PAYDAY LENDING PRACTICES AND PUBLIC POLICY

Robert W. Cook, Department of Economics

University of Richmond, Virginia 23173

ABSTRACT

Payday loans are small, very short-tem consumer loans that originate in a wide variety of storefront or pawnshop outlets. The fees charges by payday lenders imply extremely high annual percentage rates and the probability a borrower will default is equally high. Critics argue the fees charged are usurious and the borrowers are often trapped into renewing the loans for multiple terms. Lenders counter the fees charged and the repeat borrowers are necessary to sustain an industry which has no substitute in the financial services market. An earlier paper by Flannery and Samolyk examined these issues using proprietary store-specific data provided by two payday lenders [7]. They conclude that fixed operating costs and loan loss rates justify a large portion of the fees charged. This paper examines the same issues using industry data collected by the Commonwealth of Virginia State Corporation Committee and firm- specific data contained in the Form 10-K's filed by three large payday lenders. The conclusions are very similar.

INTRODUCTION

Payday loans are one example of a nonblank credit product that is intended to finance a short-term cash deficiency. Other examples include an American Express cash card, a consumer finance loan and an auto equity loan. Of these, payday loans and auto equity loans are the most recent entries into the market. Both are contentious.

Auto equity loans are only made to borrowers who can produce clear title to a vehicle that will held as collateral by the lender. The term is usually one month and the vehicle may be repossessed upon default. The borrower retains possession of the vehicle during the term of the loan and deposits the title and sometimes a copy of the keys with the lender. The average title loan is $350 and many of these loans are renewed for multiple terms [8].

The typical payday loan is for a term of two weeks or less for around $250-$300, and the typical fees/interest on these loans range from 15% to 20% of the amount borrowed. These fees translate into very high annualized rates of interest. More significantly, a large number of loan customers obtain many loans per year which to some observers implies these loans are used to finance and perpetuate chronic financial difficulties [1].

For example, in Virginia the maximum rate of interest for payday loans is 15% which translated to an average annual percentage rate of 386% in 2003 and 376% in 2004. Eighteen percent of the individuals to whom payday loans were made received thirteen or more loans in 2003 and twenty percent of the individuals to whom payday loans were made received 13 or more loans in 2004 [15] [16].

The loan product provides customers with cash in exchange for a promissory note, which is usually supported by a personal check for the amount of the advance plus a service fee. In order to be approved for a payday loan, new customers are required to have a current bank account and a regular source of income which may be, but is not required to be, a job. There is no evaluation of creditworthiness in determining approval of a loan other than identification, a bank account and a source of income. The customer is usually required to present a recent pay stub as one proof of identification. If approved, the customer enters into an agreement governing the terms of the loan. The customer then writes a personal check to cover the amount of the payday advance plus charges for applicable fees/interest, and makes an appointment to return to the payday cash center on a specified due date, usually his or her next payday, to repay the advance plus the applicable fees/interest. At the specified due date, the customer is required to pay off the payday cash advance in full, which is usually accomplished by the customer returning to the payday cash center with cash. Upon repayment in cash, the payday lender is obligated to return the customer's personal check. If the customer does not return on the specified date with cash, the lender will usually attempt to contact the customer and may deposit the customer's personal check for collection.

Payday cash advance services have grown steadily and rapidly since the early 1990's as a response to a shortage of alternative short-term credit lines from traditional and non-traditional banking institutions. Many banks and other traditional financial institutions have reduced or eliminated their provision of small-denomination short-term consumer loans, in part due to the costs associated with originating these loans. As a result, a large number of companies have begun to offer these loans to lower and middle income borrowers. Providers range from specialty offices, which provide only payday cash advances, to retail stores in other industries that offer these types of loans as ancillary services. For example, as of December 31, 2005 Advance America, one of the largest entries in the market, was making payday loans in 1,868 cash advance centers in 29 states and serving as the lending agent for the lending banks under the agency business model in 540 centers in five states.

