# Payday Lending and Large Banks

An STS Research Paper
presented to the faculty of the
School of Engineering and Applied Science
University of Virginia

by

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March 26, 2020

On my honor as a University student, I have neither given nor received unauthorized aid on this assignment as defined by the Honor Guidelines for Thesis-Related Assignments.

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## Payday Lending and Large Banks

### Introduction

Because it takes money to make money, poverty can be self-perpetuating. The Federal Reserve describes a payday loan as a “small, short-term, unsecured, single-payment, consumer loan” (Prager, 2009). In such a loan, a “borrower writes a personal check to the lender, with the amount of the check equal to the loan amount plus the finance charge. The lender agrees to hold the check for a specified period of time (usually until the customer’s next payday) before depositing it” (Prager, 2009). In 2017, there were more payday loan centers in America than McDonald’s (Bennett, 2019). Payday lenders prey on borrowers by charging interest rates sometimes exceeding 500% (Carlson, n.d.). Borrowers can become trapped, borrowing to pay interest on past loans (Stegman, 2007). Payday lenders defend their business, claiming that for many low-income people it is the sole access to credit. The alternatives, they warn, are overdrafts and non-payments. Their critics include large banks, which often compete with payday lenders, and financial advisory organizations that advertise lending products with much better rates and lower fees. Banks, such as Capital One, also advise borrowers in ways that favors their own products. States limit fees and interest for payday loans.

### Literature Review

Stegman (2007) recommends government policies to combat payday lending, warning that an educational approach would be difficult. Since 2007, however, consumer education has become easier. Chang (2019) found that access to payday lending increases the likelihood of household food insecurity by 2.8–6.0 percentage points in absolute terms, indicating payday loans can exacerbate poverty. For military families, however, Carter (2017) finds that payday loans can improve finances by “reducing the probability of an involuntary separation and improving credit outcomes in some subgroups” (Carter 2017). Carter claims this since military members rarely have any other options for short term lending, if banks entered this market the impact of payday loans could drift negatively.

For-Profit colleges in the United States pray on the same customer base as payday loans, uninformed and usually of lower income. Newton states that students receive inferior education and their credits or degree may be worthless (Newton, 2018). This leaves students in large amounts of debt without gaining a well-rounded education that is likely to result in a higher paying job. This research shows the prevalence of similar business models in other industries. Of all the U.S. colleges that have closed since 2013, 95.5% were for-profit institutions (Newton, 2018) showing flaws in the longevity of this model. Policies implemented to limit for-profit universities could be used in the creation of payday lending law.

## Credit and Lending

For low-income borrowers or borrowers with bad credit, a payday loan may be the only option. Banks generally will not lend to people with bad credit. They typically advise borrowers to stay away from payday loans, but provide no alternative (Silver-Greenberg, 2013). Payday loan centers aggressively advertise to fill this gap. In the United States, credit card companies are banned from advertising within 1,000 feet of a college campus (CARD Act, 2009). Loanmax, a Charlottesville short-term lender, advertises a $100 referral bonus for new customers with large signs on their building.

Some Fin-Tech corporations offer payday-loan alternatives. Capital One, headquartered in McLean, Virginia, offers credit cards and loans to some low-income people at more reasonable rates (Murray, n.d.), such as 26.99% for their Platinum Secured Mastercard as of March 2020 (Capital One, 2020). Larger banks are beginning to provide financial education to help borrowers recognize predatory lending practices and improve their own credit (Field, 2019). Customers who begin to show a stable lending history may qualify for larger loans or lower interest rates. Banks can thereby divert more reliable borrowers from payday services to their own institutions. Banks advertise such services, warning borrowers of payday lenders. On its website, Capital One states that borrowers should avoid payday lending (Capital One, 2018). Budd (2018) found that unfavorable media coverage of payday loans also deters borrowers from them.

Payday lenders, such as Advance America, the largest in the United States, do not consider credit in the loan approval process, but only the borrower's income (Advance America 2007). Hence payday lenders may approve loans to borrowers who have defaulted on loans. As there is a strong correlation between income and credit scores, low-income earners may have no other option but a payday loan. Payday loan businesses in Virginia cluster in low-income areas (Prager, 2009). Virginia law protects payday loan borrowers by limiting late fees, court costs, interest rates, and loan amounts (VAC 10VAC5-200-80). However, a lender following these laws may still charge a fee of $25.70 on a 7-day, $100 loan—an APR of 1339%. In Texas however, in 2014 the committee to regulate payday loans is run by William White, an executive at Cash America which is a payday lender (Wilder, 2019), which has resulted in relaxed regulations for payday lenders. White was appointed by the governor which brings into question the relationships these lenders have with the government. Cash Fairy, a Montana based online lender, has even partnered with the Fort Belknap Indian Tribe to get around regulations on maximum interest rates and fees (DFI, 2016). Since payday lenders make their profit from

interest and fees, it is in their best interest to trap borrowers in a cycle of borrowing. At ACE Cash Express a page in the employee training manual shows the cycle of borrowing that

