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Money

Photo by John Blais

Sudden Debt

By Barry Yeoman, September & October 2006

Overdrawn by $5? Need a loan until payday? Hidden bank fees and the high rates of storefront lenders land millions of Americans in trouble. Can't happen to you? That's what these folks thought

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For Mark Keil, 45, the spiral began with some smokes. It was April 2004 when Mark (pictured above) stopped by his favorite convenience store in Dayton, Ohio, and spent $19.45 for several packs of cigarettes. The self-employed residential designer knew his bank balance was running low. Nevertheless, Mark handed over his debit card. He wasn't really sure what his account balance was, but he thought the transaction would be rejected in case he didn't have enough funds. If that happened, he figured, he'd just hand the cigarettes back to the clerk and go on his way.

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The charge went through just fine. What he didn't know was his account was indeed short and that the Fifth Third Bank automatically covered his overdraft. Its fee for this service, however, ended up costing Mark almost twice what his cigarettes cost. That's because the bank automatically enrolls customers in an overdraft-protection program when they sign up for a checking account—unless they opt out or choose to link their account with a credit or savings account. This feature allows customers to overspend their accounts, with one catch. The bank tacks on a charge (in Mark's case, $30) for each overdrawn transaction, along with a $6 fee for every day the account remains in the red. Mark didn't know this, so he used the debit card a few more times over the next several days. By the time he made a deposit two weeks later, the bank had charged him $198 for the privilege of covering his $59 in overdrafts. "I couldn't keep up with it," he says.

By the following October, Mark's race to catch up had cost him more than $1,194 in overdraft fees. Finally, unable to break the cycle, he walked away from his overdrawn account. This had consequences, though: a debt collection agency came after him, and he was barred from opening a bank account for at least five years. But, he says, he had no choice: "I was throwing money down a hole."

These days a growing number of Americans of all economic levels feel as if they're throwing money down holes. That's because several multibillion-dollar industries have sprung up for the specific purpose of lending small amounts of money at interest rates that would make a loan shark blush. And, in most cases, it's perfectly legal.

Some of these loans come, as in Mark's case, in the form of "overdraft protection" charges or, as they're often referred to, "bounce loans" from banks, which lend their overdrawn customers enough to keep their accounts in the black. Other loans come from storefront companies that accept postdated checks and automobile titles as collateral for short-term loans. Companies like these may seem like godsends, especially for those who struggle from paycheck to paycheck. Godsends until their customers, unable to pay the fees and interest charges, find themselves sucked into endless spirals of debt.

Consumer-protection groups such as the Center for Responsible Lending in Durham, North Carolina, and the Consumer Federation of America in Washington, D.C., refer to these practices as predatory lending, a term previously attached almost exclusively to shady real-estate loans. They and a number of public officials—including attorneys general Thurbert Baker of Georgia, Roy Cooper of North Carolina, Patricia Madrid of New Mexico, and Tom Miller of Iowa—have led the charge for tougher regulations to curb these practices. "Consumers get on a debt treadmill and need a life preserver," says Cooper. "Instead, these companies throw them an anvil."

Shark Spotting

How do you tell the difference between a predatory lender and a fair one? Here are questions to ask that should alert you.

Will you check my credit history? If you hear "No credit check needed," an alarm should go off.

What's my annual interest rate? Ask until you get an answer. Get it on paper. A triple-digit rate is an automatic red flag for a bad loan.

Can I repay the principal in installments? Many predatory lenders have all-or-nothing payment policies, which only end up getting you deeper in debt.

Does the contract have a mandatory-arbitration clause? If so, you'll lose your right to sue if anything goes wrong. Arbitration is often biased in the lender's

Shortly after a heart attack forced her to retire, Sandra Matthis found herself short of cash. Her ex-husband had fallen behind in alimony payments, she says, and her monthly disability checks didn't quite cover all her bills. "Times were hard," says the 57-year-old former insurance agent. On a nephew's suggestion, Sandra went to a business called First Southern Cash Advance in the farming town of Clinton, North Carolina. The company, known as a payday lender, offered an attractive deal: with no credit check, it would lend her $150 until the following payday. All Sandra had to do was fill out an application, show utility bills in her name, and write a postdated check for $175 (the $150 loan amount plus $25 interest). Sandra got the $150—and paid her overdue telephone bill. "It felt pretty good," she says.

favor.

