

36% Interest

Jay Hutchins, Executive Editor

Where the legal rate of interest
...is fixed...sober people are
universally preferred as borrow-
ers, to prodigals and projectors.

Adam Smith from "The Wealth of Nations"

In Oregon, payday loans are made by independent lenders who lend the amount of a paycheck for short terms at high interest rates. The Oregon legislature recently passed a law, the Payday Loan Reform Act, which will be implemented in July 2007, meant to protect borrowers from the high fees and annualized interest rates of these loans by capping interest rates at 36 percent per annum and by regulating fees. Up until its passage, Oregon was one of seven remaining states that had not passed a law regulating payday lenders.

The design of the law appears to reflect the idea that payday lenders (lenders servicing the demand for such loans) can operate at a 36 percent interest rate plus a 10 percent fee on principal with a minimum fee of ten dollars.

We were interested in why the law caps the rate 36 percent—besides the fact this is the rate other states have chosen. In order to shed some light on this matter, we contacted the Russell Sage Foundation, who early in the 20th century was instrumental in getting a Uniform Small Loan Act passed in most states. We also contacted Professor John Caskey (Professor of Economics at Swarthmore College), a national expert on consumer finance and banking. Professor Caskey confirmed what we learned from the Russell Sage Foundation and provided us with current information about what he believed were viable interest rates for payday lending.

History

High-risk, small-loan laws were first developed and adopted in the early part of the twentieth century when the Russell Sage Foundation discovered that 90 percent of workers it had surveyed in New York City were using the services of loan sharks. In this period, commercial banks were not interested in even making mortgage loans to private buyers and most usury laws capped interest rates at 6 percent. Initially, the Foundation attempted to assuage what it saw as a serious social problem by supporting charitable organizations that offered loans at low rates of interest to needy borrowers, but soon discovered that their approach could address only a minuscule portion of the need.

Between 1916 and 1942 the Foundation drafted and promoted proposals for a Uniform Small Loan Law. The Foundation's primary objective was to create a law that would allow lenders to profitably make small loans less than \$300 and as small as \$25 and make the true costs of these loans transparent to borrowers. The Foundation's proposals most often included a 36 percent interest rate cap and strict restrictions on fees (this rate allowed lenders to make a profit of 6 percent), which was eventually adopted by most states, including New York. Language from the Foundation's work still appears in many consumer finance statutes now regulating larger consumer loans.

Why are we making laws again?

Until 1981, Oregon law capped all loans at 36 percent annual interest. In the late 1970s, rising inflation led the federal government to deregulate interest rates by pegging interest rates to Federal Reserve rates. To keep state-charted banks competitive, states repealed their interest rate cap laws. De-

regulation of financial markets opened up many opportunities to enterprising lenders. Within a few short years, rises in payday lending, check cashing, sub-prime (the customer) auto lending, and other high-interest rate lending became common. In the early 1990s, consumer advocacy groups pressured states to once again implement lending laws limiting interest rates to 36 percent per annum on predatory lenders whose charges for loans often exceeded 500 APR (annual percentage rate). APR is the effective annual interest rate, including origination and other fees.

The 21st Century

We asked Professor Caskey if legitimate lenders making high-risk loans at 36 percent annual interest rate and no fees could make a profit in today's economy, he responded that:

Payday lenders, or other lenders making short-term closed-end loans of around \$350 or less today, cannot do so profitably at a 36% annual interest rate. This was not true in the 1930s, but then \$100 in the 1930s bought a lot more than it does today.

How do I know this? No payday lenders operate in states that set monthly interest rates below 10% (120% per annum) unless they come up with an arrangement that allows them to avoid the state ceiling. This is not surprising. A \$300 one-month loan at 36 APR pays the lender only about \$9. This won't cover the costs of originating the loan and collecting. Some credit unions make such loans at an 18 APR but they do it out of a social mission, not expecting to make a profit. They can profit from low-cost open-ended lending, such as credit cards or checking lines of credit, but this is a different type of loan.

Looking at Oregon's law and combining fees with the 36 percent interest rate allowed under the law, we

came up with an APR of 156 percent on a 300 dollar, 30 day loan.

