Family Economics & Financial Education

Payday Lending

What is a Payday Loan?

There are many ways to obtain cash when a person needs money and cannot wait until payday. One option is a payday loan. A payday loan is a short-term loan providing immediate cash, typically secured by a borrower's written check or authorization for automatic withdrawal from the borrower's bank account.[4] Payday loans are also known as cash advance loans, check advance loans, post-dated check loans or deferred deposit check loans.[3] Payday loan transactions can be performed by check cashers, payday loan stores, pawn shops, toll-free numbers, and sometimes even rent-to-own companies.[2] Payday loan companies can be in the risky form of an internet lender where a person will be required to give the lending company access to financial accounts as well as a social security number. This type of transaction increases the risk of fraud and identity theft.

How to Obtain a Payday Loan

Individuals who use payday lending companies typically have poor credit histories, making it extremely difficult to obtain a traditional loan.[5] Focus groups of low-income and ethnic consumers conducted for Union Bank of California in May 2001, identified five ways check cashers were superior to banks:

- easier access to immediate cash;
- more accessible locations;
- better service in the form of shorter lines, more tellers, more targeted product mix in a single location, convenient operating hours, and Spanish-speaking tellers;
- more respectful, courteous treatment of customers; and
- greater trustworthiness.[5]

Payday lenders provide the same service -rich environments as check cashers, although may not be used as often because of high fees and continuing obligations. People with poor credit like using payday loan companies because it is a relatively effortless way to get cash; no credit history or collateral is required.[3] Usually the requirements include having a bank account, a steady source of income and identification.[2] The borrower must also sign paperwork stating they will not participate in any class action law suit, file for bankruptcy, or close financial institution accounts until the loan is paid.[1] To use a payday loan company, an individual may write a post dated check for the amount they wish to borrow along with the lending company's fee, or give the payday lender an authorization for automatic withdrawal from the borrower's financial institution account. For instance, James needs $100 in cash so he writes a check for $115 to the payday lender, or gives authorization for $115 to be automatically withdrawn from his financial institution account. The lender gives James $100 in cash and keeps $15 for fees. The lender will then hold the check until the agreed upon date, usually the borrower's payday, before cashing it. The length of a payday loan can last anywhere from one to thirty-one days and be between $50 and $1000. Fees are often between $10 and $30 per $100 borrowed.[3] This translates to an average Annual Percentage Rate (APR) of between 391% and 443%.[4]

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Payday Lending Options

Payday loans are difficult for consumers to pay back because the payday lending companies require borrowers to pay back the entire loan in one lump sum rather than installments. If a borrower does not have the funds in their financial institution account to allow the payday lender to cash their check, they have three choices: 1) rollover the loan, 2) payoff the loan, but then immediately take out another loan in a "back-to-back" transaction, or 3) default on the loan, which results in additional fees as well as still owing the full amount of the loan.[4]

★ Rollovers ★

If payday arrives and James still does not have enough money to repay his loan, one option he has is "rolling over" the fees. This means that he can pay another $15 to extend his loan until his next payday. James still owes the original $100. The lender may also automatically withdraw the rollover funds directly from James' financial institution account. Many states have regulations limiting the amount of times a lending company is allowed to rollover fees in attempt to keep payday lending a short-term borrowing option.

★ Back-to-Back ★

Payday lending companies have found a way to circumvent rollover regulations by allowing "back-to-back" loan transactions.[4] For instance, James has enough money deposited in his bank account after payday to pay back his loan, so he pays back the loan, but then he is not able to pay for anything else he might need until his next payday, forcing him to take out another payday loan.

★ Default ★

When the loan is due, the lending company will cash James' check. If he does not have sufficient funds in his financial institution account, he will default on his loan which means the lender will charge more fees. James' financial institution will also charge insufficient funds (NSF) fees and returned check fees. The lender can legally try to cash his check multiple times; resulting in NSF fees over and over.[4] Returned checks can cause poor credit ratings and impact future loans. James still owes the original amount of the loan until it is paid back in full. If he cannot pay, lending companies will use aggressive collection practices to make James pay back his loan. If James still has not repaid the loan, the lending company can threaten criminal charges.

