A CYCLE OF DEBT

KENTUCKY FAMILIES SHARE THEIR EXPERIENCES WITH PAYDAY LENDING AND OTHER HIGH-COST FINANCIAL SERVICES

Kentucky Youth Advocates

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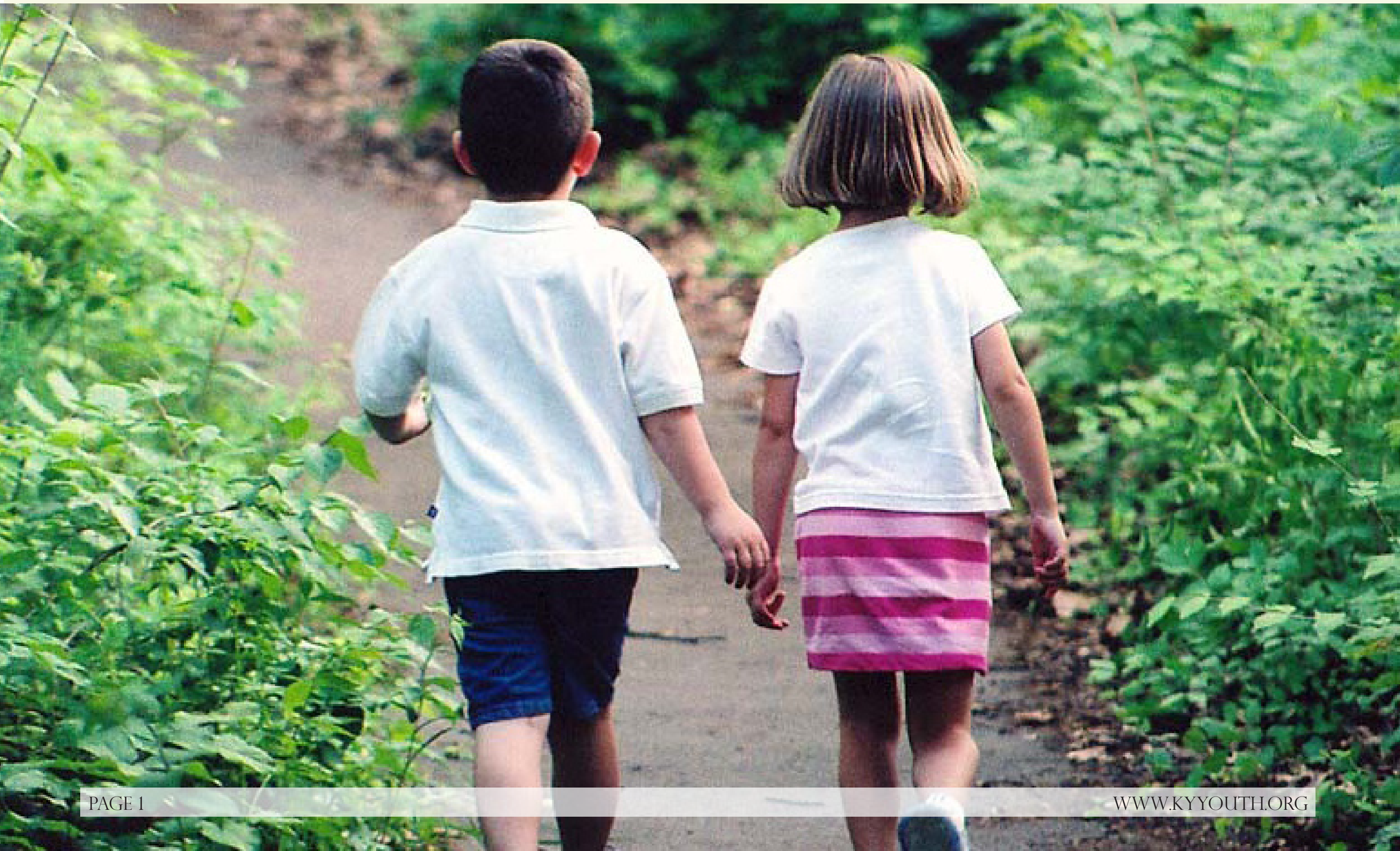


INTRODUCTION

All families need adequate income to support their children, yet many Kentucky families struggle to make ends meet.