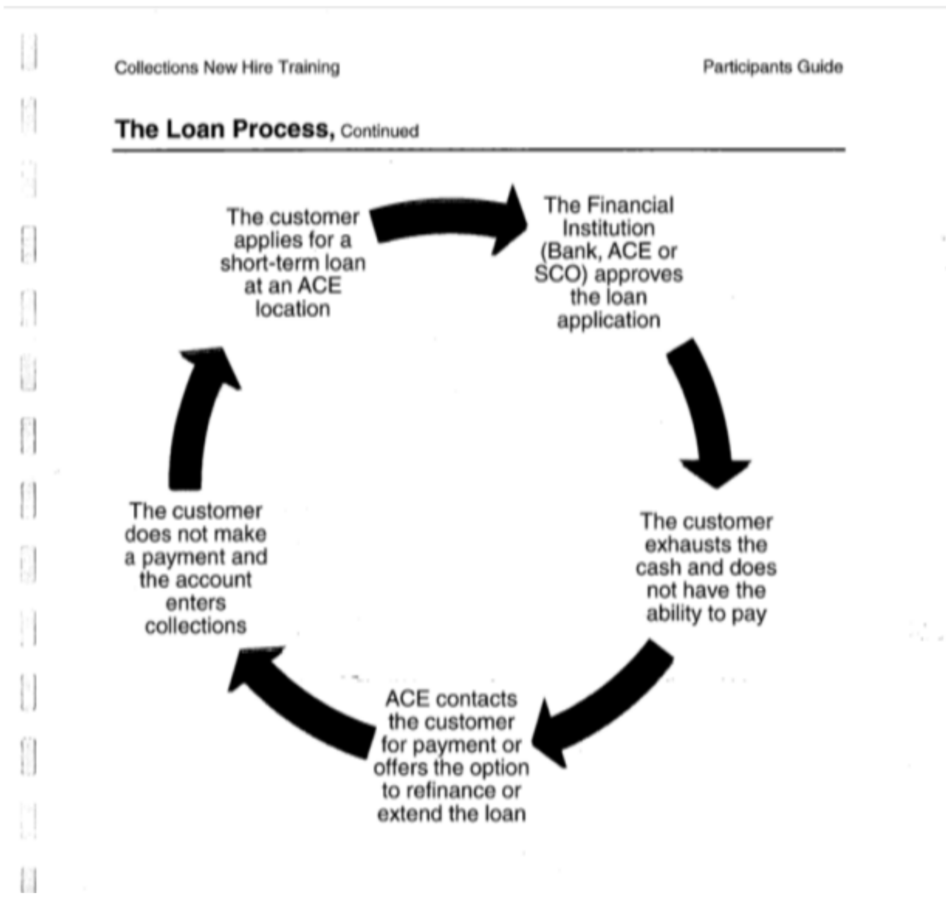


*Figure 1: Page from ACE Cash Express Employee Training Manual*

consumers can become trapped inside. This cycle is extremely profitable for the lender as with each cycle lenders are paid interest and fees for the loan while the initial borrower is unable to pay the principal.

**Advocacy Groups**

The National Association of Consumer Advocates (NACA) is an advocacy for consumers. NACA contends that payday loans are by nature predatory (NACA, n.d.), and it offers legal and other protections for its clients.

The Community Financial Services Association of America (CFSA) is a trade association for payday lenders. To avoid the unfavorable connotations of the term *payday loan,* CFSA calls them “small-dollar loans.” According to CFSA, “the average fee for a single payment small-dollar loan is $15 per $100 of the loan.” It asserts that “96% of borrowers find small-dollar loans useful, and nearly half of Americans cannot afford a $400 unanticipated expense” (CFSA, n.d.). These statements are undocumented, and critical information such as average loan duration is missing. A $15 fee on a $100 loan for 1-year yields interest rate of 15%, but if the loan duration was 1 week the interest rate would be 780%. CFSA’s members are payday loan businesses, including the biggest payday lender in America, Advance America Cash Advance Centers, Inc.

