

spotlight

No. 428 – February 27, 2013

FOR THEIR OWN GOOD

Ban on high-cost lending leaves poor consumers worse off, with fewer choices

KEY FACTS: • A 1997 bill that exempted “payday lenders” from state usury laws was allowed to sunset in 2001, and the last storefront lenders were shut down in 2005.

- About 5 percent of North Carolinians still take out high-cost, short-term and payday loans, either crossing state lines or going online.
- Critics view the loans as preying on poor borrowers and giving them exorbitant rates that leave them needing subsequent loans (“debt trap”). They project the effective annual percentage rate (APR) of the typical loan to be near 400 percent.
- The high cost owes to two unique aspects of the loans: high-risk clientele and small sums lent for short periods of time. Fees are essentially break-even prices counting default rates, and the industry is not that profitable.
- Payday borrowers dislike the loans’ high costs, but they like several nonmonetary aspects: no credit risk, convenient hours and locations, ease, friendliness, discretion, and lack of embarrassing interactions with people.
- Getting rid of payday lending in North Carolina left consumers worse off, research by the Federal Reserve Bank found. The ban led to more bounced checks, more complaints about lenders and debt collectors, and more filings for Chapter 7 (“no asset”) bankruptcy than there would have been had payday lending been allowed.
- In other words, payday borrowers were making rational decisions. Research consistently finds that borrowers clearly understand the costs of the loans and that about 95 percent are repaid.
- Bounced-check fees carry effective APRs of from 704 percent with overdraft protection to 3,520 percent without; utility disconnect or reconnect fees, 240–420 percent; credit card late payments, 965 percent; borrowing from an online payday lender, 650–780 percent; and borrowing from a loan shark, indeterminate.
- High-cost, short-term loans are hardly a solution of first resort to a shortfall. Nevertheless, poor families often find themselves faced with a sudden need and few ways to navigate it.
- Taking away choices doesn’t help them, especially not by removing costly options and leaving them with costlier ones.
- North Carolina policymakers should expand lending options in this state by legalizing small-scale, short-term and payday lending again.

200 W. Morgan, #200
Raleigh, NC 27601
phone: 919-828-3876
fax: 919-821-5117
www.johnlocke.org

The John Locke Foundation is a 501(c)(3) nonprofit, nonpartisan research institute dedicated to improving public policy debate in North Carolina. Viewpoints expressed by authors do not necessarily reflect those of the staff or board of the Locke Foundation.

Imagine an entrepreneur who sees that the poor in his community have very dim prospects for obtaining small loans: banks won't do it because they're considered not creditworthy, while loan sharks exact terms so severe he considers it akin to slave labor. This entrepreneur — doing what entrepreneurs do: seeing a need in the community and finding a way to earn a living filling that need — sets up a business offering small, collateral-free loans to the poor, nearly all of them poor women. The business charges an effective annual percentage rate that is high no matter how it is calculated, ranging from 20 percent to 200 percent to a worst-case scenario of just over 550 percent. Business booms, the company expands, and the founder boasts of routinely making a profit.

How would such a business be described? A boon to the poor? Preying on the poor? Another option for poor people in need of funds but lacking collateral? A way to trick the poor into a borrowing trap? An expensive option but better than nothing?

In 2006, the Norwegian Nobel Committee described it as “efforts to create economic and social development from below” that help “advance democracy and human rights,” and it awarded the Nobel Peace Prize of 2006¹ to the entrepreneur, “Banker to the Poor”² Muhammad Yunus, and the business, Grameen Bank in Bangladesh. The scenario above is derived from Yunus’ Nobel Lecture,³ except the interest rates, which are projected by others’ research.⁴

“It is odd: high-interest, small-scale loans to the poor in developing countries are seen as a great thing,” wrote Katherine Mangu-Ward in *The Wall Street Journal*. “When a man like Muhammad Yunus argues that such ‘microcredit’ loans can make the difference between participation in mainstream society and off-the-grid poverty, we give him a Nobel Prize. Here at home, condemnation is the reward.”⁵

Small-Scale, Short-Term Lending in North Carolina

In 1997, the General Assembly passed the North Carolina Check-Cashing Act that exempted “payday lenders” from state usury laws.⁶ By 2000, there were 902 payday lending outlets operating in North Carolina; one study estimated that there was “one check-cashing or payday loan outlet in North Carolina for every two federally insured banking offices.”⁷ The law was slated to sunset in 2001, however, and the legislature allowed it to do so. Smaller lenders either closed shop or returned to check-cashing services, while others partnered with state or national banks and continued to offer the loans. In 2005 the N.C. Commissioner of Banks declared such activity illegal, and the N.C. Department of Justice went after the remaining lenders, getting consent agreements from them to cease making the loans, only seek the principal balances on outstanding loans, and pay \$700,000 to several special-interest groups broadly defined as offering credit counseling and financial literacy programs. The top five payday lenders subsequently shut down 250 stores.⁸

A bill currently before the North Carolina Senate would allow and regulate small-scale, short-term lending in the state. Features include, among other things:

- capping the loan amount at \$500
- capping the fee (which is not to be considered interest) at 15 percent of the loan amount
- requiring a 24-hour cooling off period after paying off a loan (not rolling over a current loan)
- allowing one extended payment plan at no charge once every 12 months
- protecting a defaulting borrower from criminal prosecution (except for misrepresentation and fraud) and negative credit reporting
- forbidding the loans to members of the U.S. Armed Forces, in recognition of a pre-existing federal ban on payday lending to military personnel.⁹

Payday loans: What they are and how they work

Payday lenders are in the business of advancing people money for short periods of time, typically 15 to 30 days. They provide a service that traditional lending institutions are not willing to offer and that their customers both want and find valuable.

