Payday Loans, Not the Real Problem

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Payday loans serve a need in the community as the alternative is a high interest overdraft fee.

Payday lending when used correctly is beneficial to a customer to save them money. Organizations claim that “Payday Lenders” are taking advantage of the poor. These groups introduce bills that stop this type of lending. The opposition groups claim they are working to help the community by removing “Payday Lenders.” The most influential attackers of the payday loan have employees who are working or have worked directly for a banking institution(s). The reasons are clear why associations are attempting to stop the industry. The removal of the payday lenders as a competitive service will increase the banks’ revenues because the number of overdraft and return check charges increase. The question of what a payday loan is and how it serves the community will be answered below. Payday loans will be compared to banking industry fees to show the real motive. Removing payday lenders does have a reverse impact on the community. This essay will show that payday loans, when regulated properly, do benefit a customer.

A payday loan offers a customer a short term loan. The loan is secured by a check or debit against a checking account until the customer’s payday. This type of loan against a person’s paycheck began long ago. According to Huckstep (2007), *“In the early twentieth century, “salary buyers” offered to purchase a consumers paycheck in advance at a discount.”* (p. 204)

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Over the past five years, payday lending has become very prevalent in our society. This business has followed the same type of pattern that any profitable commerce would follow. In the beginning, business start-up costs were relatively low, and the profit margins were high. As with any industry, however, once the profitability was recognized, the market became flooded and less lucrative.

Payday lending is a much-needed service for the community. The assistance is simple and does not require a great deal of paperwork. When a consumer needs a fast source of cash, this business provides the service needed. People will choose a payday loan service over a bank loan even though the payday loan may have downsides. One arguably negative aspect is the fee for the service itself. However, when examined more closely because the payday loan charge covers a very short period. Payday loans are affordable even though an equivalent interest rate from a bank would not be. This cost is easy to explain as defined by Fox (1999, 2000), *"A typical loan might call for a charge of $17.65 to borrow $100 for two weeks; such a loan can be calculated to carry a 459% annual percentage rate (APR).(p1)* Understandably most borrowers would not want to pay a 459% interest rate. However, in most states, the amount and terms of the payday loans are regulated. These rules require the full payback of the advance on the customers next payday. Therefore if a customer pays the loan back in full as they should, then the APR becomes irrelevant. The payday loan cost should be considered a fee for service rather than interest.

The payday store must charge a high rate because it only serves the immediate community. These establishments do not offer the full services of a normal banking institution.

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The Center for Responsible Lending (CRL) claims that the payday loan industry is swimming in profits. However based on a study by the author Huckstep (2006)*," Calls for regulating the* [payday] *industry are based partially on an assumption that payday lenders generate enormous profits from the high cost of borrowing. High profits for payday lenders, however, may be more myth than reality." (p.230)* Based on his study, Aaron Huckstep exposed that the actual business costs far exceed the stated profitability numbers given by the Center for Responsible Lending (CRL).

The bank and credit union business model is more expensive. The cost of processing the loan has a large relation to the charges for a loan. The direct cost would be processing the paperwork associated with a loan. A bank requires more official procedure than a payday lender does. These procedures are the reason most depository institutions do not offer the "payday loan" product. The revenue which such a loan would generate would not come close to covering the bank's cost to process and administer the loan.

The CLR has presented a "bank and credit union loan model" has been presented by the CRL to the Federal Deposit Insurance Corporation (FDIC) as an alternative. This alternative loan is being considered by some banks', but most analysts are unsure. According to Mann & Hawkins (2007) "*We remain skeptical, however, that banks could fill the place of payday lenders without substantially duplicating the product payday lenders offer."* (p.888) Small loans are being made by very few small banks and credit unions. The problem is, according to the CRL loan guidelines, loans must be insured by the FDIC. Financial institutions will not offer the product in any form without the loan being insured. This type of insurance guarantees the funds

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will be paid to the establishment if a customer does not pay. The payday product is a high risk loan, with a high non-payment rate. With an insurance company paying the loan off if the customer fails to pay, the financial banking institution suffers no losses. However, in the end the general consumer will bear the price by the trickle down of insurance costs. When a customer uses a payday lender the payday lender bears the loss if the customer fails to pay, not the FDIC.

