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How Predatory Debt Traps Threaten Vulnerable Families

By Joe Valenti and Eliza Schultz October 6, 2016

Not long ago, Renee Bergeron—a single mother from Duluth, Minnesota—was between paychecks and took out a small payday loan to help cover her rent. Once her payday came around, Bergeron found—much to her dismay—that she was unable to pay her basic bills and also make her loan repayment. As a result, Bergeron took out another payday loan in order to finance the initial loan. Today, nearly a decade later, Bergeron and her children live in a homeless shelter, and she remains saddled with more than $4,000 in payday loan debt.[1]

Bergeron is just one out of approximately 12 million borrowers who take out such loans each year, according to the Pew Charitable Trusts. Moreover, her experience is not unique—a small payday loan routinely grows into a debt of hundreds or even thousands of dollars.[2]

Payday loans and a closely related product, auto title loans—both heavily advertised and marketed—offer fast cash or quick approval while downplaying the fact that the terms of these loans carry a hefty price. Not only are these types of loans far more expensive than most other financial products—charging interest rates 10 times to 20 times higher than a typical credit card—but rather than serving as a lifeline, they are often a leaky life vest drowning families in debt and sinking them into financial ruin.

Payday loans involve giving a lender access to one's bank account for quick cash immediately and are typically repaid upon the next payday. Auto title loans involve handing over a car title and spare set of keys in exchange for cash based on a percentage of the car's value. In both cases, borrowers often pay annual interest rates well above 300 percent, and odds are that they will require another loan to pay off the first one. Each year, combined, these products take roughly $8 billion in interest and fees out of the pockets of struggling families and communities and put those billions of dollars into the hands of lenders.[3]

These costs are largely unnecessary. Better credit options may exist for many borrowers, although they may not be available instantly. Noncredit options—such as turning to family and friends, local religious congregations, or public assistance programs—are less risky and also are unlikely to cause the same level of financial harm. More than 90 million

Americans currently live in the District of Columbia and the 14 states where these predatory products are banned under state interest rate caps.[4] But the ubiquitousness of these lenders in vulnerable communities—in Texas they even outnumber grocery stores—means that they are often to whom cash-strapped people turn.[5]

Payday and auto title lending, which came on the scene in a big way in the 1990s, exists due to a combination of stagnant economic conditions and heavy lobbying by the industry.[6] According to the Federal Reserve, roughly half of all Americans would be unable to come up with $400 without borrowing or selling something.[7] Moreover, policymakers have failed to raise the minimum wage in line with inflation over the past few decades. As a consequence, today's federal minimum wage of $7.25 per hour falls far short of its inflation-adjusted high in 1968—which was well above $10 in 2016 dollars.[8] Insufficient wages coupled with gaps in the social safety net make it more likely that too many families turn to high-cost credit to stay financially afloat.[9]

Regulators have begun to take aggressive action against these predatory debt traps. In June of this year, the Consumer Financial Protection Bureau, or CFPB, proposed the first-ever comprehensive federal regulations to address unfair, deceptive, or abusive practices in the payday and auto title lending marketplace.[10] While a strong first step, the CFPB's proposed rule should be strengthened to require that lenders determine up front whether borrowers are able to repay a loan—a common sense aspect of responsible lending—and close legal loopholes that maintain the status quo. Meanwhile, states should continue to take their own strong actions, including capping annual interest rates at 36 percent or less—inclusive of all fees—just as the Pentagon has done to protect military service members and their families from predatory lenders.[11] In addition to directly addressing financial harm, policymakers should take the necessary steps to build inclusive economies and rebuild the safety net in order to tackle the root causes of instability that lead families to turn to these onerous products in the first place.

This brief details the origins of the predatory debt trap and the consequences that these products have not only for the finances of borrowers but also on the overall well-being of their families.

Why predatory lending is so prevalent

Millions of families who take out payday and auto title loans face insufficient resources to make ends meet from month to month. Most of these loans are used to deal with recurring financial shortfalls rather than specific emergencies.[12] Women and people of color are more likely to take out a payday loan: 52 percent of payday loan borrowers are women, and African Americans are more than twice as likely to take out a loan relative to other demographic groups.[13] This disparity is reflected in not only gaps in wages and wealth but also the aggressive clustering of payday loan storefronts in African American—as well as Latino—neighborhoods.[14]

Stagnant wages and a growing wealth gap

Despite increases in worker productivity in the United States, wages have largely remained stagnant since the mid-1970s.[15] With the exception of a short period of growth in the 1990s, middle-class wages have largely stalled over the past 40 years.[16] Stagnant wages, in turn, have placed families at risk of falling out of the middle class: Half of all Americans are projected to experience at least one year of poverty or near-poverty in their lifetimes.[17] The federal minimum wage—unchanged at $7.25 per hour for the past six years—has lost nearly one-quarter of its value since 1968 when adjusted for inflation.[18] To compound stagnant wages, the growth of the on-demand economy has led to unpredictable work schedules and volatile income among low-wage workers—a group disproportionally made up of people of color and women. A slow week at work, through no fault of the employee, may result in an inability to meet basic, immediate expenses.[19]

