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Payday loans:

Quick, costly, controversial but restrictions may have unintended consequences

Whether it's unexpected car maintenance, a trip to the emergency room or an overdue utility bill, consumers may need a temporary loan that's fast and convenient.

Though payday loans meet those criteria, they are one of the most contentious forms of credit because of their fees and high propensity for repeat use.

Payday loans are usually small-dollar-amount, short-term unsecured loans that are made to high-risk borrowers. Unlike with commercial banks and other sources of short-term credit, payday lenders require the borrower to post-date a personal check for the entire amount of the loan plus the fees. The typical loan is about \$100, and the typical term is about two weeks.

As the economy continues to recover from the most recent financial crisis, many policymakers are considering strengthening payday lending restrictions with the intent of protecting consumers. Already, many states heavily regulate payday lending. As of May 2011, 16 states effectively ban it, either outright

or by restricting payday lenders so heavily they aren't profitable.

Critics of payday loans say payday lenders take advantage of borrowers by charging exorbitant fees and targeting at-risk populations. They also say payday lending causes borrowers to fall into debt spirals, which creates an unmanageable cycle of debt. However, restricting payday loans could lead to some inadvertent outcomes, says Kelly Edmiston, a senior economist at the Federal Reserve Bank of Kansas City, who recently researched the effects of payday loan restrictions. His research shows consumers without access to legal payday loans, for the most part, don't use traditional credit as an alternative.

"This suggests these consumers don't have access to short-term credit of any type or may end up turning to other options that are more costly than payday loans," he says, citing over-the-limit credit card purchases, bounced checks, pawn brokers and loan sharks as examples.

Edmiston's research does not establish whether restrictions on payday lending are

good or bad, but rather suggests that the potential harmful effects be considered when regulating the industry.

“Restrictions on payday lending may have some unintended consequences for consumers, especially those with low incomes,” Edmiston says, “including lack of access to credit or diminished credit standing. Policymakers should carefully weigh the costs of payday lending restrictions against its benefits.”

Payday loan use

“Access to payday loans improves people’s lives,” says Darrin Andersen, president and CEO of QC Holdings, which is the parent company of Quik Cash, AutoStart USA and other payday lenders. The Overland Park, Kan.-based company has loaned billions of dollars to millions of customers at more than 500 locations in 23 states. QC Holdings makes roughly 6 percent profit from each payday loan transaction.

Because consumers without access to payday loans typically don’t turn to more traditional credit, consumers are actually losing access to a form of credit without the option of a payday loan, Andersen says.

However, critics often point to the downsides of payday loans, including:

Cost: The typical charge for a \$100, two-week loan is about \$15, which equates to an annual percentage rate (APR) of about 390 percent, or 25 times greater than the interest of a typical credit card. Payday lenders generally say they charge these fees because of the nature of their business—they operate in multiple locations with extended hours for customer convenience and are loaning to high-risk borrowers with a higher probability of default.

Debt spiral: Research shows the bulk of lenders’ profits come from repeat borrowers, many of whom use new loans to pay off old ones and ultimately pay many times the original loan amount in interest. Consumer advocate organizations, such as the Center for Responsible Lending, say payday loans take advantage of uninformed borrowers who may not understand the terms and conditions of the

loan and find themselves borrowing repeatedly.

Predatory nature: Payday lenders are often accused of targeting low-income and minority borrowers, though Edmiston says it is unclear whether this demographic is targeted by payday loan companies or if the companies are offering their service where demand is the highest.

“Consumers may be borrowing money from a payday lender because they don’t have access to other loans, they don’t understand the payday loan terms or it simply makes sense for them to take a high-cost loan,” Edmiston says.

