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The End of the 460 Percent APR:

Tackling Payday Lending in California

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Introduction

In these difficult economic times, many consumers are living paycheck to paycheck or struggling to cope with the loss of a job. Regular and unforeseen expenses can quickly pile up, creating immediate liquidity shortages, particularly among low- and moderate-income (LMI) households. Unfortunately, far too many individuals are turning to high-cost payday loans to meet their short-term cash needs.

Payday loans are transactions in which a borrower provides a lender with a post-dated check and receives immediate cash. The borrower's check includes not only the principal, but also any interest and fees charged by the lender. The lender then cashes the check on the borrower's next payday.

Payday loans, sometimes called deferred deposit transactions or cash advances, comprise one corner of a larger universe of "alternative financial services," which also include check cashing services, pawn brokers, and rent-to-own stores.[2] Payday loans are typically small—between $100 and $300—and California state law caps the amount at $300.[3] The fees for payday loans tend to be extremely high: up to $17.50 for every $100 borrowed.[4] While $17.50 may not seem like much, on these small loans, it translates into a staggering 429 percent average annual percentage rate (APR), according to the California Department of Corporations.[5] All of this means that LMI households pay very large fees—well beyond those of the average credit card—in order to meet their short-term cash needs.[6]

This article will examine the current state of the payday lending industry in California and its impact on LMI communities. In addition, we'll explore how policy efforts and access to mainstream banking can limit the negative influence of payday lenders.

The Predatory Nature of Payday Lending in California

Payday lending is widespread in California. In 2006, approximately 1 million Californians were issued payday loans (at an average of 10 loans per borrower).[7] The Department of Corporations estimated that there were approximately 2,500 payday lending stores by the end of 2006.[8] Consumer advocates acknowledge that payday loans offer certain advantages; they are easy to obtain and can help some borrowers avoid the damage to their credit scores that, say, a delinquent payment to a credit card company can cause.[9] However, payday loans, as they are currently structured and permitted in California, too often create difficulties for families and certain fragile communities in ways that outweigh their benefits.

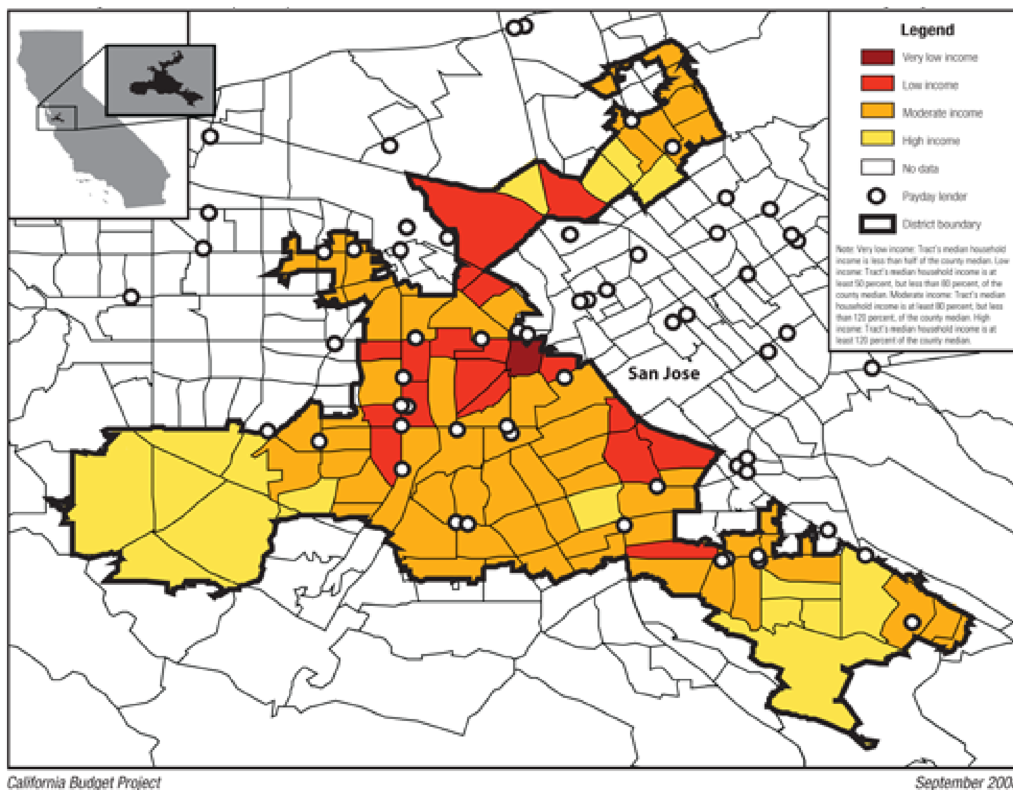
First, payday loans are exceedingly expensive. According to a 2008 issue brief by the Center for Responsible Lending, the typical payday loan borrower ultimately has to pay $800 for a $300 loan.[10] It is estimated that payday lending costs Californians over $450 million annually in finance charges.[11]

