Center for American Progress

# Predatory Payday Lending

## Its Effects and How to Stop It

By Alyssa Peterson August 20, 2013

Predatory payday and deposit advance lending is a major area of concern for consumers across the country. Although there have been many policy advances in this area over the past decade, predatory lending promotes a vicious economic cycle that especially hurts low-income Americans. There must be a discussion about how predatory lending affects the safety and economic security of some of society's most vulnerable groups—including domestic violence survivors—and how to stop such practices.

### Payday lending undermines economic security

While there is no formal legal definition of predatory lending, the Federal Deposit Insurance Corporation, or FDIC, broadly defines the practice as "imposing unfair and abusive loan terms on borrowers."[1] These could include underwriting that does not take a borrower's ability to repay the loan into account and large prepayment penalties. Predatory lending takes many forms, including payday loans and deposit advances—an emerging form of predatory payday loans, this time made by banks. In 2012 payday lending made up approximately $29.8 billion of storefront paydays and $14.3 billion of online lending.[2]

Predatory lending has damaged the national economy and individual households. Even before the recession, U.S. borrowers lost $9.1 billion annually due to these practices.[3] This harm is disproportionately concentrated, with two-thirds of borrowers taking out seven or more loans per year.[4] The consequences of this constant borrowing are stark. Households that utilized "deposit advances"—an emerging form of payday loans—were in debt more than 40 percent of the year,[5] far more than the FDIC maximum limit of 90 days. In addition, many payday loans are used for common household expenses. Sixty-nine percent of borrowers, for example, used loans to pay for recurring expenses.[6] This high level of debt and nonemergency usage encourages a vicious cycle of dependency on payday lenders.

Predatory lending, especially in the form of payday loans, undermines economic security by forcing borrowers to sell necessary assets. More than 50 percent of loan recipients defaulted on their loans, placing existing bank accounts at risk.[7] Borrowers also could have their debts sold to a collection agency or face court action. These assets are essential to household economic security. Payday lending and other forms of predatory lending are antithetical to this goal; 41 percent of borrowers require a cash infusion to pay a loan,[8] which could force them to sell possessions or request money from friends and family. This is even more troubling because fewer than half of the recipients have savings or assets from which to draw.[9]

Payday lending is especially harmful because it disproportionately takes place in vulnerable communities. Seventy-five percent of payday-loan borrowers had incomes that were less than $50,000 per year[10] in 2001, and payday lenders are concentrated in low-income areas. In Texas, for example, more than 75 percent of stores are located in neighborhoods where the median household income is less than $50,000.[11] Moreover, many recipients of payday loans are desperate; 37 percent of borrowers stated that "they have been in such a difficult financial situation that they would take a payday loan on any terms offered."[12]

## Actions to combat payday lending

Unchecked predatory lending in the form of payday loans currently occurs in 26 states. Fifteen states and the District of Columbia ban the practice entirely, and nine states allow it in limited form. These nine states use varying combinations of restrictions, such as limits on loan amounts, interest rates, loan terms, and the number of loans. Colorado, for example, caps annual percentage rates, or APRs, at 45 percent, and in Washington state, the number of loans a borrower can receive is capped at eight per annum.[13] A comprehensive 36 percent cap on APRs more or less represents a ban on predatory payday lending. Policies that ban renewals, institute payment plans, limit loan amounts, and limit the number of outstanding loans have proven to be ineffective.[14] Another ineffective strategy is to narrowly target payday loans, which allows lenders to alter their products to avoid compliance without changing their predatory nature.[15]

In contrast, states and the District of Columbia that have the 36 percent cap save their citizens more than $1.5 billion each year.[16] Supporters of high-cost payday loans claim that increased regulation of payday lending will decrease access to credit for needy families in cases of emergency.[17] In North Carolina, however, the availability of small-dollar loans at or below the 36 percent interest-rate cap has increased by 37 percent.[18] In fact, the absence of payday lending had no significant impact on credit availability within the state.[19]

Still, among the 50 states, expensive lending persists due to loopholes and out-of-state lenders' ability to occasionally evade restrictions. Payday lending in Virginia provides a strong example of how this happens. Oregon and Virginia do not ban payday loans entirely, but they cap APRs at 36 percent. Virginia state law, however, allows two fees in addition to interest rates, and as a result, there is an average annual rate of 282 percent in Virginia, despite its 36 percent cap.[20] Furthermore, in Ohio, payday lenders were able to recharter themselves and add fees to skirt the state's voter-approved 28 percent APR cap.[21]

Other actions to combat payday lending have been taken at the local level. Recognizing the harmful impact of payday lending on low-income communities, Chicago announced new zoning regulations to limit the number of payday-lending locations and gave new powers to the city regulatory agency in this area.[22] Due to a lack of state-level protections, similar zoning ordinances have passed in California cities such as San Francisco, Oakland, Oceanside, and Sacramento.[23] Cities in 24 other states have also passed zoning restrictions.[24]

Even with these efforts, the reality is that the majority of already vulnerable individuals and their families live in states and localities in which there are minimal or no checks on payday lending. Congress gave active-duty military service members and their families a reprieve in 2007 when it passed the Military Lending Act, a measure in the National Defense Authorization Act that banned payday lenders, auto-title lenders, and tax-refund lenders from charging APRs higher than 36 percent. The legislation also banned creditors from using checks or other methods of bank-account access as collateral. This action, however, excluded the vast majority of low-income families.

