Payday Lending: A Business Model that Encourages Chronic Borrowing

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The tremendous growth in the demand for very small, short-term loans by credit-constrained households is being largely filled by companies offering payday loans. This article explores the explosive growth of payday lending as a source of short-term consumer credit in low- and moderate-income communities, with a special emphasis on the relationship between industry business practices and the high incidence of perpetual indebtedness in which an increasing number of payday borrowers find themselves. Empirical analysis confirms two related truths about payday lending. First, there is no denying the large and growing demand for this consumer credit and the rapidly expanding network of companies willing to supply it. Second, despite its expanding customer base and notwithstanding industry denials, the financial performance of the payday loan industry, at least in North Carolina, is significantly enhanced by the successful conversion of more and more occasional users into chronic borrowers ***qqTB2****.*

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>
> ——National Cash Advance advertisement (n.d.)

The tremendous growth in the demand for very small, short-term loans by credit-constrained households is being largely filled by companies offering payday loans (National Consumer Law Center, n.d.). This article explores the explosive growth of payday lending as a source of short-term consumer credit in low- and moderate-income (LMI) communities, with a special emphasis on the relationship between industry business practices and the high incidence of perpetual indebtedness in which an increasing number of payday borrowers find themselves.

A payday loan, variously referred to as a "payday advance" or "deferred deposit" loan, is a high-interest, 2- to 4-week loan backed by a postdated personal check that a borrower promises to repay out of his or her next paycheck. Individual loans tend to be small; 80% of all payday loans across the country are reportedly less than $300 (Elliehausen & Lawrence, 2001). The practice was virtually nonexistent in 1990, but payday lending has grown into a multibillion-dollar industry, with an estimated 12,000 to 14,000 outlets across the country (Consumer Federation of America & U.S. Public Interest Research Group, 2001).

The rise in payday lending is attributed by fringe banking scholar John Caskey (Conte, 1999) to three complementary factors: (a) With the rise of direct deposit, check-cashing companies are looking for new business because there are fewer checks to cash; (b) friendly state legislatures allow payday lenders to charge fees that, although moderate in absolute terms, translate into

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extremely high and profitable compound interest rates; and (c) strong demand is fueled by a steady increase in the number of people with impaired credit.

The empirical core of this article attempts to quantify the relationship between industry revenues and the incidence of repeat borrowing by a large segment of payday loan customers. As discussed more fully later, despite their short terms—the typical payday loan is due and payable within 14 days or fewer—the incidence of repeat borrowing at additional fees by individual borrowers has grown to epidemic proportions. Payday loans are exempt from many state and local usury laws largely because they are written for short terms and are intended for occasional use. However, if the industry is morphing into an expensive source of longer term credit **qqTB3**, then a good case can be made for states and perhaps the federal government's strengthening consumer protections and regulatory scrutiny. Expanding the umbrella of consumer protections to include payday lending is not without precedent. Today, payday lending is either prohibited outright or effectively banned through caps on interest rates in 17 states, although it remains legal and regulated—to a greater or lesser degree—in 33 states (Elliehausen & Lawrence, 2001). For example, North Carolina law set a ceiling of $300 on the amount that could be borrowed at one time, limited fees to 15% of the amount borrowed, and provided for a maximum term to maturity of 31 days. Those regulations expired, however, on August 31, 2001.

Although this article is national in scope, it draws heavily on a unique database of the payday lending business in North Carolina. The North Carolina Commissioner of Banks conducted comprehensive surveys of licensed check-cashing and payday lending companies in 1999 and 2000. The resulting database contains company-level information on the number and characteristics of payday loan transactions: the face value of loans, loan terms, revenues, the frequency of repeat customer business, gross and net losses due to bad loans, and data on payroll expenses.

This article examines the scope and effects of this booming practice. First, we discuss the size and rapid growth of the payday lending industry, highlighting trends toward greater ownership and control by regional and national chains and the spatial patterns of payday lenders within communities. Next, we explore the premium that check-cashing businesses place on meeting the needs of LMI customers and the love-hate relationships that some payday loan customers have with their lenders. We then examine the size and composition of the market for payday loans, in terms of the aggregate demand and the characteristics of consumers who use the product. As one might expect, what most borrowers have in common is significant credit constraints, including poor and impaired credit histories. Our core empirical analysis quantifies the extent of rollovers and repeat borrowing by a significant segment of consumers. The North Carolina database helps to demonstrate the importance of rollovers to company revenues, which makes controlling this business practice the most important policy and regulatory issue. We conclude with policy recommendations.

THE SIZE AND GROWTH OF THE PAYDAY LOAN INDUSTRY

No matter how the size of the industry is measured, the statistics are striking. Whereas virtually no payday loan outlets existed 10 years ago, industry analysts estimate there are now up to 14,000 of them, with total loan originations of between $8 billion and $14 billion in 2000 alone.[1] At an average of $300 per loan, this translates to between 26 million and 47 million individual payday loan originations in 2000. Experts anticipate that a steady growth in loan demand to about $20 billion a year by 2004 will fuel expansion at a rate of about 100 new payday loan outlets a month across the country (Blackwell, 2000; Community Financial Services Association of America, n.d.).

Although there is no national directory of payday lenders, a search of local sources confirms the industry's geographical reach and rapid growth. Missouri has almost 800 outlets (Stern, 2001) and Florida (Chandler, 2001) and Illinois (Neal, 2001) each have about 500. Washington state ("The boom in Fast Cash," 2000) has more than 400. With about 2,000 outlets, California ("Stop Legal Loan Sharks," 2001) reportedly has more payday loan offices than it does McDonalds and Burger King establishments.

The little local data that could be found produce double- and triple-digit growth rates consistent with the national pattern already discussed. Over the past decade, fringe-banking companies in New Mexico, including payday and auto-title lenders, grew at a 31% compound annual rate (New Mexico Public Interest Research Group Education Fund, 2002). The number of payday loan offices in Iowa (Richardson, 2001) grew by about 20% in 2001 alone. The Las Vegas area saw a yearly increase of 142% between 1999 and 2001 (Di Edoardo, 2001). Wisconsin outlets grew 65% a year over 5 years (Gores, 2001); Ohio experienced an annual increase of 37% since 1988 (Pramik, 2001.) The 520 new outlets opened in North Carolina between 1997 and 1999 produced a compound annual growth rate of 68%, (North Carolina Commissioner of Banks, n.d.),[2] meaning there is now one check-cashing or payday loan outlet in North Carolina for every two federally insured banking offices (North Carolina Commissioner of Banks, 2000; Federal Deposit Insurance Corporation [FDIC], 2000).[3]

The growth in local loan volume is equally impressive. In 1999, Washington state payday lenders made about $494 million in loans—73 times the amount loaned 4 years earlier ("The Boom in Fast Cash," 2000). Wisconsin shows a similar trend. In just 4 years, the number of payday loans grew tenfold, from 80,000 in 1996 to almost 840,000 in 1999 (Wisconsin Department of Financial Institutions, n.d.). California's three biggest payday loan companies make 1 million loans a month (Said, 2001). Perhaps no state better reflects this national trend than Indiana. In 1994, the year payday lending was legalized, Indiana's first 11 licensed payday loan companies originated $12 million in loans. Over the next 5 years, the number of companies grew more than tenfold and the number of outlets grew almost 4 times faster and loan volume soared to $300 million (*Janet Livingston v. Fast Cash USA Inc.*, n.d.).[4]

Reliable estimates of the industry's financial status are hard to come by, but various sources suggest that payday lending generates large revenues and is highly profitable. One estimate places payday loan fees at $2.4 billion a year (Consumer Federation of America & U.S. Public Interest Research Group, 2001), whereas another report indicates that industry-wide return on equity is close to 35% a year (Koerner, 2001). A U.S. Treasury survey of check-cashing and payday lending businesses in four cities found that average pretax returns on sales were 34% (Dove Consulting, 2000). A case study of Chicago lenders places the gross margin for payday loans at between 30% and 45% of revenues and return on investment at approximately 24% (Rhine, Toussaint-Comeau, Hogarth, & Greene, 2001). Alhough using a different measure of profitability, financial reports from ACE Cash Express (2001a), one of the biggest check-cashing and payday loan companies in the country, are equally impressive. Average store "contribution"—revenues minus direct store expenses and store-related depreciation and amortization—was 23% of average total revenues for company-owned stores in fiscal 2001 (ACE Cash Express, 2001b). That amount is 25% greater than a year earlier. This compares with year-to-year growth of just 7% from 1999 to 2000 (ACE Cash Express, 2001a).