Need a small loan? To avoid predatory lenders, first contact your local credit union or ask for an advance from your employer. If you're paying off a debt, negotiate a payment plan with your creditor. For more borrowing info, read AARP.org's articles on avoiding abusive lenders.

Payday lenders typically charge customers annual interest rates of 390% to 780%.

Pretty good, that is, until the next month, when she was supposed to repay the loan. Her ex-husband still hadn't paid the alimony. As a result, Sandra couldn't pay back the $175 she owed. Desperate to cover her postdated check, she borrowed money from a second payday lender. Then she went to a third company and a fourth. "I kept digging deeper every month," she says. "By the time I paid off one loan and the interest, I had nothing left." And she wasn't alone. During her monthly trips to the various lenders, Sandra started seeing the same faces over and over again: people trapped in debt cycles similar to hers. "I'd say, 'My God, look at the money these places are making off the same people month after month.'" Eventually Sandra sought out a legal aid attorney, who in 2004 filed a lawsuit against one of the lenders and told Sandra to stop making payments. By then the North Carolinian was forced to give up her apartment and move into a trailer in her brother's backyard. She still hasn't been able to recover.

Of all the different kinds of predatory lenders, perhaps none are as visible as the payday firms, whose storefronts dot street corners of cities and suburbs across the United States. The industry took hold in the early 1990s. Since then it has grown into a formidable economic force. In 2005 loan-industry giant Advance America, for instance, reported revenues of $630 million from its 2,600 outlets in 36 states. The Center for Responsible Lending estimates that payday-loan fees cost U.S. families at least $3.4 billion a year, with the average borrower paying $800 for a $325 loan. California alone has more payday-loan outlets than it has McDonald's and Burger King restaurants combined, reports the *Los*

Angeles Times. And it's estimated that one American in 20 has taken out such a loan.

According to the University of North Carolina's (UNC's) Kenan Institute of Private Enterprise, the typical payday-loan customer has a steady job, a checking account, poor credit, and an annual income of less than $50,000. The Colorado Attorney General's Office reports that 7.4 percent of payday-loan customers in that state are older than 55. But Jean Ann Fox of the Consumer Federation of America says that figure underestimates the secondary effect of payday loans on older Americans. "They're the ones who have to bail out their adult children when they become victims," she says.

Payday lenders say they're performing a valuable service by offering quick cash to people who find themselves in temporary monetary crunches. "If you go to your bank, they're not going to loan you $200 for two weeks," says Steve Schlein, spokesperson for the Community Financial Services Association of America, a payday-lender trade group. "We fill that niche."

Over the past decade payday lenders have worked hard to reinforce that message by engaging a fleet of lobbyists, initiating a vigorous public relations campaign, and heralding an industrywide set of "best practices" that encourages, among other things, full disclosure of loan conditions. "There's been a well-funded, intentional effort to legitimize payday lenders," says Yolanda McGill, an attorney for the Center for Responsible Lending. Adds New Mexico attorney general Madrid: "The small-loan industry has argued that they're providing a necessary service. You'll probably hear that same argument from drug dealers."

California has more payday-loan outlets than it has McDonald's and Burger Kings combined.

Research from UNC's Kenan Institute, Ohio State University's law school, and various state agencies and consumer groups across the nation shows that these businesses purposely structure their contracts so consumers like Sandra have a hard time repaying their initial debts. They typically charge annual interest rates of 390 percent to 780 percent, restrict loan periods to two weeks, and refuse to accept partial payments on the principal. Consumers who can't pay off the entire debt at once must keep refinancing until they can.

