Rich Huddleston, Executive Director
Kathryn Hazelett, Research and Fiscal Policy Director
James Metzger, Consulting Economist

PAYCHECK$ and POLITICS
Arkansas Advocates for Children & Families
Issue 29: March 2005

Payday Loans Don't Pay

by Kathryn Hazelett

Summary

- There are at least 188 payday lenders operating in Arkansas. Nearly all have been established since the Arkansas legislature passed Act 1216 of 1999. Under this act, the amounts loaned by payday lenders are deemed not to be loans and the fees charged are not interest.
- Under a typical payday loan, a family borrows $100 to $500 until their next payday and is charged an annual interest rate of over 400 percent, a rate well above the 17 percent rate allowed by the Arkansas Constitution.
- Payday loans often push low-income working families further into a cycle of never-ending debt. The end result is that customers can end up paying thousands of dollars in "fees" (over several months) for an original loan of less than $500. In 2003, payday lenders nationwide generated $6 billion in revenue from $40 billion in loans.
- The payday loan industry targets individuals who have steady jobs and checking accounts, but little or no credit or savings. Typical targets are the working families of Arkansas, the military, and retirees.
- Arkansas should explore policy options that (1) require payday lenders to abide by the usury provisions (interest rate limits) set forth in the Arkansas Constitution, (2) establish safeguards that prevent payday lenders from inventing new ways to take advantage of financially-vulnerable families, and (3) create legal and financially-feasible access to short-term credit that will not trap Arkansas families in a future cycle of debt.

Introduction

Many of us have seen the signs which advertise "Fast Cash: All it Takes is your Good Word. No Credit Check!" I'm sure many of us have been tempted to use such a service or, indeed, have used such a service for convenience, for fear of a late fee, or for fear of bouncing a check. What many of us don't realize is the real cost behind the decision to use a payday lender.

The basic model of payday lending looks like this: the borrower, typically a lower to middle income individual with a steady job and a bank account, goes into a payday lender's office. The individual then writes out a check to the payday lender for an amount between $100 and $500. The payday lender holds the check until the next payday, typically 14 days. This short-term loan can have an Annual Percentage Rate (APR) upwards of 400%. Yes, 400%.[1]

At the end of the two weeks, the customer may or may not have the funds to "cover" the check, because there wasn't a credit check to ensure the individual could afford the loan.[2] The inevitable cycle of debt begins. The customer may go to another payday lender to cover the first payday loan or the customer may "rollover" the original loan by simply paying the "fee" and putting off the inevitable repayment for another two weeks. The end result is that the customer could end up paying thousands of dollars in "fees" (over several months) for the original loan of less than $500.

The Legal Climate

Doesn't Arkansas have an interest rate cap? Yes, Article 19, Section 13 of the Arkansas Constitution sets a limit

for interest rates charged on consumer loans. Interest is not to exceed 17%. This is a far cry from the APR of 400% that the Arkansan in our example paid to the payday lender.

So, how are the payday lenders continuing to operate in Arkansas? In 1999, the legislature passed Act 1216, which stated that amounts advanced by payday lenders would "not be deemed to be a loan" and the fees charged would "not be deemed interest." With this language, the payday lenders were in business in Arkansas. They could now charge an outrageous amount for a small loan and call it a "fee" thereby falling outside of the constitutional usury protections.

The good news is that our state courts have held that an interest rate greater than 17% is usury, plain and simple, and that these "fees" are really interest. Indeed, the Arkansas Supreme Court has held that the legislature can not determine what is and is not a loan nor can it predetermine what is and is not interest.[3] The constitutionality of Act 1216 of 1999 is being challenged in a case recently remanded to the Pulaski County Circuit Court.[4]

In spite of these court setbacks, payday lenders have continued to take the state by storm[5] and have often shirked the consumer protection restraints that were placed in the 1999 Act for consumer protection.[6] The Act places a limit on the amount loaned, the interest rate charged, and the maximum term of the loan. Payday lenders currently advertising in the yellow pages advertise loans for as much as $500 when the statutory limit is $400. The law states that there should be no rollovers (the process by which the borrower returns to the lender on the due date and only pays an additional "fee" allowing the loan to continue for another two weeks), but they are happening throughout the state.[7]

Payday Lending Cost Comparison

Transaction	Fees/-Month	APR
$255 payday loan	$90*	391%
$255 bounced check	$43	202%
Late fee on $255 credit card bill	$30	141%
Late fee on $800 mortgage (homeowner)	$32	48%
Late fee on $600 rent payment (renter)	$30	60%
Late fee on $300 car payment	$15	60%

Source: Center for Responsible Lending

The Market

In 2003, payday lenders nationwide generated $6 billion dollars in revenue from $40 billion in loans.[8] It is estimated that of the 105 million households in the United States, 14 million have used payday lenders.[9] An analyst for Stephens, Inc., an investment banking firm based in Little Rock, projected payday lending industry profits would increase by 6% in 2004.[10]

With such a large industry base and such large profits to be made, it is no wonder that payday lenders are more prevalent in Arkansas than McDonald's, but who are their customers?