Moreover, payday loans encourage those who are already struggling to make ends meet to further compromise their financial health. As the California Budget Project has stated, "Payday loans encourage chronic borrowing."[12] Payday loans carry a very short repayment term, usually only until the next payday—or about two weeks—at which point the full amount of the loan and the finance charge must be paid at once.[13] Since most borrowers take out payday loans to cover a chronic shortage of income over expenses, rather than to cover emergency cash needs,[14] many borrowers experience another shortfall after their first loan. That shortfall is compounded by the finance charge.

Researchers have recently shown that payday borrowers are twice as likely to file for bankruptcy in the first two years after getting a payday loan, in comparison to would-be borrowers whose loan applications are rejected.[15] These findings are consistent with the interpretation that payday loans might be sufficient to tip a population that is already severely financially stressed into bankruptcy.[16] Other researchers have found that the use of payday loans increases the incidence of involuntary closure of bank accounts.[17] Still others have determined that consumers who use payday loans encounter more financial hardship and have trouble paying other bills, getting health care, and staying in their home or apartment.[18]

While these negative consequences are harmful to all sectors of society, they are even more troubling because they disproportionately affect already vulnerable and disadvantaged families and communities. In a report issued in March 2009, the Center for American Progress found that payday borrowers tend to be low-income.[19] Analyzing data from the Federal Reserve Board, the report finds

Figure 1 *Concentration of Payday lenders in San Jose, Assembly District 24*



that payday borrowers tend to have less income, lower wealth, fewer assets, and less debt than families who have not taken out payday loans.[20]

The California Budget Project recently produced maps of payday lender locations for each of California's legislative districts (See Figures 1 and 2). The maps present a vivid portrait of California's two-tier finance system by clearly demonstrating that payday lenders tend to be concentrated in low-income communities. In addition to income, studies have shown that race plays a strong role in the location of payday lending outlets. A 2009 analysis by the Center for Responsible Lending finds that California's payday lenders are overwhelmingly located in African American and Latino neighborhoods, even after controlling for factors such as household income.[21] Their analysis shows that the racial and ethnic composition of a particular neighborhood is actually the primary predictor of payday lending locations.[22] Unsurprisingly, then, African Americans and Latinos make up a disproportionate share of payday loan borrowers in California.[23]