In 2017 the Consumer Financial Protection Bureau created new rules for payday and car title lenders that required them to assess the borrower’s ability to repay before issuing a short-term loan (CFPB, 2017). This would prevent borrowers from becoming trapped in a cycle of borrowing as customers will no longer be able to borrow more than what is possible to pay back. The Southern Poverty Law Center was in strong support of this decision, writing that “payday loans are devasting to low-income communities” and that these new rules would help limit the debt caused by these loans (SPLC, 2017) The Southern Poverty Law Center is a group that is “dedicated to fighting hate and bigotry and to seeking justice for the most vulnerable members of our society.” In 2018, the CFPB planned to reconsider the new rules and the SPLC released a statement that “The current rule must be preserved because it requires lenders to determine a borrower’s ability to pay before issuing a loan” (SPLC, 2018).

Law practices such as McCarthy Law PLC specialize in payday loan law. The provide services to help those who have payday loan debt that they are unable to repay and will give a free consultation from their website (McCarthy, n.d.). They advise consumers to be cautious with payday loans as it is easy to become trapped in a cycle of debt (McCarthy, n.d.). For those with large amounts of payday loan debt, a lawyer could negotiate the amount down to something that is much more attainable to pay off as payday loan companies would rather you pay off a portion of your loan rather than default on the entire loan or declare bankruptcy. If the debtor declares chapter 13 bankruptcy, the loan will most likely still be required to be paid off using a court-structured repayment plan. If a borrower declares chapter 7 bankruptcy a payday loan is considered unsecured debt and will likely be discharged. However, if the debtor acquired the loan in the 90 days prior to filing bankruptcy it will be unable to be discharged. Unfortunately, payday loans are a last resort for many so they will often be taken out right before declaring bankruptcy.  Since payday loans are short-term loans they will be considered "renewed" if they are not paid off each month so lenders will object to the loan being discharged on the basis of it being accrued in the past 90 days (Nolo, 2020).

**Credit Cards vs Loans**

Credit cards can provide an alternative to short term lending. The CFPB states that the payday loans are generally for $500 or less so an alternative lending method must allow at least $500 of lending. Credit scores are divided into 5 different categories: Super Prime from 781-850, Prime from 661-780, Near Prime from 601-660, Subprime from 500-600, and Deep Subprime from 300-499. Experian data from 2015 found that those in the bottom tier of credit score (300-499), also referred to a deep subprime, had an average credit limit of $509. With a credit card, purchases are charged to the bank and the user will not have to pay off this balance to not accrue interest for up to a month. If the customer does not pay off the card the balance is charged daily interest at a rate set by the bank, the APR. For the Capital One Platinum Mastercard this rate is 26.99%, well below the average rate for a payday loan. This card comes with a minimum credit line of $300 so anyone approved for this card would have instant access to a loan of that amount. Capital One offers secured cards to customers who do not qualify for a normal credit account. The customer would make a deposit of $49, $99, or $200 and would have access to this amount of credit and if payments are made on time for the first five months their credit line will be increased (Capital One, 2020). This card provides an extremely small level of risk to the bank as all purchases are backed by the initial deposit. Therefore, even those with poor credit can be approved for secured cards. While this card does help customers build credit so they will be eligible for higher tier credit cards and higher limits, on their own secured cards do not have an impact on the lending potential for customer due to the required deposit.

**Consumer Reaction**

Payday loans frequently appear in news segments, online discussion and even on comedic TV shows. John Oliver once did a segment on Payday Loans saying “Payday loans are the Lays potato chips of finance, you can’t have just one and they’re terrible for you” (Oliver, 2014). He ends the segment on his show with a sketch with the message “Instead of getting a payday loan, try literally anything else.” The /r/PersonalFinance subreddit on Reddit.com also holds a very negative view on payday loans. The Personal Finance subreddit, which currently has 14,144,845 readers, is a place where people can ask for financial advice or share stories of financial decisions they have made in the past to educate others. Multiple posts exist of horror stories from payday loans such as user Loki2002 stating “I have paid 41 payments of $60 equaling $2,460 which means that a small $200 loan cost me over $2,200. Don't do it, it's not worth it (loki2002, 2020)” or Lequids writing “I signed up for a payday loan through Speedy Cash for $425. I didn't read the contract before signing (I know, major facepalm) and I've just come to realize that not only will I be paying back $1,309 due to interest, but also an additional one-time payment of $564.26 in principal and CAB fees. $1873.26 for a $425 loan, $119 out of every check I receive for the next 6 months” (Lequids, 2019). On posts when other users have asked for advice on whether a payday loan was right for them the responses were extremely against payday lending with responses such as “DO NOT get a payday loan. Ever. Sell your possessions, borrow from friends, whatever you have to do, but DO NOT do that. You think times are hard now? They'll dang sure be hard when you're in the same situation but have a payday lender hounding you (adrianmorrell,2020)” and “Sell your phone, sell your blood, sell your shoes, sell you[r] body. DO NOT GET A PAY DAY LOAN” (4agreements, 2020).