The payday loan industry targets those individuals that have steady jobs and checking accounts, individuals with poor or no credit and little or no savings. The industry targets the working families of Arkansas, the military, and retirees.

A recent article in the New York Times stated that at least 26% of military families have done business with payday lenders.[11] Further, the article cited preliminary research which shows that payday lenders' "locational strategy suggests very, very strongly that they target military families."[12] The hard working men and women in our armed forces do not need payday lenders camped out at the gates of their bases offering loans at usurious rates.

The Solution

What can be done to protect working families from predatory payday lending practices? One option is for the Arkansas General Assembly is to repeal Act 1216 of 1999. As a follow-up protection, safeguards could be instituted to prevent the payday loan industry from reinventing itself in ways that thwart the intention of the law while abiding by the letter.

A recently enacted Georgia law provides a model of legislation to quash payday lenders in any form they may take. When a state declares that payday lending in the traditional form is illegal, payday lenders will often reinvent themselves, turning up as "internet cafes" and "catalog sales shops," or changing names and opening under the "rent-a-bank" or "rent-a-finance company" model.[13] These reinventions are simple ruses that allow payday lenders to continue operating in a different form.

Take the internet café. Unlike the legitimate internet cafes found in big city coffee houses that offer

access through numerous computer terminals, those operated by payday lenders are simply vehicles that allow them to continue loaning money for short periods of time while claiming they are providing internet access to their customers. In reality, they typically offer internet access only at one computer in their store during regular business hours.[14]

The Georgia law is drafted to prevent payday lenders from operating in any shape or form if they charge usurious interest rates. It casts a wide net and is a model that Arkansas could follow to protect low-income families through our constitutional usury limitation. Repeal of Act 1216 of 1999 is a needed first step, but payday lenders have shown an amazing ability to rise from the ashes. A comprehensive law is needed to protect vulnerable families from predatory lending practices.

Responsibility, however, does not lie solely with the legislature. Alternatives to payday lending exist – we need to encourage and promote these alternatives. For example:

- Employers can offer credit lines to employees equal to 2.5% of their salaries that could be repaid through payroll deductions spread over a year without interest.[15]

- Credit counseling can be tied to low-cost loans by banks and credit unions.

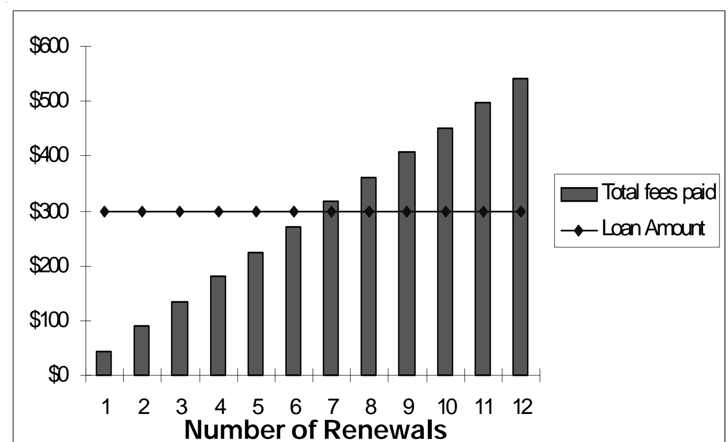
- Branches of banks could be opened in low-income neighborhoods offering check cashing services, money orders, and savings accounts to directly compete with payday lenders.

Indeed, many programs exist around the country to provide cost-effective and family friendly alternatives to payday lending. The banks and credit unions where payday borrowers hold their checking accounts are ideal candidiates for offering such programs. Many of the programs currently underway are organized by credit unions to directly compete with the payday lenders.

In Florida, the Orange County Teachers Federal Credit Union has instituted a program called People Helping People (PHP). PHP provides up to $500 for six months at no interest. These funds are for immediate personal or emergency expenses and the credit union has had success in that loss levels have been similar to those for their credit card portfolios.[16] In Ohio, Faith Community United Credit Union has developed a Grace Loan Program that ties repayment to savings and credit counseling. Their default rate is only 0.49%.[17] By encouraging savings, the Ohio credit union is addressing the problem of short-term borrowing at its source. By offering credit counseling, customers are able to better budget their resources and can gain an understanding of the true costs of payday loans.

Alternatives to the usurious practices of payday lenders are necessary to protect the economic well-being of Arkansas families. Our familes need legal and financially-feasible access to short-term credit that will not trap them in a future debt cycle. The responsibility is ours - we need to lower the high cost of being poor.

Fess Paid on a $300 Payday Loan by Number of Renewals



Note: A renewal is defined here to include extensions, rollovers, etc.