How does it work? First the borrower needs to be gainfully employed with a steady paycheck. The lender accepts a personal check from the borrower with a promise that he will not cash the check until a specified time, usually 15 to 30 days into the future. In exchange for the check, the lender gives the borrower an amount of cash that is worth less than the check's face value. For example, the borrower may write a check for \$300 to the lender and receive \$255 in exchange. The borrower receives the cash he needs today and the lender earns \$45 on the transaction 30 days later. The fee varies according to the amount borrowed. Fifteen dollars per \$100 borrowed is typical. Check-cashing companies typically receive 10 percent of the amount of a personal check, so payday lenders receive an extra 5 percent for waiting as long as 30 days before cashing the check.

— Source: Dr. Roy Cordato, "North Carolina's Price-Control Laws: Harming Those They're Meant to Help," Nathaniel Macon Research Series No. 2, John Locke Foundation, December 2006, johnlocke.org/research/show/policy%20reports/78.

Despite the ban, today approximately 5 percent of North Carolinians still take out short-term and payday loans.¹⁰ Some avail themselves of storefront lenders just over the Virginia or South Carolina borders. Earlier in 2013 Regions Bank announced it had stopped offering its short-term Ready Advance loans online to North Carolinians, amid pressure from Attorney General Roy Cooper that they were too similar to payday loans. Nearly 200 North Carolinians had been Regions customers for the deposit-advance loans.¹¹ Others seek out unlicensed online lenders.¹²

Economic paternalism: Taking away choices for your own good

In 2006 Cooper was quoted in a Consumer Affairs article that laid out critics' case against the lenders:

So-called "payday" loans are targeted at low income consumers, often struggling to make ends meet. Cooper says the lenders took advantage of their desperate circumstances to saddle them with outrageous terms.

For example, consumers who took out a typical payday loan of \$300 from one of the three companies were required to repay the loan within two weeks, plus around \$60 in interest. That amounts to an annual percentage rate of 400 percent.

Consumers who couldn't repay the loan at the end of two weeks were required to take out another payday loan to repay the first.¹³

Essentially, the concern over high-cost, short-term lending boils down to the view that the lenders prey on poor borrowers in "desperate circumstances" and make them agree to "outrageous terms" that frequently leave them needing to roll over the loans. Lenders tend to locate near their customers, who often take out successive short-term loans — described as being locked into a high-cost debt trap whose fees, if projected out from the typical two-week loan period into an effective annual percentage rate (APR), are exorbitantly high, usually in the triple digits. Although it is a questionable practice to define a short-term fee in terms of an effective APR, such a high rate sounds shocking and also would run afoul of usury prohibitions.

The ban's effect, however, removes a viable option from the poor facing an immediate shortfall, and it is especially harmful to those with the fewest options. Their remaining choices may be more expensive (bounced check and overdrafts, expensive utility disconnect or reconnect fees, penalty rates for missed credit card payments, even bankruptcy) or

illegal. The ban on high-cost, short-term loans seeks to save people from making harmful choices, on the assumption that they don't know any better, but research shows it imposes a net greater harm instead.

The ban prevents the loans because of their high cost, which supporters of the ban and borrowers alike detest. Nevertheless, the ban and its supporters ignore several aspects of payday lending that borrowers find preferable. They include such features as no credit risk, convenient hours and locations, ease, friendliness, discretion, and lack of embarrassment.

Concerning the loans' relatively high cost, economist Tom Leman of Indiana Wesleyan University explained that it owes to two unique aspects of small-scale, short-term lenders: for one, they deal with a high-risk clientele and therefore would naturally have a higher risk premium; and also, they write small loans for short periods of time, which means they face different cost recovery than large-scale lenders charging interest over longer periods of time. Leman writes,

the fixed labor and capital costs associated with offering and underwriting a small loan are the same as offering and underwriting a larger loan. With a larger loan principle, the lender can cover costs and earn a profit by charging a lower annual percentage rate over a lengthier period of time. Small principle short-term loans, on the other hand, while costing roughly the same to supply, cannot charge equally low rates of interest and expect to cover costs. They must, therefore, charge higher rates of interest over short payback periods in order to be profitably offered. Thus, by their very nature and quite apart from the risk associated with them, small-balance short-term payday loans must charge a higher effective annual interest rate to induce profit-seeking entrepreneurs to provide them.¹⁴

Furthermore, research shows that the small-scale, short-term lending industry is not that profitable, as one would assume it would be if the fees were outrageous or predatory.¹⁵ While banks and credit unions are pursuing their own high-fee, short-term loan products,¹⁶ they are finding it tough sledding.¹⁷ Instead, the fees charged by the lenders are essentially break-even prices once default rates are factored in, and the market shares several features of a perfectly competitive market. That also means that legislatively imposing lower or capped rates and fees could keep lenders from achieving profitability and thereby force them out of business.¹⁸

As a banking blog focused on alternative financial products for people without checking or savings accounts put it, "high-cost lending is less profitable than selling hamburgers."¹⁹

Who uses small-scale, short-term loans

A 2007 study on the end of payday lending conducted by the University of North Carolina's Center for Community Capital for the N.C. Commissioner of Banks surveyed 400 adults and stated that its findings "suggest[ed] that North Carolina households do not miss payday lending and have an array of other strategies to manage financial shortfalls." The survey concluded that "absence of storefront payday lending has had no significant impact on the availability of credit for households in North Carolina" and that "Nearly nine out of ten households surveyed think that payday lending is a bad thing."²⁰

The survey found only 159 of the 400 respondents who "reported experiencing at least one financial shortfall in the past three years." Of that subset, only 13 (that is, 8 percent) had received a payday loan.²¹ *Those* households might miss that option, have a less impressive array of strategies to manage sudden shortfalls, or have a revealed preference for the speed, ease, and other nonmonetary aspects of obtaining a payday loan.

