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Alternatives to Payday Loans

by Paul Kelly

Key Findings:

- Victims learn about payday loans from advertisements (32 percent), friends or family (20 percent) or signage at lender locations (14 percent).
- At the time they went to get a payday loan, 79 percent of focus group participants were getting calls demanding money from creditors, 61 percent had credit card debt they could not pay, and 82 percent could not keep up with the monthly rent or utilities at the time they applied for these loans.
- Fifty percent of focus group participants had applied for a loan but could not get one because of bad credit and 67 percent said they had no other way to raise money to pay their debts. Forty-three percent of participants had filed for bankruptcy.
- Bankers believe payday loan product alternatives should be easily available and handled as transactions rather than loans to lower costs.
- Customers seeking alternatives to payday loans should be encouraged, and perhaps required, to enroll in credit counseling and to open a savings account to avoid future problems.
- A statement from bank regulators that a particular payday loan alternative product qualified for a Community Reinvestment Act credit would be the only way that some banks would take on any low-dollar, low volume, and staff time consuming service. They suggested that the credit should be given for the cost of marketing such beyond their existing checking account customers.

Introduction:

The Check Cashers Act of 1999 classified the charge for borrowing from a payday lender as a "fee" rather than as interest. As a result of this legislation, Arkansas now has more payday lenders (281) than McDonald's restaurants (127).[1] These lenders make an estimated 880,413 payday loans per year at an effective interest rate of 391 percent to 443 percent for an initial loan.[2] These lenders exist despite the fact that the Arkansas Constitution caps interest rates for consumer loans at a maximum 17 percent. Court cases throughout the state have struck down payday lending practices as usurious. A case currently pending before the Arkansas Supreme Court will determine if the Check Cashers Act is unconstitutional.

In spite of the legal questions, these small, short-term loans fulfill a consumer credit need not being met by other existing financial institutions. Consumer advocates hoping to eliminate payday loans recognize the role these transactions play in meeting the needs of cash strapped consumers. Small, short-term loans are out of reach for many credit-risky Arkansans who then turn to payday lenders. Due to the high interest rates being charged, payday loans potentially take $45,781,479 annually from the assets of Arkansas households.[3]

This report explores alternatives to payday loans. Depository institutions have the tools and infrastructure that could be used to offer customers alternatives to payday loans at significantly lower cost.[4] This past year Arkansas Advocates for Children and Families (AACF) and Arkansans Against Abusive Payday Lending have explored potential payday loan alternatives by reviewing research on this issue, conducting focus groups with payday loan consumers, and holding discussions with bank representatives. This report summarizes (1) the findings of these focus groups, (2) the discussions with banking officials and loan officers of banks in Arkansas, and (3) a review of the literature exploring the models for such alternatives.

Focus Groups:

Three focus groups of payday loan consumers were held in August 2005 in Fayetteville, Hot Springs, and Pine Bluff, Arkansas with a total of 28 participants. A majority (56 percent) of the participants were between 31 and 50 years of age. Forty-six percent of participants were white, 43 percent were African American, and 11 percent described themselves as other. Eleven percent of the participants were college graduates, 32 percent had completed some college, 25 percent completed high school, and the remaining 32 percent of participants gave no response. Forty-three percent of the participants currently had children in their homes.

- Fifty percent of participants had incomes of less than $20,000 per year.
- Twenty-nine percent had incomes from $20,000 to $30,000, followed by 14 percent with incomes from $30,000 to $40,000 per year.
- Only 7 percent had income over $50,000 per year.

Thirty-nine percent of participants were married, 32 percent were divorced, and 25 percent were never married. One participant was a widow.

Participants were most likely to learn about payday loans from advertisements (32 percent), friends or family (20 percent) or signs at lender locations (14 percent).

While many of the participants could not recall the original amount of their loan or the exact amount they eventually paid the payday lender, 25 percent of the participants indicated that their original loan was between $100 and $199. Another 25 percent took out loans between $200 and $299, with 8 percent taking out loans or $300 or more. However, 11 percent of participants paid back more than $500 to the lender, with 18 percent paying between $400 and $499, and 21 percent paying back $300 to $399, and another 18 percent paying between $200 and $299.

There were several factors that led to participants seeking help from payday lenders. Seventy-nine percent of participants were receiving calls demanding money from creditors, 61 percent had credit card debt they could not pay, and 82 percent could not keep up with the monthly rent or utilities at the time they applied for these loans. Fifty percent of participants had applied for a loan but could not get one because of bad credit and 67 percent said they had no other way to raise money to pay their debts. Forty-three percent of participants had filed for bankruptcy.