To combat abuses in the deposit-advance system, the Treasury Department's Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation issued "Proposed Guidance on Deposit Advance Products."[25] The document describes the reputational and financial risks to banks that loan to consumers who are unable to repay the loans. It also requires banks to review whether a consumer can repay the loan and adds a "cooling off" period that effectively limits banks to one loan per customer per monthly statement cycle. In August the Justice Department announced a series of subpoenas to investigate the banks and companies that handle payments for Internet or phone payday lenders that try to skirt state laws.[26]

## Increased protections

Congress enacted the National Defense Reauthorization Act of 2007 to protect members of the military and their families from predatory payday loans. These protections should be extended to equally vulnerable civilian families. State-level protections already net more than $1.5 billion in savings and have helped low-income families escape the "debt trap."[27]

1. **Congress should enact S. 673: Protecting Consumers from Unreasonable Credit Rates Act of 2013.**

   Congress should enact S. 673, which was introduced by Sen. Dick Durbin (D-IL) and amends the Truth in Lending Act to cap APRs at 36 percent for credit transactions. States that have enacted a 36 percent cap have already netted total savings of $1.5 billion.[28] Notably, the act uses all fees to calculate APR, as the Center for American Progress recommended in May.[29] This practice is urgently necessary. In Virginia, for example, where there is no such restriction, lenders are tacking on fees that add on triple-digit interest rates to the state's 36 percent APR cap.

2. **Congress should forbid creditors from using checks or other methods of bank access as collateral. Banks should adopt policies that reduce payday-related overdraft fees and make it easier for customers to halt withdrawals and close their accounts in response to payday lending.**

   In 2007 the National Defense Reauthorization Act also forbade creditors from using checks or other methods of bank-account access as collateral. In addition, JP Morgan Chase changed its policies in February to limit overdraft fees when customers overdraw to make payments to payday lenders and to make it easier for customers to halt automatic withdrawals and close accounts to combat payday lending.[30] Fees resulting from this practice by lenders are widespread: 27 percent of borrowers experience checking-account overdrafts due to a payday lender making a withdrawal from their account.[31] These protections should be extended for all families.

## Survivors of domestic violence disproportionately at risk

The dependency perpetuated by payday lending is even more harmful to survivors of domestic violence—who are seven times more likely to live in low-income households[32]—because 99 percent of survivors already experience economic abuse at the hands of an intimate partner.[33] Economic abuse comes in a variety of forms. Abusers can make it impossible for survivors to gain or keep a job, keep survivors from accessing financial institutions, control their money, refuse to disclose financial information, and destroy a survivor's credit. When abuse and other factors such as poverty and unemployment block survivors' access to the mainstream banking system, payday loans or other predatory loans may be their only option.

The Consumer Financial Protection Bureau, or CFPB, found that the median payday-loan borrower spent 199 days per year in debt.[34] For domestic violence survivors, this debt trap is especially dangerous. Survivors who are economically dependent are statistically less likely to leave their abuser. Research suggests that income level is the best predictor of whether a survivor will leave or stay with an abuser.[35] Economic concerns are also the primary reason why survivors return to abusive relationships. As such, predatory payday lending—especially if it pushes survivors into debt—could fuel the cycle of abuse, increasing a survivor's risk of suffering bodily, psychological, or sexual harm.

As mentioned previously, 41 percent of payday-loan recipients required a cash infusion to pay off their loan.[36] Due to economic abuse, however, many domestic violence survivors lack assets of their own. In recent years programs have arisen to help build assets for survivors, but the fact remains that many survivors cannot sell possessions such as a car for an infusion of cash.[37] In addition, the nature of the abuse that survivors experience may limit their access to friends and family who could help them pay off a loan. If abusers learn about such help, survivors could be placed in physical danger.

Twenty-seven percent of borrowers experience checking-account overdrafts due to a payday lender making a withdrawal from their account.[38] For survivors, this represents a risk to their safety. Survivors who experience economic abuse may share accounts with their abusers, who could retaliate against the survivors if they gain knowledge of third parties accessing the account. This practice of lenders repeatedly and aggressively withdrawing funds against the will of the individual is extremely detrimental to survivors.

Many survivors are forced to turn to payday lending because they have poor credit scores. In some instances, abusers take out credit cards in the survivor's name for the explicit purpose of ruining credit scores.[39] As such, the CFPB should work with credit agencies to identify and resolve this "coerced debt."[40] On the whole, there is little regulation tailored specifically to the needs of survivors; the CFPB should design additional policies that can protect survivors already experiencing economic abuse from payday lending.

For safety reasons, survivors often cannot identify themselves as survivors to lenders. There have been efforts such as the Family Violence Option in the Temporary Assistance for Needy Families, or TANF, program to waive program requirements for survivors. This option is underutilized, however, because survivors are difficult to identify and may not come forward.[41] As such, a survivor-specific policy such as the military-specific policy in the National Defense Reauthorization Act of 2007 would not function effectively. Protections against predatory lending cannot be limited to domestic violence survivors; they must be enacted on behalf of all groups.

*Alyssa Peterson was an intern with the Center for American Progress.* *Thanks to Katie Wright and Joe Valenti for their advice on this column.*

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