statement, "Payday advance companies provide a useful service to consumers."[31]

Nearly half of payday-loan borrowers use more than one lender.[32]

Most borrowers spend less than 10% of their available income on repaying consumer debt, though nearly one in five borrowers spends 30% of his or her income on repaying total consumer debt, which is above average for all adults.

[26] Ibid., p.30.
[27] "Customer Profile and Industry Marketing Practices," CSBS Payday Lending Summit, June 6-9, 2004 (94% have a HS diploma or better; 56% have been to college) see also, Elliehausen and Lawrence, p.32.
[28] Elliehausen and Lawrence, p.49.
[29] Ibid., p.41.
[30] Ibid., p.34.
[31] Ibid., p.35.
[32] Ibid., p.40.

COMMENT:

"Although we'd like to see more demographic research, it appears payday loan customers are moderate and middle-income Americans, with characteristics in the main consistent with the general population."

Michael Maloney, Ph.D.

Why Consumers Choose Payday Loans

Research suggests that borrowers select payday loans over other alternatives for a number of reasons. This section examines what those alternatives are, and why payday loans are often selected.

Alternatives

Some individuals do not have the financial capacity to borrow at all, and instead draw on existing liquid assets such as savings.

Some borrowers may also have the option of various forms of credit offered by banks, finance companies and credit unions, including:

- Credit cards;
- Home equity lines of credit;
- Short-term unsecured loans;
- Secured short-term loans (e.g., in exchange for pawned items); and
- Overdraft or "bounce" protection.

Many payday borrowers, however, do not have access to a full range of alternatives. For example, they are less likely to own their own homes than the general population and accordingly, may be ineligible for home equity credit.[33] Moreover, many traditional banks do not offer local retail services in areas served by payday lenders. Heretofore, they appear to have been unlikely to offer competitive short-term access to credit products.

In contrast, payday-loan borrowers are *more* likely than the general public to use closed-end credit; this form of credit must be repaid in full (along with any interest and finance charges) by a specified future date. Automobile and real estate loans are examples of closed-end credit.[34] Payday loan borrowers are *less* likely than most to use open-ended, or revolving credit, such as credit cards.[35] Even where payday loan borrowers have credit cards, more than half report that they do not want to or cannot use them.[36]

Some choose not to apply for a new card or an increased limit because they have been rejected in the past. Nearly three-fourths of payday-loan borrowers have been unable to secure other forms of credit within the last five years.[37] This inability may be due to some borrowers' limited or poor credit histories. Additionally, another dynamic may be in play; as payday-lending providers have become increasingly common (with roughly 22,000 retail facilities across the United States), they are increasingly and readily accessible to potential borrowers.

[33] Elliehausen and Lawrence, p.42.
[34] Ibid., p.42.
[35] Ibid., p.44.
[36] Ibid., p.43.
[37] Ibid., p.45

Consumer Decision Making

While information as to why people want to take out a small loan prior to payday is somewhat limited, a few common themes are evident in the available research.[38] Despite annualized interest rates that are high, consumers sometimes choose payday loans to avoid tapping into savings. Often the borrowers are seeking only to solve an immediate need for about $200, and banks do not make such small closed-end loans.[39] Some research has speculated that such borrowers may prefer financial discipline imposed on them.[40] Others have postulated poor budgeting habits.[41] Alternatively, some may prefer to borrow to preserve a core of readily-liquefiable (cash-equivalent) assets. The explanations appear to span the breadth of reasons that are characteristic of an unfettered market.