Oregon's Future would like to find out more. What does the banking industry think? Angela Martin at Our Oregon (co-sponsor of the act) who advised us on this issue pointed out that in Oregon, the banking industry's position is that caps are philosophically not acceptable to them. Therefore, the industry did not want to determine a rate for which it should be profitable for banks to make small, short-term loans to serve payday lenders' traditional clientele.

Another confusing aspect of this issue is the default rate on payday loans. The rate is around 2 percent according to the Payday Lenders Bar Association. This default rate is very close to the default rates for both sub-prime and conventional loan programs—this contradicts the assumption that payday loans are riskier to the lender. So, why are payday loans more expensive than an auto loan to a sub-prime borrower or even a conventional consumer loan? We still don't have a good answer.

If payday loans are so profitable why aren't banks interested in making them? One answer seems to be that the banking system is still as tradition-bound as it was at the beginning of the 20th century. And if this is so, why?

If default rates on these loans are so low, why have we identified payday loans as a social problem—people are paying them back and continuing to use the services? Is it possible that the stories we hear from victims of predatory lending are a very small minority of uninformed borrowers?

The most important question is: If payday loans are wildly profitable and default rates are as low as 2 percent, why hasn't competition brought the APRs for these loans down near the APRs for other consumer credit? Is the demand growing so fast that the market has not had a chance to become more competitive? When we ask these questions we seem to encounter circular logic that takes us back to roll-over rates (about 70%) and the business model of payday lenders.

We intend to explore this topic and issues of equity and regulation of the market place, from other perspectives in subsequent issues of *Oregon's Future*.

To begin our coverage of this issue we asked **Bina Patel**, a program director at the Cascade Policy Institute, to give us *as objective a description* of Oregon's payday legislation as she could. Her article, which follows, discusses the issue of Oregon's payday loans from a free-market perspective. A response by **Angela Martin** at Our Oregon follows. ▲

Fairness and the Market: The Payday Lending Debate

Bina Patel

Payday lending emerged as a response to mainstream financial services' denial of loans to low-income individuals, people with unreliable employment backgrounds, those with no credit history, and those with a poor credit history.

The current debate revolves around the influence and danger that payday lending may present to a particularly vulnerable population. Some argue that state regulations are the best way to curb the high costs of these loans, while others argue that the market is responding to consumer demands.

What is a payday loan, and who takes them?

Payday lending offers short-term, small loans secured only by a post-dated check from the borrower. Generally, payday loans are made for less than \$500 for a 15-day loan term, including a fee-for-service transaction. A typical borrower in Oregon looking for a \$300 loan writes a post-dated check for \$360. The borrower is required to pay back the principal amount by their

next paycheck, or the lender can cash the post-dated personal check. Roll-overs occur when the borrower cannot meet the payoff obligation, and the entire loan amount is extended for an additional fee.

It is commonly thought that borrowers tend to be low-income, but recent research reveals a more complex view of users of payday loans. According to a study by Georgetown University researchers, half of borrowers tend to fall into middle-income ranges. Those making under \$25,000 account for less than 25% of borrowers. A Cypress Research Group Report surveyed 2,000 payday loan borrowers and learned that almost 60% have some college education, 50% have children in the home, 41% own a home (compared to 60% for the general US population), 64% are white, and 24% are African-American. Two-thirds have a savings account and half have a credit card.

Why?

First, half of the borrowers face extremely limited credit options, and second, payday loans are often very convenient. Interestingly, the Cypress Report survey shows that the reason many people choose a payday loan as opposed to other forms of loans is due to the quick and easy processing (38%).

More concretely, loans are taken due to cash flow issues, not necessarily due to income issues. We see that borrowers are unable to meet financial obligations in a short time frame before their next paycheck arrives. *Our Oregon*, a coalition of activists, cites that the number one reason individuals borrow from these lenders is to meet basic needs like paying bills and covering medical costs. Borrowers facing car repair needs, unexpected changes in employment, or other negative shocks to their monthly cash flow are likely to turn to payday lenders, and many do so after having been turned down for traditional credit, having no accessible savings, or having "maxed out" credit cards. Among the respondents in the Cypress

Report survey, 84% said payday loans helped with an unexpected expense, 73% avoided late charges on bills, and 62% were supported by payday loans during a spell of income reduction.