These focus participants typify the cash strapped, high credit risk, and desperate, working Arkansans who apply for payday loans. Payday lenders require a person to have a steady and reliable source of income and a checking account. The only "credit check" done by these lenders is to ensure applicants do not have multiple outstanding payday loans. Developing alternatives to payday loans will require that these challenges be addressed.

The Consumer's View of Alternatives:

Alternatives to payday loans were discussed in detail with members of the focus groups. The use of credit cards to deal with short term cash needs was seen as the most obvious alternatives to payday lenders. After all, who doesn't get an offer of a credit card on a regular basis? Some participants agreed that credit cards were good for emergencies but almost all had already had a bad experience with credit cards. Multiple credit cards were too easy to obtain and could be used for any expense, leading to high debt levels. Others were caught unaware of the excessive application fees being charged on their initial bill because of their bad credit history. Few participants actually had a credit card when they took out a payday loan. Many others were surprised how easy it was to obtain credit cards even after filing for bankruptcy. Those who had credit cards, and went to a payday lender instead, did so because getting a payday loan made them feel "like I was taking charge, solving this problem on my own."

This sense of being in charge was expressed by participants in every group as a motivating factor that lead them to payday lenders instead of asking employers, family, or friends for help when they were in a financial bind.

> **"There needs to be a place to teach us some things about budgeting so we don't put ourselves in this situation."**

- Few of the participants worked for employers who offered cash advances.
- They often had family members who were also cash strapped.
- They had exhausted just about every method of getting money.
- Fewer than half of the participants indicated they had health insurance coverage, an issue that was an ongoing cause of concern.

It was clear that, for these consumers, the payday loan business offered an attractive alternative.

- They were conveniently located.
- There was an easy application process.
- With "no credit check" they found an easy answer to their difficult financial situation.
- They were greeted by friendly, reassuring, and solicitous employees who put them at ease and treated them with respect.

Participants viewed banks as formal and intimidating places where they would be confronted with their bad credit history and inability to take care of their financial needs. It was only after they found themselves unable to pay off the payday loan that they realized they were caught in a debt trap. These families believed, perhaps naïvely, that if they worked hard, played by the rules, took care of their family, and tried to pay their bills everything would work out for them.

Many of the participants had learned other ways to obtain emergency money or anticipate hard times. Garage sales, savings accounts, rent-to-own, and bartering were just a few of their alternatives when the car broke down or the refrigerator broke.

Focus group participants were very receptive to payday loan alternatives that might require them to open a new checking account, make electronic deposits, open savings accounts, or attend credit counseling courses in order to qualify for small loans or enhance their credit standing.

The Banker's Perspective:

The Community Affairs Specialist at the Federal Reserve Bank of St. Louis distributed copies of the publication *Low-Cost Payday Loans: Opportunities and Obstacles*[5] to consumer loan officers and other bankers across the state. They were asked to read the document and join her for a discussion on payday loan alternatives. Representatives from eight different banks originally agreed to attend this meeting, and those who subsequently did not attend were interviewed by telephone.

Most of the bankers interviewed were familiar with payday lending but were uncertain how their customers were being affected. Several offered "products" that they considered to be alternatives to payday loans. The products included a no minimum loan policy, bounce proof checking, and a case-by-case provision that allows a customer to write a check without any Non Sufficient Funds penalty or fee. With the exception of bounce proof checking, these products are generally available only to established customers and are not widely marketed. Bounce proof checking was considered an important product by some bankers while others viewed it as a practice that encourages customers to overdraw their accounts and did not offer it to their customers.

"They (payday lenders) make you comfortable. They ask how your kids are doing. They offer you hot dogs and chips on Friday and Saturdays."

In discussions about payday loan alternatives, there were several factors that bank representatives thought were critical to successful alternatives.

- Product alternatives should be easily available and handled as transactions rather than as loans. This would allow the customer to access small amounts of cash without having to go through a lengthy approval process or "credit decision." For example, the initial decision for the "loan" could be made at the customer service representative level to make it more like a payday lender and ease bank costs. However, some thought it unlikely that such decisions could be made at that level.
- They generally agreed there should be a designated time frame for repayment.
- The customers should be encouraged, and perhaps required, to enroll in credit counseling and to open a savings account to avoid future problems.
- Some suggested that the alternative be "bundled," such as into a checking and savings account, and that it is a one-time loan with an incentive to build up to more traditional credit options with the bank.