Payday Lending

Using a Payday lending company is very costly to borrowers; it can trap them in a cycle of borrowing and lead to long term debt and legal problems. Payday loan customers are about four times more likely than all adults to file for bankruptcy.[5] Payday lenders are making a lot of money from their customers and it has become a very successful industry. Ten years ago the payday loan industry was virtually non-existent, then at the end of 2005, it was reported by industry analysts that payday loans amounted to $40 billion dollars with $6 billion in loan fees paid by borrowers.[2] Borrowers who receive five or more payday loans per year account for 91% of payday lenders' revenues.[4] The payday loan industry is thriving because people pay the fees instead of seeking alternative forms of credit, and because many of those relying on payday loans believe they have few alternatives through which to raise cash quickly.

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ALTERNATIVES

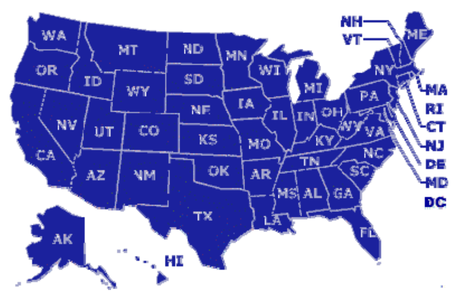
An alternative to a payday loan could be to borrow a short term loan from friends or family, which usually has minimal finance charges. Even asking an employer for a paycheck advance, or learning if your checking account has an overdraft protection option may be better than paying excessive payday lending fees. Individuals may also ask creditors for more time to pay bills. A traditional financial institution such as a bank or credit union will have APR's ranging from 10% to 18%. Even a costly credit card cash advance has APR's of only about 16% to 21% compared to the 400% APR of a payday loan.[3]

With more than 2,000 payday lending outlets, California reportedly has more payday loan offices than it does McDonalds and Burger King establishments.[5]

Payday loans are an option for short term borrowing, but should not be used for long-term purposes. For some, it can be a convenient way for quick cash, but for the majority of people that use payday loan companies, it becomes a quick way to accrue a substantial debt. To prevent this from happening, create a spending plan to track income and expenses. It is also very important to start a savings account; set aside money from each paycheck for an emergency fund to take care of unexpected expenses. Instead of borrowing with a high interest rate to pay back to a lender, let your financial institution pay you interest!

REGULATION

Some states have small loan laws or usury caps that prevent triple digit APR's and significantly limit payday loan companies, however, most do not. The Truth in Lending Act does require that payday lending companies advertise the finance charges and annual percentage rate as well as the terms of the loan in writing to customers.[2] State specific information can be found at http://www.paydayloaninfo.org/states.cfm.



If you feel victimized by a payday lender or feel they have given you incorrect information and violated the Truth in Lending Act, report complaints to the Federal Trade Commission's Consumer Response Center. Toll-free 1-877-382-4357; or by e-mail using the online complaint form at www.ftc.gov.[2]

1. About.com. Consumers Warned of Online Payday Loan Sites. Retrieved from http://usgovinfo.about.com/od/consumerawareness/a/paydayloans.htm
2. Consumer Federation of America. PayDay Loan Consumer Information. Retrieved from http://www.paydayloaninfo.org/
3. MontGuide. Payday Loans: Laws Protecting Montana Borrowers. Retrieved from http://www.montana.edu/wwwpb/pubs/mt200102.html
4. Center for Responsible Lending. Quantifying the Economic Cost of Predatory Payday Lending. Retrieved from http://www.responsiblelending.org/pdfs/CRLpaydaylendingstudy121803.pdf
5. Stegman, Michael and Robert Faris. Payday Lending: A Business Model that Encourages Chronic Borrowing. Retrieved from http://www.kenan-flagler.unc.edu/assets/documents/CC_Payday_lending.pdf

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