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THE PUBLIC POLICY CHALLENGES OF PAYDAY LENDING

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ESSAY

The Public Policy Challenges of Payday Lending

Michael A. Stegman

For the same reasons that communities can neither grow nor renew themselves without access to capital markets, families without bank accounts or access to affordable credit are less likely than other Americans to have a cushion for emergencies, to save for a home, or to build retirement security. This is why matters of credit and consumer finance are an important area of public policy. This is also why policy makers should be concerned that, despite a booming national economy and the lowest unemployment rates in a generation, 10 percent of all families—including 25 percent of African-Americans and Hispanics and a quarter of all families with incomes under $20,000—are "unbanked."[1] But having a checking account is not the same as using credit wisely. Nationwide, and in North Carolina, many families who do have checking accounts frequently pay a high price when conventional banks are either unwilling or unable to meet their acute credit needs. For people who cannot or choose not to obtain credit from mainstream lenders, the growing network of "fringe banks"—check cashers, payday lenders, and pawnbrokers—can be both a blessing and a curse.

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Rebekah O'Connell

Consumer credit counselor at Triangle Family Services

"It'd be great if it was the middle class and it was just the plumber and all they need is $200 this one time to get them by. But that's just not the reality. These are people who are really not making it. . . . They're not fixing a blown tire or a pipe—they're paying the rent.

"[Payday lenders are] taking advantage of people in time of need. . . . We've got to get some controls on the interest rates. Three, four hundred percent? There ought to be a law."

Simply put, payday loans are high-interest, short-term loans, backed by postdated personal checks, that borrowers promise to repay out of their next paycheck.[2] In North Carolina, state law sets a ceiling of $300 on the amount that can be borrowed at any one time, limits fees to 15 percent of the amount borrowed (which works out to $45 on a $300 loan), and provides for a maximum term to maturity of thirty-one days.[3] In practice, according to state regulators, the vast majority of payday loans in North Carolina last only 8 to 14 days, which, given the 15 percent simple interest rate, translates to an average annual percentage rate (APR) of approximately 460 percent.[4]

North Carolina has become fertile ground for fringe bankers. Statewide some 200 licensed check-cashing companies operate more than 1,200 outlets. While not all check cashers in the state extend credit, at year-end 1999, some 136 companies with more than 1,000 offices did engage in payday lending, which translates to about 10 percent of all payday-lending outlets in the country.[5] In 1999, payday lenders in North Carolina originated more than 2.9 million transactions totaling more than $535 million, generating in excess of $80 million in fees.[6] And these numbers are only part of the story of how nonbank financial companies are filling a critical credit void, since they exclude the 300 or so licensed pawnbrokers in North Carolina that provide their own unique brand of consumer credit.[7]

Janet Bell

Borrower

"I have used a payday lender a couple of times. I think they are easier and quicker to deal with than going to a bank. Pawnshops seem to be shady places. The thought of it. . . . I don't want to give them anything of mine.

"My experience with payday lenders? I have only had good experiences, and the people are really nice. I do feel it could be a little less interest. . . . Will I use them in the future? Probably. . . . I can go to them if I get into a desperate type situation, so it's good to know they are there."

One way of putting this booming financial services industry in perspective is to note that there is one check-cashing outlet/payday lender in North Carolina for every two FDIC–insured banking offices.[8] Five counties—Cumberland, Edgecombe, Hoke, Vance, and Washington—have either the same number of banks as check cashers or more check cashers than banking offices. Fringe banks are also expanding more rapidly than conventional banks. The number of banking offices increased by less than 2 percent in 1999 (a net increase of 40). In contrast, the number of fringe banking outlets increased by 73 percent, or by 520 offices between late 1998 and January 2001. While much of this growth has been in the poorer regions of the state—163 percent growth in the Western economic development district and 125 percent in the Northeast—wealthier districts like the Research Triangle saw a 71 percent increase in the number of check cashers and payday lenders, including 82 percent growth in Wake County.