The survey also pulled together two 10-member focus groups of payday borrowers. Only one of the 20 participants had not paid off a loan. They voiced support for the end of payday lending in North Carolina, but despite that, all but two agreed that people should have the right to borrow from payday lenders. The survey explained that "This apparent contradiction highlights the conflict between people's desire to be protected from what they view as unfair business

practices, and their deep sense of independence and accountability.”²² Essentially, what it appears to reflect is that borrowers like many things about the loans, but not their fees (this point will be discussed more below).

A similar finding was reported in a 2013 study of payday lending conducted for the Pew Charitable Trusts. “A majority of borrowers say payday loans take advantage of them, and a majority also say they provide relief,” the report noted, explaining that “appreciation for urgently needed cash and friendly service conflicts with borrowers’ feelings of dismay with high costs and frustration with lengthy indebtedness.” Overall, six out of 10 borrowers said that storefront loans helped more than hurt, but only four out of 10 said the same about online loans (which have higher fees than storefront loans).²³

A 2012 Pew study of payday lending found that 5.5 percent of Americans had used a payday loan in the past five years, and 12 million did so in 2010 (the last year for which data were available). The typical borrower was a white female aged 25–44. Five groups of people had a greater likelihood of using a payday loan: “those without a four-year college degree; home renters; African Americans; those earning below \$40,000 annually; and those who are separated or divorced.”²⁴

Pew asked survey participants how they manage shortfalls when payday loans weren’t available. Eighty-one percent said they would cut back on expenses such as food and clothing. Other options getting majority support included delaying paying bills, borrowing from family or friends, or selling or pawning possessions. Pew notes that the “options selected the most often are those that do not involve a financial institution.”²⁵

The picture that emerges from research literature on payday lending is that its customers prefer the quickness and ease of obtaining the loans, their discretion and lack of embarrassing interactions, the absence of a threat to their credit rating, the lack of hand-holding add-ons (some lending programs require a financial literacy class and a savings account), even the cleanliness and friendliness of the stores. They don’t like the relatively high financial cost of the loans, but it is instructive to note that they choose the loans with full understanding of that cost; they’re not tricked. Nine out of ten people in a tight spot might definitely rule out that choice, but a tenth might give it serious consideration, unless the state rules it out first, at which point the tenth may well be left to pursue even less desirable options.

Concerning that, UNC researchers Michael A. Stegman and Robert Faris wrote:

Although some might argue that the way to deal with abuses discussed in this article is for North Carolina to join the states that ban payday lending outright, we do not agree that this is the best approach. The reality is that decent, hard-working families who end up with too much month left at the end of their money **will go underground if necessary to get help**. Consider this observation from the owner of a check cashing company **in a state that prohibits payday lending. He sees the neighborhood loan shark turn up in one of his busiest stores every Friday afternoon to extend credit and receive payments from customers who have just cashed their paychecks**. “Everyone knows the rules of the game,” the proprietor says. “The loan shark charges 20% for a 2-week loan.”²⁶ (Emphasis added.)

Economic paternalism cannot replace the reality that poor families often find themselves faced with a sudden financial need but have fewer prospects to address it than wealthier households with better credit. As State Rep. Earl Jones (D-Guilford) warned in 2005 about drumming payday lenders out of North Carolina, “If they’re shut down, there will be no mechanism that will develop to meet that need.”²⁷

At least, not a legal mechanism.

Beg, borrow, or steal

The phrase originates from Geoffrey Chaucer in *The Canterbury Tales*, written in the 14th century. It is in The Man of Law's Prologue, whose opening lines decry the state of poverty, wherein a poor man "must, for indigence, / Go steal, or beg, or borrow thine expense."²⁸ It offers an abbreviated (though incomplete) summary of the finance options available to the poor who find themselves in immediate need of cash.

More to the point, it also highlights the perennial nature of the problem. Need will always arise; the question then is, what solutions are available? Preventing short-term lending is a paternalistic way of taking an option away from, for example, an unwed high school dropout mom whose car has broken down and needs a \$300 repair. Perhaps the majority of people facing a shortfall would not feel the absence of short-term lending, but what about her? She could, of course, cut back on clothing and groceries, sell or pawn something, hold off payment of a bill, or any other option Pew highlighted. But what if she'd rather not? Or what if those options appear worse to her, *in the context of her own situation*, than does obtaining a short-term loan to tide her over for a couple of weeks, even at a cost of a \$50 fee?

Even if that fee sounds exorbitant, are there scenarios where she is better off with the short-term loan than the other options? The answer is no under the debt-trap hypothesis, but under the economic assumption that individuals know their own situations better than outsiders applying their own preferences to a situation, the answer is yes.