Thirty-five percent of Kentucky's families live in low-income households, earning less than 200 percent of the federal poverty line or $34,340 per year for a family of three. Children in these low-income families comprise almost half of all Kentucky children (43 percent).[1] During the current economic downturn, Kentucky's families, like many across the country, are struggling more than ever to make ends meet. As the cost of meeting basic needs such as food and housing rise, the ability of working families to make ends meet without living paycheck to paycheck has become increasingly difficult.

All families need reasonably-priced financial services to pay bills and provide for their families. Yet, low-income families in Kentucky often pay higher prices than higher-income families for basic financial services, such as cashing a check or taking out a small loan.[2] More than a quarter of low-income Kentucky families surveyed in 2007 lacked a bank account.[3] Low-income families also used higher-cost check cashing services much more frequently than high-income families (31 percent and 5 percent, respectively).[4] A recent survey found that poorer families in Kentucky were also more likely to have taken a payday loan or other short-term, high-cost loan (21 percent compared to 3 percent of high-income families).[5]

Kentucky families can pay anywhere from a few dollars to more than $2,000 extra each year in additional costs for basic financial services.[6] Unfortunately, some of these financial options end up doing more harm than good for a family's economic well-being. The structure of payday loans, for example, encourages repeat borrowing and often leaves borrowers in worse financial shape. Payday loans are secured by a person's paycheck and are fairly easy to obtain. They are called "payday loans" as they are marketed to be repaid in full on the customer's next payday, ranging from two weeks to one month. In Kentucky, borrowers may have a maximum of two outstanding payday loans totaling no more than $500.[7] Research found that people who applied for and received a payday loan were more likely to file for bankruptcy within two years than those who applied and were denied because of poor credit.[8]

This report presents information that was shared by low-income working families across the state about their financial situations. Families recounted their personal experiences dealing with debt and of how they worked to make ends meet, sometimes at a very high cost. As you will read, their stories had many commonalities and reflected the national research in terms of short- and long-term consequences when faced with limited options. The research focused on families' use of financial products, specifically payday loans. The main themes that emerged show the often negative impact that the use of some services has on families and communities. The report concludes with policy recommendations aimed at eliminating the heavy financial burden of high-cost financial products that threaten the economic security of Kentucky families.

PROJECT DESCRIPTION

In 2008 Kentucky Youth Adcocates conducted a series of focus groups and interviews to evaluate the impact of payday lending services and other high-cost financial products on Kentucky's low-income families.

This qualitative research was conducted in nine communities across Kentucky that represent both the rural and urban experience. Participants volunteered to participate anonymously, signed confidentiality agreements, and were compensated for their time. The experiences expressed by the participants do not represent the experiences of all families living in Kentucky but do provide voices from daily life in Kentucky essential to informing policy.

Counties Represented in Payday Lending Focus Groups and/or Interviews

	Population (2007)	Median Household Income (2007)	Percent of Population Living in Poverty (2007)	Number of Licensed Payday Lenders (2007)
Boyle	28,664	$41,739	16%	10
Campbell	86,858	$51,383	10%	12
Christian	80,868	$37,632	19%	25
Jefferson	709,264	$43,677	15%	134
Kenton	156,675	$50,734	13%	32
McCracken	64,765	$40,899	15%	23
Mason	17,190	$38,035	19%	8
Pulaski	60,148	$32,368	22%	11
Warren	104,023	$42,303	18%	23
Kentucky	4,241,474	$40,299	17%	793

Sources: U.S. Census Bureau, Population Estimates Program and Small Area Income and Poverty Estimates (SAIPE); Kentucky Office of Financial Institutions

PROJECT FINDINGS

We asked families about their use of financial products, and participants described having few of what they described as good options. The findings present families' experiences with checking accounts, check cashing services, payday lenders and other ways they covered expenses. Several themes emerged, including the following:

1. Many families described payday loans as a poor financial choice but had learned that only through experiencing the difficulty in repaying the loans.
2. Families used high-cost financial services because they felt they had no other immediate credit options.
3. Using payday loans left families feeling trapped in debt.
4. Families reported distrust of mainstream financial institutions.

1 Many families described payday loans as a poor financial choice but had learned that only through experiencing the difficulty in repaying the loans.