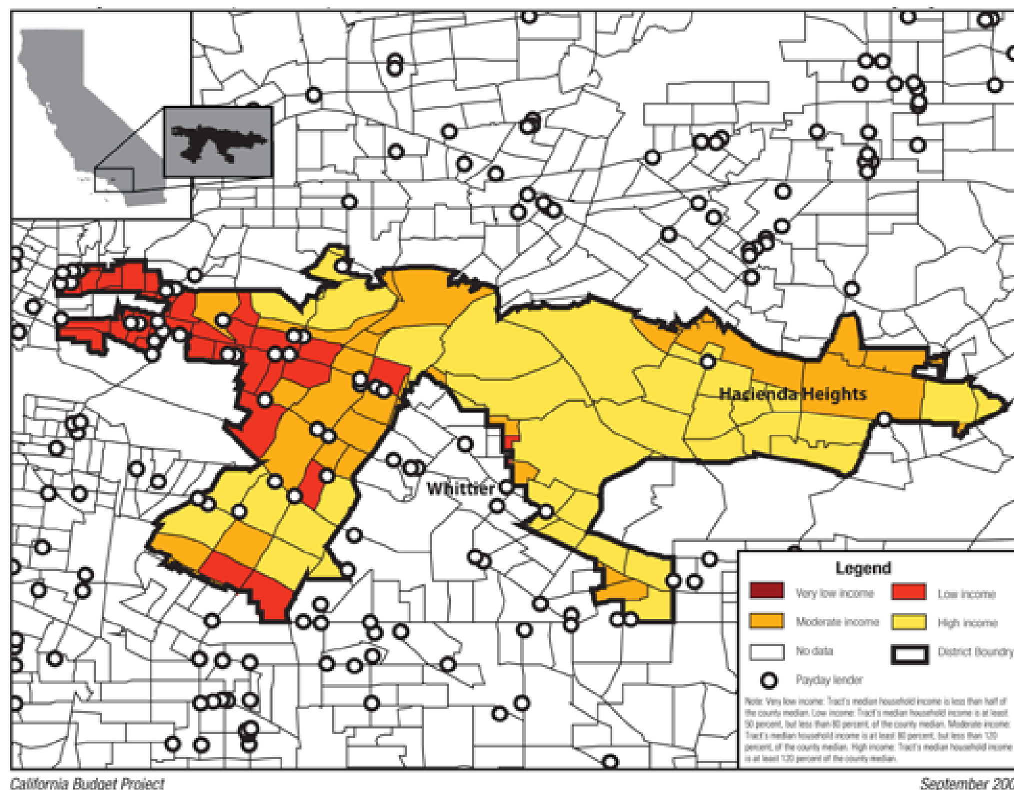
Policy Efforts to Reform Payday Lending

A number of state and local governments have introduced policies to limit the negative effects of payday lending. As of March 2009, fifteen states and the District of Columbia required payday lenders to comply with an annual percentage rate (APR) cap of 36 percent.[24] Arizona will become the sixteenth state to impose a 36 percent rate cap when a provision that currently exempts payday lenders from the cap expires in July 2010. In comparison, California law allows a 460 percent APR on two week payday loans.[25]

Research has suggested that capping the interest rate at 36 percent for small loans is the most effective means by which states can protect consumers from usurious payday loans.[26] In contrast, in states that attempted reforms but did not impose a cap, 90 percent of payday loans still went to consumers who were taking out five or more loans per year.[27] In addition to the rate cap, states may consider other effective measures, such as:

- Caps on the number of loans a borrower can receive annually to ensure that payday loans are only used occasionally in the short-term;
- Bans on the practice of holding a check or bank access as collateral or security for a loan to prevent the payday loan from taking precedence over all other debts and the borrower's ability to pay for his or her basic needs;
- Increased incentives to lenders and microfinance programs to make small loans more accessible to consumers; and
- Policies to encourage savings among low- and moderate-income families.[28]

Figure 2 *Concentration of Payday lenders in Los Angeles, Assembly District 58*



Local governments also have the power to restrict payday lending through zoning ordinances. Local ordinances designed to reduce or restrict the presence of predatory payday lending within a city's borders include:

- ***Moratorium during Study Period.*** Such a temporary moratorium could be enacted to prevent new payday lenders from setting up shop while the local government evaluates other, more permanent options.
- ***Permanent Moratorium.*** Cities may enact a permanent moratorium. They can choose to grandfather in existing stores or make a plan for phasing those stores out.
- ***Limits on Density and/or Distance.*** Cities may limit the number of payday lending outlets in a geographic area based on either distance or population density.
- ***Special Zoning.*** Cities can limit payday lending outlets to special zoning districts or a limited number of existing zoning districts.
- ***Special Permits.*** Cities may require payday lenders to obtain conditional use permits, or other special permits. Cities should ensure that such permits are subject to public notice and comment.[29]

The Role of Banking Access in Limiting Payday Lending

In addition to regulations and/or ordinances that directly affect payday lenders, another approach has been to increase the market presence and products of mainstream banks in low-income communities.[30] Mainstream lending institutions can compete with payday lenders by, in addition to offering traditional finance products, providing products that better meet the needs of potential borrowers. Options include a range of alternative financial products that specifically target the needs of lower-income households:

- ***Small consumer loans (a.k.a. small dollar loans).***[31] These loans are around $1,000 or less, with interest rates capped at 36 percent or lower, without prepayment penalties. Some of these loan products also have an automatic savings component, limited maintenance fees and an extended repayment period of up to 36 months.
- ***Credit union installment loans.***[32] Many credit unions offer unsecured installment loans with 18 percent APR or less. These loans are generally structured so that the principal and interest are repaid in equal installments at fixed intervals (usually once a month).
- ***Low-cost check-cashing (a.k.a. "ethical" check-cashing).***[33] Some financial institutions provide low-cost check cashing fees, even if the customer does not have an account at that bank.
- ***No-minimum-balance debit accounts that do not allow overdrafts.***[34]

Another critical piece is helping lower-income households build their credit and providing them with tools that can help them navigate the mainstream financial system. Some of the innovative approaches being tried include:

- ***Lending circles.***[35] These lending arrangements solve the problem of unmet banking needs in low-income communities through the informal economy. Participants contribute a certain amount of money to the "pool" and then each contributor can borrow from it when necessary; over time, each person repays the amount that they borrowed.
- ***Alternative credit reporting.***[36] Community organizations have developed ways to incorporate non-traditional credit references and scoring for borrowers with little or no credit history into credit reports in order to enable creditors to more accurately assess a person's credit history.
- ***"Starter" Bank Accounts.*** These accounts, often provided through mainstream banks, are designed to help account-holders build personal savings and establish a credit history in order to be prepared to access more affordable credit sources later.[37]
- ***Pre-paid debit cards.*** With these cards, the cardholder determines the quantity of money to add or reload onto the card, which can be equipped with direct deposit, automatic bill pay and automatic savings features, in order to enable the cardholder to easily manage his or her finances. These types of cards have very few restrictions.[38]

Researchers have noted the importance of assuring that efforts to bring LMI communities into the mainstream financial system, such as starter bank accounts, are coupled with efforts to limit potential risks for consumers.[39] For instance, individuals that open their first checking account would now be eligible to take out a payday loan. It is essential to combine efforts to bank the unbanked with solid financial education and training.

Both mainstream banks and community groups have already begun to implement some of these strategies. "Bank on San Francisco," as well as the related "Bank on" programs that have been introduced across the country, have pooled the efforts of local government agencies, key non-profits, banks and credit unions to connect new, lower-income customers with banks and mainstream financial products.

Local community groups have also sought creative ways to build credit in low-income and minority neighborhoods. For example, the Mission Asset Fund, located in San Francisco, connects low-income neighborhood

residents with alternative financial products and provides financial education in order to help build wealth and personal assets. Currently, Mission Asset Fund is partnering with One California Bank to formalize the "lending circle" model in order to allow participants to establish and develop their credit history.

Conclusion

Payday lenders have capitalized on low-income communities' demand for small-dollar credit products. Recent years have seen a marked increase in the amount of information available about payday lending patterns, as well as the ways in which the payday lending industry strips wealth from families and communities by creating a cycle of escalating debt.

Although information about the effectiveness of various strategies to combat predatory payday lending practices is less plentiful, a multi-faceted approach seems warranted. Policy efforts should continue at the federal, state, and local level to impose rate caps or other controls to protect consumers. However, given the challenges of strong and well-funded industry opposition, these policies should be complimented by on-the-ground efforts to create more affordable credit products that meet the same needs that payday loans address to some degree. Since the need for readily available small dollar loans is not likely to abate, creating and sustaining non-predatory alternatives to payday lending—whether from mainstream banks and community development financial institutions or from less "traditional" sources like lending circles—is imperative. Further, education and organizing efforts can help empower members of low-income and minority communities to make informed financial decisions, to build wealth in their neighborhoods, and to participate in policymaking. CI

Payday Plus SF

The better small dollar loan™

In December 2009, San Francisco Mayor Gavin Newsom and Treasurer José Cisneros launched Payday Plus SF, an alternative payday loan product offered by five San Francisco credit unions that will provide responsible small dollar loans of up to $500, with low interest rates, financial counseling, and an extended repayment term. The program is designed to help San Franciscans avoid high-interest rate payday loans that often trap borrowers in a cycle of debt.