The cost of entry into the payday cash advance business is relatively low and many state statutes offer a regulatory safe harbor for the industry. In Virginia an applicant must post a surety bond of $10,000 and each office must possess $25,000 of unencumbered liquid assets. As of 2004, 36 states and the District of Columbia had legislation permitting and regulating payday loans. Most of the cash centers are located in middle to low income shopping areas with high retail activity. Other tenants in the areas are typically grocery stores, discount retailers and video rental stores. Recently, businesses offering payday cash advances and short-term loans over the internet and the telephone have begun to appear.

Increases in the charges associated with insufficient funds, as well as late penalty fees and minimum payment requirements by financial institutions and merchants have also fueled demand for payday cash advances. Some studies indicate that a large percentage of payday cash advance customers do not regularly transact loan business with banks. A payday cash advance usually involves a single charge, unlike other alternatives that may require collateral, origination and administration fees, prepayment penalties and charges for other services such as credit life insurance, accident and health insurance or other incremental charges. Industry representative believe customers use short-term payday cash advances because they provide simple, quick, and confidential ways to meet short-term cash needs between paydays while avoiding potentially higher costs and negative credit consequences of other alternatives.

The industry maintains their sole market focus and competitive strength allows them to primarily reach and service middle income employed customers. For example, Table I is included in Advance America, Cash Advance Center Inc.'s 12/31/2004 Form 10-K as a description of it's customer base. The table implies the average household which obtains a payday loan is somewhat similar to the average household in United States [1].

Table I

	Customers	U.S. Census 2000
Average Age	38.4	35.8
Percentage between 18-44	64%	40%
Median household income	$40,125	$41,994
Percentage homeowners	42%	66%
Percentage with high school degree	84%	80%

PUBLIC POLICY CONCERNS

Some consumer advocate groups and state legislators are not as sanguine. Critics wonder why most payday loan centers are located in low-income neighborhoods, near military bases or near neighborhoods populated by illegal immigrants. The Center for Responsible Lending and The Consumer Federation of America has stated payday advances are "marketed as small emergency loans, but in reality these loans trap borrowers into a cycle of debt". "Because the loans are typically made without regard to the borrower's ability to pay and because they are structured to be repaid as a single balloon payment after a very short term, borrowers frequently cannot pay the full amount on the maturity date and instead find themselves extending or rolling over the loan repeatedly. In this way, borrowers may pay fees well in excess of the amount they originally borrowed [8]." In response to these concerns, several states do not permit payday lending. However, the legislative trend has been permissive with regard to allowance but restrictive with regard to maximum fees and effective annual percentage rates.

Despite the controversy there is relatively little evidence, other than antidotal, regarding the relative profitability of payday loans. The most recent and rigorous study by Mark Flannery and Katherine Aomolyk of the FDIC Center For Financial Research concludes, "To a great extent, the high APR's implied by payday loan fees can be justified by the fixed costs of keeping stores open and the relatively high default losses suffered on these loans." Their results also show the industry "could survive with fewer high-frequency borrowers, but its long-term scale would be smaller".

In this paper I take a different approach. Rather than attempting to explain store-level APR's based on the fixed cost of operations and loan loss ratios, I compare the rates of return in the payday loan industry to the rates of return in other more traditional banking institutions. To achieve these comparisons on a national basis, I employ the 10-K's of the largest payday lenders. To achieve these comparisons on a local basis, I employ the operating data reported by banks, credit unions, and payday lenders to the Commonwealth of Virginia State Corporation Commission.

COMPARATIVE DATA

Table II describes the growth and characteristics of payday lenders in Virginia. The "Payday Loan Act" became effective July 1, 2002. As of December 31, 2002, the Bureau of Financial Institutions regulated 60 payday lenders operating 596 offices and acted on 251 applications for licensees, additional offices and relocations of existing offices. By December 31, 2005 the number of lenders had grown by 38% and the number of offices had increased by 27%'

The average rate is 15% of the loan made however some introductory rates are as low as 0%. Loans turn approximately twenty-four times each year so the average rate translates to about a 360% annual percentage rate. Since 90,859 of the 445,891 borrowers obtained at least 13 loans in 2005, approximately 35% of the loans were made to the same individuals. This validates the main concerns of industry critics. The effective interest rate is extremely high and approximately 20% of the borrowers rely on payday loans as a continual source of cash [15] [16] [17]. Surprisingly, despite intense legislative pressure to cap the annual number of loans to a borrower, the average loans per borrower rose substantially from 2005 to 2006.