Victor Stango pointed out in *Regulation* the importance to borrowers of the *non-price characteristics* of standard payday loans.²⁹ Consider what Mangu-Ward, a payday borrower herself, wrote: "I'd happily lay out 50 bucks, the net cost of my payday loan, to avoid awkward interactions with my phone company, my doctor, my friends, my colleagues, my bank, or worst-case scenario, the boys in blue."³⁰ Many in the UNC focus groups "said they appreciated the discretion of a payday loan. One person said that with a payday loan, 'there is no family drama;' another said it enabled him to 'hide my head.'" They also liked the fact that it did not affect their credit, and "Some participants felt that payday loans were less expensive than pawnshop loans, while others felt pawnshops were the better deal."³¹ Nearly half (44.6 percent) of payday borrowers surveyed by researcher Gregory Elliehausen for the George Washington University School of Business chose that option after considering others.³²

Just as important, half (50.6 percent) of the borrowers in Elliehausen's study believed a payday loan was their only choice.³³

North Carolinians are worse off after the ban, not better

The Center for Responsible Lending (CRL) projected that a payday lending ban would save North Carolinians \$155 million in 2006.³⁴ Researchers Donald P. Morgan and Michael R. Strain at the Federal Reserve Bank of New York, however, examined the end of payday loans in Georgia and North Carolina and concluded that the bans did not leave consumers better off. Instead, they found that after the ban on payday lending, Georgians and North Carolinians had "bounced more checks, complained more about lenders and debt collectors, and have filed for Chapter 7 ('no asset') bankruptcy at a higher rate."³⁵

Morgan and Strain furthermore noted that the "increase in bounced checks represents a potentially huge transfer from depositors to banks and credit unions."³⁶ Instead of saving households millions of dollars as supporters of the bans predicted (CRL had also projected \$149 million in savings for Georgians in 2006³⁷), the bans wound up costing consumers millions of dollars per year in returned-check fees. They write:

While our findings contradict the debt trap/addiction hypothesis against payday lending, they are consistent with alternative hypothesis that payday credit is cheaper than the bounce "protection" that earns millions for credit unions and banks.

Forcing households to replace costly credit with even costlier credit is bound to make them worse off.³⁸ (Emphasis added.)

Rational decision-making in undesirable circumstances

What the Fed report highlights is not only that taking away short-term lending options failed to improve borrowers' prospects, but also that the *borrowers were making rational decisions when they chose short-term loans*. Instead of needing protection from predatory lenders, they needed protection from paternalistic policymakers and their negative unintended consequences.

Rational decision-making includes understanding the cost of the loans, and payday borrowers are consistently found to understand the costs. Morgan and Strain wrote that, "To our knowledge, not even critics of payday lending allege that payday lenders are opaque about their borrowing terms."³⁹ The UNC focus groups showed that borrowers understood the fees and accepted them, though they found them excessive and burdensome.⁴⁰ Six out of seven borrowers in the Pew study said the loan terms and conditions were clear to them.⁴¹ Elliehausen found that 94.5 percent of payday borrowers knew the finance charges of their loans, and also that nearly half had considered other sources than payday lenders. The vast majority (88.4 percent) also reported to Elliehausen that they were satisfied with the loan but that cost was not a reason for their satisfaction — and of the minority of borrowers who reported dissatisfaction, over two-thirds (68.5 percent) were dissatisfied because of high costs.⁴² Anecdotally, Mangu-Ward said that "in my line, people were very aware of the rates, grumbling about them and, in one case, asking detailed questions to figure out the cheapest way to carry some debt for an additional month."⁴³

So what options does a poor consumer have in obtaining funds when faced with an immediate shortfall? The table on the following pages gives a range of options, listing potential pros and cons of each. Some are clearly superior to others, but they don't apply in all circumstances; some are clearly inferior but may be the only options available; and some are illegal. Short-term loans would be among the less desirable options, but those choosing that option comprise around five percent of borrowers — about half of whom may consider it their only viable option.

It is worth noting that the two primary criticisms leveled at payday loans apply to several other options as well. Options carrying fees that equate with high effective APRs include bounced-check fees, whether with no overdraft protection (3,520 percent for the median charge) or with overdraft protection (704 percent); utility disconnect or reconnect fees (240–420 percent); credit card late payments (965 percent); and borrowing from an online payday lender (650–780 percent) or loan shark (indeterminate). Many also carry an inherent debt-cycle risk for borrowers who fail to adopt greater financial discipline, including using credit cards and doing any kind of borrowing (whether from family and friends, financial institutions, online payday lenders, or loan sharks).