Even consumers who can access alternative sources of credit have opted for the relative convenience and speed of a payday loan. A Georgetown University survey found more than half (59%) identified the most important reason for choosing a payday loan over another source was "quick, easy process, fast approval, less paper work." About 10% chose a payday loan because of a convenient location. Significantly, about 10% identified privacy as a critical and most important reason.[42]

Another alternative for consumers facing a cash shortfall is to seek an advance from family or friends. Payday lenders report that borrowers often prefer to pay for the advance from a payday lender rather than reveal their financial situation to friends or family. Additionally, some borrowers may have exhausted their access to such informal alternatives.[43]

For many, it is a choice of taking out a payday loan, going without, or confronting more expensive alternatives (as described below). These consumers, who do not have access to other forms of credit, nonetheless have other "alternatives." For example, they can merely write a bad check and incur bank and check recipients' returned-check fees (which could together amount to or exceed $50 per occurrence in 2004), while also seeing their credit rating eroded. Recently, many banks (including Wells Fargo and the Bank of America) have begun to offer a payday-loan-like product described as "Bounce Protection" or "Automated Overdraft Privilege."[44] This credit product effectively functions like a line of credit attached to a checking account, but the banks offering the service claim that it is not a credit product, and thus do not identify it as a finance charge, just an overdraft fee.[45] The overdraft fee is

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[38] John P. Caskey, *The Economics of Payday Lending*, April 2002, p. 13.
[39] Caskey, p.13.
[40] Elliehausen and Lawrence, p.16.
[41] Caskey, p.13.
[42] Elliehausen and Lawrence, p.51.
[43] Caskey, p.14.
[44] Ibid., p.27.
[45] Ibid., p.28.

much higher than what the banks would earn in finance charges on a line of credit, and they presumably market the product to borrowers whose credit histories make them ineligible for credit lines. A borrower might, for example, write a check for $100 drawn on insufficient funds that the bank honors, for a $20 overdraft fee. If the borrower has two weeks to return the account to a positive balance, one could argue that the effective cost of this credit, expressed as an APR, is 520%.[46]

Comparative Fees

Alternatively, consumers can opt to forego the product or service they need. However, even if a payday loan is relatively expensive, in the short term, it is often less expensive than:

- Bank charges for a bounced check, which averages $30;[47]
- Retailer fees for the same bounced check — typically an additional $25 — although the charge can be higher; and
- Interest or penalties for late payment of bills.

The foregone service can be a utility bill. The costs of reconnecting utility services can be significant. These examples illustrate the range of such fees:

- Phone (e.g., $12 to reconnect in Illinois);
- Cable (e.g., $5 penalty per month in Virginia);
- Natural gas (e.g., $78 to reconnect in Maryland);
- Electric (e.g., $37.80 during the day or $73.83 at night, in North Carolina); and
- Water/sanitary services (e.g., $25 in Texas).

In addition to the above illustrative reconnect fees, some states permit their regulated utilities to collect deposit fees from residential borrowers with histories of non-payment. For example, in Illinois, if a borrower makes more than four late payments in one year, gas or electric utilities may require deposits of as much as 1/6th of the estimated annual bill.[48] For water and sewer services in the same state, the deposit amount cannot exceed 1/3 of the estimated annual charges. If timely payments are made thereafter, borrowers accrue interest on these funds. Notwithstanding this benefit, a consumer with a checkered credit history could face an immediate demand for additional hundreds of dollars. Against these requirements, the decision to obtain a payday loan or cash advance comes into focus, and could easily be less costly than

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[46] Ibid., p.28.
[47] Shannon Buggs, "Loss of Float Means You Have to Swim," Houston Chronicle, Aug. 8, 2004.
[48] Illinoisprobono.org at Chicago-Kent College of Law, http://www.illinoisprobono.org/index.cfm?fuseaction=home.dsp_content&contentID=303.

all or a portion of the five example fees highlighted above — or a far more significant requirement to escrow future multiple utility payments.

COMMENT

"Consumers who are faced with a multitude of fixed cost fees that cannot be escaped may be making a prudent — and possibly less expensive — decision by opting to get a brief payday loan."

James Meehan, Ph.D.