From 1999 to 2000, the number of companies (not outlets) engaged in payday lending in North Carolina increased by 16%, whereas gross revenues rose by 28%, from $97 million in 1999 to more than $123 million in 2000 (see Table 1).

Confirming its lofty position in the national marketplace, North Carolina's payday loan companies earned about 7% of the estimated $1.4 billion the entire industry generated across the country in 1999 (Gordon, 1999). That figure is a 73% increase over the industry's reported $810 million in loan fees in 1998 (Diekmann, 2000).

The Trend Toward Consolidation

"Payday loans are provided by stand-alone companies, by check cashing outlets and pawn shops, through faxed applications to loan servicers, online, and via toll-free telephone numbers" (Robinson, 2001). Stand-alone or otherwise, the same competitive forces affecting mainstream banks are at work in the payday lending industry, with scale economies and technology the principle drivers. Although 10 large chains were reported to control more than one third of all outlets in the late 1990s (Gordon, 1998), further consolidation has likely occurred since then. The catalyst for more mergers—in the form of smaller, independent operators selling to deeper pocket regional

TABLE 1
Payday Lending Industry Data, North Carolina, 1999 and 2000

	1999	*2000*	*% Change*
Number of deferred deposit checks	2,910,366	3,469,917	19.2
Total face value of deferred deposit checks	$649,506,935	$834,784,932	28.5
Total dollar amount of payday loan fees collected	$96,608,226	$123,318,563	27.6
Total dollar amount of net charge-offs[a]	$9,878,891	$15,199,745	53.9
Total number of customers	378,564	413,214	9.2
Total number of outlets	807	902	11.8
Number of companies	142	165	16.2

SOURCE: North Carolina Commissioner of Banks (2000, 2001).
a. The amount lost due to not sufficient funds (NSF) checks, net of recoveries.

and national companies—is the growing number of legal challenges brought by increasingly aggressive consumer interests and the growing complexity of regulatory environments. Both of these significantly increase legal costs.

No single business controls more than a small fraction of all payday loan offices, but two publicly traded companies are each reported to own at least 10% of all payday loan outlets in the country. South Carolina-based Advance America, the nation's largest payday lender, operates more than 1,300 stores nationwide (Fox & Mierzwinski, 2001). Dallas-based ACE Cash Express Inc. operates a network of 1,166 stores in 35 states and the District of Columbia (ACE Cash Express, 2001a). With 89 outlets in North Carolina, Advance America is the state's biggest payday lender. Advance America and the four next biggest companies offering payday loans in the state owned 31% of all outlets, served 45% of all customers, originated half of all loans, and generated half of all gross revenues from loan fees in 2000 (see Table 2).

Besides contributing to more consistent store environments, more diverse product menus, and, perhaps, scale economies, greater industry concentration has important policy implications. For example, Illinois state regulators report that smaller independent operators are less likely to use computers and more likely to write each loan contract manually, thus increasing the likelihood of errors and unintended violations of truth-in-lending laws (Illinois Department of Financial Institutions, Consumer Credit Division, n.d.). An analysis of North Carolina lending data suggests that there may be less benign consequences of large size. North Carolina's "big five" seem to feature somewhat shorter term loans and more repeat borrowing by a larger share of their customer base than other companies—two business practices that have potentially debilitating consequences for financially fragile families.

Despite the fact that the cost to consumers is the same for a 31-day loan as it is for a 1-day loan—$15 per $100 borrowed—73% of the big five's loans in North Carolina in 2000 written in 2000 were for 14 days or less. That compares with an average of 60% of loans originated by all other payday loan companies in the state. Similarly, whereas the average big five customer took out about nine payday loans in 2000, the average customer for all other companies took out about seven loans. Some could argue that these figures reflect the greater customer appeal of the biggest companies, but the down side is that more of their customers are using their product as a source of long-term credit. The issue of rollovers and repeat borrowing is further discussed later.

. . . even where mainstream banks have not physically withdrawn from low- and moderate-income communities, fringe banks are moving in. . . . Charlotte fringe banks favored working-class neighborhoods over the city's poorest communities. . . . other factors are at play, besides bank closings, in the concentration of fringe banks in working-class neighborhoods.

The Spatial Location of Payday Lenders

As technology allows greater use of electronic transactions and consolidation leads to increased bank fees and reduced branch locations, fringe banks are "filling this void by diversifying their services, extending hours of operation and adding locations where banks have closed, many in suburban strip centers" (Gordon, 1998, p. 136). Our own research, in Charlotte, North Carolina, suggests that even where mainstream banks have not physically withdrawn from low- and moderate-income communities, fringe banks are moving in. This regional banking center has about 2.4 mainstream banks for every fringe bank citywide, but two thirds of the latter are located in zip codes containing

TABLE 2

Profile of Largest Payday Lenders, 2000

	Advance America	*Check 'n Go*	*Foresight Management*	*Check Into Cash*	*McKenzie Check Advance*	*Total for Top Five Companies*	*Total for All Other Companies*[a]
Total number of payday loans	570,615	348,688	229,038	316,050	255,370	1,719,761	1,753,224
Total customers	64,289	39,882	24,754	33,503	29,504	191,932	239,282
Number of outlets	89	54	53	45	37	278	624
Gross payday lending revenue[b]	$21,800,000	$12,900,000	$8,207,467	$10,900,000	$9,901,676	$63,709,143	$61,668,544
Average number of loans per customer[c]	8.9	8.7	9.3	9.4	8.7	9.0	6.7
Percentage of customers borrowing monthly[c]	30.8	30.1	33.1	33.7	29.8	31.3	22.5
Percentage of customers who borrowed 24 times[c]	5.7	6.1	6.6	7.4	5.1	6.1	2.6
Percentage of loans that are 2 weeks or less[d]	72.8	77.8	65.6	75.0	69.6	72.8	65.5
Market share of payday lending customers (in percentages)	14.9	9.2	5.7	7.8	6.8	44.5	55.5
Market share of gross payday lending revenues (in percentages)	17.4	10.3	6.5	8.7	7.9	50.8	49.2
Market share of outlets (in percentages)	9.9	6.0	6.0	5.0	4.1	31.0	69.0

SOURCE: North Carolina Commissioner of Banks (2001).

NOTE: NSF = not sufficient funds; MGI = modified gross income.

a. $n = 159$ payday lenders in 2000. **IS THIS FULL STUDY SAMPLE OR SUBSAMPLE? (n or N)**

b. Includes payday lending fees and NSF fees from payday lending.

c. Means of this variable are weighted by the company's total number of customers.

d. Means of this variable are weighted by the company's total number of loans.

between 6 and 20 FDIC-backed financial institutions (Kolb, 1999). Although not all North Carolina fringe banks are in the short-term credit business, in 2000, about 70% of them offered payday loans in 2000, with the remainder focusing exclusively on check cashing (see Table 3).

Charlotte fringe banks favored working-class neighborhoods over the city's poorest communities. There were more than five outlets per 10,000 households in neighborhoods in which the median income was between $20,000 and $40,000. That compared with 3.4 per 10,000 households in neighborhoods in which the median income was less than $20,000. These banks also disproportionately favored high-minority neighborhoods. Relative to population, there were one third as many banking offices and more than four times as many check-cashing offices in neighborhoods that were at least 70% minority as in neighborhoods that were less than 10% minority (Kolb, 1999).

In short, our research suggests that other factors are at play, besides bank closings, in the concentration of fringe banks in working-class neighborhoods, including more convenient hours of operation and a preferred product mix relative to mainstream banks. We explore these findings later.

HOW DO CONSUMERS FEEL ABOUT THEIR LENDERS?