State regulators in Illinois, Indiana, Washington, and Wisconsin looked at data between 1999 and 2003 and concluded the average payday customer takes out ten or more loans each year. A 2005 survey commissioned by the Oklahoma Department of Consumer Credit identified more than 1,500 Oklahomans who had borrowed at least 40 times over a 12-month period. The same survey showed that 34 percent of all payday-loan customers used two or more different lenders. "The repeat transactions are where the abuse is," says attorney McGill.

After Anita Monti borrowed $300 from Advance America to buy Christmas presents in 2001, she found that she wasn't able to pay off the loan all at once. Since Advance America had an all-or-nothing repayment policy, Anita had to refinance the loan continuously for two years. During that time the principal amount stayed the same. "Those clothes and those toys," says the 63-year-old North Carolinian. "My grandchildren outgrew them long before the loan was paid off." By then she had added another $400 to her loan principal. That $700 total ended up costing her $1,780 in finance charges.

As more stories like Anita's have surfaced, state governments have tried to regulate or even ban high-interest payday lending. But the industry manages to stay one step ahead by finding and using a wide range of loopholes. For example, some payday firms affiliate themselves with banks in less regulated states. Patsy Alston, Advance America's senior director of public affairs, explains that these arrangements are necessary for her company to survive. "What we're trying to do is provide options to customers," she says. "Without our product, where are they going to go?"

Delores Jones turned to a different type of lender when she needed new tires for her Buick Park Avenue in 2002. The 78-year-old retired elder-care worker had seen advertisements for Wisconsin Auto Title Loans, one of a number of firms nationwide that use customers' vehicles as collateral for high-interest loans. She went to an office in her hometown of Milwaukee, turned over the required spare key and title to her car, and signed a contract to borrow $730 at an annual interest rate of 300 percent. When the loan came due a month later, the payoff fee had grown to $1,027. Delores couldn't pay it. The amount due was more than her entire Social Security check. She couldn't imagine forfeiting her vehicle. "I would be so lost without a car," says Delores, who asked that her real last name not be used. So she began borrowing money from other sources just to pay the monthly interest, without ever making a dent in the principal. The auto-title-loan debt grew until finally, in 2003, she sold the '92 Buick for $1,000 to help pay the debt.

Auto-title loans like Delores's are especially hard on consumers, according to lawyers, activists, and officials who fight predatory lending. Says Pete Koneazny, an attorney with the Legal Aid Society of Milwaukee: "They're really devastating for elderly people who need their cars." The loans keep increasing and using up more and more of the borrower's income. "Consumers end up buying back the use of their own car at 500 percent interest," says Koneazny, who represents Delores and two others in a lawsuit against Wisconsin Auto Title Loans, which declined to comment.

Less reluctant to comment was LoanMax, one of the nation's largest auto-title lenders. In a December 2005 press release, the Georgia-based company described itself in heroic terms. It claimed to fill the void created by banks whose "pernicious and discriminatory attitudes" deny credit to women, minorities, and the elderly. Owner Rod Aycox says his company's loans aren't meant to be refinanced repeatedly but rather to offer "a solution to a short-term problem."

Short-term, unfortunately, isn't always the case. An Oregon Division of Finance & Corporate Securities report showed that 28 percent of auto-title loans weren't paid off until after the third renewal. Studies by the Missouri state auditor and the Illinois Department of Financial Institutions yielded similar results. And, as with payday lenders, most auto-title firms don't accept partial payments. This makes refinancing almost inevitable for many customers. Worse, says Iowa attorney general Miller, auto-title lenders aren't justified in the rates they charge, which often hover around 300 percent annually. Still, LoanMax's Aycox insists he would go out of business if he couldn't charge triple-digit interest. "The average age of my cars is in excess of eight years," he says. "When I repossess a car, it's basically valueless."