The Charlotte area also witnessed significant growth, with Mecklenburg County having 47 more fringe banking offices today than two years ago, bringing the grand total of fringe banks to 115 outlets in the heart of North Carolina's and the Southeast's banking capital. While there has been no systematic analysis of where fringe banks locate relative to mainstream banks within communities, our own research in Charlotte is instructive.[9] We found that check cashers and payday lenders are not scattered throughout the city, but are more likely to locate in high-minority and working-class neighborhoods. Relative to population, there are one-third as many banking offices and more than four times as many check-cashing offices in high-minority neighborhoods as in low-minority neighborhoods.[10] Because payday lenders target working families with bank accounts—you need a checking account in order to patronize a payday lender—they are most likely to locate in moderate-income neighborhoods rather than in the city's poorest communities. Eighty-five percent of all check cashers in Charlotte (compared with 55 percent of all households) are in working-class neighborhoods with median incomes of $20,000 to $40,000.[11]

The explosive growth of fringe banks in North Carolina appears to mirror national trends. Across the country an estimated 6,000 check-cashing centers cash more than 180 million checks a year with a face value of $55 billion.[12] Notwithstanding the fact that they are banned in nineteen states because of their high cost and potential for abuse,[13] the number of payday lenders has grown from just a few hundred outlets in the mid-1990s to approximately 10,000 today.[14] One investment banking firm "forecasts the market to expand to 25,000 stores by 2002, producing 180 million transactions, and $45 billion in loan volume that will generate $6.75 billion in fees annually."[15]

The most urgent policy and regulatory challenges posed by payday lending in North Carolina relate to the repeated use of such loans. Because of their high fees, after just a few renewals, "borrowers may find themselves owing many times the amount they originally borrowed."[16] The issue of repeat use is critical because the industry defends its high fee structure on the basis that payday loans are the only accessible source of occasional short-term credit for hard-pressed consumers. Because individual borrowers are not supposed to use payday loans on a continual basis, the industry argues that the APR is not a relevant measure of the cost of credit.[17] If many consumers use payday loans over longer periods, however, then the triple digit APRs charged by payday lenders may "go well beyond what is normal or fair, and, in some cases, particularly when the rollover usage pattern is taken into account, appear[] abusive."[18] That some families with fragile finances can become addicted to payday loans is con-

Steve Grow

North Carolina Association of Check Cashers

"The check-cashing business has identified a community need—people who have been disenfranchised by banks—and check cashers are filling it. The North Carolina statute that licensed and regulated us was something that we, the industry, fought to get passed, not something which we worked against. The law got a lot of riff-raff out of the industry.

"Outlets that offer payday lending are essentially offering short-term loans to people who cannot get the money in other ways. The payday cash advance service allows consumers to choose a short-term financial product for a short-term fee because of its time-limited nature. You could take a taxi from Raleigh to Cary—or you could take that same taxi from Raleigh to Seattle for exactly the same rate, but the total expense would be ridiculous. It would be much cheaper to fly. The same is true with cash advance. It would be silly for a cash advance customer to take a single cash advance for an entire year. We cannot always control consumer behavior."

Steve Grow is president of the North Carolina Association of Check Cashers and owner of three check-cashing outlets.

Otis Meacham

Office of the Commissioner of Banks

"It is safe to say that there is a genuine need [for payday lending]; otherwise we wouldn't have over 1,000 locations throughout the state.

"Say you have someone in your family who is ill and all of a sudden you have a $100 bill from the doctor and medicine that will cost another $100. What cost are you willing to pay to obtain that $200?

"You can't sit down and be by the side of every borrower. . . . What role do I have to say, 'No, you can't have that [payday loan] because you already have two of these outstanding, and we as a government agency will not let you go to the third.' Is that right? Is that the proper role of government? That's not for this agency or the Commisioner. That is a legislative item, not for us."

Otis Meacham is deputy commissioner of the North Carolina Office of the Commissioner of Banks.

firmed by the accompanying narratives (see pages 16–21) and by recent reports from regulatory agencies in Indiana and Illinois. Indiana found that 77 percent of payday loans are rollovers, with the average payday customer averaging more than ten loans per year.[19] The pattern of repeat usage is even greater in Illinois, where the typical customer averages more than one payday loan per month.[20]

While some might argue that the way to deal with such problems is for North Carolina to join the states that ban payday lending outright, I do not agree that this is necessarily the answer. The reality is that decent, hard-working families who end up with too much month left at the end of their money will go underground if necessary to get help. I was recently told by the owner of a check-cashing company in a state that prohibits payday lending that the neighborhood loan shark turns up in one of his busiest stores every Friday afternoon to extend credit and receive payments from customers who have just cashed their paychecks. "Everyone knows the rules of the game," says the proprietor. "The loan shark charges 20 percent for a two-week loan."