Research and market studies confirm that fringe banks, most notably check-cashing establishments, generally meet the financial services needs of lower income communities better than do mainstream financial institutions. Focus groups of low-income and ethnic consumers conducted for Union Bank of California in May 2001, for example, identified five ways in which check cashers were superior to banks: (a) easier access to immediate cash; (b) more accessible locations; (c) better service in the form of shorter lines, more tellers, more targeted product mix in a single location, convenient operating hours, and Spanish-speaking tellers; (d) more respectful, courteous treatment of customers; and (e) greater trustworthiness. Despite what some might consider higher costs, focus group participants believed that the pricing policies of check cashers were more transparent than those of banks (Andre Associates, 2001). This latter point is worth emphasizing. The focus groups said banks' increasing reliance on "relationship" pricing and complex fee structures made them "think they are being cheated or tricked because they don't have sufficient resources or know how to work the system to avoid the fees" (Andre Associates, 2001, p. 7).

With respect to operating hours, Dove Consulting (2000) found that check cashers it surveyed were open between 63 and 77 hours per week and that 96% of them were open on Saturdays and 26% on Sundays. Dove also found the same kind of cultural sensitivity and preferred product mix that Union Bank's focus groups identified. Across Boston, Atlanta, San Antonio, and San Diego, Dove found fringe-banking staffs that spoke at least nine different languages. It also noted a more attractive menu of services, including money orders, lottery tickets, and public transportation passes. Other sources have catalogued additional services available, such as cellular phones, photocopy and fax machines, prepaid local and long-distance phone cards, stamps, envelopes, notary services, car insurance and registration, and marriage, birth and death certificates (Progressive Policy Institute, 2001).

Even though payday lenders may provide the same service-rich environments, display similar cultural sensitivities, and feature the same convenient locations and business hours, because they are lenders of last resort, they may not have the same kind of broad customer appeal as do check cashers whose fee-for-service business practices carry with them no continuing obligations on the customers' part. This was suggested by Union Bank's focus groups, which gave mostly neutral ratings to payday lenders and pawnbrokers. Some members considered them "necessary evils" (Andre Associates, 2001, p. 10). About one third of the participants rated these lenders negatively. In fact, payday lenders "amassed more negatives than any other [financial services] providers, though a healthy minority admitted using them when necessary and when lacking alternatives" (p. 10).

Even in their industry-financed national survey of payday loan customers, Elliehausen & Lawrence (2001) found substantial concerns among borrowers about the high costs of payday loans. Three quarters of respondents either strongly agreed or somewhat agreed with the statement "The government should limit the fees charged by payday advance companies" (p. 35).

TABLE 3
Distribution of Licensed Check Cashers[a] by Business Operations, North Carolina, 1999 and 2000

	1999		*2000*	
	Percentage	*Number*	*Percentage*	*Number*
Check cashing only	29.4	59	29.2	68
Payday lending only	27.4	55	21.9	51
Both	43.3	87	48.9	114

SOURCE: North Carolina Commissioner of Banks (2000, 2001).
N = 201 in 1999, 233 in 2000.

Interviews with payday loan customers in North Carolina reflected the same kind of ambivalence toward lenders—appreciation for the ease of access to the credit but dismay about its high costs and addictive qualities. Here's what one borrower said:

> I have four [payday lenders]. On a monthly basis I pay $350 worth of interest. That's my car payment right there in interest. I am making two car payments, but I have only one car. In a way, they are doing a favor for people, but in the long run it's not a favor. You have to pay them to get your money back so you can pay somebody else. It's not designed so you can get yourself together; it's designed for you to come back to them. (Stegman & Skillern, 2000, p. 19)

HOW BIG IS THE MARKET FOR PAYDAY LOANS?

Policy makers, regulators, and consumer advocates have as great a stake as the industry in getting a handle on the size and composition of the market for payday loans. If the near-term growth in demand by consumers who have never taken out a payday loan is insufficient to meet the industry's dramatically expanded capacity to originate them, the only way to make up the deficit in new demand is for lenders to encourage existing customers to borrow more frequently. This means developing marketing and other strategies to convert occasional users of payday loans into habitual borrowers.

Considerably less data are available on the aggregate size of the market for payday loans than there exists on the characteristics of borrowers. An analyst for Atlanta-based Stephens Inc., a consulting firm that closely follows the industry, estimates that about 5% of the U.S. population has taken out at least one payday loan at some time (Chandler, 2001). An industry trade organization reports that more than 24 million Americans (10% of the population) say they are somewhat or very likely to obtain a payday advance (Community Financial Services Association of America, n.d.). Taken together, these estimates suggest that the industry has thus far penetrated about half its potential market and that there are substantial unrealized growth opportunities without having to entice existing customers to borrow more frequently.

Who Are the Customers?

However one might describe them—as hardworking, middle-class Americans without a cushion of liquid assets; as young families who have not yet reached their peak earning years; or as vulnerable women on welfare—there is widespread agreement that most payday loan customers are credit constrained.[5] Nearly all payday advance customers (91.6%) use other types of consumer credit. According to Elliehausen & Lawrence (2001), for example, more than 60% of payday loan customers use bank or retail credit cards, and 79% use closed-end consumer credit.[6] Relative to all U.S. adults, three times the percentage of payday loan customers are seriously debt burdened and have been denied credit or not given as much credit as they applied for in the last 5 years

(Elliehausen & Lawrence, 2001). Payday loan customers are also about four times more likely than all adults to have filed for bankruptcy (Elliehausen & Lawrence, 2001).

Family stereotypes aside, the core market for payday loans are from households with checking accounts, steady employment, impaired credit, and annual incomes under $50,000 (Elliehausen & Lawrence, 2001). How much under $50,000 depends on geography and source of the data. For instance, Indiana regulators report payday loan customers to be in the $25,000 to $30,000 income range (Wisconsin Department of Financial Institutions, n.d.). In Illinois, the average is $24,000 (Illinois Department of Financial Institutions, Consumer Credit Division, n.d.). Borrowers in Wisconsin, according to state regulators, are even less affluent, with an average income of just $19,000 (Wisconsin Department of Financial Institutions, n.d.).

Although Elliehausen & Lawrence's (2001) national customer survey made no mention of race, the recently published North Carolina Financial Services Survey (NCFSS), which we conducted under contract with the North Carolina Department of Health and Human Services, found distinctly different racial patterns of payday loan use (Stegman & Faris, 2001).

Conducted in late 2000, the NCFSS was a statewide telephone survey of 1,501 North Carolina families with incomes under $30,000. By design, we oversampled current and former welfare recipients, Hispanics, and residents of Charlotte and Wilson, which enabled us to generalize our results statewide as well as to lower income families in North Carolina's largest city and a representative rural community. The Health and Human Services department selected the representative communities. Technical specifications of the NCFSS—including sample frame, survey methodology, statistical weights, and response rates—can be found in our monograph, *Welfare, Work and Banking* (Stegman & Faris, 2001).

According to the NCFSS, 6% of all families with incomes under $30,000 had taken out at least one payday loan in the 24 months preceding the survey. African American households were about twice as likely to borrow from a payday lender as Whites (see Table 4). About 10% of low-income Black families had taken out at least one payday loan in the previous 2 years, compared to 5% of all lower income Whites. More problematic was the fact that once families used this easy-to-obtain credit, many became chronic borrowers. One sixth of all lower income White borrowers and nearly one third of African American customers either renewed their loan or paid it off and took out a new one at least once a month.

Regardless of race, families who had been involved with the welfare system in North Carolina were also more likely than other families to take out a payday loan. About 10% of all current welfare recipients and 20% of those who had transitioned off welfare in the past 18 months had recently taken out at least one payday loan. More than one fifth of the latter and more than 40% of current welfare customers had become chronically dependent on payday loans, taking out at least one loan a month over the previous 2 years.

Because about 40% of families involved with the welfare system are unbanked and therefore cannot obtain a payday loan, effective borrowing rates among welfare families with checking accounts are much higher than those reported earlier. This kind of chronic indebtedness—the stringing together of one payday loan after another in an effort to make up the deficit until the next paycheck or benefit payment arrives—makes the transition of welfare to the workforce all the more challenging (see Table 4).

Modeling Borrower Behavior

Table 4 characterizes the frequency of payday loan use by race and welfare status, but it does not account for the possible confounding influences of other family factors, such as education, marital status, or employment. Therefore, the demand for payday loans among lower income families in North Carolina was modeled using a multivariate regression technique that allowed for the isolation of specific borrower characteristics and circumstances.