Critics

The phrase “predatory lending” is widely used by payday lending critics to articulate the ensnaring tactics used by lenders, noting that they often establish themselves in storefronts located in lower-income and minority neighborhoods. Advocates for regulations on payday lenders are concerned that it is too easy to take these loans out, and that the incredibly high interest rates are not made clear. Critics calculate the one-time fees on an annual basis, resulting in interest rates as high as 500 percent.

Arguments in opposition to payday lenders are based on fairness—that those who are most vulnerable to negative shocks to their budgets are adversely targeted. The 15-day loan repayment due date tends to be difficult for borrowers to meet and increases the need to rollover the loan. Those who find themselves having to rollover loans can see other obligations suffer while the debt continues to mount. The roll-overs, and the high loan fees/interest rates associated with them, mean that borrowers can quickly see their small loan spiral out of control. The borrower who started with \$300 in principal, unable to pay it back, and rolling it over in eight weeks might owe \$540.

The Defense

Defenders of the payday lending industry point out that lenders are filling the market void for financial products available to those with poor or no credit and spotty employment history, and that individuals freely sign onto these loans.

The industry cites research that shows borrowers have fairly high satisfaction levels: 77% as compared to 61% satisfied when going to a local government office for help, or 55%

when applying for a loan at a bank or credit union.

The industry replies that convenience is usually seen as a good thing for consumers, and the cost of their service is clear, since a borrower writes a post-dated check for \$360 to repay a \$300 loan. All borrowers are given a statement showing loan costs and annual interest rates, as mandated by the federal Truth in Lending Act. Even though these are short-term loans, they are based on annual installment payments. Industry supporters compare payday lending rates to more traditional financial products that charge fees, like bounced check fees. When annualized, these fees can run into thousands of percents and are charged both by the bank and the depositor. When making a rational choice between two high cost options, many people clearly have chosen payday loans as their best alternative.

In response to the predatory description of the high fees and rates, operators claim they cannot lower loan costs because it is not sustainable for lenders to do so, which is why traditional banks do not serve these clients with small loans.

According to the Federal Deposit Insurance Corporation (FDIC), the high-risk population taking these loans makes this industry much less profitable than one would assume (the FDIC has discouraged its members from entering the payday loan market). Further, regardless of the loan size, whether \$300 or \$300,000, overhead costs remain relatively constant. For payday lenders, these small loans are relatively expensive to provide, as they do not have larger loans to spread the expenses. Some of their costs are offset by their limited underwriting practices, but are deferred by higher defaults and collection costs.

Default rates for payday loans are about 2% which is comparable to most other consumer loans. Aggressive collection costs to maintain this default rate may be higher for payday lending—Editor's note.

Responses

The Oregon Legislature adopted Senate Bill 1105, effective July 2007. It states that lenders are held to 36% annual interest rates (equaling \$36 per \$100 borrowed annually), an origination fee no less than \$10 or 10% per \$100 borrowed, loan terms extended to 31 days, and renewal of loans no more than twice.

Another response comes from credit unions, which are starting to provide short-term loans that are more affordable to high-risk populations. Under an online directory of social services, 211info.org, 24 credit unions are listed as alternative payday loan providers in Portland. Most require becoming a member of the credit union, and while more time consuming, it does provide more access to other forms of financial services. It will be interesting to see if these credit unions will be able to sustain a high-risk, small loan business and whether or not customers will seek them out.

Conclusion

The Cascade Policy Institute believes the payday loan industry emerged to meet a perceived need in the marketplace. Better financial education, better budgeting techniques, and emergency savings accounts could go a long way toward reducing this need. Unfortunately, simply capping fees through legislation does not reduce the need for payday loans. If payday lenders can no longer operate and credit unions are unable to meet their needs, vulnerable people will face even higher costs in the underground economy because loan sharks are never regulated.

Concerns about morality should be balanced with the perspective that competent adults should be free to make important choices about their own lives; even choices that others may deem as harmful to them. In addition, when critics question the morality of payday lenders, they open themselves up to similar criticism when they seek

to take away borrowing options from vulnerable people without providing a proven alternative.

This brief overview of the payday lending debate, including my concluding remarks about Cascade Policy Institute's position, leaves much room for additional comment. Research about this industry is often contradictory and begs examination beyond the numbers. In the end, it seems we are left with imposing and enduring uncertainty.