One of the most provocative discussions involved whether a payday loan alternative's profitability or its qualification for Community Reinvestment Act (CRA) credit was a motivational factor for banks. For some, a statement from bank regulators that a particular payday loan alternative product qualified for CRA credit would be the only way they would take on any low-dollar, low-volume, staff-time-consuming service. They suggested that credit should be given for the cost of marketing beyond their existing checking account customers. Others thought that both of these factors were important. This discussion also evoked comments on the role of banks in the larger community.

Hurdles to creating alternatives clearly exist. Offering payday loan alternatives that serve the larger community through the banking system will have to be flexible enough to take into account the poor credit histories of the families who need theses services the most. Encouraging banks and credit unions to offer alternatives within the state, without a national effort, was seen as a significant challenge for Arkansas.

Can Depository Institutions Offer Low-Cost Alternatives?

Banks and credit unions have the potential to offer realistic low-cost alternatives to payday loans because[6]:

- Their operational costs are minimized given their pre-existing infrastructure. They already have the physical facilities, loan staff, collection processes, etc., in place.
- They are in a better position to minimize credit losses through the use of direct deposit and automatic deductions for repayment-tools generally unavailable to payday lenders.
- They have the advantage of offering and deriving revenue from a variety of products and services, allowing them to profitably offer small dollar credit at lower margins.
- Payday loan alternatives offered by banks and credit unions in the form of revolving lines of credit are superior to payday loans in terms of customer convenience, speed and privacy.

Those same financial institutions, however, face three major obstacles to creating these alternatives.

- Though depository institutions have the means to offer low-cost payday loan alternatives, the proliferation of fee-based bounce protection programs represents a significant impediment to competition.
- To promote competition and help consumers identify the lowest-cost credit product, the Federal Reserve Board would have to impose homogenous disclosure requirements on all functionally equivalent forms of small dollar credit.
- Perceptions of regulatory hostility discourage banks and credit unions from offering low-cost payday loan alternatives.

Comments:

Arkansas has one of the lowest median household incomes in the country and one of the highest bankruptcy rates. The overall economic well being of our citizens cannot be enhanced by the proliferation of businesses that extract significant assets from working families.

The families currently using payday lending services are working hard, providing for their families, and contributing to the economy of our state. Those families, like the rest of society, are victims of a culture that encourages spending beyond our means and requires caution and a "buyer beware" mentality. The drastic consequences of the personal decisions that place all of us at financial risk must be offset by financial services that encourage responsible consumer behavior.

AACF will continue to work with financial institutions, consumer advocates, regulators, and community leaders seeking ways to reduce the high cost of being poor. During the upcoming months, the Federal Reserve Bank plans to bring in the author of *Low Cost Payday Loans: Opportunities and Obstacles*, referenced in this report, and three representatives of current working models of payday loan alternatives to meet with Arkansas banking officials. Working with Arkansans Against Abusive Payday Lending, The Federal Reserve Bank, and local banks and credit unions, we will identify alternative solutions that build on the lessons learned from discussions with families and the financial community. Developing low-cost alternatives to payday lending is critical to the economic sustainability of Arkansas families and their children.

(Endnotes)

1 Klein, H.C. "Payday Lenders in Arkansas, the Regulated and Unregulated." Arkansas Against Abusive Payday Lending, AARP/Arkansas. There are 127 McDonald's restaurants in Arkansas, according to a September 20, 2005 e-mail communication from McDonald's Corporation.

2 *Arkansas Assets and Opportunity Scorecard 2005*. Southern Good Faith Fund. December 2005 www.southerngoodfaithfund.org

3 Ibid, page 19

4 Bair, Sheila, Low Cost Payday Loans: Opportunities and Obstacles. Isenberg School of Management, University of Massachusetts at Amherst. Prepared for the Annie E. Casey Foundation, June 2005

5 Ibid

6 Ibid

The Mission of AACF and State Fiscal Analysis Initiative (SFAI)

The mission of Arkansas Advocates is to ensure that all children and families have the resources and opportunities to lead healthy and productive lives and to realize their full potential. The goal of our SFAI project is to improve the economic well-being of the state's families with children by providing timely and credible analysis to policymakers, the media, and the public and promoting a more informed public debate about state tax and budget issues.

Support AACF's Work

AACF is a non-profit organization. If you would like to support our work you may donate online at www.aradvocates.org or mail contributions to the address listed below.

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