Springing the Debt Trap:
Rate caps are only proven payday lending reform

Executive Summary

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About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

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Payday lenders argue that charging 400 percent annual interest is the only way their business model can be profitable. Some states have responded by exempting payday lenders from the interest rate caps imposed on small loans in general. Perhaps this special treatment would be justified if payday loans provided a strong public benefit, but the experience of borrowers shows the reverse. The vast majority of families taking out payday loans are ensnared in long-term debt, making them worse off than they would be without high-cost payday lending.

A payday loan typically ranges from $300 to $500 and is secured by a personal check. It is marketed as a short-term advance on the borrower's next paycheck, but the high price and the fact that it must be paid off in one lump sum two short weeks later virtually ensures that cash-strapped borrowers will be unable to pay off their loan with a single paycheck and still meet their basic expenses.

Payday lenders justify payday loans and their high costs because they are short-term loans that get borrowers past an immediate shortfall. To give payday lenders the benefit of the doubt in our definition of the debt trap, we assume that a borrower may have one of these shortfalls every quarter—this reasoning would justify four loans per year. When borrowers receive greater than this number, we can assume that the difficulty in repaying the short-term balloon debt has forced the borrower to convert that short-term loan into long-term, high-cost debt. The borrower is therefore caught in a debt trap—a cycle of debt they cannot afford to pay off for good.

States approach payday lending in one of three ways. Some allow payday lenders to operate with virtually no legal restrictions. Others enforce an interest rate cap at or around 36 percent on small loans, inclusive of payday lending. And a third group attempts to create a middle ground where payday lenders can charge triple-digit interest rates with certain restrictions intended to make sure that payday loans don't create a debt trap for borrowers.

In this paper, we evaluate the efficacy of this third approach. We find:

- The debt trap of payday lending persists even in states that have attempted to reform the practice. In these states, 90 percent of payday lending business is generated by trapped borrowers with five or more loans per year.

  More evidence that the debt trap persists:

  - Over 60 percent of loans go to borrowers with 12 or more transactions per year;
  - 24 percent of loans go to borrowers with 21 or more transactions per year;
  - One of every seven Colorado borrowers have been in payday debt every day of the past six months; and
  - Nearly 90 percent of repeat payday loans are made shortly after a previous loan was paid off.

- As implemented in any state, none of these restrictions have stopped payday lending from trapping borrowers in long-term debt:
  - Renewal bans/cooling-off periods
  - Limits on number of loans outstanding at any one time
  - Payment plans
  - Loan amount caps based on a borrower's income
  - Databases which enforce ineffective provisions
  - Regulations that narrowly target payday loans

- Those states which enforce a comprehensive interest rate cap at or around 36 percent for small loans have solved their debt trap problem; realizing a savings of $1.5 billion for their citizens while preserving a more responsible small loan market.

In sum, the only proven way for state policymakers to protect their citizens from predatory small loans is to enforce a comprehensive small loan law with an interest rate cap at or around 36 percent.