Concerning financial discipline, Pew found, among other things, that many payday borrowers have difficulty paying their bills half the time, had overdrawn their checking accounts in the past year, and could afford only about \$100 a month.⁴⁴ The findings seem to illustrate the riskiness of the clientele rather than the loans, however. Leman noted that although short-term lending may be correlated with chronic borrowing, that does not mean it causes it. As he explained:

payday loans appeal to a clientele that face numerous financial difficulties (many of them self-induced), quite independent of the payday lending industry itself. Most of these households have failed to establish good credit, have poor credit histories, are not known for their timely bill-paying habits, frequently bounce checks, frequently change jobs, and may relocate often. In short, they are the type of people who are going to be frequently short of cash and who will borrow "chronically" when given the opportunity. Because payday lending institutions provide them with this opportunity to borrow when other institutions will not does not mean that

Options for the Poor Who Face an Immediate Cash Shortfall

Option	Pros	Cons
Cut back on expenses	<ul style="list-style-type: none"> • First and best option if workable • No financial institutions or credit risk • Discreet 	<ul style="list-style-type: none"> • Immediacy of the need usually precludes this option • Risk of negative health consequences if expenses cut are necessities
Use a credit card	<ul style="list-style-type: none"> • Timely • Discreet 	<ul style="list-style-type: none"> • Likelihood of availability unclear — immediate need could well be a credit card payment • Going over credit limit could result in penalties, higher rates • Late payment fee — effective APR of, e.g., 965%^a • Debt cycle risk if individual fails to adopt greater financial discipline
Delay paying bills	<ul style="list-style-type: none"> • Allows for planned cutbacks on expenses in ensuing weeks to catch up • Discreet 	<ul style="list-style-type: none"> • Significant credit risk • Risk of harassment from debt collectors • Other risks, depending on the delayed bill(s): late fees, loss of utility service (power, water, phone), loss of property (repossession), default on mortgage <ul style="list-style-type: none"> — \$40–\$70 disconnect/reconnect penalties for canceled utilities — effective APR of 240%–420%^b — Credit card late payment fee — effective APR of, e.g., 965%^a • Debt cycle risk if individual fails to adopt greater financial discipline
Sell possessions	<ul style="list-style-type: none"> • No financial institutions or credit risk • Depending on the possession sold, could lead to reduction in bills 	<ul style="list-style-type: none"> • Loss of possessions • May be hard to find buyer(s) or receive expected selling price(s) • A strategy with diminishing returns
Pawn possessions	<ul style="list-style-type: none"> • No financial institutions or credit risk 	<ul style="list-style-type: none"> • Potential loss of possessions • Typically obtain small amounts • Another bill/payment • A strategy with diminishing returns
Take out a title loan	<ul style="list-style-type: none"> • Opportunity to build credit rating if loan repaid in timely fashion 	<ul style="list-style-type: none"> • Potential loss of possession • Another bill/payment
Pay by check/debit card — overdraft protection	<ul style="list-style-type: none"> • Timely • Discreet • Allows for planned cutbacks on expenses in ensuing weeks to catch up 	<ul style="list-style-type: none"> • High fees — effective APR of, e.g., 704%^a • A strategy with diminishing returns
Pay by check/debit card — no overdraft protection	<ul style="list-style-type: none"> • Timely • Discreet • Allows for planned cutbacks on expenses in ensuing weeks to catch up 	<ul style="list-style-type: none"> • Very high fees — median charge carries an effective APR of 3,520%^c • Could be compounded by fees by merchants • Bounced check could (depending on recipient) lead to canceled insurance, loss of utility service, etc., plus indirect costs such as disconnect/reconnect fees (see above) and security deposits • Possible arrest for writing worthless checks, which could lead to jail time and a criminal record
Borrow from a bank or credit union	<ul style="list-style-type: none"> • Opportunity to build credit rating if loan repaid in timely fashion • Keep possessions used as collateral • Likely lower annual percentage interest rate than fees equivalent of bouncing checks or borrowing from short-term lenders • Allows for planned cutbacks on expenses in ensuing weeks to catch up 	<ul style="list-style-type: none"> • Option not always available, especially if borrower deemed not creditworthy • Another bill/payment • Time-consuming and indiscreet • Significant credit risk • Risk of losing possessions if used as collateral • Risk of harassment from debt collectors • Debt cycle risk if individual fails to adopt greater financial discipline
Borrow from a short-term lender — storefront	<ul style="list-style-type: none"> • No financial institutions or credit risk • Timely • Discreet • Low likelihood of being turned down • Keep possessions; no collateral • Repayment over short period (e.g., 2-4 weeks) • Allows for planned cutbacks on expenses in ensuing weeks to catch up 	<ul style="list-style-type: none"> • High fees (typically \$15 per \$100 received) — effective APR of, e.g., about 400%^d • Another bill/payment • Debt cycle risk if individual fails to adopt greater financial discipline
Borrow from family, friends, or employer	<ul style="list-style-type: none"> • No financial institutions or credit risk • Could feature no fees or interest • Allows for planned cutbacks on expenses in ensuing weeks to catch up 	<ul style="list-style-type: none"> • Option not always available • Risk of damaging relationships with loved ones • Embarrassment or awkwardness • Another bill/payment • Debt cycle risk if individual fails to adopt greater financial discipline