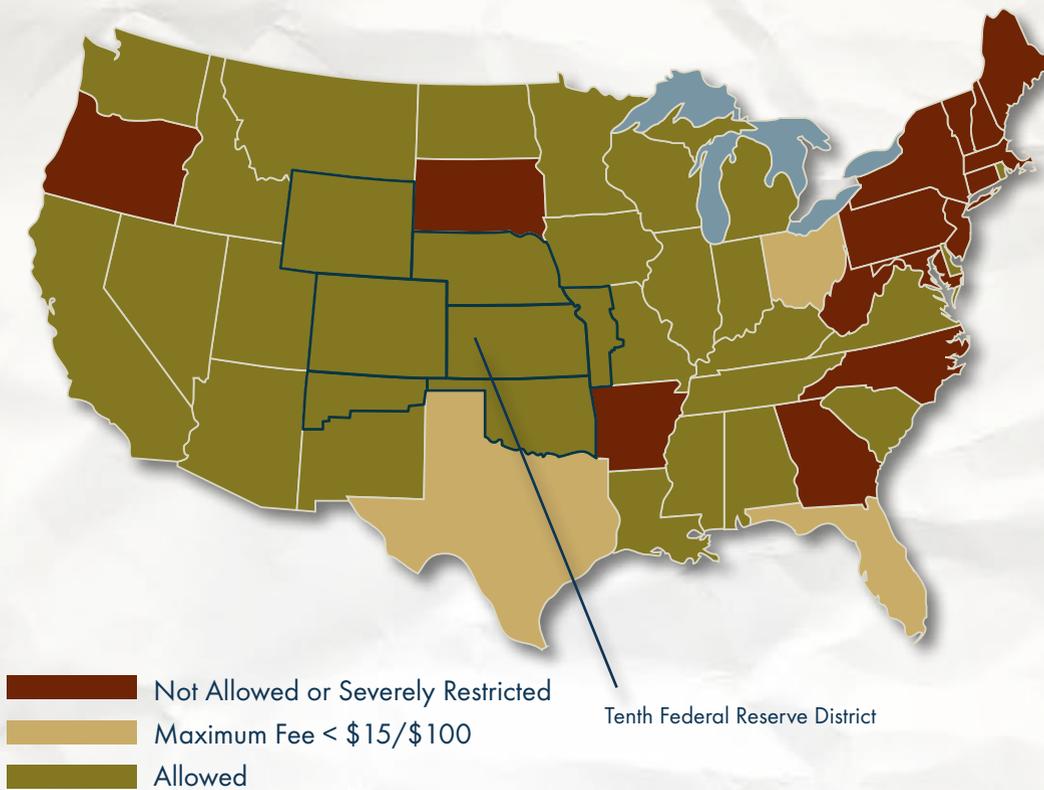
However, Josh Frank, a senior researcher at the Center for Responsible Lending, which provides research and policy advice on consumer lending, says, “There are plenty of alternatives.” He adds that payday loans may be a short-term solution for borrowers, but don’t solve the larger issue: consumers’ lack of personal savings.

“A loan is the last thing you need Ultimately hard choices need to be made,” Frank says, such as liquidating assets at a pawn

