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Mayday for Payday Loans

In the wake of the subprime loan meltdown, Congress and many state legislatures are now promising a crackdown on the "payday" loan industry. This looks like another illustration of how to hurt working Americans in the name of helping them.

Payday lenders offer short term loans, typically of between $100 to $500, to workers who need cash in advance of their next paycheck. Consumer groups and banking industry critics complain that the fees charged on payday loans are "predatory" and ensnare the poor in a "debt trap." The Center for Responsible Lending, a liberal activist group, claims the industry costs Americans $4.2 billion a year by charging exorbitant fees.

Several dozen U.S. Congressmen recently signed a letter excoriating payday lenders as "unscrupulous." Last year, Missouri Republican Jim Talent was looking for a populist issue to save his Senate seat, so he led the fight in Congress to enact legislation chasing payday lenders from military bases. Mr. Talent still lost, but he helped set a precedent that Democrats are pursuing with more onerous measures now.

But if payday lending is such a consumer rip off, no one has explained why these stores have become so popular. There are some 25,000 payday stores across America, and in many small towns the payday loan store is now as commonplace as the local post office. It has become something like a $6 billion industry serving 15 million people every month.

Consumers seem to like the convenience of instant cash in advance of their paycheck and prefer this to pawnshops or borrowing money from family members. Payday lenders have grown in size, customer base and profitability by discovering an unserved niche in the loan market for convenient, short term micro-loans. More to the "populist" point, payday loans offer a valuable service to moderate income workers. Most borrowers have incomes between $25,000 and $50,000, and payday loans are cheaper than most alternatives for those facing short-term financial distress.

Critics complain that the annual percentage rate (APR) on a two-week loan of $100 with a $15 fee amounts to a predatory 390%. But the equivalent APR cost to the borrower of writing a bounced check can exceed 1,300%, while a credit card late fee charge can reach 700%. Some borrowers will also go to loan sharks as an alternative, and we know how high their "fees" can be.

Georgia outlawed payday loans in 2004, and thousands of workers have since taken to traveling over the border to find payday stores in Tennessee, Florida and South Carolina. So the effect of the ban has been to increase consumer credit costs and inconvenience for Georgia consumers.

The most common proposals in Congress would cap payday loan interest rates at 36% APR. This would cut the fee to $1.38 for a $100 loan, less than the charge for a typical $100 ATM fee, and far below the check transaction cost. This could shut down much of the industry. But to what end? This debate is much like the controversy over bank ATM fees a few years ago. Consumer advocates demanded laws capping fees, and where those took effect the result was not so much lower charges but fewer ATMs and thus less convenience.

A 2007 New York Federal Reserve Bank study rejects the notion of payday as predatory and concludes that high prices "may reflect too few payday lenders, rather than too many." It adds that more regulation could reduce market entry and "the lack of competition could drive rates higher." Banning payday loans might please competing banks, credit unions and so-called consumer advocates, but it's hard to see how actual consumers would benefit.

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