Issue Brief

Payday Lending: Whittling Away at Working Families' Income

All families need steady, stable income to meet basic needs and support their children's healthy development. Yet many Kentucky families struggle to make it until their next payday. Some families rely on short-term payday loans to make ends meet, but working Kentuckians lose millions of dollars annually in fees paid for these loans. Despite the toll on Kentucky families, the number of payday lending businesses has grown significantly in recent years, more than doubling between 1999 and 2006.

Kentucky can help working families keep more of their paychecks by requiring loan terms that are reasonable and fair. To do this, the Kentucky General Assembly should take action in several key areas, including extending the minimum loan term, lowering the maximum fee allowed per $100 and limiting the use of rollover loans. In addition, Kentucky should establish a database monitoring the use of payday loans to enforce current limits on the number of loans outstanding at one time and to gain a better understanding of how Kentuckians use payday loans.

The findings in this report grew out of a study conducted in June 2007 by Kentucky Youth Advocates and the Brookings Institution, which detailed the higher costs low-income families pay for goods and services. To help Kentucky families keep more of their earnings, that report – *The High Price of Being Poor in Kentucky* – highlighted three strategies: creating market-based solutions, financial literacy and curbing unscrupulous business practices. Kentucky Youth Advocates established a commission, made up of elected officials, bankers and members of the advocacy community, to identify workable approaches for Kentucky in these three areas. The solutions offered here reflect the commission's work to address one major aspect of the problem – payday lending.

The Lending Landscape

The subprime lending market has received an abundance of attention in recent years due to the rapid growth in the payday loan market and, recently, trouble in the subprime mortgage market. The subprime market provides loans to Kentuckians who would otherwise be denied them in the standard (prime) market due to poor credit or previous bankruptcy. In order to compensate for the added risk associated with the loans, higher interest rates are charged.[1] While subprime lenders provide small loans in a quick timeframe to Kentuckians without access to other credit, the loan terms eat up significant portions of working families' paychecks and put borrowers at risk of entering a downward financial spiral. Subprime and payday lending, in the simplest of terms, is high cost lending.[2] It is estimated that U.S. borrowers lose $9.1 billion annually to subprime lending practices.[3]

Payday Lending

Payday loans are small in amount, typically less than $300, and are secured by a person's check or authorization to withdraw from their bank account. These loans are short-term loans designed to be repaid in full on the customer's next payday, ranging anywhere from two weeks to a month. The term payday loan is used because the loan is intended to hold a person over until his or her next paycheck. Most of these loans are made by check cashing outlets, pawn shops and internet sites.[4]

February 2008

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Support

This report is funded by The Annie E. Casey Foundation. The contents of this report are the sole responsibility of Kentucky Youth Advocates and do not necessarily reflect the opinions of any funder.

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Payday lending takes a significant toll on Kentuckians. Research concluded that payday lending cost Kentucky residents $131 million in 2005.[5] On a $300 payday loan, a customer is typically charged $45 in fees and receives $255 cash.[6] Annual percentage rates for payday loans generally start at 391 percent. In Kentucky, payday lenders are allowed to charge up to 38 times more than the average credit card for a comparable loan.[7]

While payday lenders market a one-time, two-week loan, data show this rarely occurs.[8] Much of the profit for payday lenders comes from making repeated small cash advances, essentially making them long-term, high-interest loans. Ninety percent of payday lending revenue comes from fees charged to repeat borrowers.[9] Less than one percent of all payday loans go to customers who take out one loan a year.[10] National statistics show that 40 percent of Americans who took out payday loans refinanced more than five loans within the same year.[11]

The repeated use of these loans reflects, in large part, the practices of the industry. Payday lenders typically do not take into account the client's ability to repay but only require a checking account and a pay stub verifying employment. Despite having steady income, many borrowers are unable to repay the full amount within a two-week period. Kentucky families earning the median income in their region have very little cash remaining after covering basic expenses for housing, food, child care, transportation, health care, and other necessities (see Figure 1). For many, refinancing the loan is the only option. Lenders will continually collect multiple renewal fees every time a person is unable to repay the loan.[12] Research shows that payday lenders actually compete for long-term clientele rather than seeking out new customers. In order to accomplish this, some lenders will lower the price of the first loan, than charge high renewal fees and interest rates on subsequent loans, launching customers into an endless cycle of debt.[13]

Racial disparities are also evident in the locations of payday lenders and in the use of subprime loans. Research uncovered that African-American neighborhoods in North Carolina have three times as many payday lending stores as white neighborhoods.[14] This fact remained unchanged when controlling for different neighborhood characteristics including income, home ownership, poverty, unemployment rate, urban location, gender distribution and share of households with children. Other research demonstrates that as housing segregation increases, the portion of subprime loans to African-Americans, Hispanics and other minorities grows more rapidly than prime lending to these groups.[15] The unavailability of mainstream financial institutions and short-term loan products limits the options available to these groups and reinforces a reliance on payday loans.