Because banning payday lending could force families underground in their desperate search for short-term credit, in its 1997 session, the North Carolina General Assembly decided to regulate rather than prohibit such activity. As indicated earlier, the North Carolina Check Cashers Act requires the licensing of check-cashing outlets and payday lenders, sets maximum fees and charges, and imposes disclosure requirements and other conditions for doing business in the state. To prevent the problems that have occurred in Illinois and Indiana—though we have documented that these provisions are not working as intended—the General Assembly has prohibited lenders from extending, renewing, or rolling over payday loans.[21]

The statute authorizing payday lending was "given an experimental period of existence—it expires on July 31, 2001, unless it is reauthorized or otherwise extended—in order to determine the practices of check cashing firms that offer this service and its effect upon the consuming public."[22] To help inform its collective judgment, the General Assembly has called upon the North Carolina Commissioner of Banks to prepare a report on payday lending, which should include "any evidence as to consumer complaints, unfair or deceptive trade practices, and the frequency of repeat use by individuals of postdated or delayed deposit checks."[23]

It is clear from our research that some hardworking people in North Carolina are becoming "hooked" on payday loans. Many are taking out repeated back-to-back loans from the same payday lender, which is against the law. Others are borrowing from one payday lender to pay off another, which is permitted under North Carolina law. Both practices result in additional loan fees, which can soon exceed the original principal and leave the borrower in a deeper hole than when he or she began.

While there are no simple answers to the consumer protection challenges posed by payday lending, this modest project suggests that policy makers, regulators, and mainstream banks carefully consider four issues. First, the Banking Commission should examine the books of payday lenders on a regular basis, paying special attention to the issue of back-to-back transactions, including those at multiple locations. With respect to repeat usage, the current focus of the Banking Commission is limited to the extent to which individual borrowers are repeat customers of the same lender. Currently, examiners make no effort to determine whether individual borrowers are borrowing from one payday lender to pay off another, or whether they have multiple payday loans outstanding at any point in time. Given the explosive growth of the industry and the additional time it would take examiners properly to document the extent to which borrowers are engaged in back-to-back borrowing from multiple payday lenders, the General Assembly must ensure that the Banking Commission has sufficient examiners to do its work.

Second, while frequent examinations by the Banking Commission and stiffer penalties for violators can reduce the incidence of illegal back-to-back loans, these will not prevent consumers from borrowing simultaneously from two or more payday lenders, which violates the spirit of the law. This is why the General Assembly and the Banking Commission should look into how existing credit-reporting technology might be adapted for regulatory purposes. Many payday lenders already incorporate this tracking technology into their risk management systems, and the Banking Commission could require all licensed companies to report all payday loans to a specified reporting agency. Then, either by law or regulation, the state could decide how many outstanding payday loans an individual should be permitted to hold at any one time, as well as the minimum time that must elapse before an individual is eligible to take out another payday loan, from the same or a different lender.

Third, the General Assembly should make a bigger commitment to financial education. If nothing else, the collection of stories accompanying this article underscores the importance of having ready access to short-term credit and the consequences of not using that credit wisely. Too often, credit counseling begins when people are already in crisis. Through our educational system and community institutions, we all need to do a better job of helping families learn how to manage their finances, use credit more responsibly, and regardless of their race or income, obtain equal access to all available credit options. Because family money management is critical to many

BERNICE STEWART YON

Borrower

"Which payday lender did I use? I used five. I went because I was on disability and my check only comes at the end of the month. I told them I couldn't pay every two weeks. . . . I had to go to the other ones, and this is how I got hooked. I got arrangements with all of them. I owe about $1,000.

"It is a nightmare. I warn people if you don't have to mess with them, please don't. You can get hooked on them. . . . so I warn, if you don't have to, please don't."

Nick Burks

Borrower

"I was unemployed and needed quick money to pay a bill. I had heard of Advance America, where I could write a postdated check. . . . and go buy it back in two weeks for a small fee. Or what was a small fee back then. I thought, you know, free money.

"Right now I'm kind of stuck with them. I've got a check for $300 outstanding and I've been unable to roll it over or buy it back.

"I think it is definitely a good service for people, but not for their target audience, people who are short on money. Their rates can be so high that it is pretty much impossible not to get in a cycle there."

of the General Assembly's social and economic initiatives—Work First and family self-sufficiency, savings and asset building through individual development accounts, and helping more North Carolina residents buy their first home—the state should make financial education a greater priority.