Options for the Poor Who Face an Immediate Cash Shortfall

Option	Pros	Cons
Borrow from a short-term lender — online	<ul style="list-style-type: none"> • No financial institutions or credit risk • Timely • Discreet • Low likelihood of being turned down • Keep possessions; no collateral • Repayment over short period (e.g., 2-4 weeks) • Allows for planned cutbacks on expenses in ensuing weeks to catch up 	<ul style="list-style-type: none"> • Higher fees than storefront lender (e.g., \$25–\$30 per \$100 received) — effective APR of 650%–780% • Another bill/payment • Debt cycle risk if individual fails to adopt greater financial discipline
Play the lottery	<ul style="list-style-type: none"> • No financial institutions or credit risk • Keep possessions • No fees or interest • Roughly a third of the ticket sale would be used to replace funds for public education now being used for other purposes since the passage of the lottery^e • Odds of working are approximately one in every 1,000 times attempted, or lower, depending on the game chosen and how big a jackpot is needed^f 	<ul style="list-style-type: none"> • Odds of failing are approximately 999 in every 1,000 times attempted, or higher, depending on the game chosen and how big a jackpot is needed • Immediate loss of income during acute need for greater cash on hand • Delay in payoff as winning tickets still need to be verified • A strategy with diminishing returns
Declare bankruptcy	<ul style="list-style-type: none"> • Stops all collections actions by creditors • Can exempt key possessions in many states, such as house or car^g 	<ul style="list-style-type: none"> • Significant black mark on credit report for 10 years • High difficulty in ensuing years to obtain a mortgage, finance a car, get life insurance, or even get a job • Immediate loss of all credit cards and long-term high difficulty in obtaining another one • Potential loss of possessions • Indiscreet • Shame, embarrassment
Beg	<ul style="list-style-type: none"> • No financial institutions or credit risk • Keep possessions • No fees, but some cities and counties — such as Greensboro, Raleigh, Wake County, and Johnston County — require privilege licenses to panhandle 	<ul style="list-style-type: none"> • Time-consuming • Indiscreet • Shame, embarrassment • Personal risks include verbal assault, physical assault, and exploitation • Risk of arrest for begging without a panhandling license • A strategy with diminishing returns
Borrow from an illegal lender/loan shark		<ul style="list-style-type: none"> • Higher fees than legal lenders — i.e., effective APR > 400% • Personal risk of threats, physical violence, and exploitation from debt collectors • Risk of loss of possessions • Debt cycle risk if individual fails to adopt greater financial discipline
Steal		<ul style="list-style-type: none"> • Illegal • Danger to life and limb in general, potentially higher depending upon disposition of local gun laws and/or status of gun ownership • High risk of arrest, jail time, criminal record • A strategy with diminishing returns
Engage in illegal commerce (including, selling drugs, prostitution, etc.)		<ul style="list-style-type: none"> • Illegal • Danger to life and limb • High risk of arrest, jail time, criminal record • A strategy with diminishing returns

Table citations:

- a) Claude Solnik, “Banks tiptoeing into payday-style lending,” *Long Island Business News*, February 11, 2013, libn.com/2013/02/11/banks-tiptoeing-into-payday-style-lending.
- b) Assumes utility charge of \$50/month.
- c) Kathy Chu, “Anger at bank overdraft fees gets hotter, bigger and louder,” *USA Today*, October 2, 2009, usatoday30.usatoday.com/money/perfi/credit/2009-09-28-overdraft-fees-anger-regulation_N.htm.
- d) North Carolina Attorney General Roy Cooper, as quoted in “North Carolina Declares Victory In War On Payday Lending,” *Consumer Affairs*, March 9, 2006, www.consumeraffairs.com/news04/2006/03/nc_payday.html.
- e) Jon Sanders, “Just Not Worth the Gamble: The NC Education Lottery’s many problems have a common solution,” *John Locke Foundation Spotlight* No. 405, February 2, 2011, johnlocke.org/research/show/spotlights/256.
- f) 1:1,000 odds to win \$500 in Carolina Pick 3; see “How to Play,” North Carolina Education Lottery, nc-educationlottery.org/pick3_how-to-play.aspx, accessed February 20, 2013. Odds for other games to win figures equivalent to small loans are significantly longer, such as 1:13,781 on up to win \$150 in Mega Millions (3+Mega Ball) and 1:12,245 on up to win \$150 in Powerball (3+Powerball), per JustLottery.com, justlottery.com/us/games.html, accessed February 23, 2012.
- g) “The Pros and Cons of Bankruptcy,” *Consumer Affairs*, consumeraffairs.com/finance/bankruptcy_02.html, accessed February 23, 2012.

payday lenders cause this behavior. They simply provide an opportunity for this behavior to be exhibited more often than otherwise.⁴⁵

Such aspects could be seen in the UNC study's focus groups. Participants told the UNC study they would "probably not" have been able to obtain the loan had there been a credit check. Though many liked the fact that they could borrow small amounts, several felt prompted to borrow more than they needed and did. Some took out successive loans as they found it difficult to pay them off in the short time window. One even used the loans to continue a dating relationship while hiding a gambling habit.⁴⁶

Nevertheless, despite the burdens of repayment, all but one participant in the groups had paid off the loans — a finding in keeping with the Consumer Financial Services Association of America's number that 95 percent of loans are repaid,⁴⁷ which is similar to findings by state regulators and compares favorably with repayment rates for subprime adjustable rate mortgages.⁴⁸ Pew research suggested that 97 percent of payday loans are repaid.⁴⁹

A few other observations from the focus groups show that the loans' high costs had a positive side benefit of inducing some of the borrowers (many presumed to have poor credit and bad financial habits) to develop better financial discipline. Some excerpts:

- One man said, "Every two weeks I have to run down and get another [loan] before they close. It became a part of my life, until I realized I was paying \$45 every two weeks. Then it started to come to me."
- At first they thought of a payday loan as income or extra money, but later they realized that rather than adding to their income they had just "killed one bill with another."
- [One borrower] said the loan's onerous terms had taught him a lesson and led him to fundamentally change his financial management.
- One frequent borrower explained, "If you borrow \$300 and pay back \$45, and you're going in there two times a month, at the end of the year that's \$1,180 in interest and you still owe \$300. That's what woke me up — \$1,180. You could use that for something a lot more important."
- Four frequent borrowers got money from other sources to pay off their payday loans, including pawnshops, friends and family, and a bank overdraft that was subsequently converted to an installment loan.
- When pressed, most said it had been difficult to pay back their loans. Several people said that once they realized how much the cycle cost them, they paid off by "easing out," taking consecutively smaller loans.
- Others took part-time jobs or cut back on spending.⁵⁰