As a result, payday lending businesses have flourished in recent years. In 1999 there were 352 payday lending facilities in the state. In 2007, that number grew to 801, an average annual growth rate of 11 percent (see Figure 2).[16] Payday lending facilities exist in every county in Kentucky. Additionally, no clear trends emerge when examining the rates of payday lenders per capita. Counties with high rates are distributed across the state and include a mix of rural and smaller urban areas (see Figure 3).

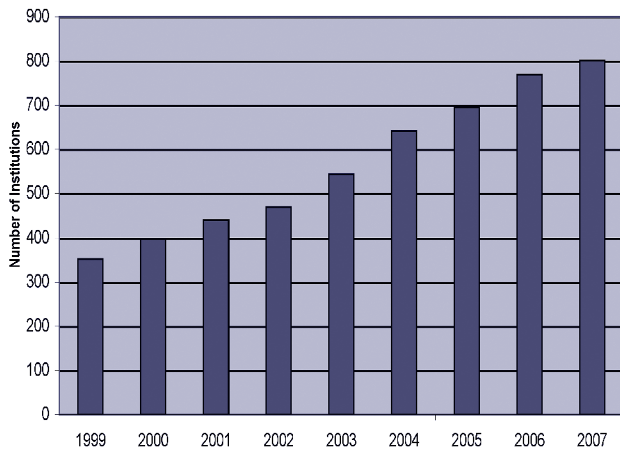
Figure 1 Median Income and Basic Budget for a Two-Parent, Two-Child Family

	Rural Kentucky	Lexington	Louisville	Northern Kentucky	Owensboro
Median household income	$37,369*	$42,442	$40,793	$49,833**	$37,171
Bi-monthly earnings	$1,557	$1,768	$1,700	$2,076	$1,549
Bi-monthly expenses:					
Housing	$222	$286	$277	$326	$252
Food	$294	$294	$294	$294	$294
Child Care	$344	$382	$382	$382	$382
Transportation	$210	$162	$194	$179	$188
Health Care	$151	$151	$151	$151	$151
Other necessities	$139	$157	$154	$168	$148
Taxes	$64	$125	$134	$135	$95
Total bi-monthly expenses	$1,423	$1,556	$1,584	$1,634	$1,508
Balance after expenses	$134	$213	$116	$442	$41

* Median income reflects the median income for the entire state, including urban areas.
** Median income for Northern Kentucky reflects the average median income for Boone, Campbell, and Kenton Counties.

Source: Family Basic Budget, reflecting 2004 expenses, Economic Policy Institute. Median household income, reflecting 2005 income, U.S. Census Bureau, American Community Survey.

Figure 2 Growth in Payday Lending Institutions



Source: Kentucky Office of Financial Institutions

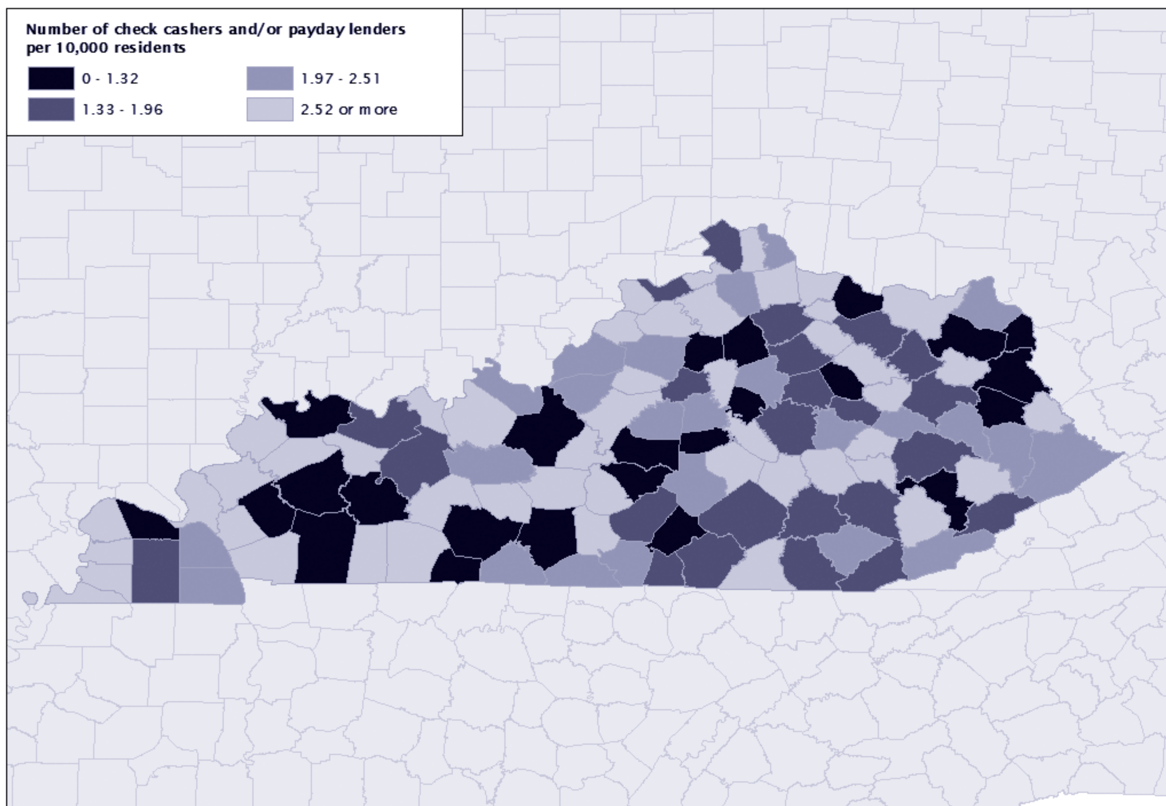
State and Federal Action on Payday Lending

