Even Simple Policies Can Be Screwed Up

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Article:

The subprime lending crisis that is still roiling financial markets was caused in part by excessive complexity. The securitization of mortgage loans was so complicated that it flummoxed regulators and rating agencies. But bad policy can happen even when things are simple. Payday lending is a perfect example.

In payday lending, a borrower writes a check that the lender cashes on the borrower's next pay day. In return, the borrower receives an immediate loan of less than the value of the check, with the difference serving as the interest rate. A 2005 study by the Federal Deposit Insurance Corp. found that the average loan and fee at established payday-loan stores were $240 and $43, respectively.

The $43 fee translates to an interest rate of about 18 percent, and for a two-week loan that implies an annual percentage rate (APR) of nearly 470 percent. That huge APR angers consumer advocates and it's essentially what ended payday lending in North Carolina in early 2006. But the high interest rates are a function of the high cost of issuing small short-term loans. The FDIC study found that the average cost per payday loan was $28. Even if payday lenders earned no profit and merely covered their costs, the implied APR would be more than 300 percent.

There are many misconceptions involving payday lending. For example, it's not true that borrowers come from the poorest segment of society, because of course one has to have a checking account in order to get a payday loan. It's not true that payday lenders profit from bad loans that get rolled over again and again, because that increases the risk of default.

It's also not true that the typical payday borrower is caught in a "debt trap" of rolled-over loans. While most borrowers take out a number of payday loans per year, the vast majority take out fewer than one per month. Their loans are sporadic rather than continuous.

Finally, it's not reasonable to compare the APR on a short-term payday loan with longer-term debt. And even if it were, the fees and penalties for bouncing a check amount to an even higher effective APR.

But the biggest misconception is that banning payday lending is good for lower-income people. A recent study by the Federal Reserve Bank of New York tested this by examining the effect of the end of payday lending in North Carolina and Georgia. The study found that the payday-loan bans in those states have led to higher and/or faster increases in the rates of bounced checks, complaints about lenders and debt collectors, and Chapter 7 bankruptcy filings. It would appear that far from preying on lower-income people, payday lenders provide them an important credit option.

Some advocates of poor and working-class families are beginning to understand this. A position paper released this summer by the Urban Institute acknowledges the special credit needs of asset-poor families, and it treats payday loans as one of a number of viable options. Instead of greater restrictions, the Urban Institute report calls for increased competition among payday lenders, along with improved regulation, including better disclosure of loan terms.

This is a reasonable message, but it’s tough to get it out. A study this year by George Mason University notes that media coverage tends to echo the views of opponents of payday lending, focusing on victims and villains rather than the realities of household debt among the poor.

It’s frustrating enough that the media cannot seem to understand this simple issue. What’s much more distressing is the inability of regulators, including right here in North Carolina, to get it right.