"A lot of people don't know what they're signing… All they know is I'm borrowing this, I'm paying back this, and this is what I have to do."

- Jefferson County participant

Most participants understood that poor credit limits the chance of acquiring a loan from a bank, and they also knew how easy it is to qualify for a payday loan with a paycheck and checking account. Families who had used payday loans reported they were unaware of the long-term consequences when they took the loans. Some participants spoke of borrowing amounts as little as $100 to help them get through a rough patch, but were still paying off the loan months–and sometimes years–later. Most of the participants felt they had learned from costly experience how payday lending practices really worked and stated that "payday lending gets you into trouble" and that they "prey on people" to survive. Many focus group participants stated that they had taken out several loans at once from payday lenders to pay off prior loans. One person shared that she and her husband had taken out nine separate loans in order to pay off the interest accumulated on the others.

"I would not suggest getting into a routine in those places [payday lenders]…it's a cycle and I don't think people realize that."

- Warren County participant

A financial crisis can significantly impact economic stability. Research shows that individuals who experienced a financial crisis within the past three years were more likely to rent their home, not have a credit card or have exceeded their existing credit card limit, not have a bank or credit union savings account, and be divorced.[9] These characteristics illustrate the financial insecurity of individuals and families without the assets, credit, savings, or joint incomes that those in higher income brackets have. Approximately 28 million

Americans do not have a bank account and over 50 million have no credit score, resulting in no access to mainstream credit.[10] Poor credit history leaves many low-income Kentuckians with a lack of financial options and little choice but to use non-traditional financial products such as payday loans.

"Almost $7,000 we've paid back in extra money we had to pay back to them and that's just the fee part." - Mason County participant

What makes payday loans difficult to pay off?

Borrowers typically use payday loans when strapped for cash. If someone takes out a $500 loan, they typically walk out of the store with $425 after the payday lender takes out the fee of $15 per $100 borrowed. The borrower must repay the $500 in full with their next paycheck (normally a 2-week timeframe). Borrowers who have most of their paycheck dedicated to covering rent, utilities, groceries, and other necessary living expenses will have a difficult time finding the money to repay the loan in full in that short time period. For many borrowers this leads to a cycle where the borrower "rolls over" the loan – essentially paying $75 every two weeks to maintain the loan until they are able to pay off the original $500 loan amount. If it takes the borrower 4 months or longer to pay off the loan, they will have paid more in fees than they originally borrowed.

