EFFECTS OF STATE PAYDAY LOAN PRICE CAPS & REGULATION

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Payday lending has become one of the most widely used forms of short-term credit: an estimated 19 million households, or 5% of the U.S. population, borrowed approximately $50 million in payday loans in 2007.[1] In the last several years, payday lending has received significant scrutiny because of evidence that some borrowers become trapped in debt cycles that far outlast the term of the original loan, incurring additional fees at high interest rates. In response, states have taken a wide variety of approaches to limit predatory lending and regulate the payday loan industry.

This brief categorizes current regulations of short-term (payday) lending, examines studies of the potential effects of implementing fee and interest rate ceilings on payday loans, and identifies possible alternatives to high-cost, short-term credit. It focuses on the following question: What happens to borrowers who rely on payday loans when access to expensive, short-term credit is restricted?

Highlights

- Seventeen states and the District of Columbia prohibit short-term loans at interest rates higher than 36% APR.
- Twenty-seven states have implemented interest rate and fee limits above 36% and capped maximum loan amounts, but six states do not regulate interest rates or fees for payday loans.
- The supply of payday loans significantly decreases when rates are capped at 36% or less.
- Few financially attractive alternatives to payday lending currently exist in the marketplace—without access to payday loans, consumers likely use overdrafts, pawnshop loans, and late bill payment to cover short run credit needs.
- Household financial security does not necessarily improve after payday lending is prohibited through rate and fee ceilings of less than 36%.
- Aside from rate and fee ceilings, several policies can be used to regulate the payday loan industry, including mandating fee disclosures, longer loan terms, installment repayment plans, and restricting terms of debt per year.
- Of the Northwest Area Foundation States, Oregon and Montana have the lowest interest rate caps for payday loans, at 36%. Iowa, Minnesota, North Dakota, and Washington have implemented a variety of regulations, but each cap interest rates between 390%–520% on a $100 loan. Idaho and South Dakota have implemented no limits on interest rates or fees.

Payday Lending Regulation

Payday lenders, along with check cashers, pawnshops, and money wirers, are classified as alternative financial services and are not regulated by national lending laws, like traditional banks or other financial institutions. These lenders are often not subject to state usury laws and often charge the equivalent of 350%–500% annual percentage interest rates (APR) on a 14-day loan. Lenders argue that payday loans serve a niche market for short-term credit and are not designed to be year-long credit options. Thus, using APR to evaluate the cost of a short-term loan might be problematic. Mortgages and other long-term credit options, while charging APRs lower than those of payday loans, require a much larger overall payment as a percentage of the principal loan amount than payday loans. It can be argued that as long as loans are paid back within their terms, and are not carried over in the long-run, high interest rates may be justified for payday loans—much the same way the price per mile for a taxi is extremely expensive, but justified when compared to a buying a car, which is more expensive overall. Under this logic, if they are paid back at the end of their terms, access to payday loans might actually improve an individual's ability to cope with financial hardship, improving financial security overall.[2]

Although the federal government does not regulate payday lending in general, in 2007 payday lending to members of the military at rates higher than 36% was banned. As a result, most payday lenders have ceased lending to military borrowers. Other than restrictions to military borrowers and certain fee disclosure requirements, there are few federal guidelines regulating the payday lending industry.

States take various approaches to payday lending regulation. Some require all licensed short-term lenders to comply with state usury laws—the same laws that regulate banks. These rates are often under 30% APR, which effectively bans payday lenders from operating. Other states allow exemptions from usury laws for short-term lenders, but cap interest rates at a point that makes it unprofitable for payday lenders to operate. The numbers of payday lenders operating in each state is difficult to ascertain because of the volatile nature of the market, the tendency for payday lenders to operate as small storefront businesses, and the growth of internet lending. However, it is likely that there are no operating payday lenders in the majority of the states with interest caps at 36% or below (Figure 1), with the exception of Arizona, Massachusetts, and Oregon, where there are likely a number of payday lenders, because lenders are able to charge a fee in conjunction with the specified interest rate.