The Payday Loan Industry

There is a long U.S. history of consumer demand for small, short-term loans. However, traditional lenders like banks and finance companies have often been constrained by usury laws that made providing small, short-term loans uneconomical.[49]

Furthermore, following deregulation of the banking industry in the 1980s and increased competition, many banks and finance companies that traditionally provided small short-term loans refocused their businesses to larger, more profitable loans.[50] For many of these lenders, smaller, short-term loans are:

- Costly to provide (smaller loans are more labor intensive and lenders still must cover their loan losses[51]);
- Incompatible with the risk appetite common to many larger banks; and
- Unable to satisfy investors.

Traditional banks appear to have moved away from subprime lending as a whole, while payday lending has grown significantly. The business of payday lending is labor-intensive, because lenders interact with borrowers every two weeks. Many lenders, for example, reportedly call borrowers prior to the maturity of their loans to remind them that the loans are due and, if thought to be appropriate, to urge them to take actions to prevent default.[52] Clearly, subprime-lending specialists are cultivating this economic niche. The market for subprime credit and debit cards has grown significantly in recent years, perhaps in part due to better information and technology available to lenders to assess risk.

The departure of traditional credit providers appears to have contributed to the rise of payday lending. Perhaps as a result, this relatively new industry is experiencing widespread growth.

Initially, payday lenders were largely comprised of many sole proprietors operating in local markets. However, beginning in the 1990s, consolidations took place, and branded entities arose. Many of these entities are capable of operating within several states where payday lending is authorized.

The number of retail outlets where consumers can obtain payday loans grew from virtually none in 1990 to more than 10,000 by the end of the decade.[53] Estimates suggest that there are currently about 22,000 payday lending outlets in the United States.

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[49] Elliehausen and Lawrence, p.1.
[50] Ibid., p.1-3.
[51] Caskey, p.7.
[52] Ibid., p.7.
[53] UNC: Stegman and Faris, 2003.

With the advent of economies of scale and heightened regulatory interest, larger payday lenders were compelled to introduce high standards to satisfy:

- Service quality;
- Borrower convenience;
- Choice of loans;
- Consistent risk management; and
- Regulatory authorities.

The Cost/Risk of Providing Payday Loans

For the payday lending industry, and as previously discussed, smaller loans cost more to originate than larger ones on a cost-per-dollar basis. This is because lenders, regardless of their structure, incur fixed costs in originating a loan, whatever its size. In the case of payday lending, these costs include:

- Defaults on extensions of unsecured credit to borrowers of moderate means;
- Operating costs, such as salaries, facilities, processing applications, and collection of payments;
- Taxes; and
- Return on investment capital.

Available data on defaults suggest that unpaid obligations to payday lenders amount to about 10 to 20 percent of the finance charges they levy over the course of a year.[54]

The operating costs, which represent the largest part by far, are fixed and are not affected by the loan amount. While the fixed costs of facilitating a $200 loan are not substantially different from those likely to be incurred to facilitate and place a $20,000 home equity loan or $5,000 cash advance on a credit card, actual labor costs associated with servicing payday loans are higher.

Within the parameters of the marketing proposition — i.e., a quick, convenient loan, as an alternative to credit card borrowing — payday lenders can be expected to do as much as they can to ensure that the risk of default is low. For example, payday lenders require borrowers to produce proof of a checking account, identification and a pay-stub; some lenders screen for histories of bounced checks.

For payday loans — as for other unsecured, subprime loans — the costs relating to collection of payments is significant. Our reading of Prof. Caskey's analysis suggests that payday lenders are exceptionally close to their borrowers. Payday loans are generally originated and serviced by local loan offices.[55] For example, in an effort to prevent defaults, many payday lenders

[54] Caskey, p.16.
[55] Ibid., p.7.

appear to initiate personal contact with borrowers *before* a loan is due.[56] We know of no comparable sustained behavior by alternative credit providers.

COMMENT

"Payday loans often provide access to a source of emergency funds for low and moderate-income households that may face limited alternatives in a financial pinch. Thus, critics and social activists who successfully restrain the growth of this industry may do indirect harm to families they would otherwise prefer to help."

Thomas Lehman, Ph.D.