What causes these loans to occur in the first place—mismanagement of money, or the need for immediate gratification? Why restrict payday loans, but not auto title loans? Are we going to restrict all the loopholes that allow lenders to set their own rates? What is it about our education system that leaves people ignorant of the consequences of taking these loans? What happens if lenders stop offering these loans before financial education programs reach the families that need them? How do banks profitably serve high-risk borrowers?

In a world without payday lenders, will the burden on social service agencies become smaller, or will it balloon? After Oregon's payday loan law is implemented in July 2007 we will begin to find out. ▲

Ellehausen, Gregory Ellehausen and Edward C. Lawrence. Georgetown University, *Payday Advance Credit in America: Analysis of Customer Demand*, April 2001.

Cypress Research Group, "Payday Advance Customer Satisfaction Survey" May 2004.

Payday Loans and Predatory Lending

Angela Martin, Director, Economic Fairness Coalition of Our Oregon

At the heart of the issue behind predatory loan reform is the idea that all consumers deserve access to fair, responsible, affordable credit. In its

current form, triple-digit payday loans do not represent helpful credit. Rather than help borrowers meet their financial challenge, these high-cost loans trap borrowers in a cycle that puts them in a worse financial situation.

Payday loans are small loans that carry large fees. The loan requirements are deceptively simple. There is no credit check and no assessment of a borrower's ability to repay based on their debt to income ratio. To get a loan the borrower simply needs proof of income and a checking account. For a \$300 loan the borrower writes a \$360 check and receives \$300 cash. The lender will cash the check on the borrower's next payday, typically two weeks away.

The problem is that the majority of borrowers are not able to pay off the loan in two weeks so they pay another \$60 to extend the loan two more weeks. That's called a rollover. Current Oregon law allows three rollovers. The total repayment for borrowing \$300 for 8 weeks is \$540.

Oregon has experienced astronomical growth in payday lending. In 1999 there were fewer than 300,000 loans made. In 2004, the last year for which statistics are available, more than 720,000 loans were made—nearly 2,000 loans every day. If this rate of growth continues it will soon be easier to find a payday loan than a Big Mac or a tall non-fat mocha latte.

Who are the payday lenders? Two thirds of the storefronts in Oregon are owned by large out-of-state corporations. In 2005 the industry pocketed \$6 billion in fees on loans totaling \$40 billion. The six publicly traded companies reported a 24 percent increase in loan volume from 2004 to 2005. Fiscal year 2007 earnings estimates for Cash America project a 28 percent increase over prior year earnings. In other words, payday loan sharking is an extremely lucrative business.

Impact on Low-wage Workers

Behind all of the numbers and sta-

tistics are the human stories of people who have taken out payday loans. Ruby Stoker lives in Florence, Oregon with her husband and five children. They took out their first payday loan after losing their food stamps and came very close to losing their house as one loan turned into another and another.

"We asked for a payment plan and they said no," she says, her voice shaking as she described the terrible financial burden these loans placed on her family.

Maryann Olson lives in an adult foster care home in Portland, Oregon. Her monthly Social Security check was not enough to cover the cost of orthopedic shoes she desperately needed. The slick advertisements promising fast cash seemed to be the answer. However, her \$150 loan quickly turned into \$1,900 in debt to multiple lenders. Every few weeks when the loans came due, she found herself a little closer to the financial edge and turned from one shop to the next in an effort to stay one step ahead. In the meantime, her household bills were piling up which is when she turned to a local social service agency for emergency assistance.

Repeat customers like Ruby and Maryann are the bread and butter of the industry. Borrowers who take out five or more loans per year account for 91 percent of payday loan revenues. More than 55 percent of revenues are generated from borrowers with 13 or more payday loans per year.

Like the majority of payday loan borrowers, Ruby and Maryann were taking out a loan to meet basic living expenses. Consumer research, including industry sponsored polling, reveals that people are turning to high-cost credit for this same reason. Payday lenders claim that this fact proves they are providing a necessary and valuable service. However, at some point we have to ask ourselves if lending grocery money at 500 percent interest is a useful service, how have we failed the hundreds of thousands of families now footing the bill for this service?