We hypothesize that a lower income household's likelihood of patronizing a payday lender is a function of its socioeconomic characteristics, welfare status, savings behavior, credit history, and neighborhood characteristics having to do with proximity to mainstream and fringe banks. The

TABLE 4
Payday Loan Use Among Lower Income Households, by Race, North Carolina, 2001 (in percentages)

Borrowed in	*the Past 2 Years*	*Once or Twice a Year*	*Three or Four Times a Year*	*Monthly*	*Biweekly*
Overall[a]	6.4	52.7	26.4	12.0	8.9
White	5.2	57.8	27.4	13.2	1.6
Black	10.1	44.6	24.6	8.8	22.1
Hispanic[b]	4.2	—	—	—	—
Other[b]	0.0	—	—	—	—
Current Work First[c]	10.4	37.1	22.4	19.1	21.4
Recent Work First[d]	18.7	58.2	19.4	18.2	4.2

SOURCE: Center for Community Capitalism, North Carolina Financial Services Survey, 2001.
a. N = 1,169 banked and recently banked (within the past 2 years) households.
b. Insufficient observations for borrowing frequency.
c. Households receiving benefits at the time of the survey.
d. Households that received benefits between January 1999 and January 2000.

rationale for our a priori expectations of the influence of the independent variables in our borrower models are briefly summarized below.

Race and ethnicity. Relative to White non-Hispanics, we expect relatively more minority households to use payday loans than Whites. This is consistent with empirical studies of subprime and predatory mortgage lending activity and an extensive literature on discrimination in credit markets, which suggests that Blacks and other minorities have less access to mainstream sources of credit (Bradford, 2002).

Education. We expect an inverse relationship between the use of payday lenders and years of schooling because more highly educated people should be more fully informed of available credit options and their costs and the serious consequences of carrying excessive debt.

Welfare status. Because of their extremely low incomes, we expect current welfare recipients to be less likely to use payday loans than non–welfare recipients, whereas former recipients, because of the added expenses of preparing for a job and working, would be more likely to take out one or more payday loans.

Income. Because the NCFSS is a survey of low-income households, we do not expect to find a strong relationship between income tier (less than $10,000, $10,000 to $20,000, etc.) and payday loan use. However, we expect that families closer to the upper limit of our survey—those between $20,000 and $30,000—would be somewhat more likely to use payday loans than others.

Employment. Because most payday lenders require a borrower to have a paying job to qualify for a loan, we would expect households with no employed adult to be less likely to use payday loans.

Household composition. If one controls for the number of children and other factors, single adult households are less likely to use payday loans than are married or unmarried couples because fewer adults in the household translates to less demand for credit.

Age. The life cycle model of savings posits declining credit use over time as older people finance consumption from accumulated savings (Bloom, Canning, & Graham, 2002). Therefore, we would expect to find an inverse relationship between age and use of credit, including payday loans.

Children. Because of the greater needs of households with children, we would expect to find a positive relationship between number of children and the use and frequency of payday borrowing.

Savings-related variables. People who save regularly and have been brought up in a family that had a banking relationship are less likely than others to use payday loans, but those with no savings are more likely to use payday loans.

Credit-related variables. Households with impaired credit, reflected by bouncing checks, working with a credit counselor, or being referred to a collection agency for failure to pay bills on time are more likely to use payday loans.

Geography. Because banks and payday lenders in North Carolina are generally interspersed in the same neighborhoods, we do not expect to find a significant relationship between the number of local banks and a household's use of payday loans. However, we do expect to find greater use of payday lenders in neighborhoods experiencing more rapid growth in the number of outlets.

Empirical Results

We estimate two separate models: The first uses for its dependent variable a binary indicator of whether a household used a payday lender at all in the past 2 years; the second analyzes the frequency with which customers used the service, based on the frequency categories shown in Table 4. We estimate the former using logistic regression and the latter, ordered logistic regression. These techniques allow us to estimate the relative likelihood of using a payday lender at all and for those who do, the frequency with which they borrow.

We tested for multicolinearity using the Variance Inflation Factor (VIF), calculated by reestimating the models in ordinary least squares, as suggested by Menard (1995). In the binary model, average VIF was 2.07, and no variable was higher than the suggested cutoff of 10. In the ordered model, average VIF was 5.09, and just two variables—bank branches (VIF = 15.7) and growth in check cashers (VIF = 14.0)—had higher than the accepted cutoff of 10. We include them in the model because of their theoretical importance and because none of the cases was completely determined by the independent variables. Moreover, no substantive changes occurred in the other coefficients when the county variables were dropped from the ordered logit.

The results confirm the importance of race, with one exception. Controlling for other family characteristics, the model confirms that lower income African American families in North Carolina are more than twice as likely to have taken out a payday loan in the past 2 years than have White non-Hispanic families (see Table 5). However, contrary to our expectations, Hispanics are much less likely than non-Hispanic Whites and African Americans to patronize payday lenders. In related research not presented here, Kidd, Faris, and Stegman (2002) found that low-income Hispanics were more likely to access short-term credit from pawnbrokers than from payday lenders. Although race matters when it comes to using a payday lender, once a customer, race does not affect the frequency of borrowing.

Education also matters, but more schooling does not consistently dissuade householders from taking out a payday loan. Although there are no differences in the likelihood of using a payday lender among those with 12 through 16 years of education, controlling for other socioeconomic and credit factors, high school dropouts are much less likely to use payday lenders than are college graduates. Moreover, among active customers, the lower the education, the less frequent the borrowing.

We found no statistically significant welfare effects. When we controlled for other factors, current and former recipients were as likely to have taken out a payday loan at least once over the previous 2 years as were all other low-income families in North Carolina. Contrary to expectations, former recipients are less frequent borrowers than are families who have never received welfare.

Neither a householder's employment status nor the number of adults in the household affects the threshold decision to use payday loans as a source of credit, although, conditional upon having taken out at least one loan, single-adult households are less frequent borrowers than are married or unmarried couples.

Age behaves as expected. Each year of age reduces the likelihood of using a payday lender by 2%, which means, for example, that a 40-year-old householder is just 80% as likely to have used a payday lender as a 30-year-old. Moreover, the older the customer, the less frequent the borrowing.

We found no statistically significant relationship between a lower income household's savings behavior and use of payday loans, as we thought we would, but adults who were raised in families in which parents had a banking relationship are less likely to be payday borrowers. This might reflect a greater awareness of credit options and is consistent with related research that shows adult children's portfolio holdings are influenced by the holdings of their parents (Chiteji & Stafford, 1999).

TABLE 5
Use of Payday Lenders and Frequency of Borrowing, Lower Income Families, North Carolina, 2001[a]

	Overall	*Used a Payday Lender*[b]			*Frequency of Use*[c]		
	Mean	*Coefficient*	*Odds*	SE	*Coefficient*	*Odds*	SE
Race and ethnicity of household head							
African American	26.9%	0.80*	2.23	(0.33)	2.10	8.14	(1.44)
Hispanic	6.0%	–2.28†	0.10	(1.42)	–0.19	0.83	(6.23)
Other minority	1.5%	0.56	1.76	(1.56)	2.79	16.34	(3.72)
Education level							
High school dropout	18.0%	–2.40**	0.09	(0.88)	–6.32	0.002	(2.51)
High school graduate	39.9%	–0.26	0.77	(0.44)	–3.65*	0.03	(1.57)
Attended college	24.5%	–0.15	0.86	(0.46)	–2.58	0.08	(2.01)
Welfare and food stamp status							
Current Work First participant[d]	2.1%	–1.32	0.27	(0.93)	–2.91	0.05	(2.37)
Recent Work First participant[e]	2.4%	–0.89	0.41	(0.90)	–3.05†	0.05	(1.75)
Income							
$10,000 to $15,000	22.7%	0.07	1.07	(0.43)	3.28*	26.59	(1.61)
$15,000 to $20,000	15.5%	–2.92***	0.05	(0.74)	–0.11	0.89	(1.74)
$20,000 to $25,000	14.6%	–0.34	0.71	(0.45)	1.27	3.57	(1.63)
$25,000 to $30,000	25.1%	–0.91*	0.40	(0.43)	–3.15†	0.04	(1.75)
Household variables							
No employed adult	47.6%	–0.25	0.78	(0.46)	–2.79	0.06	(2.23)
Single	46.6%	0.10	1.10	(0.31)	–2.15†	0.12	(1.18)
Age of head	53.4	–0.02†	0.98	(0.01)	0.20***	1.22	(0.06)
Number of children	0.6	0.02	1.02	(0.12)	0.59	1.81	(0.83)
Other socioeconomic variables							
Contributes to savings at least every month	28.0%	–0.47	0.62	(0.37)	–1.16	0.31	(1.49)
Has no savings	33.2%	0.28	1.32	(0.36)	0.51	1.66	(1.82)
Parents were banked	60.2%	–0.91*	0.40	(0.39)	–0.94	0.39	(1.53)
One or more NSF checks in past 5 years	24.0%	1.40***	4.06	(0.33)	–0.18	0.83	(1.30)
Has worked with a credit counselor	7.2%	1.46***	4.31	(0.40)	–0.98	0.38	(1.09)
Called by a collection agency for overdue bills	30.3%	–0.06	0.94	(0.33)	6.38***	589.98	(1.74)
County variables							
Number of bank branches, 2000	52.6	–0.01†	0.99	(0.01)	0.05**	1.05	(0.02)
Change in number of check cashers, 1998-2000	10.4	0.06*	1.07	(0.03)	–0.24*	0.79	(0.10)
Constant 1		–1.13	—	(1.12)	11.58	—	(4.35)
Constant 2		—		—	15.26	—	(4.48)
Constant 3		—		—	19.55	—	(4.93)
Log likelihood		–183.8			–49.0		
Chi-square		122.0***			163.8***		
N		910			114		