Over the past few years many banks have started to cash in on the same market targeted by auto-title and payday-lending services, through their "overdraft protection service." The premise is simple: the bank will honor checks, ATM withdrawals, and debit-card purchases even if the accounts are overdrawn. The rub is that the bank tacks on a service charge for each transaction—typically $20 to $35—often without the customer's knowledge. "This revolutionary program has resulted in a 50 to 300 percent sustainable increase in noninterest income for our clients," says John M. Floyd & Associates, a Texas firm that helps set up overdraft plans at banks and credit unions. The Center for Responsible Lending estimates Americans pay more than $10 billion in overdraft fees every year.

Bankers, however, tout overdraft protection as a useful tool for consumers. "People today are having trouble making ends meet," says Richard Edgar, president of Valley Ridge Bank in Kent City, Michigan. "If this is a way for them to get food or their prescriptions, more power to them." Edgar says his bank's overdraft program is "not a loan" but rather "a privilege." Yet opponents say that such overdraft "privileges" are indeed loans—and predatory ones at that. "These products are worse than payday loans," says Chi Chi Wu, an attorney with the National Consumer Law Center in Boston. "With payday loans at least you get a disclosure, which is required by federal law, so you know how much they're gouging you." The federal government, though, doesn't require banks to disclose the annual interest costs on overdraft programs, although various studies have pegged them at 1,100 percent or higher for loan periods of up to seven days. For example, a $35 fee on a $100 overdraft, if repaid the following day, would be equivalent to an annual interest rate of 12,775 percent. The smaller the overdraft amount and the shorter the loan period, the more astronomical the annual interest rate.

What makes overdraft loans even more insidious, critics say, is that many consumers aren't notified about the charges until they receive their bank statements. By then the damage is done. As Ohio's Mark Keil attests, many people believe that if an ATM spits out money, it's because their account is in the black. This assumption can cost an unwary customer hundreds of dollars in fees in just a single day. Some banks even display the overdraft limit—instead of the actual amount of funds in the account—on ATM screens, which can trick consumers into overdrawing their accounts and incurring more fees. Last year Kentucky's Farmers Bank and Capital Trust Co. disclosed that one of its account holders had racked up an astonishing $6,800 in overdraft fees in just 11 months.

And that isn't an isolated incident. After San Diego's USA Federal Credit Union started offering overdraft protection, it found that nearly one third of its customers who used the service overdrew their accounts six or more times per month. "Once they've maxed out at a negative $1,000, which is our limit, the next paycheck is automatically spent once deposited," president Mary Cunningham wrote in *The Credit Union Journal* last year. "In this case, we are no longer offering value—we're adding to his problems." In response, the credit union changed some of its overdraft policies, lowered fees, and beefed up its education and counseling programs.

Across the country, consumer-friendly institutions are starting to provide more ethical alternatives to small, high-interest loans. In 2001 the North Carolina State Employees' Credit Union unveiled a low-cost program for depositors who found themselves temporarily strapped for cash. "We became appalled by how our members were being abused by payday lenders," says Phil Greer, the credit union's senior vice president of loan administration. Now, with a program called Salary Advance, customers can borrow up to $500 until the next payday at only 12 percent annual interest (a maximum finance charge of $5.10 for a 30-day loan). One requirement: members have to deposit 5 percent of any amount they borrow into a savings account. They have access, but if they withdraw the money, they get no cash advance for six months. Since the program's inception, more than 68,000 people have used the program—and socked away more than $9 million in savings. Other institutions now offer similar programs. At the same time, officials and activists have been mobilizing to crack down on predatory lending. In July 2005, Representative Carolyn Maloney (D-NY) introduced a bill to extend federal truth-in-lending laws to overdraft programs.

On the state level, many lawmakers are taking a hard look at payday and auto-title loans, often with the encouragement of consumer groups and state attorneys general. (So far this year, AARP has worked in 13 states to pass legislation that fights predatory lending practices.) "These lenders prey on our most vulnerable citizens," says AARP Foundation senior attorney Deborah Zuckerman, who represents predatory-lending victims and has filed numerous "friend of the court" briefs for AARP in these types of cases. "And they're really no better than common thieves."

Contributing editor Barry Yeoman, based in North Carolina, wrote "Rethinking the Commune" for the March-April 2006 issue.

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