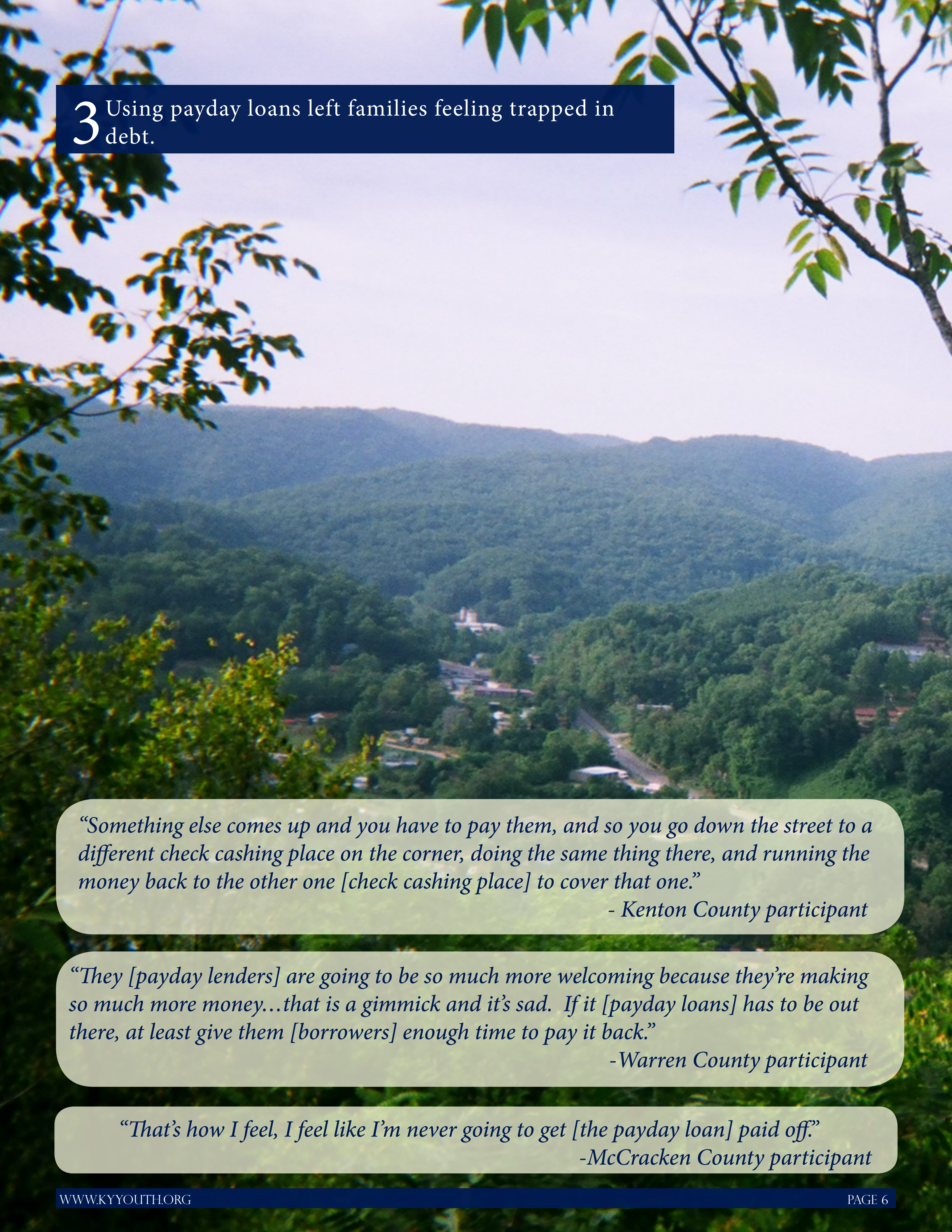
2 Families used high-cost financial services because they felt they had no other immediate credit options.

" I don't have any options…people get into this situation, it's just unreal. I went to those check advance places because my daughter was in a situation and it was either being on the street with no food or going to a check advance place and the interest rates are like 220-230 percent interest… I had no other options and I had no idea what to do. It was the only thing I knew to do. I was kind of forced into it because it was either that or live on the street. I pay $262 dollars a month just in interest. All I've done is just turn over interest". - Boyle County participant

Focus group participants that reported filing bankruptcy or depleting their credit felt that they had little or no options for banking. Others stated that they only used services like check cashing and payday loans when banks refused to help. Participants with poor credit reported that they were unable to access short-term loans from regulated mainstream financial institutions. Still, they recognized that payday lending was not a sound answer to meet financial needs. The focus group participants who had used these services themselves shared that payday loans were not worth the cost once they understood how they worked.

For many working families facing a financial crisis that requires immediate cash, options do exist. Alternatives to payday loans include salary advances from employers, negotiating bill payment with companies (i.e., utilities), or working out repayment plans with creditors. Others are able to borrow from friends, relatives, religious institutions, or social service agencies.[11] An increasing number of institutions are also developing lower-cost alternatives to payday loans that have better repayment terms. After North Carolina banned payday lending, former payday borrowers reported finding other ways to cover expenses and described a positive impact on their household.[12]

"Because I had to file chapter 13 years ago,… they [commercial bank] refused me and it really wasn't that much [loan amount]...The loan officer even said 'I'm not worried at all about you making the payments, but it's just a collateral type thing and you need a co-signer.… I tried another place but nobody will touch me because I filed chapter 13." - Boyle County participant



3 Using payday loans left families feeling trapped in debt.

"Something else comes up and you have to pay them, and so you go down the street to a different check cashing place on the corner, doing the same thing there, and running the money back to the other one [check cashing place] to cover that one."

- Kenton County participant

"They [payday lenders] are going to be so much more welcoming because they're making so much more money…that is a gimmick and it's sad. If it [payday loans] has to be out there, at least give them [borrowers] enough time to pay it back."

-Warren County participant

"That's how I feel, I feel like I'm never going to get [the payday loan] paid off."