SOURCE: Center for Community Capitalism, North Carolina Financial Services Survey, 2001.
NOTE: NSF = Not Sufficient Funds.
a. Reference categories are White, college graduate, income < $10,000, married, and had not received welfare recently.
b. Logistic regression.
c. Ordered logistic regression.
d. Households receiving benefits at the time of the survey.
e. Households that received benefits between January 1999 and January 2000.
$^{*}p < .05$. $^{**}p < .01$. $^{***}p < .001$. $^{\dagger}p < .05$, one-tailed test.

The cluster of credit-related variables included in our model also behaves as expected. Households with impaired credit—measured variously by bounced checks, collection agency referrals, and so forth—are much more likely than others to both use payday lenders and, at least with respect to the latter, to be more frequent borrowers. This part of our model confirms the primacy of a family's credit circumstances over education. These results are generally consistent with Elliehausen

and Lawrence's (2001) survey that found "families with high school graduates and/or adults who have attended, but not graduated from college, are less likely to have taken out a payday loan than an otherwise similar family containing one or more college graduates" (p. 33).

Finally, the neighborhood mix of mainstream and fringe banks does affect payday loan use although not in a straightforward way. Although the number of FDIC-insured banks and thrifts in a household's neighborhood has a small but statistically significant negative effect on the use of payday lenders, the recent rapid growth in the number of local payday lenders has a much greater, positive influence on use. For each new neighborhood payday loan outlet opened between 1998 and 2000, the likelihood of having taken out a payday loan during that time increased by 6%. However, the more rapid the growth, the less frequently individuals borrow. A plausible interpretation of this finding is that the new outlets are responding to a growing customer base, which, over time, may become frequent borrowers and more dependent on payday loans as a source of longer term credit.

That the payday loan industry's customer base consists largely of credit-impaired families is problematic but not necessarily of policy concern. That a large number of consumers are becoming dependent on this high-cost credit, which is largely exempt from state usury laws because of its occasional nature, should be of interest to policy makers and is a topic to which we now turn.

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THE TROUBLING ISSUE OF ROLLOVERS

Rollovers occur when a borrower cannot repay a loan that is due and so renews it for another short term by paying another fee.

> To avoid appearing to "roll over" the debt, some lenders ask the debtor to take out a "new loan" by paying a new fee and writing another check. Also, in a practice called "touch and go," lenders take a cash "payoff" for the old loan that they immediately reloan with new loan funds. Irrespective of whether the repeat transactions are cast as "renewals," "extensions," or "new loans," the result is a continuous flow of interest-only payments at very short intervals that never reduce the principal. (*Janet Livingston v. Fast Cash USA Inc., n.d., p. 6)*

Because of the high fees and very short terms, borrowers can find themselves owing more than the amount they originally borrowed after just a few rollovers within a single year. For example, in the course of site examinations of licensed lenders, Illinois regulators found evidence of "customers who were borrowing continuously for over a year on their original loan" (Illinois Department of Financial Institutions, n.d., p. 8).[7]

As suggested earlier, the industry defends its high fee structure largely on the grounds that "because many of the costs of consumer lending do not vary by loan size, small loans are relatively more costly per dollar to originate and service than are large consumer loans" (Elliehausen & Lawrence, 2001, p. 3). Because, the argument goes, payday loans are one of the few accessible sources of very short-term, *occasional* credit for hard-pressed consumers and are *not* intended to be a source of longer term credit, the annual percentage rate (APR) is not a fair way of assessing the reasonableness of the industry's charges. In North Carolina, for example, the median payday loan fee of $36 for the median loan of $244 in 2000 translates to a median APR of 419%. For a 7-day loan, the same loan parameters produce a 920% APR, and more than 7% of all loans in 2000 had a term of 7 days or less (see Table 6).

As one owner of a North Carolina payday loan company put it when discussing the legitimacy of using APR as a measure of fees,

> You could take a taxi from Raleigh to Cary [about a 2- or 3-mile trip], or you could take the same taxi from Raleigh to Seattle for exactly the same rate, but the total expense would be ridiculous. It would be much cheaper to fly. It would be silly for a cash advance customer to take a single cash advance for an entire year. (Stegman & Skillern, 2000, p. 15)

But, he then added, "We can't always control consumer behavior."

TABLE 6
APR of Payday Loans, North Carolina, 2000

Term	*Percentage of Loans*[a]	*APR*[b] *Range*
1 to 7 days	7.4	6,441-920
8 to 14 days	52.8	805-460
15 to 21 days	21.9	429-307
22 to 28 days	7.2	293-230
29 to 31 days	10.7	222-208

SOURCE: North Carolina Commissioner of Banks, 2001.
NOTE: APR = Annual percentage rate.
a. $N = 164$.
b. APR = (fee amount/cash advance) × (365/term in days) × 100.

Thus, whether rollovers are a serious regulatory and policy issue is a matter for empirical determination. If repeated, chronic borrowing is as commonplace as it appears, then the triple-digit APRs charged by most payday lenders may go beyond what is fair and become abusive and predatory (Riccobono, 2000).

That rollovers are widespread is documented in a national study of payday loan customers, in regulatory audits and examinations, and in a detailed study we conducted in North Carolina. Elliehausen & Lawrence (2001) reported that 25% of the customers in their national sample didn't roll over a single loan, but about 40% rolled over more than five loans in the preceding 12 months, including 10% who renewed an existing loan 14 or more times.

Wisconsin regulators examined 17 payday loan locations throughout the state in 2001 and found that 53% of the more than 3,600 payday loans analyzed were rollovers, meaning they were either paid off by the proceeds of a new loan or were paid off in full on the same day a new loan was taken out (Wisconsin Department of Financial Institutions, n.d.). The Indiana examiners reviewed more than 5,300 payday loans originated from July 1, 1999, to September 30, 1999, tracking multiple loans made during the previous year to the same consumer. The result showed that the average payday customer took out more than 10 loans per year (Indiana Department of Financial Institutions, n.d.). That was a little less than in California ("Stop Legal Loan Sharks," 2001) and Illinois (State Public Interest Research Groups & Consumer Federation of America, 2000), where repeat usage rates within a single year were reported to be 11 and more than 12, respectively.

The now-expired North Carolina statute authorizing payday lending addressed the problem of rollovers in two ways. First, it prohibited any check casher or affiliate from repaying one deferred deposit check with the proceeds of another deferred deposit check. Second, the statute stated that a check casher "shall not, for any consideration, renew or otherwise extend any postdated or delayed check or withhold such check from deposit for any period beyond the time set forth in the written agreement with the customer" (An Act to Regulate, 1997, Sec. 53-281). The law provided that "a licensee shall not, for any consideration, renew or otherwise extend any postdated or delayed check or withhold such check from deposit for a period beyond the time set forth in the written agreement with the customer" (Sec. 53-281).

