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PAYCHECK \$ and POLITICS

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Existing Options for Arkansas Consumers: Avoid the Payday Loan Debt Trap

by H.C. "Hank" Klein

Summary

The average (\$500) payday loan comes with an interest rate on the high side of 500 percent APR (Annual Percentage Rate) for 14 days. Comparatively, the average credit card cash advance from a bank-issued card carries an interest rate close to 100 percent APR for 14 days while a cash advance from a credit union carries an interest charge of only 11 percent APR. Overdraft protection from banks and credit unions also carries a much lower interest rate than traditional payday loans, about 18 percent APR.

Fifty-seven percent of traditional payday loan customers have a credit card, enabling them to take out a credit card cash advance at one of the 13,420 member financial institutions across the country. A form of identification and the credit card are all that are needed.

Every payday loan customer already has a checking account at a financial institution. This is a prior requirement for every payday loan. Most financial institutions offer a small line of credit tied to a customer's checking account as a form of overdraft protection. There is usually no fee for this service, but the interest must be paid for as long as the loan is outstanding and the interest rate is typically 18 percent APR or lower.

These two options, credit card cash advances and overdraft protection, are currently available for Arkansas consumers and carry a much lower cost than does a traditional payday loan.

Background

Everyone agrees that a 500 percent Annual Percentage Rate (APR) is an outrageous rate of interest on a loan, even a loan due on the next payday, but when consumer groups suggest that payday loans are predatory and should be outlawed, the press and legislators often ask what other options consumers have. In fact, there are options already available at many traditional financial institutions, such as banks and credit unions.

This issue brief will explore two of those options, their costs and convenience.

Credit Card Cash Advances

The trade association for the payday lending industry, the Community Financial Services Association of America (CFSA), says that 57 percent of their customers have a major credit card.¹ Consumers can obtain a cash advance on their existing credit card for a much lower cost than a payday loan.

Visa and MasterCard credit cards are issued by member financial institutions across the nation. In addition to issuing the cards to their customers and the customers of all sorts of businesses, each of the 13,420 member financial institutions that issue cards also provides cash advances at their numerous branch offices in the United States to the holders of those cards at the teller line in each of their branch offices.² The cardholder need not be a customer of the financial institution or the branch, the only requirements are presentation of the credit card and identification.

No application is needed and there is no credit check. The cardholder simply takes the card to a teller and asks for a cash advance in any amount up to the cardholder's available cash advance limit. Financial institutions use the same type of approval process a merchant or a restaurant does. A swipe of the card and a couple of key strokes on the keyboard and the consumer is approved. Once approved, consumers are given the cash on the spot and will have the option of paying the entire balance or a small minimum payment upon receipt of the monthly statement.

There are two costs involved for a cash advance on a credit card issued by most banks and only one cost for a cash advance on a credit card issued by credit unions. Banks usually charge a cash advance fee, which credit unions do not, of 3 percent of the advance (\$3.00 for a \$100.00 advance and \$15.00 for a \$500.00 advance).

In addition to the cash advance fee on bank issued credit cards there is also an interest charge for the exact number of days the money is used.

Here is an example: if a cardholder were to keep a \$500 cash advance for 14 days (a typical time period for a payday loan) at an interest rate of 20.23 percent APR (the average interest rate on a bank cash advance), the interest would be \$3.88 plus a cash advance fee of \$15 (this fee is not charged on Visa and MasterCard credit cards issued by credit unions). This would result in a total cost of \$18.88 for a cash advance obtained through a bank credit card or just \$2.09 for a cash advance on a credit card issued by a credit union.

When compared to the typical interest cost of \$100.00 for a similar \$500.00 loan for 14 days from a payday lender, a cash advance on a credit card is much less expensive. Even if the bankcard interest rate is at the high end of the scale, say 27.50 percent APR, the interest cost for 14 days would only be \$5.27 plus the cash advance fee of \$15.00 (if the consumer uses a bank issued credit card) for a total cost of \$20.27.³

With a credit card advance there is no requirement to pay the entire loan back on the next payday, although that should happen if it is affordable to do so. When the consumer receives a monthly statement, there will be a choice to pay the balance in full, pay the minimum payment, or pay any amount in-between that the consumer's budget allows.

Banks and credit unions may not be open as late as payday lenders, but they are usually open until 6:00 pm on Friday evenings (most consumers' payday) and on Saturdays.

If those hours are not convenient enough the consumer needing a cash advance on a credit card can obtain one at over 400,000 ATM machines in the United States and more than 1,000,000 ATM machines found in every country in the world.⁴ Insert the card and use the PIN (Personal Identification Number) that was received a few days following the receipt of the original card and any renewal cards.