Conclusion and Recommendations

"Why do we think we are helping adult consumers by taking away their options?" asked former Democratic presidential candidate George McGovern in *The Wall Street Journal* about payday lending bans.⁵¹

North Carolina's ban on small-scale, short-term lenders has left potential borrowers worse off by removing a viable option from them, especially from those with the fewest choices who are closest to going underground to obtain necessary funds. It is governmental paternalism seeking to save people from making harmful choices, but it imposes a net greater harm instead. It does so by assuming people don't know their own business and can't manage their own affairs, all the while ignoring that the ban forces potentially greater costs on the very people it is supposed to help. In taking high-cost, short-term loans off the menu of options, it leaves poor borrowers in need of immediate cash at risk of higher bounced-check fees, expensive utility disconnect or reconnect fees, penalty rates for missed credit card payments, and other actions that would harm their credit ratings, including bankruptcy. It also keeps from them a lending option with superior nonmonetary features, including convenient hours and locations, ease in obtaining a

loan, friendly and nonjudgmental staff, discretion, being able to avoid embarrassing personal interactions with family, friends, and employers, etc.

High-cost, short-term loans are hardly a solution of first resort to a sudden shortfall. Nevertheless, for some borrowers, they are the only solution available to them. But they aren't currently available to them in North Carolina, unless of course the borrower wishes to cross state borders or try an unlicensed online lender.

North Carolina policymakers should expand lending options in this state by legalizing small-scale, short-term lending again. Legalization could take into consideration industry best practices (for an example, see the Community Financial Services Association of America's list⁵² for its members), which would include such things as full disclosure of rates, limitation on rollover, appropriate (nonabusive) collection services when necessary, no criminal prosecution for lack of payment, and the offer of an extended payment option. Given the highly competitive market structure, however, state leaders should avoid the temptation to micromanage rates and fees.

Finally, legalization would also lead to job creation across the state, as it would undo the ban that shuttered at least 902 storefronts across North Carolina. There are approximately 24,000 storefront payday lenders in the U.S.⁵³

The Nobel Prize winner Yunus said that at the heart of his work was "creation of opportunities for the majority of people — the poor."⁵⁴ Viewed in that light, high-cost, small-scale loans for the poor are a good thing. Not allowing those opportunities because some would misuse them is, in net effect, harmful to the very people it is supposed to help.

Jon Sanders is Director of Regulatory Studies at the John Locke Foundation.

End notes

1. "The Nobel Peace Prize of 2006," press release, the Norwegian Nobel Committee, October 13, 2006, nobelprize.org/nobel_prizes/peace/laureates/2006/press.html#.
2. "Banker to the Poor," Muhammad Yunus biography, the Norwegian Nobel Committee, 2006, nobelprize.org/nobel_prizes/peace/laureates/2006/yunus.html.
3. Muhammad Yunus, Nobel Lecture, December 10, 2006, nobelprize.org/nobel_prizes/peace/laureates/2006/yunus-lecture-en.html.
4. David Roodman, "Quick: What's the Grameen Bank's Interest Rate?," David Roodman's Microfinance Open Book Blog, Center for Global Development, September 24, 2010, blogs.cgdev.org/open_book/2010/09/quick-whats-the-grameen-banks-interest-rate.php.
5. Katherine Mangu-Ward, "Money Needed, Right Now," *The Wall Street Journal*, June 25, 2010, online.wsj.com/article/SB10001424052748704629804575325840351124892.html.
6. S.L. 1997-391, ncga.state.nc.us/Sessions/1997/Bills/Senate/HTML/S312v3.html.
7. Michael A. Stegman and Robert Faris, "Payday Lending: A Business Model That Encourages Chronic Borrowing," *Economic Development Quarterly*, Vol. 17, No. 1, February 2003, pp. 8–32, ccc.unc.edu/documents/CC_Payday_Lending.2.2003.pdf.
8. Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans," Federal Reserve Bank of New York *Staff Reports*, no. 309, November 2007, revised February 2008, newyorkfed.org/research/staff_reports/sr309.html.
9. Senate Bill 89, "Deferred Presentment Services," ncga.state.nc.us/gascripts/BillLookUp/BillLookUp.pl?Session=2013&BillID=S89.
10. "Payday Lending in America: Who Borrows, Where They Borrow, and Why," The Pew Charitable Trusts, July 2012, pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Payday_Lending_Report.pdf.
11. Anetrise Cole, "Regions halts its advance loan program in North Carolina," *Birmingham Business Journal*, January 18, 2013, bizjournals.com/birmingham/blog/2013/01/regions-halts-its-advance-loan-program.html.
12. Mark Huffman, "Payday Lenders Move Online, Try to Bypass State Laws," *Consumer Affairs*, November 20, 2006, consumeraffairs.com/news04/2006/11/wv_payday_lenders.html. See also, e.g., MyPaydayLoan.com's web page for North Carolina, mypaydayloan.com/north-carolina-payday-loans.htm, and Payday Loan Ranger.com's page for North Carolina, paydayloanranger.com/North_Carolina_Payday_Loans.php, both accessed February 20, 2013.
13. "North Carolina Declares Victory In War On Payday Lending," *Consumer Affairs*, March 9, 2006, consumeraffairs.com/news04/2006/03/nc_payday.html.
14. Tom Leman, "In Defense of Payday Lending," *The Free Market*, Vol. 23, No. 9, Ludwig von Mises Institute, September 2003, mises.org/freemarket_detail.aspx?control=454.
15. A. Barton Hinkle, "The Unintended Consequences of Cracking Down on Payday Lenders," *Richmond Times-Dispatch*, October 24, 2012, via reason.com/archives/2012/10/24/payday-lending-convenient-service-or-evi.
16. Jessica Silver-Greenberg and Ben Protess, "Chasing Fees, Banks Court Low-Income Customers," *The New York Times*, April 25, 2012, nytimes.com/2012/04/26/