Nine Signs of a Predatory Payday Loan

1. Triple digit interest rate
Payday loans carry very low risk of loss, but lenders typically charge fees equal to 400% APR and higher.
2. Short minimum loan term
75% of payday customers are unable to repay their loan within two weeks and are forced to get a loan "rollover" or back-to-back transaction at additional cost.
3. Single balloon payment
Unlike most consumer debt, payday loans do not allow for partial installment payments to be made during the loan term. A borrower must pay the entire loan back at the end of two weeks.
4. Loan flipping (extensions, rollovers or back to back transactions)
Payday lenders earn most of their profits by making multiple loans to cash-strapped borrowers. 90% of the payday loan industry's revenue growth comes from making more and larger loans to the same customers.
5. Simultaneous borrowing from multiple lenders
Trapped on the "debt treadmill", many consumers get a loan from one payday lender to repay another. The result: no additional cash, just more renewal fees.
6. No consideration of borrower's ability to repay
Payday lenders encourage consumers to borrow the maximum allowed, regardless of their credit history. If the borrower can't repay the loan, the lender collects multiple renewal fees.
7. Deferred check mechanism
Consumers who cannot make good on a deferred (post-dated) check covering a payday loan may be assessed multiple late fees and NSF check charges or fear criminal prosecution for writing a "bad check."
8. Mandatory arbitration clause
By eliminating a borrower's right to sue for abusive lending practices, these clauses work to the benefit of payday lenders over consumers.
9. No restrictions on out-of-state banks violating local state laws
Federal banking laws were not enacted to enable payday lenders to circumvent state laws.

Source: Center for Responsible Lending
http://www.responsiblelending.org/payday/signs.cfm

Footnotes

[1] According to the Consumer Federation of America, the average effective APR of payday loans in Arkansas is 579%. *See* Consumer Federation of American, *Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury,* Jean Ann Fox, March 30, 2004, pg. 30.
[2] Most payday lenders use a system called Telecheck to determine if there are bounced checks in someone's past and will often not issue a loan if there are outstanding checks. This is not a credit check to ensure that the borrower can afford the loan.
[3] *Luebbers v. Money Store, Inc., et al.*, 344 Ark. 232, 2001.
[4] On January 20, 2005, in *McGhee, et al. v. Arkansas State Board of Collection Agencies*, the Arkansas Supreme Court reversed the dismissal of the case and remanded it to the circuit court for a ruling on the constitutionality of Act 1216 of 1999.
[5] There are currently **188** payday lenders operating in Arkansas.
[6] The payday lending industry in Arkansas is regulated by the Arkansas State Board of Collection Agencies, Division of Check Cashers. *See*: www.asbca.org/check_cashing/index.htm
[7] The terms of the Arkansas law for check-based loans can be found in Ark. Stat. Ann. § 23-52-101 et seq. 1999. (The pertinent limits are listed below.)The Arkansas Supreme Court ruled that the fee section is an invalid attempt to evade the usury provisions of the Arkansas Constitution. (Luebbers v. Money Store, Inc., et al., 344 Ark. 232, 2001).

Arkansas' Legal Limits*
Minimum Loan Term: 6 days
Maximum Loan Term: 31 days
Maximum Loan Amount: 10% plus $10
Maximum Cost/$100: $22.22

*It should be noted that when applying these statutory limits the effective APR for a 14 day loan is 579%.

[8] Bloomberg, *JPMorgan, Banks Back Lenders Luring Poor With 780 Percent Rates*, November 23, 2004.
[9] *Ibid.*
[10] *Ibid.*
[11] Diana B. Henriques, *Seeking Quick Loans, Soldiers Race Into High Interest Traps*, The New York Times, December 7, 2004.
[12] *Ibid.*
[13] Payday lenders choose a rent-a-bank or rent-a-finance company model in order to import an interest rate that is higher than that allowed by Arkansas law. Payday lenders make also seek out-of-state partners in order to make loans with terms that exceed state law limits such as the size of loans or the repayment terms. Arkansas's Attorney General is currently investigating two payday lenders operating in the rent-a-finance company model.
[14] The Arkansas Attorney General recently settled two cases with companies which allegedly disguised payday loans as Internet services at a fee of $60 paid every 14 days for an entire year. The companies agreed to leave Arkansas and pay a $10,000 fine. *See* David Smith, *State Studying Firms that Give Payday Loans*, Arkansas Democrat-Gazette, January 20, 2005.
[15] *See*: Annie E. Casey Foundation, *The High Cost of Being Poor: Another Perspective on Helping Low Income Families Get By and Get Ahead*, Kids Count 2003, pg. 26.
[16] The Credit Union National Association, *Report of the CUNA's Alternatives to Payday Lending Task Force*, Colleen Kelly, pages 6-7.
[17] Woodstock Institute, *Reinvestment Alert, Number 16*, March 2001.

For More Information:
Kathryn Hazelett
kathryn.hazelett@aradvocates.org
www.aradvocates.org

Arkansas Advocates for Children & Families
523 S. Louisiana St., Suite 700
Little Rock, AR 72201
(501) 371-9678