**Disaster Scenarios**

All information in the following section in relation to COVID-19 pertains to the response of banks and lenders up to March 22nd 2020, on this date there were 33,404 confirmed cases of Coronavirus and 400 deaths in the United States (CDC, 2020).

As the Coronavirus continues to rapidly spread throughout the United States governments in areas such as San Francisco and New York city are enforcing full lock downs. Many businesses such as airlines and hotels, and restaurants are performing layoffs to counteract decreases in customers (Voytko, 2020). According to the US Federal Reserve Report in 2018 40% of Americans would have to borrow money to pay an emergency $400 expense (Federal

Reserve, 2018), so a high number of layoffs will lead to a higher need for short- and long-term lending. Ally, an online only US bank, has waived all fees for overdrafts and excessive transactions for the next 120 days (Ally, 2020). For home and auto loans, payments can be deferred for up to 120 with no late fees or penalties. These actions can help reduce expenses of their customers to prevent additional lending. Capital One has also aided their customers but instead of a blanket policy, customers must contact them and they will provide customized assistance (Capital One, 2020), specifics of which are not easily found. For those with good credit, another option is applying for a credit card with a 0% APR for purchases or balance transfers. During the COVID-19 outbreak Capital One offers the Quicksilver card with a 0% APR for the first 15 months so that all purchases would not have to be paid for until June 2021. JPMorgan Chase, the largest bank in the United States (Federal Reserve 2019), currently does not allow for deferred loan payments. Reddit user Pil3_Up states "I called Chase, who I've banked with for over a decade and refinanced my Mortgage with in 2017, to find out about deferred Mortgage payments, as several of my Friends have said they've done successfully with their Bank. All Chase is offering is to not report to my credit for the next 90 days if I have late payments. Nearly every other major mortgage provider is deferring payments for their customers due to the ongoing COVID-19" (Pil3_Up, 2020). Therefore, Chase loan customers will still be charged late fees if they miss any payment date during the Coronavirus pandemic. Chase mortgage customers may be forced to look elsewhere for financial assistance during this crisis which could lead them to payday loans. Citi allows customers to withdraw from Certificate of Deposit (CD) accounts without any fees until April 9, 2020 (Citi, 2020). This would allow customers to increase the liquidity of their assets for emergency expenses without any penalty.

Payday loan business are being impacted by this crisis as well. The Wisconsin Department of Financial Institutions (“DFI”) released an emergency guidance for payday lenders for the duration of the pandemic stating “effective immediately, this Department shall deem it an essential failure of your character and fitness if you increase your customary interest rates, fees, or any costs of borrowing in response to this crisis” (DFI, 2020). The DFI also urges payday lenders to “reduce your rates and fees as low as operational expenses and sound lending practices allow” (DFI, 2020). Finally, the DFI states that noncompliance with these terms is proof of a company’s “lack of character and general fitness” and will cause their license to operate in Wisconsin to be suspended or revoked. If payday lenders truly follow these demands and provided low cost loans they will provide an overall positive benefit to low income communities during this pandemic. This pandemic could be a turning point for payday lenders as they will either help support their communities to improve their overall reputation of if they take advantage of this crisis they could be banned.

**Conclusion**

As a highly profitable business, payday lenders will continue to aggressively market their services to gain as many customers as possible. Other lenders, such as large banks try to target the most trustworthy of borrowers in order to give loans with significantly lower interest rates. Credit cards can provide an alternative to loans if the customer never needs to borrow more than their credit limit. Most Americans know that payday loans are bad for them, yet some continue to regularly utilize them. As more research is done on the negative impact of payday loans more regulations are being put in place to limit them. But lending centers are slowing down regulations through lobbying or even avoid regulations using legal loopholes. To benefit their communities, payday loans must be regulated so that fees and interest are capped and the loans do not go to those who cannot repay them.

As we don't know if March 2020 is the beginning, middle, or end of the COVID-19 pandemic, future research on payday practices throughout this disaster would prove very useful. As this is the first major modern pandemic the behavior of the payday loan industry will show if owners care about the communities they operate in or only focus on profits. Due to the economic impacts of COVID-19 the future might also bring more legislation regarding the lending industry as a whole due to the extremely high need for lending during this pandemic. Hopefully, paying over $1,200 to repay a $200 loan will soon be a thing of the past.

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