Decades of wage stagnation are coupled with an increasing wealth gap that leaves families less able to meet emergency needs or save for the future. Between 1983 and 2013, the median net worth of lower-income families declined 18 percent—from $11,544 to $9,465 after adjusting for inflation—while higher-income families' median net worth doubled–from $323,402 to $650,074.[20] The racial wealth gap has persisted as well: The median net worth of African American households in 2013 was only $11,000 and $13,700 for Latino households—one-thirteenth and one-tenth, respectively, of the median net worth of white households, which stood at $141,900.[21]

Failures of the social safety net to meet struggling families' needs

Changes in public assistance programs have also left gaps in families' incomes, particularly in times of emergencies. Perhaps the most significant modification to the safety net came in 1996 with the Personal Responsibility and Work Opportunity Reconciliation Act, the law that "ended welfare as we know it."[22] In place of Aid to Families with Dependent Children—a decades-old entitlement program that offered cash assistance to low-income recipients—came the Temporary Assistance for Needy Families, or TANF, program—a flat-funded block grant with far more restrictive eligibility requirements, as well as time limits on receipt. The long-term result has been a dramatic decline in cash assistance to families. Moreover, the block grant has lost fully one-third of its value since 1996, and states are incentivized to divert funds away from income assistance; thus, only 1 out of every 4 TANF dollars goes to such aid.[23] As a result, TANF reaches far fewer families than it did 20 years ago—just 23 out of every 100 families in poverty today compared with 68 out of every 100 families during the year of the program's inception.[24]

Other critical public assistance programs have seen declines as well. TANF's nonrecurrent short-term benefits—intended to offer short-term aid in the event of an unexpected setback—are less able to serve families today than they were two decades ago, before the program, then known as Emergency Assistance, was block-granted under welfare reform.

Adjusted for inflation, expenditures on nonrecurrent short-term benefits have declined substantially over the past 20 years. Federal and state funds devoted to this short-term aid totaled $865 million in 2015, far less than the $1.4 billion that 1995 federal funding levels alone would reach if adjusted for inflation.[25] Relatedly, funding for the Community Services Block Grant, or CSBG—a program through which local agencies are provided funds to address the needs of low-income residents, such as employment, nutrition, and emergency services—has also seen sharp declines since its 1982 inception. When adjusted for inflation and population growth, the CSBG has been cut 15 percent since 2000 and 35 percent since 1982.[26] Finally, unemployment insurance, or UI—the program designed to help keep families afloat while they are between jobs—has failed to keep pace with changes in the economy and the labor market. In 2015, only 1 in 4 jobless workers received UI benefits. In 13 states, that figure is 1 in 5.[27] Together, declines in emergency assistance, CBSG, and UI, as well as other public assistance programs, have made families trying to make ends meet more vulnerable to exploitative lending practices.

The growing government reliance on tax expenditures to address poverty has also indirectly challenged financial security. Two programs—the Earned Income Tax Credit, or EITC, and the Child Tax Credit—have become among the most successful antipoverty policies in the nation. Together, the two programs lifted 9.8 million Americans out of poverty in 2014.[28] But the tax credits are delivered in lump-sum form at tax time, and while funds are often used to make large purchases or save for the future, many families are left financially insecure for the rest of the year. Nearly a quarter of EITC dollars went toward paying existing debts among recipients interviewed in 2007.[29] And despite regulatory crackdowns on products such as refund anticipation loans, many recipients remain tempted to borrow against their tax refunds.[30] Additionally, the lump-sum structure of the tax credits makes families more likely to resort to predatory loans during the interim.[31]

Changes in credit availability, encouraged by lobbying

In addition to changing economic conditions, changes in the use of credit also contributed to the payday lending industry's growth. In the early 2000s, then-bankruptcy professor Elizabeth Warren—now the democratic U.S. senator representing Massachusetts—documented the rise in consumer credit as a way for families to keep up with declining real wages, with sometimes devastating consequences.[32] Changes in legislation and regulation fostered this rise. The U.S. Supreme Court's 1978 *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.* decision limited states' ability to cap interest rates for out-of-state banks, negating state interest rate caps, and was reinforced by subsequent legislation that emphasized the ability of national banks to set rates.[33] As the industry grew in the 1990s, payday lenders either exploited loopholes or encouraged enabling legislation that would allow exceptions to rate caps.