-McCracken County participant

Even though payday loans are advertised as a means for weathering one-time emergencies, 91 percent of loans nationally are made to borrowers with 5 or more loans per year which could add up to thousands of dollars in fees on sometimes very small loans.[13] In spite of the marketing claims, the majority of the payday loan industry's profit is from loan fees paid by repeat customers.[14] In fact a former store manager in Ohio stated, "we made the process very simple and easy at the front end to get people into the loan. But at the back end, we made it very difficult for customers to get out of the loan." [15]

"They're [payday lenders] okay if you're in a bind, you need money right on the spot, but then, in my experience, I wasn't able to pay them back and then I was in debt for awhile."
- Christian County participant

Many participants shared experiences of taking out a loan then finding it took them months to obtain enough money to pay the loan back. In McCracken County, one participant had taken out a payday loan over a year ago but was still unable to pay off the full amount. In addition to rolling over her loan and paying additional fees every two weeks, she had to pay a friend to drive her to the nearby town where the store was located to make the payment. Many participants relayed similar stories, despite state statute stating payday lenders "shall not for a fee renew, roll over, or otherwise consolidate a deferred deposit transaction for a customer."[16]

A significant amount of the profit for payday lenders comes from making repeated small cash advances to borrowers, essentially turning them into long-term, high-interest loans. Lenders will continually collect multiple renewal fees every time a person is unable to repay the loan.[17] In order to accomplish this, some lenders will lower the fee of the first loan, and then charge high renewal fees on subsequent loans, launching customers into a long cycle of debt.[18] Payday lenders typically do not take into account the client's ability to repay and only require a checking account and a pay stub verifying employment. Nationally, 40 percent of Americans who use payday loans refinance more than five loans within the same year.[19] The repeated use of these loans reflects the unrealistic time period allowed for repaying the loan in full.

Kentucky has begun to address the debt problems associated with payday loan borrowing. During the 2009 General Assembly, legislation was signed by Governor Beshear to create a database to verify customers had no more than two loans outstanding at one time totaling no more than $500.[20] States who have enacted similar databases, however, have not seen a significant reduction in borrowers with high-volume loan use.[21] The changes also created a payment plan option, which payday lenders must offer to customers after they have taken out six consecutive loans.[22] However, critics of this provision argue that after six consecutive loans, customers will have already paid renewal fees nearing the full loan amount. This new law takes effect on January 1, 2010.

"One time when I did it [took out a payday loan], it took me almost a year to not [take out another payday loan] because I couldn't break even."
- Campbell County participant

4 Families reported distrust of mainstream financial institutions.

Most participants expressed dissatisfaction with all financial institutions including banks, check-cashers and payday lenders. Low-income families oftentimes face structural barriers to accessing traditional banking institutions, including location (the absence in low-income neighborhoods), hours of operation, lack of transportation, and negative or discriminating interactions with bank employees. [23]

"The banks make everything so difficult… the bottom line is you're putting your money in there for them to borrow…they're using your money." - Pulaski County participant

Distrust between clients and financial service providers comes from a lack of clear information explaining "hidden fees", overdraft charges, and

"I don't trust the banks. If I had a large amount of money I would feel safer having it in a lockbox than in a bank."

- Campbell County participant

security and access to the account. Participants specifically expressed frustration with bank overdraft fees and felt the "[debit] card should be declined the minute you don't have any money in there" to prevent overdraft charges from accumulating. One person also explained, "if you can't get a checking account they give you a little card and they nickel and dime you to death on the card. It's prepaid and they charge you every time you use it. You get charged when your checks are deposited and every time you use it in a store."

National research indicates that approximately 83 percent of the population that does not use a bank is comprised of low-income families with annual incomes of less than $25,000.[24] Most who do not use a bank stated that they do so due to "income and cost issues" associated with banking. Experiences shared throughout the focus groups reflect national opinions that the fees charged by financial services are enough to deter usage and create distrust between consumers and financial institutions. Other practices that families perceive as unfair at commercial banks include holding deposits longer than necessary or clearing the highest-price transactions before lower-priced transactions, which often allows the bank to charge more fees than are warranted.[25] Banks and credit unions are collecting $17.5 billion per year in overdraft fees.[26]

"When you're dealing with a financial institution it affects the way people have access to their money. It seems unfair and unfortunate that the people who are being hit by the higher percentage rates,… fees, and daily overdrafts are people who are already struggling initially."