The banking system collects fees from a customer in other ways. One of the most widely used is called a "direct deposit advance." It has been adopted by a few credit unions and one large nationwide bank. The qualifications for the advance service are more complex and determined by the customer's credit score. The consumer must have direct deposit of his or her paycheck. When the customer's payroll is deposited, the bank collects the full loan amount plus the fee. The fees range from 99% to 500%, or $8.25 to $19.23 per hundred per pay period.

Several credit unions began to offer this service, but changed the guidelines. These institutions began with the same premise as the bank advance, but changed the conditions quickly due to losses. Now the customer must have a savings account with a balance equal to the loan size. This new advance type undermines the requirements by putting security on the loan. The problem here as outlined by Stegman (2007) *"The money in the account belongs to the member, but a member who makes a withdrawal becomes ineligible for a Salary Advance Loan Product (SALO) advance for the following six months "*(p.184, 185) If a consumer had the money in savings to use, why would a consumer pay a fee to use it?

The overdraft charge is to a bank or credit union what a payday loan is to a lender. Overdraft charges are an alternative banking product. This is a fee for exceeding the funds available in the customer's checking account. This charge varies by company. Based on the

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figures in chart 1 below the average is $34 for any overdraft. For the example below, $100 is the amount of the overdraft. Looking at these figures as an APR the objective of a bank is clear.

CHART 1

Bank or Credit Union*	Check Amount	Overdraft or NSF	14 Day APR
Bank of America	$100	$39	**1017%**
Wells Fargo	$100	$35	**913%**
Nevada State Credit Union	$100	$28	**730%**

“Figures obtained from branches located in Nevada.

Chart 2 is an actual example of an unnamed customer’s bank statement. This accounting also shows the fees associated with different amounts based on APR’s. Careful examination of bank overdraft charges as APR’s shown in chart two. Chart two shows an understanding of why the banking industry does not offer an advance product. Based on Chart two’s numbers, the bank would lose revenue.

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Chart 2

Unnamed customer bank statement showing overdraft charges as a percentage of APR

	Activity	Amount	Balance	APR 14 day Loan	APR 31 day Loan	APR 365 day Loan
Starting balance			**$1.46**			
8/4/2008	Pilot, Denver, CO	$14.46	($13)	6311%	2850%	242%
8/4/2008	Pilot Dallas TX	$9.06	($22.06)	10072%	4549%	386%
8/4/2008	Burger King	$5.95	($28.01)	15336%	6926%	588%
8/4/2008	Wal-Mart	$5.92	($33.93)	15414%	6961%	591%
8/4/2008	Choctaw Travel Plaza	$3.30	($37.23)	27652%	12488%	1061%
8/4/2008	Pilot, Denver, CO	$1.94	($39.17)	47036%	21242%	1804%
	Total Overdraft	**$40.63**		**13475%**	**6086%**	**517%**
8/5/2008	Overdraft	$35	($74.17)			
8/5/2008	Overdraft	$35	($109.17)			
8/5/2008	Overdraft	$35	($144.17)			
8/5/2008	Overdraft	$35	($179.17)			
8/5/2008	Overdraft	$35	($214.17)			
8/5/2008	Overdraft	$35	($249.17)			
	Total Fees	**$210**				

The organizations that are involved in regulating payday lenders seem to be coming in on both sides of the table. The main supporting group for payday lenders is the Community Financial Services Association (CFSA). They have introduced a set of "*Industry Best Practices*" (Online 2008) stating how the industry should self-govern themselves in business. The lender must follow the 13 requirements as a member. These rules insure the customer is treated fairly openly and honestly. This set of practices has been established with the cooperation and support

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of all members. The current membership in this organization is stated at *over 22,000 locations.* (Center for Responsible Lending, 2008) The problem with any industry is not all lenders are members. Because of this many businesses do not follow ethical concepts. This is why the industry runs into problems. The effort of this organization and others like them to enact proper legislation is important. Rules that make all lenders follow ethical rules.