Figure 1. States with caps on payday interest rates at 36% APR or lower

State	APR	State	APR	State	APR
Arizona	36% with fee	**Maryland**	33%	**Ohio**	28%
Arkansas	17%	**Montana**	36%	**Pennsylvania**	24%
Connecticut	30.3%	**New Hampshire**	36%	**Oregon**	36% with fee
Georgia	16%	**New Jersey**	30%	**Vermont**	18%
Massachusetts	23% with fee	**New York**	25%	**West Virginia**	31%
Maine	30%	**North Carolina**	36%	**Washington D.C.**	24%

The remaining 33 states have implemented a variety of regulations on short-term lenders. All of these states limit maximum loan amounts ($300–$1,000); additional regulations include term requirements, interest rate and fee limits, and loan rollover restrictions. Six states (Delaware, Idaho, Nevada, South Dakota, Utah, and Wisconsin) do not limit interest rates or fees for short-term loans.

The eight Northwest Area Foundation States have implemented a variety of interest rate and fee restrictions for short-term lenders (Figure 2). As mentioned above, Oregon and Montana have the lowest interest rate caps, each at 36% (although Oregon also allows a fee of $10–$30 per loan). Idaho and South Dakota have implemented no limits on interest rates or fees. Iowa, Minnesota, North Dakota, and Washington have implemented interest rate or fee limits, at widely varied amounts.

Figure 2. NWAF State Payday Lending Interest Rate and Fee Limits[a]

State	Finance Rate	Fees	Total charged for $100 loan	APR on $100 loan	Max Loan	Term
Idaho	No Limit	No Limit	No Limit	No Limit	$1,000	No Limit
Iowa	N/A	$15: $0–$100 $10: $100 over	$16.67	433%	$500	Max. 31 days
Minnesota	Scaled to loan amount: $5.50–$26	$5	$15	390%	$350	Max. 30 days
Montana	36% APR	$0	$1.39	36%	$300	Max. 31 days
North Dakota	20% of loan	Not Specified	$20	520%	$500	Max. 60 days
Oregon	36% APR	$10/$100, up to $30	$13	156%	No limit	Min. 31 days
South Dakota	No Limit	No Limit	No Limit	No Limit	$500	No Limit
Washington	10%–15% of loan	$0	$15	390%	$700 or 30% monthly income	Max. 45 days

Interest rate and fee restrictions are not the only tools that states use to limit high-cost lending. Many states limit the amount borrowed by a single borrower at one time, restrict the number of rollover loans allowed, limit the number of consecutive loans (through mandated cooling-off periods) or loans borrowed per year, and by requiring repayment plans (making short-term loan structure more like that of a traditional loan or mortgage). Notably, Washington is the only state to require installment repayment plans—if a borrower requests additional time to pay back the loan prior to default, up to 180 days is provided (depending on principal amount). The effectiveness of these regulations in actually reducing the number of households whose financial security is afflicted by payday debt cycles, however, is unclear.

[a] Data and calculations compiled from National Conference of State Legislatures: www.ncsl.org and the Consumer Federation of America: www.consumerfed.org

Figure 3. NWAF State Payday Lending Regulations

State	Max amount borrowed at one time	Rollovers[b] permitted	Cooling-off period[c]	Repayment Plan
Idaho	$1,000	3	N/A	N/A
Iowa	$1,000	0	N/A	N/A
Minnesota	No limit	0	N/A	N/A
Montana	No limit	No limit	N/A	N/A
North Dakota	$600	1	3 days	N/A
Oregon	No limit	2	7 days	N/A
South Dakota	No limit	4	N/A	N/A
Washington	$700 per lender	0	N/A	90–180 day plan

Effects of Payday Loan Interest Rate and Fee Restrictions

High Cost of Short-term Lending

The supply of payday loans after a price cap depends largely on the profit margins of lenders—while fee or rate ceilings will cut into profits, payday lenders may stay in the market if there is still an economic return. Studies have suggested, however, that payday lenders do not make excessive profits for several reasons.[3,4] First, the cost of providing short-term credit is significantly higher than financing long-term credit. Secondly, payday lenders face much higher rates of default than traditional lending and thus need to charge a higher average fee per loan. Third, although annual percentage rates are high for short-term loans, the actual payment received by lenders is quite low—often $10–$15 per $100 loan.

