Payday Lending

Payday loans are short-term loans that a borrower agrees to repay upon receipt of their next paycheck. Borrowers often must provide a payday lender with bank account information so the lender can withdraw payment electronically on the date of maturity. These short-term, low-principal loans often bear a high nominal rate of interest on an annualized basis, although interest only accrues during the weeks the loan is outstanding.

Eighteen states have effectively banned payday lending by setting a statutory cap on the annualized rate of allowable interest. Another three states have either banned the assignment of wages as security for a loan or have prohibited loans with small principal amounts.

In 2017, Nevada lawmakers created new limitations on payday lending: These loans cannot have terms greater than 90 days and cannot require a payment that would be greater than 25% of the borrower's gross monthly income. Upon borrower default, the lender must also drop the interest rate to prime plus 10% and provide a repayment plan.[1] In January 2024, a new nonprofit filed a ballot initiative aiming to ban payday lending by capping annualized interest rates at 36%.[2]

Key Points

Borrowers often pose high credit risks. Borrowers of payday loans tend to be young, hourly wage earners. Early-career hourly wage earners may have unpredictable work schedules that lead to inconsistent earnings. Borrowers require access to some form of short-term credit to meet ongoing obligations. An average borrower uses eight loans over the course of the year, lasting 18 days each and 69% of loans are used to cover monthly expenses like rent and utilities during times of inconsistent earnings.[3]

Unavailability of short-term credit can be detrimental to borrowers. When asked what they would do if payday loans were unavailable, four-fifths of respondents to a Pew poll said they would have to buy less food or clothing. Majorities said they would delay paying bills like rent and would sell or pawn personal possessions.[4] These outcomes may be worse alternatives.

Payday loans may be the cheapest form of credit for high-risk borrowers. Research from the Federal Reserve indicates that borrowers resort to more costly forms of financing in states without payday lending. After Georgia and North Carolina banned payday lending in 2004 and 2005, respectively, households bounced more checks and paid more overdraft fees, which are forms of temporary bank financing that imply interest rates higher than payday loans. Households in these states also began filing for bankruptcy at higher rates.[5]

Payday lenders face higher administrative costs than traditional lenders. The principal amount of a payday loan is typically $500 or less and loans are often due within 2-4 weeks.[6] More traditional lending often involves much greater loan principals and longer terms. This can mean the administrative expense of qualifying borrowers for payday loans is higher as a proportion of total lending volume than for traditional lenders. Higher costs and rapid turnover, combined with greater risk among the borrower population, explain why payday lenders charge high interest rates on an annualized basis.

An interest-rate cap is a price control. Interest is the price paid by borrowers to savers so borrowers can accelerate future consumption into the present while savers agree to delay consumption to the future. Interest is the price signal that coordinates society's consumption and production signals across time. As with all price controls, interest-rate caps distort these signals and may lead to a suboptimal allocation of society's available resources –

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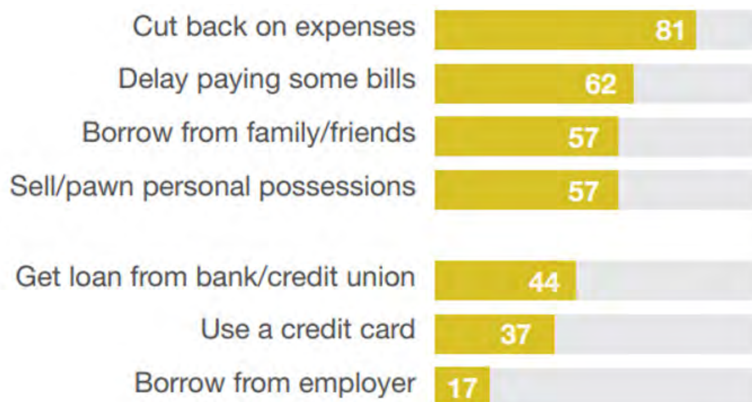
[1] Nevada Legislature, 79th Session, Assembly Bill 163.
[2] Eric Neugeboren, "Initiative Filed to Cap Nevada Payday Loan Interest Rates," The Nevada Independent, January 8, 2024.
[3] Nick Bourke et al., "Payday Lending in America: Who Borrows, Where They Borrow, and Why," Pew Charitable Trusts, July 2012.
[4] Ibid.

savers reduce their savings while borrowers are forced to forego consumption in the present.

Recommendations

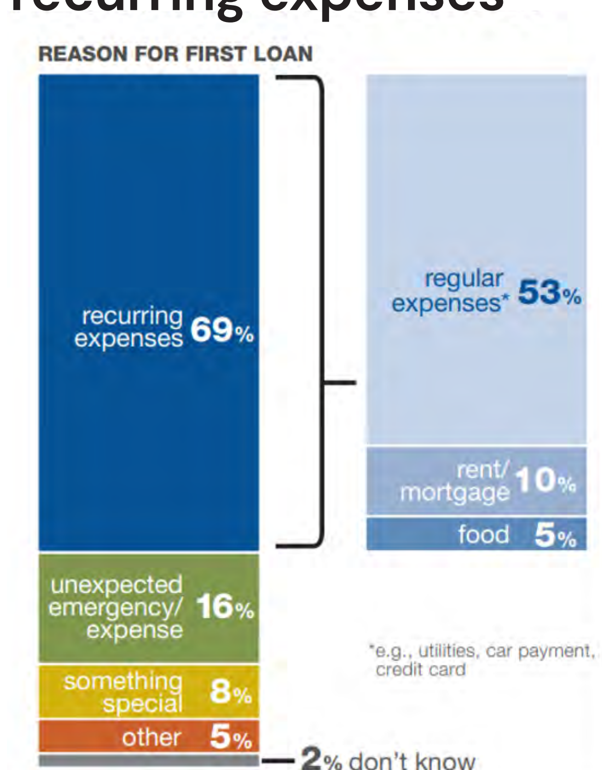
Do not ban payday lending. Although payday loan servicing may appear unfair to observers who have many available alternatives, payday loans might be the cheapest and best form of credit for high-risk borrowers.

Alternatives if payday loans were unavailable



Borrowers are more likely to choose options that do not connect them to a formal institution.

Most borrowers use payday loans for recurring expenses



Source: Nick Bourke et al., "Payday Lending in America," Pew Charitable Trusts.

[5] Donald Morgan and Michael Strain, "Payday Holiday: How Households Fare after Payday Credit Bans," Federal Reserve Bank of New York Staff Report No. 309, November 2007 (Revised: February 2008); Donald Morgan et al., "How Payday Credit Access Affects Overdrafts and Other Outcomes," Journal of Money, Credit and Banking, Vol. 44, Iss. 2-3 (March 2012).

[6] Federal Trade Commission, "What to Know About Payday and Car Title Loans," July 2023.