Table II

Payday Lending Activity in Virginia

	2004	2005	2006
Number of payday lenders	78	83	84
Number of payday locations	696	756	791
Number of loans made	2,898,934	3,372,103	3,593,401
Loans made	$988,135,464	$1,197,105,829	$1,311,902,305
Number of borrowers	387,686	445,891	433,537
Borrowers who received 13 or more loans	76,068	90,859	96,831
Average annual percentage rate	373%	386%	378%
Average term in days	19	15	15
Avg. number loans per borrower	7.5	7.6	8.3

Table III

Payday Lenders and State Chartered Bank and Credit Unions
Net Income as a Percent of Gross Income

Lender	2004	2005	2006
State Chartered Banks in Virginia	34.4	36.3	35.9
State Chartered Credit Unions in Virginia	14.8	12.8	46.9
Cash America Form 10-K	12.1	7.6	7.5
Advance America Form 10-K	14.6	10.0	10.4
QC Holdings Form 10-K	14.8	3.5	5.3

Table III compares the operating ratios of the three largest payday lenders in America to those of state-chartered credit unions and banks in Virginia [1] [2] [3] [4] [5] [6] [9] [10] [11] [12] [13] [14] [15] [16] [17]. While the absolute ratios are somewhat smaller for the payday lenders the comparative results are not unfavorable. The payday lender's claim that their profit margins are not inflated beyond those of traditional lenders by the relatively high APR on loans made is supported by the data. Net income as percent of gross income is only one possible comparison. Since the total assets of banks and credit unions far exceed the total assets of payday lenders a comparison of net income as a percent of average assets would yield a much different result.

Table IV

Payday Lenders
Loan Loss Expense as a Percent of Loans Made

Lender	2004	2005	2006
State Chartered Banks in Virginia	1.3	1.5	1.6
State Chartered Credit Unions in Virginia	.5	.5	.3
Payday Lenders in Virginia	2.8	2.4	2.1

Table IV provides one possible explanation for the favorable comparison in Table III [12] [13] [14] [15] [16] [17]. The loan loss expense is extremely high for payday loans. However it unclear if this expense is a function of the creditworthiness of the borrower or weak collection procedures and the absence of any credit checks by the lender.

Table V

Payday Lenders
Market Share

Lender	2004	2005	2006
State Chartered Banks in Virginia	93.4%	92.7%	91.2%
State Chartered Credit Unions in Virginia	4.67%	5.10%	6.10%
Payday Lenders in Virginia	1.9%	2.2%	2.7%

Table V demonstrates the relative and growing importance of payday lending in the state-regulated marketplace. While the Virginia General Assembly is actively pursuing restrictive legislation the industry is actively pursing expansion [12] [13] [14] [15] [16] [17].

CONCLUSION AND POLICY RECOMMENDATIONS

The payday firm data and payday state level data is not directly comparable. The loan loss ratios and the income ratios for payday licensees are not compiled by the Virginia Bureau of Financial Institutions. However, the micro data is reported by each licensee to the Bureau and the data is not yet accessible. When it is available I plan to use the micro data in a future paper to determine store level profitability.

The industry data reported in this paper implies policy recommendations similar to those made by Flannery and Samolyk as a result of their store-specific analysis. High payday loan APRs are somewhat justified to cover unusually high default rates as the rates of return on income reported by payday lenders are significantly below the rates of return reported by more traditional lenders. The proportion of rollover loans is an important source of revenue as these borrowers encompass one-third of the customer base. It is uncertain the industry could survive if rollovers were severely limited by legislators.

The state level comparisons in this paper may also overstate the long-tem profitability of the industry. Payday lending is an immature industry in Virginia. The "Payday Loan Act" was effective on July 1, 2002 and the number of participants and locations is still growing rapidly. Market share and the number of loans per borrower is rising, losses as percentage of revenue is falling and the effective APR has not been reduced. In the equilibrium state rates may fall below 15% as new entries offer more attractive products. But there is no short-term evidence of this effect. That said, it also clear payday lenders continue to provide short-term solutions to many borrowers and may also continue to provide a mechanism for short-term cash requirement to migrate to long-term and chronic borrowing.

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