Consistent with this evidence, several studies show that lower rate and fee ceilings for both payday and pawnshop loans are associated with reductions in supply. [5,6] State caps on payday loan interest rates at or near 36% appear to lead to a significant reduction in payday lenders. In Oregon, for instance, there were 346 payday lenders licenses prior to enacting the 36% interest rate cap in 2007 and only 82 payday lenders in operation one year later.[7]Capping rates at 36% appears to significantly reduce the frequency of payday providers, rather than simply the profit margins of existing providers. There is also evidence that capping payday loan interest rates might reduce the *number of stores* that payday lenders operate, without significantly reducing the *number of loans* provided.[8] This is true up to a point, of course: At some level of fee ceiling, likely near 36% APR, payday lending will become financial unviable for lenders, and overall borrowing rates will decline.

If rate caps higher than 36 percent do not reduce or increase the frequency of loans, then it is likely that the lower fees will improve the financial well-being of families that use pay day loans. For regulations that do restrict access to loans or reduce the supply of payday lenders, the question is whether borrowers will turn to alternatives that are more or less harmful.

[b] A rollover loan occurs when the lender continues the current loan for an additional term while charging an additional fee for the extension.

[c] A cooling-off period indicates a period of time before and after the end of a payday loan term during which the borrower cannot take a new loan.

Lack of Alternatives to Payday Loans in Market

If regulation leads to fewer loans to consumers, it is helpful to examine the alternatives to payday loans or coping mechanisms that consumers will use. Some borrowers may substitute more traditional and lower cost financial products for credit where these products are available, convenient, and well marketed (e.g., credit union short-term loan programs), possibly improving borrowers' financial security in the long run. Conversely, borrowers might substitute other high-cost financial services, such as pawnshops, ultimately making their financial situation less secure.

It appears that only imperfect substitutes to payday lending exist. Up to 70% of payday loan borrowers surveyed immediately prior to the payday lending cap in Oregon could not identify a replacement source for short-term credit.[9] While some of these households might avoid short-term lending all together, many will use alternative products or a variety of other financial coping mechanisms. In the absence of payday lending, it appears that many consumers use checking account overdraft protection (for a fee, banks temporarily cover the costs of bounced checks or ATM withdrawals that exceed account balance) and late bill payment as ways to cope with financial instability. Research suggests that overdrafts may be even more financially destabilizing and costly than payday loans.[10]

There is also some evidence that previous payday loan borrowers switch to pawnshops for short-term credit needs after payday lending is prohibited.[11] However, short-term substitutes to payday loans do not appear to fully absorb payday loan borrowing after a cap: For instance, after Oregon capped payday loan interest rates in 2007, all short-term loan borrowing (payday and pawnshop loans) decreased 26%–28%. Total loan borrowing, bounced check, and late bill payment rates decreased only 7%–9% in comparison to comparable rates in Washington.[12]

Mixed Effect of Payday Loan Regulation on Financial Security and Access to Credit

Without a variety of alternative forms of short-term borrowing, restricting payday loans may limit a household's ability to access credit. If financially attractive alternatives exist and are convenient, financial security might improve, especially in the long run. If borrowers are forced to use inferior financial services or strategies, like overdraft protection or pawnshops, financial stability might deteriorate or short-run household well-being might suffer because of a lack of cash for expenses like food, medical care, or household and car repairs.

Some evidence suggests that "regulating out" payday lending (so that no high-cost lending happens in the state) may cause short-term financial hardship of households that rely on short-term loans: bounced checks, bankruptcy filings, and consumer complaints rose after fee ceilings effectively banned payday lending in Georgia and North Carolina.[d,13] In Oregon, self-assessments of deteriorating financial security and unemployment rates among payday borrowers increased after the rate cap, supporting the theory that restricting payday loan access might hinder positive investments or consumption "smoothing" that facilitates job retention and search.[14] Because low-income households tend to experience more financial

[d] These effects were significant in Georgia, but not significant in North Carolina.

insecurity, short-term credit likely softens financial shocks—without this credit, households may experience more instability.