- Kenton County participant

SOLUTIONS

Kentucky's families make important decisions as consumers everyday. Unfortunately, for many low-income families the expenses are great, the resources are few, and there is little opportunity to build assets.

Financial products like payday loans provide immediate cash, yet the high cost and consequences of these products too often do significant damage to a family's economic stability.

Kentucky can take action to help working families keep more of their hard-earned money by limiting unreasonably costly lending practices. The Kentucky General Assembly could require reasonable terms for payday loans at no cost to the state budget. Most participants stated that they would not miss the high fees and debt associated with payday lenders and check cashers, and would like to see regulatory action limiting or prohibiting these practices. In North Carolina, nine out of ten households surveyed after that state banned payday loans stated that payday lending was a "bad thing" and felt better off without payday lending services. This survey also included households that had previous financial hardships and had used payday lending services.[27]

Create More Employer-Based Payday Lending Alternatives

Models exist of alternatives to payday loans that have proven to be effective in Kentucky as well as in other states. One example is the "Save It! Loan" program offered by the Mountain Association for Community Economic Development and the Appalachian Federal Credit Union in partnership with Kentucky businesses.[28]

The “Save It! Loan” offers an affordable 10-month personal loan with a cash savings account. The repayment term of 10 months makes it easier to repay the loan compared to the two-week term for a payday loan. It provides loans with 18 percent interest on the loan amount and there are no hidden fees charged to the consumer. The program also provides financial counseling on topics such as money management at no extra cost.

An example from North Carolina is the Salary Advance Loan (SALO) created by the North Carolina State Employees' Credit Union. SALO is a revolving loan with a maximum balance of $500 and an annual percentage rate of 12 percent, making it much more affordable than a regular payday loan. The loan also includes a mandatory savings initiative in which five percent of every advance is put into a savings account.

Lower the Cap on Payday Loan Fees

The negative impact of high fees associated with payday loans have become a growing concern in recent years. For instance, the Department of Defense sought a cap on payday loan fees at the equivalent of 36 percent annual percentage rate for military families to address the high number of security clearances being lost due to debt problems associated with payday loans.[29] Congress responded and passed a law capping the effective interest rate (calculating the fees as an annual percentage rate) of payday loans at 36 percent for military families, which took effect in October 2008. During the elections in November of 2008, voters overwhelmingly supported a new law in Ohio capping the interest rates of payday lenders at 28 percent, and voters in Arizona resisted the efforts of payday lenders to renew the law authorizing their high fees – effectively bringing the interest rates of payday loans back under the usury laws.

The current payday lending fee structure in Kentucky creates loans with the equivalent of an annual percentage rate near 400 percent. Kentucky can follow the example set by Congress and our neighbors in Ohio and cap payday interest rates at 36 percent, creating a more reasonable and fair interest rate for Kentucky borrowers.

Utilize Faith-Based and Community Outreach to Improve Financial Literacy

All consumers need complete information and a full understanding of financial products to make the best decisions about finances. However, many Kentuckians report not fully understanding financial factors, such as credit scores and the implications of low credit scores.[30] Low-income Kentuckians were less likely than higher-income counterparts to report fully understanding financial components such as credit scores.[31] Community- and faith-based efforts provide a strong vehicle for offering financial education, because they are known by the target audience. Programs can offer additional information about the benefits and risks of financial products, and customize that information to products readily available in the community.

Reach the Unbanked Population with Appropriate Products

Families are more likely to use high-cost financial services when they do not have a checking account or other connection with a bank or credit union. Partnerships between local governments and financial institutions can encourage the development and use of checking accounts, which can improve the financial stability of citizens and their neighborhoods. Louisville was recently announced as one of eight new cities participating in the “Bank on Cities” project of the National League of Cities, which is modeled after the successful Bank on San Francisco project that increased the number of low- and moderate-income families with checking accounts.[32] The program seeks to reach the unbanked population and connect them with mainstream financial institutions that offer an alternative to high-cost financial services.[33] Expanding similar initiatives to other parts of the state could reduce the need for high-cost products.

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