Many states have taken action to limit the negative consequences of payday lending on their citizens. As of 2007, 31 states limited rollovers, 20 states (including Kentucky) limited the number of payday loans a consumer may have at one time and seven required a cooling-off period before a consumer can take out another loan.[17] A number of states, including Illinois and Indiana, also have databases in place to monitor payday transactions and enforce state law.[18]

Currently, 12 states and the District of Colombia have taken the strongest action by enacting small loan laws that cap interest rates at under 36 percent. In North Carolina, where in 2001 legislators chose not to reauthorize the law allowing payday lending, small loan alternatives from other financial institutions and credit unions remain an option for residents experiencing financial hardship. From 2002 to 2006, the number of small consumer finance loans in North Carolina amounting to $600 or less increased by 37 percent.[19] Additionally, the North Carolina State Employees Credit Union (NCSECU) created an alternative payday loan with an annual interest rate of 12 percent, including no additional fees. This product also requires individuals to put five percent of the loan amount into savings to help employees cover future emergencies without using a loan.[20]

The U.S. Congress has taken action to protect military personnel on active duty from the negative impact of payday loans. In 2005, one in five active duty military personnel used payday loans, and payday loan businesses clustered around military bases.[21] A new law, which took effect in October 2007, sets a 36 percent interest rate cap on payday loans for active-duty members of the military and their families.[22]

Figure 3 Number of Check Cashers and/or Payday Lenders per 10,000 Residents, by County



Source: Brookings analysis of data from the Kentucky Office of Financial Institutions, the Federal Deposit Insurance Corporation, infoUSA, and the U.S. Census Bureau. Financial services data are current as of 2006.

Solutions for Kentucky's Working Families

Kentucky can take action to help working families keep more of their hard-earned money by limiting unreasonable payday loan terms. The Kentucky General Assembly should take a measured approach to addressing the high costs of payday lending, and this can be done without impacting the state budget. Legislation should be enacted that does the following:

Creates a database to track the use of payday loans. Currently, little is known about the number of loans Kentuckians take out during a year. The database would gather information on loan usage and also allow Kentucky's Office of Financial Institutions to monitor compliance with current law.

Extends the loan term. The short repayment term, along with the requirement that the loan be paid in full, makes it nearly impossible for Kentuckians to repay payday loans completely without needing to take out another loan. By extending the minimum loan term, borrowers will have additional time to pay the loan in full and avoid falling into a cycle of debt.

Clarifies rollover language to eliminate the cycle of borrowers paying off a loan in cash and immediately taking out another payday loan. In states able to track the use of payday loans by individuals, the data show that most borrowers have 12 or more transactions per year. Limiting the ability to immediately take out another loan discourages consumers from falling further into debt.

Lowers the cap on fees. The current fee structure in Kentucky creates loans with the equivalent of an annual percentage rate near 400 percent. A moderately lower cap on fees will create a more reasonable and fair interest rate for Kentucky borrowers.

Financial education and alternative financial options also play a critical role in reducing the effects of payday lending on Kentuckians. Young Kentuckians should leave high school knowing how to make smart financial decisions. All consumers should have readily accessible information on the effective interest rate for these products. Kentucky businesses and employers can also follow models in other states to encourage alternative short-term lending options in the marketplace. With a strategy to increase wise financial decisions and improve market opportunities for low-income consumers, Kentucky's working families will come out ahead.

Alternative Financial Options in North Carolina

North Carolina provides a case study on the impact of a payday lending ban on consumers who used such loans. Research examining the aftereffects of the North Carolina ban on payday lending concluded that it did not have any noteworthy consequence on the accessibility of credit for families. Former payday loan customers reported that the absence of payday lending had a positive effect on their households because they sought out better credit options or modified their spending. Nine out of ten households held a negative view of payday lending, with many citing the difficulty of getting out of a payday loan.

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