Store Locations

Payday lenders have tended to locate their facilities in areas close to the borrowers whom they serve. The demographics of these areas appear to correlate with borrower profiles described earlier — largely young, moderate- to middle-income families with children.[57]

[56] Ibid., p.7.
[57] "Customer Profile and Industry Marketing Practices," Conference of State Bank Supervisors Payday Lending Summit, June 6-9, 2004.

Best Practices

The increased number and consolidation of lenders has given rise to the development of "best practices." Since its inception in 1999, CFSA has represented a majority of payday advance lenders in the country.[58]

CFSA recognized that, for the industry to survive, it had to ensure that its members adhere to responsible business practices and to regulatory groundrules. From these concerns arose the industry-initiated set of "best practices." These practices obligate CSFA members to:

- Clearly disclose costs (expressed in dollars and as an APR) and relevant terms;
- Comply fully with applicable state and federal laws;
- Ensure clear and truthful advertising;
- Limit the number of times a loan can be rolled over (to a maximum of four, or the state limit, whichever is lower);
- Allow the borrower to cancel a loan within a cooling-off period;
- Comply with the Fair Debt Collection Practices Act;
- Eschew threats of criminal prosecution to collect on a returned check;
- Support state legislation incorporating these standards; and
- Ensure when payday loans are provided in partnership with a bank, that the bank, too, holds to these standards.[59]

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[58] CFSA, http://www.cfsa.net.
[59] Ibid.

The Regulatory Environment

The payday loan industry is regulated by a combination of state and federal laws and regulations and competitive market forces. As the payday loan industry has matured over the past decade and consumers continue to demonstrate a desire for payday loans, the state and federal regulatory environment has worked to evolve along with the industry.

State Laws

Thirty-nine states and the District of Columbia explicitly allow payday lending. However, via the internet and telephone, payday lending is a de facto reality in virtually all states.[60] Typically, these states excuse payday lenders from interest-rate limits otherwise applicable to consumer loans in exchange for maximum fees and rollover limits. States also apply licensing regimes and conduct regular examinations. Twenty two states do not permit immediate rollovers. Five states limit rollovers to three times.[61] Some states condition rollovers on the availability of debt counseling.[62] Only Georgia and Maryland explicitly prohibit payday lending in every form (however, we understand that Georgia's prohibition is in litigation).

The vast majority of states that permit payday loans have established limits on the loan amount. Many of these limits are set at about $500.[63]

Three states limit the size of a payday loan to a proportion of the borrower's salary. Ten states have no statutory loan cap and look to the involved parties to determine loan amount. State laws usually prohibit lenders from threatening borrowers with criminal or civil action if the borrowers default. In states where payday lending is authorized, regulatory regimes exist to ensure that lenders are complying with state and federal laws, and that they are not financially vulnerable.

Of interest to many states and state regulators that impose usury ceilings are payday loan stores that operate as an agent of a bank whose home office is in a permissive state. In this case, a marketer/servicer acts as an agent of a bank, with the marketer/servicer handling the paperwork, while the bank provides the funds for the loan and generally retains all or a significant portion of the risk of non-repayment. Under preemptive federal law discussed below, banks are able to operate across state lines.[64]

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60 FiSCA, Consumer Financial Freedom of Choice in Payday Advance Transactions, June 1, 2004.
61 Elliehausen and Lawrence, p.5-7.
62 FiSCA.
63 Ibid., p.5-7.
64 Caskey, p.26.