- business/chasing-fees-banks-court-low-income-customers.html*. A few examples include Wells Fargo’s “Direct Deposit Advance,” Fifth Third Bank’s “Early Access,” U.S. Bank’s “Checking Account Advance,” Guaranty Bank’s “Easy Advance,” and Region Bank’s “Ready Advance.”
17. Victor Stango, “Are Payday Lending Markets Competitive?”, *Regulation*, Fall 2012, pp. 26–33, via cato.org/sites/cato.org/files/serials/files/regulation/2012/11/v35n3-5.pdf.
 18. Stango, “Are Payday Lending Markets Competitive?”
 19. “The High Cost of Making High Cost Payday Loans,” BankTalk.org, February 5, 2013, banktalk.org/2013/02/05/the-high-cost-of-making-high-cost-payday-loans.
 20. “North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options,” Center for Community Capital, UNC College of Arts and Sciences, prepared for the North Carolina Commissioner of Banks, November 2007, nccob.gov/public/docs/News/Press%20Releases/Archives/2007/NC_After_Payday.pdf.
 21. “NC Consumers After Payday Lending.”
 22. “NC Consumers After Payday Lending.”
 23. “How Borrowers Choose and Repay Payday Loans,” The Pew Charitable Trusts, February 2013, pewstates.org/research/reports/how-borrowers-choose-and-repay-payday-loans-85899452131.
 24. Pew, “Payday Lending in America.”
 25. Pew, “Payday Lending in America.”
 26. Stegman and Faris, “Payday Lending.”
 27. John Hood, “People really just want to be left alone,” The Locker Room blog, John Locke Foundation, July 9, 2008, johnlocke.org/lockerroom/lockerroom.html?id=16456.
 28. Geoffrey Chaucer, “The Man of Law’s Prologue,” *The Canterbury Tales*, 1387–1400, viewable at librarius.com/canttran/manlawtrfs.htm.
 29. Stango, “Are Payday Lending Markets Competitive?”
 30. Katherine Mangu-Ward, “Payday of Reckoning,” *Reason*, September 25, 2009, reason.org/news/show/payday-of-reckoning.
 31. “NC Consumers After Payday Lending.”
 32. Gregory Elliehausen, “An Analysis of Consumers’ Use of Payday Loans,” *Financial Services Research Program Monograph No. 41*, The George Washington University School of Business, January 2009, approvedcashadvance.com/docs/GWUAnalysis_01-2009.pdf.
 33. Elliehausen, “Analysis of Consumers’ Use of Payday Loans.”
 34. Uriah King, Leslie Parrish, and Ozlem Tanik, “Financial Quicksand: Payday lending sinks borrowers in debt with \$4.2 billion in predatory fees every year,” Center for Responsible Lending, November 2006, responsiblelending.org/payday-lending/research-analysis/rr012-Financial_Quicksand-1106.pdf.
 35. Morgan and Strain, “Payday Holiday.”
 36. Morgan and Strain, “Payday Holiday.”
 37. King, Parrish, and Tanik, “Financial Quicksand.”
 38. Morgan and Strain, “Payday Holiday.”
 39. Morgan and Strain, “Payday Holiday.”
 40. “NC Consumers After Payday Lending.”
 41. Pew, “How Borrowers Choose and Repay Payday Loans.”
 42. Elliehausen, “Analysis of Consumers’ Use of Payday Loans.”
 43. Mangu-Ward, “Payday of Reckoning.”
 44. Pew, “How Borrowers Choose and Repay Payday Loans.”
 45. Leman, “In Defense of Payday Lending.”
 46. “NC Consumers After Payday Lending.”
 47. “Myth vs. Reality,” Consumer Financial Services Association of America, cfsaa.com/aboutthepaydayindustry/myth-vs-reality.aspx, accessed February 20, 2013.
 48. Mangu-Ward, “Payday of Reckoning.”
 49. Pew, “How Borrowers Choose and Repay Payday Loans.”
 50. “NC Consumers After Payday Lending.”
 51. George McGovern, “Freedom Means Responsibility,” *The Wall Street Journal*, March 7, 2008, online.wsj.com/article/SB120485275086518279.html.
 52. “Best Practices for the Payday Advance Industry,” Community Financial Services Association of America, cfsaa.com/Portals/0/Members/CFSA_MembershipKit_BestPractices.pdf, accessed February 20, 2013.
 53. Stango, “Are Payday Lending Markets Competitive?”
 54. Yunus, Nobel Lecture.