Payday Lending

January 29, 2003

Summary

Payday lending - among the highest risk subsets of subprime lending - is characterized by small-dollar, short-term, unsecured lending to borrowers typically experiencing cash flow difficulties.

Some insured depository institutions have failed to properly assess and control the risks associated with their payday lending programs. The consequences of deficiencies in risk management practices for payday lending programs can be severe.

The risks of payday lending are challenging for bankers and merit the continuing attention of depository institution supervisors. This issue of FYI provides additional information about payday lending.

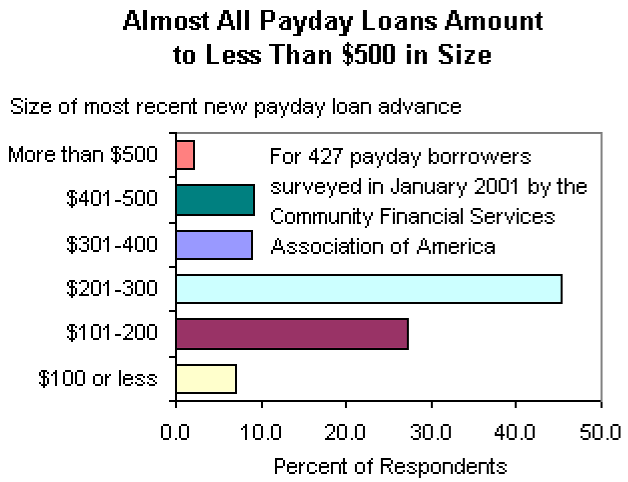
What Are Payday Loans?

Payday loans are small-dollar, short-term, unsecured loans that borrowers promise to repay out of their next paycheck or regular income payment. Payday loans are usually priced at a fixed-dollar fee, which represents the finance charge to the borrower. Because these loans have such short terms to maturity, the cost of borrowing, expressed as an annual percentage rate, can range from 300 percent to 1,000 percent, or more. An example of a typical loan process for payday lending is described in the adjacent box.

How Payday Loans Work

In return for the small loan - usually less than $500 (See Chart 1) - the borrower provides the lender with a check or debit authorization for the amount of the loan plus the finance charge. The lender agrees to defer presentment of the check until the customer's next payday. At the next payday, the customer may redeem the check by paying the loan amount plus the finance charge, or the lender may cash the check. In some cases, the borrower may extend the loan by paying only the finance charge and writing a new check.

Chart 1

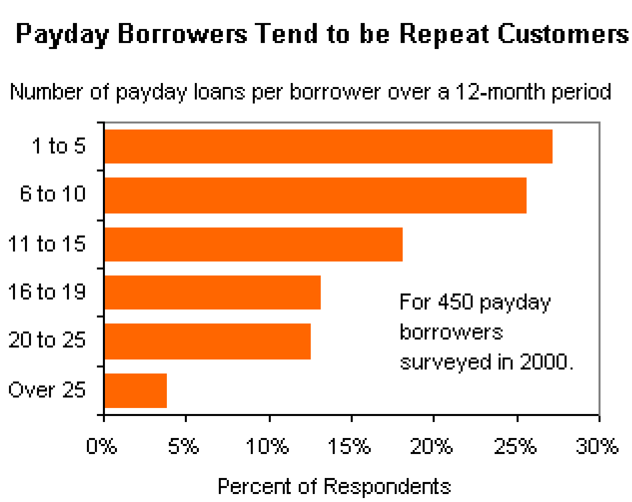


Source: Elliehausen and Lawrence (2001)

Who Are the Borrowers?

Typically, payday customers have cash flow difficulties and few, if any, lower-cost borrowing alternatives. Payday customers tend to be frequent users of payday advances, often choosing either to "roll over" their credits or to obtain additional subsequent extensions of credit (See Chart 2). This data indicates that the cash flow difficulties experienced by many payday customers are a long-term credit characteristic as opposed to a short-term temporary hardship.

Chart 2



Source: Wisconsin Department of Financial Institutions

A study by the Credit Research Center at Georgetown University's McDonough School of Business indicates that payday customers often rely on payday loans because they have either been turned down for other forms of credit or offered less credit than the amount for which they had applied. The study also indicates that payday advance customers frequently have other characteristics associated with credit problems or limited credit availability, including borrowing from a pawnshop in the past five years, filing for bankruptcy in the past five years, or making payments 60 or more days late on a mortgage or consumer debt in the last year.[1] As a result of these characteristics, payday lending is generally characterized as a form of subprime lending.

Who Makes Payday Loans?

At the beginning of the 1990s, payday lending was primarily the domain of smaller independent check cashing outlets and pawnshops that offered services related to check cashing. These firms specialized in making high-priced loans to borrowers with limited access to credit.

The number of payday lenders, however, has surged in recent years as more companies have been attracted by the higher fees earned on payday loans, as well as a high level of consumer demand for short-term, small denomination credit. New payday participants include large regional or national multi-service providers of payday loans, large regional or national monoline payday loan entities, and insured depository institutions. Although the number of known insured depository institutions involved in payday lending is small, third party payday lenders are actively seeking relationships with insured financial institutions.

Industry analysts estimate that the number of payday loan offices nationwide increased from less than 500 in the early 1990's to approximately 12,000 in 2002, with continued growth expected. The Community Financial Services Association of America, a trade group of the payday lending industry, estimated that payday lending activity in the United States during 2002 would reach about 180 million payday loans with a gross dollar volume of $45 billion.[2]

Insured Institutions and the Payday Market

Subprime lending in insured depository institutions is most commonly associated with auto, home equity, mortgage, and credit card lending. More recently, however, insured institutions have ventured into the payday lending arena.