States Permitting Payday Loans, and Important Measures of How They Are Regulated

States Permitting Payday Lending	Permitted Fees	Permitted Period	Maximum Amount	Rollover Limit
Alabama	17.50%	10 - 31 days	$500	One
Alaska	Parties determine	Parties determine	$500	N/A
Arizona	15% of check	Min. of 5 days	$500	Three
Arkansas	10% of check, + $10 charge + $5 on 1st transaction	6 - 31 days	$400	Prohibited
California	15% of check	Max. of 31 days	$300	Prohibited
Colorado	20% of 1st $00 + 7.5% of amount > $300	Max. of 40 days	$500	One
Delaware	Parties determine	Max. of 60 days	$500	Four
District of Columbia	Scale of Fees*	Max. of 31 days	$1,000	No limit
Florida	10% of advance + $5 verification fee	7 - 31 days	$500	Prohibited
Hawaii	15% of check	Max. of 32 days	$600	Prohibited
Idaho	Parties determine	Parties determine	$1,000	Three
Illinois	N/A	Max. of 30 days	$400 P&I can't exceed 50% of borrower income for period	Two, so long as outstanding balance is reduced by 20%
Indiana	15% on first $100, 10% above $100; fee can't exceed $35.	Min. of 14 days	$400	One; subsequent rollovers (up to 3) require 25% reduction in principal amount
Iowa	15% of check on 1st $100; 10% in subsequent $100 increments	Max. of 31 days	$500	Prohibited
Kansas	Scale of Fees*	Max. of 30 days	$860, adjusted yearly	Prohibited
Kentucky	$15 per $100 on face amount of check	14 - 16 days	$500	Prohibited
Louisiana	16.75% of check	Max. of 30 days	$350	Prohibited, but can accept part. Pmt. Of 25% + fees, and enter new agreement
Michigan	N/A	N/A	N/A	N/A
Minnesota	Scale of Fees*	Max. of 30 days	$350	Prohibited
Mississippi	18% of check	Max. of 30 days	$400	Prohibited
Missouri	No limit, but total fees (incl. rollovers) can't exceed 75% of initial loan	14 - 31 days	$500	Six; borrower must reduce principal by at least 5% each time

States Permitting Payday Loans, and Important Measures of How They Are Regulated (Continued)

States Permitting Payday Lending	Permitted Fees	Permitted Period	Maximum Amount	Rollover Limit
Montana	Can't exceed 25% of amount advanced	Max. of 31 days	$300	Prohibited
Nebraska	$15 per $100 on face amount of check	Max. of 31 days	$500	Prohibited
Nevada	Parties determine	Parties determine	1/3 of borrower's monthly net income	Limited to 10 weeks after initial loan
New Hampshire	Parties determine, however, after initial loan, rate can't exceed 6% per yr.	7 - 30 days	$500	Prohibited
New Mexico	Parties determine	Parties determine	$2,500	N/A
North Dakota	20% of amount borrowed	Max. of 45 days (incl. rollover)	$500	One
Ohio	$5 per $50 + 5% per month	Not to exceed 6 months	$500	Prohibited
Oklahoma	15% of 1st $300 + 10% of higher amounts	13 - 45 days	$500	Prohibited
Oregon	Parties determine	Max. of 60 days	$50,000	Three
Rhode Island	10% of check, or $5, whichever is greater	Fix 14 day term	$300	Prohibited
South Carolina	15% of check	Max. of 31 days	$300	Prohibited
South Dakota	Parties determine	Parties determine	N/A	NA
Tennessee	15% of check, or $30, whichever is lesser	Max. of 31 days	$500	Prohibited
Texas	Scale of Fees*	Min. of 7 days	N/A	Limited
Utah	Parties determine	Parties determine	N/A	Limited to 12 weeks after initial loan
Virginia	15% of amount advanced	Min. of 7 days	$500	Prohibited
Washington	15% of principal on 1st $500; 10% thereafter	Max. of 45 days	$700	Prohibited
Wisconsin	Parties determine	Parties determine	$25,000	NA
Wyoming	$30 or 20% per month on the principal balance	One calendar month	No statutory cap	Prohibited

*Source: www.fisca.org – January, 2004

Although deferred deposit services (payday loans) are not permitted under state law in eleven states (CT, GA, ME, MD, MA, NJ, NY, NC, PA, VT and WV), some payday-loan marketer/servicers have established agreements with banks located in other states where the loans are permissible. Under such arrangements, the banks are making the loans consistent with the usury laws of their home states.

COMMENT

"There is little doubt that excessive rollovers of payday loans present risks to borrowers and lenders alike. State regulations and industry adherence to 'best practices' standards are both designed to prudently limit the number of permissible rollovers, and to support at least partial payoffs of prior loans."