Results of annual mail surveys of payday loan companies conducted by the North Carolina Commissioner of Banks suggest that existing statutory limitations on rollovers are not very effective. According to the commissioner, the average payday loan customer in North Carolina took out about seven loans in 2000, a sizable increase over the 1999 level of 5.8 loans (see Table 7.) Notwithstanding the state's prohibition of rollovers, 18% of customers used the services of the *same* lender more than once a month in 2000, including 7% who took out or rolled over their loans more than 20 times in a 12-month period (see Table 8). In 1999, 201 of 220 companies responded to the commissioner's survey, for a 91% response rate; in 2000, the response rate was 96%.

These statistics . . . understate the real magnitude of the problem because they do not account for a family's use of more than one payday lender at a time or the use of a loan from one payday lender to pay off another.

These statistics are striking by themselves, but they understate the real magnitude of the problem because they do not account for a family's use of more than one payday lender at a time or the use of a loan from one payday lender to pay off another—"borrowing from Peter to pay Paul." The reason for this is that the bank commission survey asked each company to report the total number of

TABLE 7
Average Number of Loans per Payday Borrower, by Company, North Carolina, 1999 and 2000

	1999	*2000*	*Change*	*% Change*
All payday lenders[a]	5.8	7.3	1.5	26
Small companies (1-2 locations)	5.6	7.4	1.8	32
Medium companies (3-10 locations)	5.8	7.1	1.3	22
Large companies (11+ locations)	6.7	7.1	0.4	6
New companies in 2000 (*N* = 29)	—	4.4	—	—

SOURCE: North Carolina Commissioner of Banks (2000, 2001).
a. *N* = 130 companies operating in both 1999 and 2000.

customers, and no cross-checking was possible to avoid double-counting those customers who borrowed from multiple lenders. The extent of underestimation is potentially large: If each customer patronized just two different payday loan companies within a given year, the total number of individual customers would be halved, and the average number of loans per customer would double to 14.

Although the use of multiple lenders in North Carolina cannot be tracked, the practice does occur, as the following account of one local borrower attests:

> I used five [payday lenders]. I went because I was on disability and my check only comes at the end of the month. I told them I couldn't pay every two weeks. . . . I had to go to the other ones, and this is how I got hooked. I got arrangements with all of them. I owe about $1,000. . . . It's a nightmare. I warn people if you don't have to mess with them, please don't. You can get hooked on them. . . . So I warn, if you don't have to, please don't. (Stegman & Skillern, 2000, p. 27)

Because their survey is customer based and national in scope, Elliehausen & Lawrence (2001) are able to address the concurrent borrowing issue more directly than does any other study with which we are familiar. They confirm our anecdotal findings—47% of their respondents had obtained payday loans from more than one company in the 12 months preceding the survey, and, of these, almost two thirds used two companies, one quarter used three companies, and 13% used four or more companies.

Although a majority of Elliehausen & Lawrence's (2001) respondents thought that government should neither limit their access to payday loans nor regulate prices, a significant number felt otherwise: 30% either strongly agreed or somewhat agreed that "the government should limit the number of payday advances I can get in a year"; 36% believed that "the government should limit the number of times a payday advance can be renewed without a break" (p. 35).

Table 8 illustrates the importance of rollovers and repeat business to North Carolina companies' bottom lines. For example, 38% of all customers took out one to three loans in 2000 and accounted for 12% of total payday-lending revenues. In contrast, 18% of all borrowers took out a new loan or rolled over an existing loan at least once a month throughout the whole year, and they generated 40% of all gross payday loan fees (Skillern, 2002).

Modeling Industry Revenues

As we did earlier with respect to borrower behavior, we used multivariate statistical techniques to analyze the individual influence of specific business practices, such as APR and company size, on industry revenues in North Carolina, while holding constant other factors. Two different measures of company revenues are used: total revenues from payday lending and a measure referred to as modified gross income (MGI). MGI is defined for each outlet as total fees from payday lending plus returned check fees (technically referred to as not sufficient funds, or NSF, fees), less the sum of three separate expense elements: outlet-level payroll costs, losses due to uncollectible loans, and

TABLE 8

Percentage of All Payday Loan Fees Attributable to Repeat Customers, North Carolina, 2000

	Overall[a]			*Small Companies*[b]		*Medium Companies*[c]		*Large Companies*[d]	
Number of Loans	*Percentage of Revenues*	*Percentage of Customers*	*Total Customers*	*Percentage of Revenues*	*Percentage of Customers*	*Percentage of Revenues*	*Percentage of Customers*	*Percentage of Revenues*	*Percentage of Customers*
1 to 3	11.6	37.5	155,139	10.9	35.6	13.0	42.3	12.1	38.5
4 to 6	15.2	19.6	81,051	15.4	20.0	14.2	18.3	15.9	19.9
7 to 12	32.5	24.7	102,260	33.0	25.7	30.7	21.9	32.9	24.7
13 to 19	22.5	11.6	47,901	22.5	12.1	23.2	10.9	21.2	10.5
20 to 24	11.6	4.6	18,955	11.4	4.6	12.7	4.9	11.1	4.1
25 or more	5.9	1.9	7,908	5.8	1.9	5.7	1.7	6.7	2.1
Total	100	100	413,214	100	100	100	100	100	100

SOURCE: North Carolina Commissioner of Banks (2001).

a. $N = 135$, excluding companies that were not in business for all of 2000.

b. 1 to 2 locations.

c. 3 to 10 locations.

d. 11 or more locations.

subscription costs for a screening service to determine whether the borrower has any outstanding payday loans with another company. Although MGI is not a true measure of profits or store-based cash flow, it is as close as we can get to a real bottom line because the Commissioner of Banks surveys do not collect full expense data.

Based upon existing research and our understanding of industry economics, we include in our model two clusters of independent variables that reflect "street traffic" and scale economies, including technology-based efficiencies, which we expect to be positively related to profits. The former is measured by the average number of customers per outlet, and the latter is determined by the number of outlets and the use of computerized office systems to originate, screen, and collect loans. Because of our interest in rollovers, we include the percentage of total customers who borrow at least monthly to separately capture the boost to outlet-level revenues accounted for by chronic borrowers.

Three additional independent variables—the use of a third-party screening service to identify high-risk applicants who are more likely to default on their loan and estimates of gross and net losses due to bounced checks—capture business acumen, including service and collection efficiencies. We expect the use of an outside screening service and high collection efficiencies to be positively related to revenues, whereas the higher the gross rate of bad loans made, the lower the revenues.

We also include the average APR in our revenue model, which, in the case of payday lending, is largely a function of loan term because most companies charge the maximum fees permitted by law. We expect APR to be positively related to revenues. The final two independent variables—whether the company offers check-cashing services in addition to payday loans and a measure of companies new to North Carolina—are included as controls.

Because our dependent variables are continuous, we use ordinary least squares to estimate both models. However, because our independent variables use different metrics—some are measured in percentages, some in dollars, and others in absolute numbers—and we want to be able to estimate the relative importance of each variable as well as its absolute importance to an outlet's bottom line, we standardized the regression coefficients. Standardizing the coefficients allows us to quantify and rank the independent variables by their respective degrees of explanatory power.

The models of outlet-level financial performance using both total revenues and MGI produce consistent results. In each case, the most powerful explanatory variable of financial performance is the number of customers who patronize the outlet. Also, in both models, the measure of rollovers—the percentage of customers who are chronic borrowers, taking out at least one loan per month—is the second most influential determinant of outlet-level revenues.

The results provide useful insights into the underlying business model of the payday loan industry (see Table 9). First, the model confirms the existence of scale economies as gross revenues per outlet increase with the number of outlets a company operates, even when controlling for the number of customers per outlet. Second, as one might expect, the lower the incidence of bad loans, the better the bottom line. However, the model clearly illustrates the primacy of location and convenient access, which generate maximum street traffic, over minimizing bad loans. However, contrary to expectations, use of a screening service does not, other things being equal, improve outlet-level revenues. This is consistent with Illinois regulators' finding that "some licensees do not subscribe since they do not want to incur the added cost, while others do not want to lose the added volume of customers that would be eliminated" (Illinois Department of Financial Institutions, Consumer Credit Division, n.d., p. 28).

The average payday loan company in North Carolina had more than 3,100 individual customers in 2000, an increase of about 13% over the previous year (see Table 10). The big difference between the mean and median customer base reflects the tremendous variation in company size and number of outlets owned. This is also true for the number of outlets operated by licensed lenders. The average payday lender originated more than $6.2 million in loans in 2000, a 28% increase in dollar volume over 1999. With the average number of individual loans growing a robust, but lower, 19%, the growth in the number of companies and outlets accounted for a sizable portion of the expanded loan volume between 1999 and 2000.