The History of Usury Laws

Limitations on lending rates in Western law derive from biblical prohibitions against usury, which is why so many faith-based leaders and organizations support predatory loan reform. In the early 1900s progressive reformers started a national campaign against loan sharks who preyed on low-income, working-class families with limited access to mainstream credit. The Uniform Small Loan Law was model legislation drafted by leaders at the Russell Sage Foundation. These early reformers were staunch advocates for the poor and viewed consumer credit laws as a way to increase the economic stability of the most financially vulnerable. The USLL allowed lenders to charge slightly more than regular loan rates. The goal was to open up the market for small, higher risk consumer loans to low and middle-income workers.

Today's proposed rate cap of 36 percent carries decades of historical precedent and market testing. In 1931, Oregon passed a small loan law setting the interest cap at 36 percent annually. By 1932, 36 states had small loan laws. Over the next five decades, access to consumer credit and the consumer based economy grew under these regulations. From washing machines to the family car and even the family home, consumer credit helped families improve their standard of living.

But then came the 1980s and the rise of deregulation as ideology rather than a tool. Under this philosophy, all regulation is seen as a negative restraint on the market which will self regulate due to competition, supply, and demand. It was during the 1980s when Oregon legislators eliminated usury laws and then began the rise of the payday lenders.

One Step Forward, One Step Back

Last April, lawmakers passed the Payday Loan Reform Act which is intended to cap loans at 36 percent an-

nual interest, limit fees to \$10 per \$100 on the first loan and extend the pay-back period to 31 days. Under this scenario, a \$300 loan would cost \$39 for 31 days instead of \$120—the current going rate. That's still a lot of money but payday lenders aren't satisfied.

During the debate about payday loan reform, industry spokesman Mark Thompson warned that making 500 percent interest illegal would not stop the payday lenders from crafting a scheme to protect their high profits.

In his testimony to state lawmakers, he explained, "lenders will develop new products that are unregulated." And, he said, "you will see an increase in scam-type transactions."

Lenders have already developed a new payday loan product as a way to evade the interest cap and other protections that will apply to short-term payday loans. Here's how:

The new law affects only payday loans. Payday loans are defined as short-term personal loans made for 60 days or less. Conventional consumer loans are defined as 60 days or longer and typically feature payments covering both principal and interest until the loans are paid off. Lenders making conventional consumer loans can charge as much as they want because Oregon is one of only 16 states with no cap on interest.

Oregon has no interest cap on traditional consumer loans and payday lenders are using this fact as a loophole to the new law. These new high-cost loans are at least 61 days long but they carry interest rates as high as 370 percent.

It will take decisive action by lawmakers to close this payday loan loophole.

However, closing the door on predatory lending is not enough. We must also work to open up the door to affordable financial services. Nonprofits, community leaders, and lawmakers must work to encourage businesses to serve low-income consumers. In some cases this will involve working togeth-

er to address barriers both businesses and low-income consumers face. We must also increase financial education, starting with middle and high school students, to help more Oregonians become financially savvy consumers.

The combination of consumer protection laws, public education, and market innovations represent a real opportunity to improve the economic stability of Oregon families. The only question that remains is whether we have the political will to take the first steps. ▲

State of Oregon Department of Consumer and Business Services, Policy Review of Consumer Finance and Payday Lending, July 2004.

Associated Press, "Borrowers keep returning for payday loans," May 22, 2006.

Rich Dupry, MSNBC, "Cash America Clicks with Payday Loans," September 19, 2006., Keith Ernst, John Farris and Uriah King, "Quantifying the Economic Cost of Predatory Payday Lending," Center for Responsible Lending, December 18, 2003.

Regulation Does Not Always Increase Equity

In Washington State during the 1960s, credit card interest rates hovered at an annual rate of 18 percent. Consumer advocates wanted to lower the rates to aid poor people. In 1968, the maximum rate was lowered by referendum to 12 percent. Demand for credit increased, but the supply of funds did not. Welfare mothers, people with records of un-stable employment, students, and the elderly tended to be turned away because there were more credit-worthy customers using cards. Those who gained from the reduced rates were the ones who had the most wealth, the best jobs, and the highest probability of being able to repay the loan. (*Usury Laws: Harmful When Effective by Normann N. Bowsher*)

This demonstrates that regulating business to increase equity in our communities must accommodate what we already understand about economics. ▲

Jay Hutchins