Finally, this project suggests that North Carolina's banking community should examine the implications of payday lending. The prolific growth and profitability of such lending reflect the fact that mainstream financial institutions have failed to meet the demand for short-term credit by working people who already have banking relationships. Moral obligations aside, banks, thrifts, and credit unions have a real market opportunity to "reach out to these consumers and provide responsible services for their legitimate needs."[24]

Notes

1. For a fuller description of the unbanked, *see* Congressional Testimony of Professor Michael A. Stegman on H.R. 4490, The First Accounts Act of 2000, before the House Committee on Banking and Financial Services (June 27, 2000). The data come from the Federal Reserve System's 1998 Survey of Consumer Finances.

2. Memorandum for Chief Executive Officers from Richard M. Riccobono, Deputy Director, Office of Thrift Supervision, U.S. Department of the Treasury, Subject: Payday Lending, at 1 (Nov. 7, 2000).

3. N.C. Gen. Stat. § 53-275 *et seq.* (hereinafter G.S.). Article 22 of Chapter 53 is entitled "Check-Cashing [B]usinesses." All further references to the North Carolina law governing the check-cashing and payday-lending industry refer to this statute.

4. Telephone Interview with Otis Meacham, Deputy Comm'r of the N.C. Office of the Comm'r of Banks (Dec. 14, 2000).

5. *Id.*

6. *Id.*

7. Irwin Speizer, *Hock Heaven: They're Not High Finance, but Pawnshops Continue to Thrive as Lenders*, Business North Carolina, Apr. 1, 1997, at 47.

8. This figure and all of the following data on the number and location of check cashers and payday lenders in North Carolina are the results of the author's calculations from data obtained from the North Carolina Office of the Commissioner of Banks. Details are available from the author.

9. Anthony Kolb, Spatial Analysis of Bank and Check-Cashing Locations in Charlotte, N.C. (Dec. 30, 1999) (unpublished draft, Center for Community Capitalism, The Univ. of N.C. at Chapel Hill).

10. *Id.* We identified 3.8 banking offices and 6.7 check-cashing outlets per 10,000 households in Charlotte neighborhoods that are at least 70 percent African-American, compared with 12.5 banking offices and 1.6 check-cashing outlets per 10,000 households in neighborhoods that were less than 10 percent African-American.

11. *Id.*

12. Michael A. Stegman, Savings for the Poor: The Hidden Benefits of Electronic Banking 63 (Washington, D.C., Brookings Institution Press, 1999).

13. Marcy Gordon, *Senator Condemns "Payday Loans,"* Associated Press Report, Dec. 15, 1999.

14. Donna Tanoue, Chairman, Federal Deposit Insurance Corporation, Remarks before the Seventh Annual Greenlining Economic Development Summit, June 13, 2000, at 2.

15. *Id.*

16. Memorandum for Chief Executive Officers from Riccobono, at 1.

17. *See, for example, Unregulated Payday Lending Pulls Vulnerable Consumers into Spiraling Debt,* REINVESTMENT ALERT (Woodstock Inst.), Mar. 2000, at 3.

18. Memorandum for Chief Executive Officers from Riccobono, at 2.

19. Cited in SHOW ME THE MONEY! A SURVEY OF PAYDAY LENDERS AND REVIEW OF PAYDAY LENDER LOBBYING IN STATE LEGISLATURES 8 (Washington, D.C.: Public Interest Research Groups & Consumer Federation of America, Feb. 2000).

20. *Id.*

21. Specifically the law provides that "a licensee shall not, for any consideration, renew or otherwise extend any postdated or delayed check or withhold such check from deposit for a period beyond the time set forth in the written agreement with the customer." G.S. 53-281. See first-person accounts of the problems caused by back-to-back renewals and rollovers in TOO MUCH MONEY AT THE END OF THE PAYCHECK (Durham: Community Reinvestment Ass'n of N.C.; Chapel Hill: Center for Community Capitalism, The Univ. of N.C. at Chapel Hill, Jan. 2001).

22. Declaratory Ruling—Issues under the North Carolina Check Cashers Act, in Correspondence from Hal D. Lingerfelt, Comm'r of Banks, to Jennie Dorsett, Exec. Director and General Counsel, N.C. Check Cashers Ass'n (Nov. 30, 1998).

23. *Id.*

24. Memorandum for Chief Executive Officers from Riccobono, at 1.