If a credit card is at or near the credit limit, there is another option that may be even less expensive than a credit card cash advance and much less expensive than the 500

Cost for a \$500.00 14-day Loan			
	Traditional Payday Lender	Bank Issued Credit Card Advance	Credit Union Issued Credit Card Advance
Amount of Loan	\$500.00	\$500.00	\$500.00
Cash Advance Fee - 3%	-0-	\$ 15.00	-0-
Interest	\$100.00	\$ 3.88	\$ 2.09
Total Cost	\$100.00	\$ 18.88	\$ 2.09
Annual Percentage Rate	521.08% APR	98.18% APR	10.99% APR
Each Additional 14-day Period	\$100.00	\$ 3.88	\$ 2.09
Annual Percentage Rate	521.08% APR	20.23% APR	10.99% APR

Availability of a \$500.00 14-Day Loan			
	Traditional Payday Lender	Financial Institutions Branch Offices Available for Visa Cash Advances	ATM Available for Visa Cash Advances
United States	24,000 Stores	Branch offices of 13,420 Member Institutions	400,000
World	Unknown	Unknown	1,000,000

Note: Each payday lender store is independent. When a consumer takes out a loan at one payday lender, they do not have the option of renewing it or paying it off at another payday lender. Member financial institutions that issue Visa Credit Cards are a part of a worldwide network. Any member financial institution that issues Visa will assist with a cash advance at any of their branch offices. Additionally, cash advances can be obtained from any ATM on the Visa network.

percent+ APR of a traditional payday loan. This is overdraft protection.

Overdraft Protection

Every payday loan customer already has a checking account at a financial institution (bank or credit union). This is a prior requirement for every payday loan.

Most financial institutions offer a small line of credit tied to a customer's checking account as a form of overdraft protection. Some will tie the credit card balance to the checking account so that there is only one loan outstanding and one payment to make. This product is NOT the well-advertised Bounce Proof Checking service that actually overdraws an account and charges the regular overdraft fee of \$25 - \$35 or more. That option is expensive and can be confusing when a checking account is not kept in strict order.

This product is overdraft protection in the form of an open-ended line of credit that is tied to a checking account. If there is an inadvertent overdraft of the checking account, a loan to cover the overdraft will automatically be made. There is usually no fee for this service, but the interest must be paid for as long as the loan is outstanding and the interest rate is usually very reasonable (typically 18 percent APR or lower).

The financial institution's overdraft protection service is much less expensive than a loan from a payday lender and can be applied for when opening an account or any time thereafter at the financial institution. Then, if it is ever needed, as in the case of an emergency, consumers can

write a check to cover the costs, the check will be presented to the merchant against the consumer's checking account, and the overdraft protection will kick in.

The amount of the overdraft (let's say it is \$500.00) will cost about 25 cents per day at 18 percent APR.

Cost (Interest) Difference for a \$500 Loan	
Traditional Payday Lender Overdraft Protection	Financial Institution – Overdraft Protection
\$100.00	\$ 3.07
Every 14 Days	Every 14 Days
521.08% APR	16.00% APR

If the financial institution's overdraft protection is used, the cost is \$3.07 for a \$500.00 loan compared to a traditional \$500 payday loan that will usually cost \$100.00 for a 14-day term.

Conclusion

Banks and credit unions in Arkansas have options already in place with lower costs than traditional payday loans. These two options, credit card cash advances and overdraft protection are widely available, and Arkansans Against Abusive Payday Lending (AAAPL) is working to ensure that there will be others. Building on a report written for the Annie E. Casey Foundation by Dr. Sheila Bair, *Low-Cost Payday Loans: Opportunities and Obstacles*,⁵ AAAPL has met with representatives of the local banking community and held focus groups with payday lending consumers to determine what other options traditional financial

institutions and consumers could offer and utilize. The Federal Reserve Bank is offering technical support and we are hopeful that these efforts will result in a small short-term loan for a reasonable cost. Please continue to check our website, www.aradvocates.org, for updates on options for Arkansas consumers. We are indeed hopeful that soon other options will be available from traditional financial institutions; it is vital for Arkansans to avoid the debt trap of payday lending.

(Footnotes)

- 1 <http://www.cfsa.net/govrelat/pdf/Payday%20Advance%20Customer%20Profile.pdf>
- 2 Visa, USA
- 3 http://www.paydayloaninfo.org/PDLwebsite_cost_comparison_chart.pdf
- 4 <http://www.corporate.visa.com/md/st/statistics-quickfacts.jsp>
- 5 http://www.aecf.org/publications/data/payday_loans.pdf

The State Fiscal Analysis Initiative (SFAI) Project

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. The views of this report are those of the author and does not reflect that of the funders.



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