Some of the key elements of the payday loans offered through Payday Plus SF include:

- **A non-predatory rate:** A short-term loan of up to $500 with a maximum APR of 18%.
- **Building credit:** Borrowers will be able to build credit as the loan is repaid over a period of up to 12 months.
- **Reducing debt:** The product helps borrowers escape the debt trap by paying off payday loans and consolidating other debts.
- **Access to healthy financial partners:** Credit unions are non-profits with a wide array of healthy financial products and a commitment to working closely with their members.
- **Responsibility:** The program limits borrowers to 3 loans per year and the loan must be paid in full before another advance. The program will also include financial education.

For more information on Payday Plus SF,
please contact Marco Chavarin at marco.chavarin@sfgov.org

Endnotes

Community Change Initiatives from 1990-2010

1 The full publication will be available in summer 2010. For more information, see www.aspenroundtable.org or contact akubisch@aspenroundtable.org

Understanding the Different Types of Low-Income Neighborhoods

1 Elwood M. Hopkins is Managing Director of Emerging Markets, Inc. and President of the Center for Place-Based Initiatives. Juan Aquino, Rudolph Espinoza, and Daniel Tellalian also contributed to this article.

2 *Managing Neighborhood Change, A Framework for Sustainable and Equitable Revitalization* (2006), Alan Mallach proposes a six-type classification system based on the condition of the local housing stock, homebuyer characteristics, and housing prices. For each type, he specifies strategies for improving housing as well as the implications of these strategies on local residents. In a 2005 study entitled, "Housing in the Nation's Capital," Margery Austin Turner, G. Thomas Kingsley, Kathryn L.S. Pettit, Jessica Cigna, and Michael Eiseman propose a new neighborhood typology for Washington, DC neighborhoods based on housing characteristics.

3 The Center for Housing Policy uses a composite of data on subprime lending, foreclosures, and mortgage delinquencies to categorize neighborhoods according to foreclosure risk. Similarly, in *Using Data to Characterize Foreclosure Markets*, Phyllis Betts at the University of Memphis segmented five different types of home loan borrowers (in terms of their level of financial precariousness and ability to absorb a mortgage) and characterized neighborhoods according to which of type of borrower predominates. She then factors in the type of housing stock and general housing market trends, discovering four distinct neighborhood types: Classic Distressed; Transitional-Declining; Stable Neighborhoods of Choice; and Transitional-Upgrading.

4 In *Contributions of Accessibility and Visibility Characteristics to Neighborhood Typologies and their Predictions of Physical Activity and Health*, a team from the University of Michigan and Detroit Health Department proposed nine neighborhood types in terms of health impact. For each, the team correlated physical characteristics (housing density, sidewalk coverage, street configurations, pedestrian pathways) to physical activity of residents and the prevalence of heart disease, diabetes, dietary cancers, and obesity.

5 In 2005, the USC School of Policy, Planning, and Development compared twenty residential neighborhood types in terms of the mobility patterns of residents. They separated neighborhoods by their location in the inner city, inner suburbs, outer suburbs, or exurban areas. The types are grouped according to clusters of traits that influence transportation decisions: street configurations, access to freeways or public transit, local land uses, topographies versus level ground and so on.

6 In *How Does Family Well-Being Vary across Different Types of Neighborhoods?*, Margery Austin Turner and Deborah Kaye use data from the National Survey of America's Families to classify neighborhoods as family environments. The authors of *Neighborhood Poverty: Policy Implications in Studying Neighborhoods,* tackle a similar task. In "Explorations in Neighborhood Differentiation" in *The Sociological Quarterly,* Donald Warren compares service utilization across neighborhoods.

7 In *Sharing America's neighborhoods: The Process for Stable Racial Integration,* Ingrid Gould Ellen examines six types of neighborhoods in various stages of racial and ethnic transition. For each, she identifies a typical bundle of quantifiable factors (ethnic breakdown, tenure, and demographic shifts underway) and qualitative factors like overall social stability. In *Paths of Neighborhood Change,* Richard Taub, D. Garth Taylor, and John Dunham identify eight neighborhood types at different stages of evolution from decline to gentrification to stability.

Five Simple Rules for Evaluating Complex Community Initiatives

1 CCIs here are defined broadly and include community change initiatives, complex community initiatives, comprehensive community initiatives, and even comprehensive place-based initiatives.

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