The organization most involved in stopping payday lenders is the (CRL). They are a not-for-profit group that has taken a firm stance against the industry. Referring to the President of the CRL, Martin Eakes, according to statements made in an article by Fitch & Woolsey (2008) the state, *"what he is up to is questionable."(Fitch & Woolsey, p.1).* The questions came after laws were enacted in North Carolina. Arguments from the North Carolina based CLR's recommendations, a sunset clause allowing payday lending was allowed to expire. The resulting effect banned payday loans. Following the statements in the CNN article, I located and read the article by the Federal Reserve Bank of New York. Fitch & Woolsey clarified the statement,

> *"Who, then, really benefits from payday loan bans? Credit unions, for one, notes Morgan. He says that interest rates on overdrafts charged by credit unions and banks can exceed 2,000%, dwarfing the high interest rates on payday loans. Credit unions, he adds, have been especially hurt by payday lenders cutting into their overdraft fees--bounced-check revenue at the typical credit union can amount to 60% of net operating income. (It's just 18% for banks.") (p.1)*

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The numbers in the statement above would explain the attack of the CLR on the payday loan industry. Removing payday lenders from the state would reestablish credit union and banks' revenues. Martin Eakes was the former president of a credit union. Based on the same article by Fitch & Woolsey (2008), *support and donations for the organization have increased two fold in states where* [payday] *lending has been outlawed."(p.1)* Questionability plays into this group's motive. The organization's methods and cause are open to question and should be fully investigated. The activities of the CLR makes one think of the adage, "watch out for wolves in sheep's clothing."

Contrary to some allegations the typical advance client is not a lower income consumer. Authors of the articles like "Payday Profiteers," written by Lydersen (2001), like to incite the community with statements such as *"payday loans target the working poor."* (p.1)Based on Lydersen's declaration would everyone be considered *"the working poor?"*(p.1) probably not. In fact, according to a report done by Lawrence & Elliehausen (2008)," [payday loan businesses have a] *relatively heavy concentration in customers predominately having <u>moderate</u> incomes."(p.8)* "Moderate income" is defined by Encarta (2008) as" *having an income close to the national average."*

Rather, the typical advance client is one who is considered "un-bankable." In other words, a payday loan benefits the customer because of their credit and bankability status. The payday loan does not benefit a bankable customer. The definition of "bankable" is, "*acceptable to the bank, ready and legally acceptable to the bank."*(Encarta, 2008) This creates a new term for the payday loan and overdraft customer as being "un-bankable." The payday loan is designed

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for this type of person. The customer type maintains a financially sound history. The extension of available credit would involve disproportionate time and effort. The simplest options for the un-bankable customer would be overdraft protection or a payday loan. The un-bankable customer is a consumer who maintains a financially sound payment history but lacks qualified assets to pledge to a bank as collateral.

In the event a consumer requires temporary cash the options are limited. The customer can choose to use overdraft protection or a payday loan. The easiest and most convenient for a customer to use is the payday product. The customer is given a contract and understands the terms defined in the agreement. Minimal time is spent during the approval process, and the customer walks out with the funds.

True the bank's product is also simple to use. The customer writes a check, and if the funds are not there to cover the check the consumer pays an overdraft fee. This charge is declared by the financial institutions rules. Depending on which situation a customer chooses, both are simple to use. However, bank customers who use overdraft protection are often unaware of the charges until they have written several checks on an account. Possibly due to an event beyond a customer's control, such as deposits not clearing in a timely manner. Before they know it they have incurred three or four charges of $35 each (a common rate).

In summery the payday product does benefit a customer who has a short term need. Comparing the cost of the advance against overdraft charges, the numbers show the payday loan is cheaper. The payday loan contract establishes agreed-upon terms by both parties up front with informed consent by the customer. Claims made by oppositional groups which have ties to the

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financial and banking industry should be called into question. The wrong legislative action hurts the consumer. Based on the figures presented the banking industry benefits when these organizations help pass laws. In states which have adopted laws outlawing or over-regulating payday loans there have been notable increases in the banking revenues. Alternative products are unrealistic in concept and practice and do not work. If a loan must be insured, and nonpayment occurs, consumers will inevitably end up paying for it. "Rather than continue to enact more regulation, one should ask, "When does legislation stop and personal responsibility commence?"

People need to take responsibility for their actions. If a consumer does not like the terms which the payday advance offers, choose another. Elect the overdraft buying a hamburger while the bank account has insufficient funds. Remember that the payday advance product fully informs a consumer about the fee for the service up front, with no hidden fees to surprise the consumer after the fact. The banks, on the other hand get a free pass to charge whatever they dictate without question or even acknowledge actual knowledge of the consumer. The payday advance, when properly regulated, does serve a need in the community. Our nation's consumers should not be deprived of the opportunity to select this service when it meets their needs.

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