Payday lending is not delineated in either bank Reports of Condition and Income or Thrift Financial Reports, but periodic surveys conducted by the FDIC indicate that relatively few insured depository institutions are currently involved in payday lending. However, there is no universal definition for payday lending, and some insured depository institutions have recently implemented overdraft lending programs that may, depending on the specifics of the program, exhibit characteristics similar to payday lending programs.

Insured depository institutions that are involved in payday lending have used various strategies to establish a presence in the market. Some have formed joint ventures with companies specializing in payday lending, while others have initiated payday lending programs internally. Insured institutions have extended loans directly to payday lenders, purchased payday loans from loan brokers, or lent to payday specialty lenders in the form of loan participations, warehouse lines, liquidity facilities, or dealer lines. While there is no evidence of an established asset-backed securities market for payday lending, some insured depository institutions have explored the possibility of securitizing and selling payday loans.

Risks Associated with Payday Lending

While the payday lending business presents banks with new growth opportunities, it also presents significant risks. To be sure, higher pricing on payday loans promises higher revenues and wider margins for lenders. However, there also are greater risks associated with payday lending. The credit risk associated with payday lending is significant, even when compared to other types of unsecured subprime lending such as credit card lending.

There are key differences between the underwriting methods used for subprime credit card lending and payday lending that renders payday lending among the highest risk subsets of subprime lending. Payday underwriting requirements are substantially less than those required by subprime credit card lenders who often supplement a prospective borrower's credit bureau report with such additional information as income, employment history, and the nature of prior credit problems. The prevailing underwriting criteria of most payday lenders require that consumers need proof only of a documented regular income stream, a personal checking account, and valid personal identification to receive a payday loan.

Credit quality data for specialty payday lending entities is lacking since most payday lenders are small, non-publicly traded firms. Review of publicly traded company reports indicates that some specialty payday lenders have recently recorded quarterly annualized net charge-off ratios as high as 83 percent,[3] far higher than the typical annualized net charge-off ratio for subprime credit card lenders. Recent charge-off ratios for subprime lending institutions' credit card portfolios, while still high, typically do not exceed 20 percent. Higher default rates for payday loan portfolios indicate that loan loss reserves and capital levels that may be adequate for some other forms of subprime lending may not properly cover the greater risks associated with payday loans.

Depository institutions involved in payday lending also may enter arrangements with third parties to originate payday loans. These loans often involve fees and charges in excess of those the third party could otherwise charge under state law. Although federal banking statutes authorize insured depository institutions to "export" interest rates from states where the lender is located on loans made to borrowers residing outside the state, litigation involving the use of this authority by third-party payday lenders has recently increased. In addition, some suits also have alleged lender violations of various state and federal consumer protection laws in connection with these loans. Thus, participation in these arrangements may expose insured depository institutions to substantial legal and reputational risks. In addition, third-party arrangements may also pose additional operational risks, such as a heightened risk of transactional error or fraud.

Regulatory Implications

Recently, bank examinations have disclosed that a number of institutions involved in payday lending have failed to properly assess and control the risks associated with payday lending, and federal banking agencies have taken swift action to address the identified problems. For example, in September 2002, the FDIC entered into a formal enforcement action with one of its state nonmember institutions involved in payday lending. The FDIC required the institution, in part, to strengthen risk management practices associated with payday lending and to significantly augment capital to cover the greater risks associated with payday lending activities. The Office of the Comptroller of the Currency also has recently entered into formal agreements with several national banks, in some cases requiring the institutions to exit the payday lending business as a result of their failure to properly manage the attendant risks.

Depository institutions involved in payday lending should implement risk management programs that appropriately identify, measure, monitor, and control the risks associated with payday lending. The FDIC has recently developed draft guidelines for payday lending that would apply to all institutions under the FDIC's supervision that offer payday programs. The guidelines describe the FDIC's expectations for prudent risk management practices for payday lending activities, particularly with regard to capital, allowance for loan and lease losses, and loan classifications. The draft also addresses guidelines for recovery practices, income recognition, and managing risks associated with third-party relationships, as well as compliance with consumer protection laws.

Conclusion

Payday lending presents insured depository institutions with significant risks. To be successful in payday lending, depository institutions must adequately identify, measure, monitor, and control the attendant risks. Depository institutions also must ensure that adequate management expertise and the appropriate level of capitalization are available, as well as programs that ensure compliance with consumer protection laws. Conversely, deficiencies in assessing and controlling the risks of payday lending can have serious consequences. Such deficiencies have surfaced at a number of insured institutions.

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[1] Gary Elliehausen, Ph.D and Edward C. Lawrence, Ph.D, P*ayday Advance Credit in America: An Analysis of Customer Demand,* April 2001.

[2] Robert W. Snarr, Jr., *No Cash 'til Payday: The Payday Lending Industry,* Federal Reserve Bank of Philadelphia, CRA Compliance Corner, First Quarter 2002.

[3] SNL Database.

About *FYI*

FYI is an electronic bulletin summarizing current information about the trends that are driving change in the banking industry, plus links to the wide array of other FDIC publications and data tools.

Disclaimer

Last Updated 3/04/2004

Chart 1
Almost All Payday Loans Amount to Less Than $500 in Size

Size of most recent new advance	Percent of Respondents
$100 or less	7.0
$101-200	27.3
$201-300	45.4
$301-400	8.9
$401-500	9.2
More than $500	2.2

Source: Elliehausen and Lawrence (2001)

Chart 2
Payday Borrowers Tend to be Repeat Customers

Number of payday loans per borrower over a 12-month period	Percent of Respondents
Over 25	4%
20 to 25	12%
16 to 19	13%
11 to 15	18%
6 to 10	26%
1 to 5	27%

Source: Wisconsin Department of Financial Institutions