For example, Ohio passed legislation in 1995 to exempt payday lenders from state usury caps, and its industry grew from 107 payday lender locations in 1996 to 1,638 locations in 2007, increasing more than fifteenfold in just 11 years.[34] Nationally, the industry grew from virtually nonexistent to approximately 25,000 locations and more than $28 billion in loan volume between 1993 and 2006.[35] While Ohio legislators attempted to reverse course in 2008—ultimately 64 percent of Ohio voters supported a 28 percent interest rate cap in a statewide referendum—the Ohio Supreme Court upheld a loophole in state law that allowed the lenders to stay in business.[36] Overall, industry campaign contributions at the federal and state levels, plus federal lobbying expenses, between 1990 and 2014 exceeded $143 million after adjusting for inflation, all in the service of making or keeping these dangerous products legal despite public opposition.[37]

The real consequences for vulnerable families

Payday and auto title loans often have devastating consequences for families. These loans often contribute to financial distress, including the risk of eviction or foreclosure. Many borrowers face other devastating outcomes, from repossessed cars that contribute to job loss to challenges in caring for children and maintaining family stability.

Financial distress and housing insecurity

Instead of being quickly paid off, the vast majority of payday and title loans result in another loan. Eighty percent of payday and auto title loans will be rolled over or followed by an additional loan within just two weeks of the initial loan, as borrowers are unable to afford other essential expenses.[38] The median payday loan borrower is in debt for more than six months, and 15 percent of new loans will be followed by a series of at least 10 additional loans.[39] A typical borrower takes out eight loans during one year, paying an average of $520 in interest on a $375 loan.[40] In many cases, the cost may be much higher. In 2008, Naya Burks—a single mother living in St. Louis—had a $1,000 loan turn into an unanticipated $40,000 debt, as interest accrued rapidly at 240 percent when she could no longer keep up with payments, and the lender eventually sued her.[41]

Because payday and auto title lenders have access to either a customer's bank account or car, they take a privileged position over all other expenses. Struggling borrowers are then left with little agency over personal finances and are unable to prioritize critical needs such as medicine, rent, and diapers. Payday loan borrowers who fail to keep up with payments—including roughly 1 in 4 online payday loan customers—may see their bank accounts closed due to insufficient funds, making it more difficult and expensive for them to manage money in the future.[42] And about 1 in 5 title loan borrowers have their vehicles seized or repossessed by the lender when they cannot keep up with payments—and they may still owe debt in addition to repossession fees.[43] Even borrowers' traditional credit can be affected: Those with access to credit cards are nearly twice as likely to become delinquent on them if they take out a payday loan.[44]

This, in turn, leads to a ripple effect across family budgets. A 2011 study found that among those who earn an annual household income of $15,000 to $50,000—which comprises the vast majority of payday loan borrowers—living near a state where payday lending is legal is associated with a 25 percent increase in the likelihood that these families will have trouble paying their mortgage, rent, or utilities.[45] Ultimately, this may lead to eviction or foreclosure, with devastating consequences not only for affected families but also for their communities. Housing instability, a result of foreclosure and eviction—the primary cause of homelessness—compromises children's academic outcomes and both their physical and mental health.[46] It also leads families into substandard housing arrangements such as unsafe neighborhoods or units with physical and safety hazards.[47] Both time consuming and thought consuming, housing instability can also lead to job loss, leaving borrowers without a lifeline of steady income.

One way or another, taxpayers often end up paying the price. Between expenses related to emergency shelter, medical treatment, and incarceration, homelessness places a tremendous cost burden on taxpayers.[48] Moreover, high-cost, risky loans can also lead to increased reliance on public assistance. In areas where payday loans are readily accessible, the likelihood that a household will enroll in the Supplemental Nutrition Assistance Program, or SNAP, increases 5 percentage points—a 16 percent increase in enrollment in the program—compared with areas where state regulations restrict payday lending.[49] This conclusion helps explain why research has found that payday loans are not generally associated with an increase in hunger: Borrowers who might otherwise cut back on food consumption instead turn to SNAP.[50]

Car repossession threatens jobs and child care

Auto title loans in particular threaten not just financial security but physical mobility as well. Borrowers face a 1 in 5 chance that their cars will be repossessed. In Virginia alone, 20,000 cars were repossessed last year for nonpayment of auto title loans.[51] Given that approximately 35 percent of households taking out title loans own just one car, the loss of a vehicle wreaks havoc on their ability to meet basic needs. In one survey, 15 percent of respondents reported they had no alternate way to get to work or school in the event of repossession.[52] Residents of rural areas and low-wage workers with ever-changing work schedules are particularly vulnerable due to major gaps in public transportation.