TABLE 9
Ordinary Least Squares Regression of Gross Revenues[a] From Payday Lending per Outlet,[b] North Carolina 2000

	Coefficient	SE	*Standardized*	M
Constant	27.15*	(13.75)	—	
Number of outlets	0.89***	(0.20)	0.11	5.5
Customers per outlet	0.22***	(0.01)	0.89	352.4
Subscribes to a screening service	1.27	(5.42)	0.01	0.75
Uses a computer data management system	9.49	(5.12)	0.05	0.73
Total value of NSF checks as a percentage of the total value of all checks	–0.46	(0.48)	–0.03	6.57
Percentage (by value) of NSF checks recovered	–0.01	(0.08)	0.00	67.37
Minimum average APR[c]	–0.10***	(0.03)	–0.10	417.3
Percentage of customers who borrow at least monthly	1.06***	(0.18)	0.17	20.1
Offer check cashing services	–4.05	(4.87)	–0.02	0.69
New company in 2000	–4.82	(6.46)	–0.02	0.18
Adjusted R^2: .913				
F test: 162.9***				

SOURCE: North Carolina Commissioner of Banks, 2000.
NOTE: NSF = not sufficient funds; APR = annual percentage rate.
a. Payday lending fees plus NSF fees, in thousands of dollars.
b. N = 156 companies.
c. The minimum APR for each loan term (≤ 1 week, 1-2 weeks, etc.) is used.
*$p < .05$. **$p < .01$. ***$p < .001$.

TABLE 10
Basic Payday-Lending Statistics, North Carolina, 1999 and 2000

	1999[a]		*2000*[b]		*Change*		
	Median	*Mean*	*Median*	*Mean*	*Median*	*Mean*	*% Change*
Total customers[c]	463	2,828	549	3,188	89	360	13
Number of payday loans	2,621	21,744	4,206	25,814	763	4,071	19
Total value of all loans	$664,928	$4,858,473	$992,860	$6,215,170	$215,818	$1,356,697	28
Number of locations	2	6	2	6.3	0	0.37	6
Average loan size	$234	$234	$244	$238	$7	$3	1

SOURCE: North Carolina Commissioner of Banks (2000, 2001).
a. N for 1999 = 201 total, 142 payday lenders, 146 check cashers.
b. N for 2000 = 233 total, 165 payday lenders, 182 check cashers.
c. Customer data was collected only for payday lending operations.

The proposition tested was that payday lenders who cultivate more repeat business from existing customers—measured as the percentage of all customers who take out a new loan or roll over an existing loan at least once a month—will fare better financially than those who do not. Significantly, this independent variable is the second most important determinant of financial success. Each 1% increase in customers who borrow at least monthly generated a $1,060 increase in gross outlet revenues in 2000.

Finally, APR, which is a proxy for the cost of money, is shown to affect the bottom line: The higher the APR, the lower gross revenues. Unlike fees, which are a relatively constant 15% of loan principal, APR is almost exclusively a function of loan term, rising as the term decreases. The model suggests that payday lenders who reduce loan term in the hopes of encouraging more repeat business may discourage some future business. Because the model controls for number of customers and chronic borrowers, the negative relationship between APR and outlet revenues may reflect

The proposition tested was that payday lenders who cultivate more repeat business from existing customers . . . will fare better financially than those who do not. Significantly, this independent variable is the second most important determinant of financial success.

a reduction in the frequency of borrowing by those who are among the occasional and moderately active customers (i.e., those who take out one to seven loans per year).

When we quantified the above findings, other things being equal, each payday customer generated an additional $220 in outlet revenues. Reflecting scale economies, holding constant the number of customers per outlet, each additional outlet increased gross revenues per outlet by $500. Each 1 percentage point of payday loan checks that fail to clear when the lender deposits them (so-called NSF checks) reduces revenues by $460 per outlet, whereas each percentage point increase in the average APR decreases revenues by $90.

As mentioned above, similar results are achieved using MGI as the dependent variable, which reduces gross revenues by the sum of payroll costs, screening services, and net losses from uncollectible checks (see Table 11). The median MGI per outlet was about $41,000 in 2000, with the top quarter of all outlets earning $81,000 or more. In general, MGI per outlet increases with company size, reflecting both scale economies and the big companies' larger customer base (see Table 12).

It is important to confirm the importance of repeat borrowers to a company's MGI. Each 1% increase in monthly borrowers increases MGI per outlet by $790. Not only does this variable retain its importance as a determinant of outlet-level income, but the share of a company's borrowers who take out at least one loan a month increases in importance using MGI as the revenue measure (compare the size of the standardized coefficients in Tables 9 and 11).

We know of no other studies that directly link rollovers to company revenues, but there are other indications that this is the case. For example, a federal examination of one of the country's biggest payday lenders found that Dollar Financial (partnering with Eagle National Bank) provided incentives to its employees to actively promote repeat borrowing, "which resulted in a higher volume of rollovers than new loan originations and a misuse of the loan product for long-term credit" (U.S. Comptroller of the Currency, 2002, p. 2). Also, Illinois regulators noted in a recent report on payday lending that, even when a single licensee has a limited customer base, "if the customer regularly refinances a loan the store may be quite profitable" (Illinois Department of Financial Institutions, Consumer Credit Division, n.d., p. 6).

CONCLUSIONS

This article confirms two related truths about payday lending. First, there is no denying the large and growing demand for this consumer credit and the rapidly expanding network of companies willing to supply it. Second, despite its expanding customer base and notwithstanding industry denials, the financial performance of the payday loan industry, at least in North Carolina, is significantly enhanced by the successful conversion of more and more occasional users into chronic borrowers. Not only does our empirical research support this conclusion, but the federal government has found that one of the country's biggest payday lenders provides financial incentives to its staff to encourage chronic borrowing by individual patrons.

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In the extreme, the business practices pursued by many payday loan companies can have the same wealth-depleting effect on financially fragile families as other abusive consumer credit practices. For this reason, payday lending should be receiving the same kind of serious policy scrutiny predatory mortgage lending is currently getting from Congress and the states.[8] The purpose of this final section is to (a) frame the policy discussion; (b) underscore the need to build financial education into school curricula and community development policies; and (c) encourage banks, thrifts, and credit unions to take a fresh look at the commercial potential of expanding their business lines to include less expensive and more consumer friendly payday loanlike products.

The Future of Payday Lending in North Carolina

After a 1-month extension of a 4-year test run, during which the North Carolina General Assembly failed to reach a consensus on a reform measure that would have removed the law's sunset provision, the statute authorizing payday lending in North Carolina permanently expired on August

TABLE 11

Ordinary Least Squares Regression of Modified Gross Income[a] per Outlet, North Carolina, 2000

	Coefficient	SE	*Standardized*	M
Constant	22.07	(12.65)	—	
Number of outlets	0.50**	(0.18)	0.09	5.5
Customers per outlet	0.14***	(0.01)	0.85	352.4
Subscribes to a screening service	–1.30	(4.99)	–0.01	0.75
Uses a computer data management system	3.93	(4.76)	0.03	0.73
Value of NSF checks as a percentage of total value of all checks	–1.02*	(44.41)	–0.09	6.57
Percentage (by value) of NSF checks recovered	0.14	(7.72)	0.06	67.37
Minimum average APR[b]	–0.09***	(0.02)	–0.12	417.3
Percentage of customers who borrow at least monthly	0.79***	(16.22)	0.19	20.1
Offers check cashing services	–3.30	(4.50)	–0.03	0.69
New company in 2000	2.40	(5.97)	0.01	0.18
Adjusted R^2: .839				
F test: 80.58***				

SOURCE: North Carolina Commissioner of Banks (2001).
NOTE: $N = 154$. NSF = not sufficient funds; APR = annual percentage rate.
a. Modified gross income = (payday lending fees + NSF fees) - (NSF losses + NC payroll + screening costs).
b. The minimum APR for each loan term (≤ 1 week, 1-2 weeks, etc.) is used.
*$p < .05$; **$p < .01$; ***$p < .001$.

