

A low, low interest rate of 396 percent

By Les Christie
December 14, 2007

NEW YORK (CNNMoney.com) -- At the East Side Organizing Project in Cleveland, six home owners recently went in for group foreclosure counseling. When asked if any had taken out payday loans, four hands shot up.

A payday loan is a small-dollar, short-term loan with fees that can add up to interest rates of almost 400 percent. They're generally taken out when the borrower is caught short on cash and promises to pay the balance back next payday.

If it sounds like legal loan-sharking, it's not. "Loan sharks are actually cheaper," said Bill Faith, a leader of the Ohio Coalition for Responsible Lending.

The industry portrays it as emergency cash, but critics say the business model depends on repeat borrowing where the original loans are rolled over again and again.

They're available in 41 states, but they've been particularly troubling in Ohio, one of the states hit hardest by home foreclosures.

"There may be a correlation between not having the means to pay mortgages and payday loan borrowing," said republican state legislator William Batchelder, at a Thursday press conference held with the Center for Responsible Lending (CRL). Batchelder is sponsoring a bill that would cap payday loan interest rates at 36 percent.

Jim Rokakis, treasurer of Cuyahoga County, which includes Cleveland, said, "I've been to [foreclosure counseling] sessions where almost everyone raised their hands," saying they had payday loans.

One ESOP client said, "You get a payday loan and you take your pay next payday and pay back the loan. Then you don't have enough money to last to the next payday, so you go back. If you don't pay the loan, they call everybody from your employer to your sister."

Faith said he saw a sign in the window of a payday lending shop that read: "The first loan is free." The business evolved from check-cashing services. In Ohio, the number of lender locations jumped from 107 in 1996 to 1,562 10 years later.

"If you want to see what an unregulated market economy looks like," said Rokakis, "come to Ohio." There are now more payday lending shops in the state than McDonalds, Burger Kings and Wendy's restaurants combined, he noted.

Lenders only require borrowers show pay stubs, checking accounts and references. They don't credit-check, except to make sure borrowers haven't defaulted on previous payday loans.

The lenders ask borrowers for post-dated checks for the amount borrowed, plus fees, which average \$15 per \$100 loan. If the loan goes un-repaid, lenders deposit the checks.

The term is usually two weeks, "Most people believe they're just going to borrow the one time," said Faith. Instead, when the two weeks goes by, they often go back to the shop and roll it over for another two weeks. To do that, they pay another \$45 in fees.

"It's not a two-week loan," said Uriah King, of the CRL. "Most loans are rolled over 10, 12 or 13 times. That's the business model even though the industry says it's not."

When the CRL took the average payday loan principal as reported by state regulators and multiplied it by the average number of loan rollovers per year, it found that typical borrowers pay back \$793 for a \$325 loan.

At least 10 million households get payday loans over the course of a year, according to the CRL. Borrowers are disproportionately minority, female and in the military. They have lower income and education levels than the general population.

Not everyone agrees that payday lending is bad. "People are not complaining, CRL is complaining. Go to any state consumer complaint agency and you'll find very few about payday lending," said Steven Schlein of the Community Financial Services Association, a payday lending group.

A paper by Donald Morgan, a research officer with the Federal Reserve Bank of New York, indicates that payday lending may be preferable to some alternatives. In two states where it was banned, he found, consumers were worse off.

They're more likely to bounce checks, he found, which is more expensive than payday loans. Fees on bounced checks can carry an annual percentage rate of 1,000 percent.

But King believes that's a false comparison. "People don't knowingly bounce checks," he said. It's usually an accident, and it's illegal. "How do you take a payday loan to avoid bouncing a check?" he asked.

Most consumers who get caught short have much cheaper alternatives to payday loans, according to the CRL. Many have credit cards that could provide them with cash advances with much lower interest. Others have access to credit union loans, pay advances at work or home equity loans. Debtors can also work out delayed payments plans with creditors.

Federal and state governments have started to take aim at the industry. Last year Congress passed legislation capping interest rates on consumer loans for military personnel at 36 percent. North Carolina and Georgia have both ended payday lending. Other states like Ohio are discussing remedies like Batchelder's bill.

But the CRL doesn't believe changing state laws to fix payday lending is enough. "We've concluded that this is a defective product," said King, "that can't be reformed."