However, evidence that household financial security deteriorates with payday loan prohibition is largely inconclusive or incomplete and isolating the effects of payday loan borrowing on consumer welfare is difficult. Indeed, there is some evidence that households with access to payday loans report more financial hardship and more difficulty meeting household expenses due to debt.[15] Additionally, a majority of former payday loan borrowers in North Carolina reported that the 36% rate cap had either no effect on their household's financial security or improved financial security. Because of this mixed support, it is likely that a more complex borrower relationship with payday loans exists—while offering important access to credit for some households, payday loans may trap other households in long-run debt.

Encouraging products that are less costly and more attractive than payday loans will likely enhance consumer well-being, while continuing to provide access to much needed credit. Ultimately, improving the financial stability of households that rely on payday loans and other high-cost forms of credit, through incentivized savings programs, financial education, budgeting, and other services may be the best tool to avoid long-term debt cycles and high-cost borrowing. Through these services, households that formerly used short-term, high-cost financial services may no longer need these emergency financial products, though again, conclusive evidence on this is lacking.

Additional Regulations for Payday Loan Harm Mitigation

Many consumer organizations advocate for a 36% national usury rate—effectively extending current restrictions for military borrowers to all borrowers.[16] This would address growing indications that borrowers in states with payday lending prohibitions access payday loans in adjacent states or on the internet. However, as noted above, this might significantly restrict access to short-term credit for households without access to traditional credit. Aside from rate and fee ceilings for payday loans, several other alternatives have been proposed as potential solutions.[17,18] An FDIC-sponsored pilot program evaluated the effects of various regulations, by tracking banks who participated in the program by offering short-term credit products.[19]

Regulating fee disclosures: Under federal law, all payday lenders are required to disclose APR for each loan. However, research suggests that borrowers understand fee disclosures (including the costs of defaulting or rolling over a loan) better than APR. Making consumers aware of the fees per loan, rather than APR, may decrease borrowing that is not absolutely necessary. Additionally, many borrowers report borrowing more than initially planned once they entered a payday lending operation, and mandating additional fee disclosures may reduce this trend.

Requiring longer repayment terms: Having more than two weeks to repay a short-term loan may allow borrowers who take out a payday loan because of a financial shock more time to regain stability. Some states, such as Oregon, already mandate that payday loans have at least a one-month term. The FDIC pilot program found that extending loan terms to 90 days would be most helpful for borrowers to fully pay off the loan and avoid the need for rollover loans.

Requiring a repayment plan in multiple installments: Washington currently requires payday lenders to offer installment repayment plans for borrowers who request them prior to default. Such repayment plans make a payday loan similar to traditional loans in structure and may allow borrowers to pay down the principal and interest over time, rather than making large, lump sum payments that are more difficult to afford.

Verify repayment ability: States can require that payday lenders verify and document a borrower's ability to repay the loan. Using credit scores, income, or assets to verify a borrower's ability to repay and to set allowable loan amounts may maintain access to essential credit while requiring the lender and borrower to consider repayment ability. Many banks and credit unions that participated in the FDIC pilot program used more stringent underwriting, such as credit reports, to verify ability to repay and to set loan amounts, without actually requiring high credit scores for the loan—this will likely cut default costs to lenders and thus allow lenders to offer more competitive products.

Restrict aggregate amount of time with payday loans: Restricting the total time that a single borrower is in debt over a specified time period will allow borrowers to access necessary credit when it is urgently needed, but to cut down on repeat borrowing that outlasts loan terms. States can mandate limitations on the total amount of time a borrower is indebted per year, on loans with interest rates higher than 36%, as recommended by FDIC guidelines.[20] Such a restriction would likely necessitate improving payday loan database and tracking systems.

Savings component: Some lenders, particularly credit unions, require a small deposit in a savings account when a borrower receives a short-term loan. While additional research on the long-term effectiveness of such programs is needed, this requirement may encourage emergency savings, making future short-term loans during times of instability unnecessary. States, or the federal government, can incentivize such savings components by providing credits to lenders who include such components (e.g., Community Reinvestment Act funding currently offered to banks who comply with FDIC guidelines).[21]

Lower-cost alternatives: As regulation of payday lending becomes more prevalent, banks and credit unions have filled this void with short-term lending programs of their own, some of which charge less than payday loans. Increasing the market of financially viable alternatives for users of payday loans, and making these alternatives more convenient, will limit repeat borrowing of high-cost loans.

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