Losing a vehicle to a predatory title loan also makes it enormously difficult to access child care. Child care close to home can be hard to find, as illustrated by Illinois and Georgia, which are also states where title loans are legal. Sixty percent of ZIP codes in Illinois qualify as so-called child care deserts—areas with so few centers that there are at least three children competing for each child care slot.[53] In Georgia, more than one-third of the state contains child care deserts.[54] A majority of rural areas in the eight states—Colorado, Georgia, Illinois, Maryland, Minnesota, North Carolina, Ohio, and Virginia—examined in a upcoming Center for American Progress report have no child care centers.[55] Not only is child care an economic necessity for parents in the labor force, but 90 percent of a child's development occurs in the first five years of life, a time key to positioning children for later educational and economic success.[56] Informal child care arrangements, such as leaving children with friends and relatives, can leave children without the high-quality care needed to get ahead.[57]

Family instability, distress, and domestic violence

The costs of predatory debt traps do not stop at financial harm or losing one's home or car. Payday and title loans—like other kinds of consumer debt—can escalate tensions between parents and within households.

The privileged position of payday and title lenders also means that child support payments take a back seat to recurring financial obligations. In areas where payday loans are accessible, child support payers are 12 percent more likely to fall behind on or pay reduced child support payments, even though households with payday loan access are no more likely to have a child support obligation in the first place. These delinquencies and inadequate payments likely occur because lenders have seized key economic resources from child support payers or because the only way for these borrowers to stay afloat in the face of payday loan debt is to forgo other important bills, such as child support payments.[58] Recipients of child support also report that those within access of payday loans are more likely to receive lower child support payments than they are owed, particularly when the payer lives nearby and therefore also has access to these loans.[59] In turn, child support recipients lose a vital economic resource and noncustodial parents run the risk of garnished wages, liens against assets, suspended licenses, and even incarceration.[60] Not only does this make it even more difficult to repay debt, but it carries the potential to instigate or intensify conflict between payers and recipients.

Child support disputes are only one type of psychological distress resulting from toxic debt. Among individuals, higher consumer debt is associated with depression, general psychological distress, and thoughts of suicide.[61] Married couples may be strained by these debts as well. The economic instability associated with debt may undermine some of the basic expectations that couples have before they enter into a marriage, which can cause partners to exit the arrangement. Moreover, debt can cause disruptions in usual patterns of family life, such as the amount of time that spouses spend together compared with time spent at work. And among heterosexual spouses, it is not uncommon for unpleasant tasks such as bill management to be shifted to wives in the event of financial instability, which can fuel further resentment between partners.[62] In addition, debt and its associated economic instability can spark arguments and disagreements both related and unrelated to finances. A 2011 study found that every tenfold increase in the amount of consumer debt was associated with a 7 percent to 8 percent increase in the likelihood of divorce.[63] The deeper the debt trap in which a household is caught, the more likely it is to face varying degrees of marital strife.

Domestic abuse victims, in particular, are disproportionately harmed by predatory loans. In 99 percent of instances, domestic violence comes hand in hand with economic abuse, wherein one partner exerts harmful control over the financial resources of the other.[64] Economic abusers can destroy survivors' credit: Poor credit can make it impossible for survivors to find or keep a job, closing off access to mainstream financial institutions along with other related negative outcomes. Too often, predatory loans may appear to be the only option available to domestic abuse survivors who find themselves in financial straits and facing uniquely dangerous consequences.[65] Individuals who are economically dependent are less likely to exit a violent relationship and more likely to return to it for financial reasons.[66] They are also more likely to be socially isolated and lack personal assets that they can liquidate to raise needed cash.[67] And if a bank account is shared, lender withdrawals and involuntary account closures may put domestic violence survivors at an increased risk of further physical and psychological harm.

Conclusion

The CFPB has proposed the first comprehensive federal rule to rein in predatory lenders and the resulting debt traps that affect millions of Americans. These rules should be supported and strengthened to reverse the troubling trends of the predatory lending that has grown exponentially over the past three decades. Among other changes, the CFPB should require that all loans rely on a meaningful determination of the borrower's ability to repay a loan without refinancing or taking out another loan—the hallmark of responsible lending.[68]

While the CFPB's efforts are significant, the bureau cannot act alone. Fully addressing the economic insecurity of struggling families and reversing the rise of predatory lending and its subsequent debt traps requires comprehensive changes to the economy and the nation's social safety net. Adequately addressing the problem demands an increase in wages and improved safety net programs that truly meet the needs of struggling families, including parents with young children.[69]

By tackling both predatory credit practices and an economic structure that fails to support everyone, policymakers can help all families thrive free of the threat of financial ruin from small but often chronic financial shortfalls.

Joe Valenti is the Director of Consumer Finance at the Center for American Progress. Eliza Schultz is the Research Assistant for the Poverty to Prosperity Program at the Center.

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