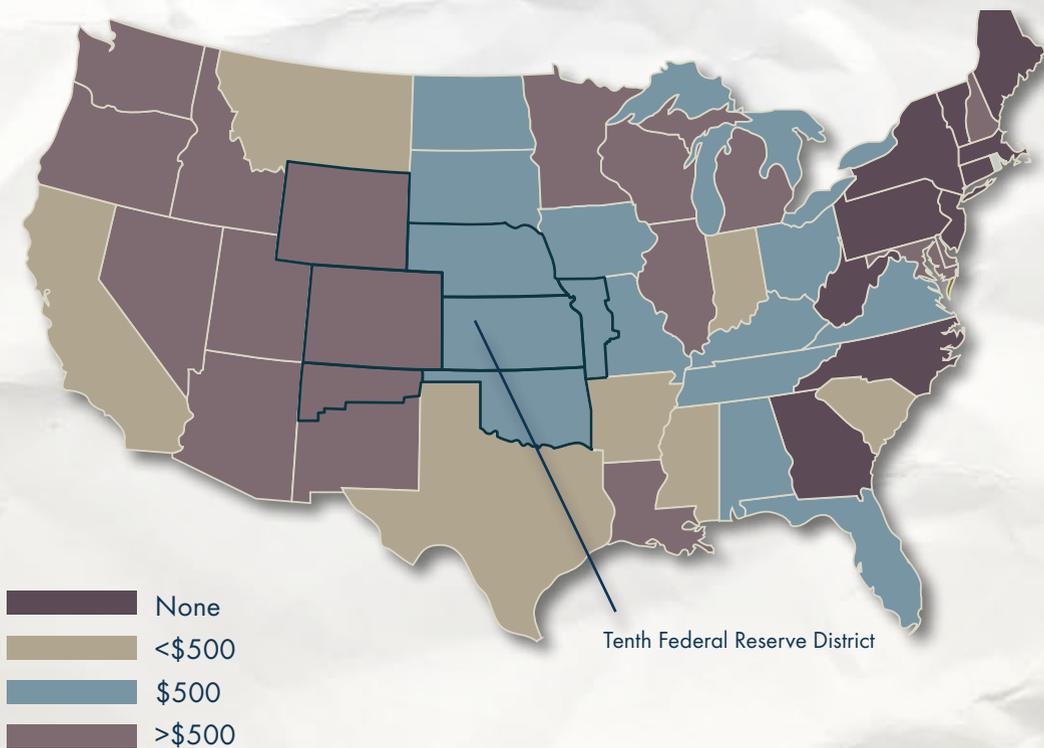


THE KANSAS CITY FED recently hosted a seminar and panel discussion on payday lending with moderator Tammy Edwards, assistant vice president of Community Development; Darrin Andersen, president and CEO of QC Holdings; Kelly Edmiston, a senior economist at the Kansas City Fed; and Josh Frank, a senior researcher at the Center for Responsible Lending. Watch a video of the seminar and view the presentation slides at KansasCityFed.org/community.

Effective Bans on Payday Lending



Maximum Loan Amount



shop, for example, to quickly make ends meet.

A report by the Center for Responsible Lending suggests other alternatives to payday loans: payment plans with creditors, advances from employers, credit counseling, emergency assistance programs, credit union loans, cash advances on credit cards and small consumer loans. These options arguably offer better terms than payday loans for most financially strapped consumers, but their access is limited, Edmiston says.

Restrictions, possible consequences

Concerns over high costs, unmanageable debt spirals and the targeting of financially vulnerable populations have led some states to regulate payday lending.

Of the states that have not effectively banned payday lending, many mandate a cap on the fees for payday loans and many others restrict the loan by varying amounts.

Other common restrictions include:

- limits on the number of times consumers can roll over a loan;
- limits on consumers' collateral requirements;
- an option for the borrower to reconsider the loan within a certain time period; and
- payment plans for troubled borrowers.

Many common payday lending regulations are intended to protect consumers from both lenders and themselves—but they are unlikely to severely reduce use of payday loans or increase use of other forms of credit, Edmiston says.

“The most obvious and important cost of restricting payday lending would be the potential loss of credit access for consumers who may not have other sources of credit,” Edmiston says. “Consumers may not have options, such as borrowing from family or friends, and may opt for other, more costly credit options, such as making over-the-limit credit card purchases or bouncing checks. These choices also can have consequences.”

Payday loan restrictions can affect:

Credit standing, including reduced credit scores and late bill payments. Edmiston's

research shows consumers without access to payday loans have, on average, more late-bill payments. Consumers with access to payday lending may be able to better maintain their credit standing by reducing the number of outstanding loans reported to credit bureaus. According to another study, after payday loans were banned in Georgia and North Carolina, households bounced more checks, complained more to the Federal Trade Commission about lenders and debt collectors and filed for Chapter 7 bankruptcy more often than households in states where payday lending was permitted.

Alternative credit choices, such as loan sharks, which are often associated with organized crime, become options because payday lending has been restricted and borrowers are seeking nontraditional credit.

Borrowers' convenience, which is a factor in their decision to seek a payday loan rather than some other, perhaps less costly, means of short-term financing, is reduced or eliminated.

Critics, such as the Center for Responsible Lending, contend payday loans too often are used to pay for regular monthly expenses when there are safety-net alternatives from the government or nonprofit organizations, such as federal food stamps or housing and utility bill assistance. Payday lenders, like Andersen of QC Holdings, say borrowers have many credit options and sometimes a payday loan makes the most sense.

“If it (a payday loan) was a bad choice for consumers,” Andersen says, “they wouldn't use it.”



BY BRYE STEEVES, EDITOR

FURTHER RESOURCES

“COULD RESTRICTIONS ON PAYDAY LENDING HURT CONSUMERS?”

By Kelly D. Edmiston
KansasCityFed.org/research