William Brown, Ph.D.

Federal Laws

Payday loans are subject to a number of federal laws, including:

Truth in Lending Act — This law requires lenders to disclose the APR and finance charge. The Federal Trade Commission oversees compliance with this legislation by non-bank payday lenders, and the FDIC generally enforces compliance for its insured banks.

Fair Debt Collection Practices Act — While this legislation applies only to third-party collection, the industry best practices set out by the CFSA suggest that members adhere to the Fair Debt Collection Practices Act.

The Federal Deposit Insurance Act — Under Section 27 of the Federal Deposit Insurance Act, insured state-chartered banks (which are presently the only banks making payday loans) are entitled to charge nationwide the interest rates that apply in their home states. This law (and its analog with respect to national banks, Section 85 of the National Bank Act) has led a number of financial institutions to establish credit card banks in states without interest rate limits. Some payday lenders have agreements with Delaware- and South Dakota-based banks, by which the bank provides the loan by "exporting" the interest-rate laws of its home state. The CFSA's "best practices" place restrictions on such relationships.

Gramm-Leach-Bliley Act — The Act's privacy requirements apply to payday lenders and are enforced by the Federal Trade Commission with respect to non-bank lenders.

Other Federal Regulations

In 2003, the FDIC published guidelines for its member banks to follow if they make payday loans. These guidelines include regulatory reporting, risk management and capital requirements.[65] The FDIC issued these guidelines because of what they called the "high risk" nature of the loans and the "substantial growth of this product." The FDIC guidelines are further evidence that this product and the payday loan industry are maturing, and we believe that all the parties involved in payday lending will benefit from the increasingly candid recognition of this product and the people who use it.

COMMENT

"Payday loans meet the needs of a large and increasing number of Americans who apparently aren't accommodated by large commercial banks and credit unions."

David Findlay, Ph.D.

"These short-term credit vehicles must fully comply with appropriate state and federal lending requirements. While the annual percentage rates are derided by critics, 90% of the consumers who avail themselves of these services use payday loans as the very short term bridging mechanisms they are professed to be. They quickly pay off their loan. For these consumers, faced with potentially more costly options like bounced check fees and/or multiple utility shut-offs, a solid case can be made for a brief payday loan.

Perhaps it is for this reason that this relatively new lending service has seen such ascendancy. It's clear more Americans are using payday loans."

Michael Maloney, Ph.D.

[65] FDIC, "Guidelines for Payday Lending," http://www.fdic.gov/regulations/safety/payday.

Conclusions

Payday lending has experienced extraordinary growth since the 1990s, and it appears to be continuing in this decade.

While critics of payday loans are troubled by the high annualized interest rates associated with payday loans, consumers apparently do not share that concern. Consumers appear to make rational choices when it comes to the cost of credit and are well informed as to the dollar cost of their various options. The phenomenal growth of payday loans suggests that in aggregate, the need for, and acceptance of, short-term credit products like payday loans has been made abundantly clear.

Given this need, policy makers, financial service providers, consumers and entrepreneurs all have important roles to play. As economists, we believe it is essential that:

- Borrowers are fully informed about the costs of obtaining a payday loan;
- The market is best disciplined by vigorous competitive forces;
- The proper regulatory role includes the disclosure of fees, terms and conditions; it does not include rationing or other efforts that have the effect of limiting access to payday loans;
- The market is left open to respond to demands for small, short-term credit; and
- Barriers to entry into payday lending should remain low to entice new entrants to compete for borrowers and to lower borrowing costs for consumers.

Lenders can and will profitably compete in this market and competitively drive interest rates down to the ultimate benefit of payday borrowers and all of those who benefit from access to credit. Efforts to ration or eliminate payday loans could hurt those who need them most, and may have the harmful effect of driving this service into the informal or underground economies where few of the essential conditions necessary for rational economic choice are likely to exist.

Further Reading

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