Payday Loans Provide Credit to People with Few Options

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***** Note: Figures may be missing from this format of the document**

Article:

Payday loans are, for all practical purposes, no longer available in North Carolina. Earlier this month the last three payday lenders operating in the state (Check Into Cash, Check 'n Go, and First American Cash Advance), agreed to stop offering the high-interest quick-cash loans. As part of their deal with Attorney General Roy Cooper, the three companies also agreed to pay $700,000 to fund credit-counseling programs.

A fourth payday lender, Advance America, had already closed its North Carolina offices after the state banking commission ruled that its interest rates were too high. All together, the four lenders operated nearly 270 stores in the state.

The end of payday lending in North Carolina pleases consumer advocates. They believe they've done something good for poor people, the group most likely to take out payday loans. But they've actually hurt the poor by unnecessarily restricting their credit options. The $700,000 would have been better spent educating these do-gooders about credit markets.

The process of payday lending is simple. A person needing cash but finding herself two weeks short of her next paycheck can write a check to the payday lender and receive somewhat less than the face value of the check as a two-week loan.

When payday lending was legal and licensed by the state of North Carolina, the maximum fee was 15 percent of the face value of the check, so a $200 check would generate a $170 loan to the customer. After two weeks, the lender would cash the check and receive the full $200. But $30 of interest on a $170 loan actually implies an interest rate of 17.6 percent, and that in turn implies an annual percentage rate (APR) of 460 percent.

The huge APR is what makes consumer advocates hyperventilate. They claim that payday lending is unfair because the people paying these high rates tend to be poor (which is true, though studies have shown that borrowers are more economically diverse than is often believed). They claim that payday lenders profit most when borrowers default and have to continue writing check after check, all to pay off the original loan.

But before we start hyperventilating as well, let's take a closer look at this issue. In particular, does the APR make sense in the context of payday lending? Are high interest rates necessary to cover payday lenders' costs and generate a reasonable profit? Is there anything wrong with letting poor people decide for themselves whether payday loans are a good or bad deal? And why can't credit-counseling programs coexist with payday lending, instead of being a substitute for it?

The first thing we need to do is divorce ourselves temporarily from the APR concept. The APR of a payday loan is an interesting number, but it's meaningless. It's like calculating how fast a sprinter could run a marathon if he could maintain his 100-yard pace throughout the entire 26-plus miles. Just as that calculation would tell us nothing about the sprinter, the 460 percent APR tells us nothing about a payday loan. It's not repaid over the course of a year. It's a short-term loan (a lending sprint!), and its interest rate should be assessed on that basis.

Suppose payday lenders were forced to charge an interest rate equal to the prime rate, which is currently about 7.5 percent (in APR terms). At that rate, a two-week loan for $170 would generate less than 50 cents of interest to the lender. Is 50 cents enough?

The answer can be found in a 2005 working paper by the Federal Deposit Insurance Corporation, which surveyed over 1,000 payday lending stores around the country. It found that lenders, like all businesses, must pay wages and rent and utility costs. In addition, lenders must incur costs for collections and lost loans. The result is a fairly high fixed cost per loan.

I'll exclude the stores in the FDIC survey that were open less than a year, because they had the highest costs. The remaining stores made an average of 7,500 payday loans per year for an average of $240 per loan. Their average cost per loan was $28.40, which means that an APR equal to the prime rate is way too low to cover a payday lender's costs.

The average fee charged by these stores was $42.60 per loan, so clearly these stores are earning a healthy profit. But it's hardly the sort of profit that smacks of robber barons and Simon Legree. The FDIC study's authors write, "We find that fixed operating costs and loan loss rates do justify a large part of the high APRs charged on payday advance loans."

The FDIC study also addresses the claim that payday lenders profit by luring people into a cycle of repeat loans with ever higher effective interest rates. The study finds that repeat loans are no more lucrative than new loans. In other words, payday lenders benefit when they make *more* loans, but it doesn't matter whether the increase comes from new or repeat borrowers.

The FDIC study isn't alone in finding such results, but there are some dissenters. A 2003 study by two researchers at the University of North Carolina at Chapel Hill argues that payday lenders' profits rise when more of their customers are chronic borrowers. However, the study has an important technical flaw (involving "omitted variable bias," in case you're interested in that sort of thing) that makes this particular result a bit suspect.

An even more problematic study is a 2004 report by the Center for Responsible Lending. The CRL study claims that payday lending costs the American economy $3.4 billion per year, which follows from its assumption that *all* payday loans to frequent borrowers are "bad." From that it concludes that the interest charged on those loans is a cost to society. It's a laughable result, even aside from the study's failure to mention any possible benefits of payday lending. But CRL is an advocacy group, not a think tank. The CRL website lists some alternatives to payday loans. One is "cash advances on credit cards." Great financial advice, huh?

In spite of all the righteous indignation against payday lending, serious research makes it clear that the economic case against it is weak. And there are strong cultural and social reasons to allow it. One is our traditional preference that prices and interest rates be determined by individuals acting freely in markets, not by the government dictating to them. Indeed, the entire campaign against payday lending is a belief by well-intentioned people that they know what the correct interest rate is.

But they don't. One of the more hilarious remarks on the subject was made recently by a CRL official. Regarding the interest rate on payday loans, she said, "maybe it needs to be a few points higher, but that's a better strategy than starting at 400 percent."

We can ignore the comment about "400 percent," because we now understand that it's a useless number. Therefore, the CRL is on record saying that payday interest rates need to be higher than, say, the prime rate.

Now how do we decide *how much* higher they should be? I have an idea. Let’s ask lenders and borrowers, the people who really have a stake in the decision. And the best mechanism to coordinate their decisions is the market for payday loans.

With payday lending, a person who needs cash quickly is able to get it, but he has to pay a higher interest rate. Isn’t that reasonable? After all, a person who needs an airline ticket at the last minute has to pay a higher airfare. A person who needs a car *today* will most likely have to pay more because she won’t have time to shop around for the best price. Needing something quickly almost always means paying more for it.

And payday borrowers will continue to pay more for quick credit, with or without payday loans. When the state started licensing payday lenders in 1997, one of the specific reasons was to undercut illegal loan sharks. Banning payday lending just opens the market back up for unlicensed lenders. The ban is like a jobs bill for loan sharks.

It’s easy for well-intentioned people to believe that they know what’s best for others. But if we’re concerned that the poor are making ill-informed decisions, the solution isn’t to outlaw the decision. The solution is to inform them. A 2001 report by the state Commissioner of Banks recommended expanding educational efforts, but instead North Carolina has decided that when it comes to credit, poor people aren’t worth educating.