TABLE 12

Modified Gross Income From Payday Lending[a] per Outlet, North Carolina, 2000 (in dollars)

	25%	*Median*	*Mean*	*75%*
All companies offering payday loans[b]	11,634	41,198	57,599	80,799
100% payday lenders only	16,594	37,653	62,969	101,359
Small companies (1-2 locations)	8,764	33,691	52,110	72,177
Medium companies (3-10 locations)	11,634	41,198	59,935	89,602
Large companies (11+ locations)	16,786	88,952	79,984	115,264
New companies in 2000 (N = 29)	584	7,451	21,419	38,106

SOURCE: North Carolina Commissioner of Banks (2001).
a. Modified gross income = (payday lending fees + not sufficient funds [NSF] fees) - (NSF losses + North Carolina payroll + screening costs).
b. $N = 161$.

31, 2001. Among the proposed reforms upon which legislators failed to agree were measures that would allow a lender to extend the effective term of the loan at no additional cost to the borrower (Procedure for Delayed Deposit Checks, 2001); reduce allowable fees on successive loans taken out by the same borrower during a single year; impose a 31-day minimum loan term and require a 30-day cooling off period between loans to the same consumer (Revise Law Governing Delayed Deposit Checks, 2001); reduce fees for successive loans during a calendar year (Improve Regulation of Payday Lenders, 2001); and regulate the practice of charter renting, which we discuss further below (Reform Payday Lending, 2001).

North Carolina is not the only state that has been unable to achieve political consensus on meaningful reforms. The National Conference of State Legislatures (2001) reported that 86 legislative measures relating to payday lending were defeated in 29 states during the 2000 legislative sessions. In their 2001 sessions, 28 states considered at least 78 separate bills related to check cashing and payday lending (National Conference of State Legislatures, 2002).

Immediately after the law sunset, the North Carolina Commissioner of Banks notified the industry that there was no longer any “lawful basis” for continuing to originate payday loans in the

state (Lingerfelt, 2001, p. 1). Notwithstanding the fact that the commissioner's cease and desist order included a prohibition against "payday lending transactions effected by 'agents' or 'facilitators' of out-of-state lending institutions" (W. Deaton, personal communication, November 28, 2002), at least 10 payday loan companies in North Carolina quickly established charter-renting relationships with at least seven out-of-state banks, some of them involving higher loan fees than the expired payday lending law previously allowed. Shortly after the law expired, North Carolina's Attorney General and Commissioner of Banks went to court in an attempt to stop Ace Cash Express, the Texas-based company with at least 16 stores in North Carolina, from continuing to make payday loans through its new bank partner, California-based Goleta National Bank (Bason, 2002).

Charter renting is a euphemism for partnerships between payday lenders and out-of-state banks and thrifts entered into to take advantage of federal laws granting all banks and thrifts the right to "export" their higher, home-state interest rates to lower-interest-rate states (Federal Deposit Insurance Act, 1980; Geller, 2001; The Home Owners' Loan Act of 1933, 1989; National Bank Act, 2002). Under this "rent-a-bank-type partnership," the payday lender becomes an agent of the bank, and the loan becomes a bank-originated transaction. In essence, customers in a state that either prohibits payday lending or includes payday loans under the state usury law "can walk into a payday loan store and walk out with high-interest money borrowed, at least on paper, from a faraway bank" (Geller, 2001).

Federal regulators have identified "the practice of renting a charter merely to collect a fee to allow a high-cost payday lender to circumvent state law" as an "inappropriate" use of the preemption privilege under federal statutes and have warned banks and thrifts engaging in such activities that they may face stiffer examinations as a consequence of the safety and soundness issues they raise (Federal Deposit Insurance Act, 1980; Geller, 2001; The Home Owners' Loan Act of 1933, 1989; National Bank Act of 1864, 2002). In North Carolina's case, the state law that such partnerships evade is the Consumer Finance Act, which, in the absence of a payday loan law, caps loans under $600 at a 36% APR.

At least two bills have been introduced in Congress to address some of the most extreme consumer protection abuses of payday lending, but none has received the kind of broad, bipartisan support necessary for enactment. Among the issues these measures would address include eliminating charter renting by federally insured depositories, mandating federal Truth in Lending Act disclosure requirements for all payday lenders across the country, capping interest rates, limiting fees, barring payday lenders from seeking criminal penalties for nonpayment of debt except in the case of fraud, and prohibiting lenders' use of coercive tactics to collect payday loan debt.[9] But despite the tough talk, neither federal regulators nor Congress has yet done the right thing and banned charter renting altogether.

To help mitigate the impacts of an eventual ban on charter renting, one of the country's biggest payday loan companies tried to buy its own bank. In July 2002, Ohio-based CNG Financial Corp. filed an application with Illinois regulators to buy the $5.2 million asset, Bank of Kenney (Kidd, Faris, & Stegman, 2002). CNG operates more than 700 Check 'n Go stores in 25 states, including 57 in North Carolina. All Check 'n Go loans would become bank loans if the bank transaction is approved, thereby allowing CNG to continue exporting its payday loan terms to all its outlets with impunity even if Congress were to end charter renting. This is why consumer advocates are strenuously opposing CNG's application.

Market Opportunities for Mainstream Financial Institutions

Arguing that "the state's payday lending industry holds people in 'economic bondage,'|" and should be shut down, North Carolina State Treasurer Richard Moore has urged the state's traditional banks to "do a better job of servicing their clients for an honest amount of profit." (Veverka & Johnson, 2001, p. B1) According to Moore and many community advocates, the prolific growth and profitability of payday lending reflect the failure of mainstream financial institutions to meet working peoples' demand for short-term credit. But, until recently, no mainstream financial

institution had chosen to reenter the small loan market by offering a product that would compete head-to-head with a payday loan.

Competition was limited to a few small community development credit unions that created low-cost credit alternatives to protect their members against what they considered to be the predatory practices of conventional payday lenders—products that were neither commercially viable nor widely available. An example is Florida-based Orange County Teachers Federal Credit Union People Helping People Program's interest-free loans of up to $500 for up to 6 months, for members in hardship (Credit Union National Association [CUNA], n.d., p. 6). Another example is Carolina Trust Federal Credit Union's Micro Loan program, an 18% $300 payroll deduction loan that, like a payday loan, does not require normal credit underwriting to qualify (CUNA, n.d., p. 7). Harahan, Louisiana-based ASI Federal Credit Union's Stretch Plan, a $500 line of credit at 18%, is another payday loanlike product that requires payroll direct deposit as a condition of eligibility (Woodstock Institute, 2001, p. 2).

In January 2001, the North Carolina State Employees Credit Union (NCSECU) recognized this untapped market and introduced its new Salary Advance Loan (SALO), which is the closest that any mainstream financial institution has come to creating a credit product of significant scale that favorably competes with payday loans in terms of price and cost recovery, if not profitability.

NCSECU, the second biggest credit union in the country, introduced SALO after an informal survey of branch managers found that in a single month, credit union members had written 4,000 checks to payday lenders (Nilsen, 2000). SALO is a reusable line of credit with a maximum loan of $500 and an APR of 11.75%. It is available to all NCSECU members who receive their salary by direct deposit. SALO advances are repaid automatically from the borrower's next direct payroll deposit (Nilsen).

Within SALO's first 9 months, NCSECU originated more than 40,100 loans totaling almost $15 million for more than 9,000 members. As with traditional payday loans, renewals are outnumbering new loans by a 3:1 margin, with the average SALO borrower having used the product more than four times in its first 9 months of availability.[10] Because it is a direct deposit–based program with automatic repayment, SALO is a low-cost and low-risk product from NCSECU's standpoint. Total charge-offs through the first 9 months of lending activity totaled $30,000, or just two tenths of 1% of cumulative loan principal.

Because one of NCSECU's purposes in introducing SALO was to help its members break the payday lending cycle, the success of the product is a mixed blessing. With renewals substantially outnumbering new originations, management is troubled that its payday loan substitute seems to be as habit-forming as the industry's more costly product. As a result, NCSECU has contracted with an outside organization to offer customers telephone-based financial counseling and debt management services, which brings us to the final issue of financial education.

Consumer Education

We hope that this article will draw as much attention to the consequences of not using credit wisely as it does to the importance of people's having ready access to short-term credit. Too often, credit counseling and financial education begin when people are already in a debt crisis. According to Federal Reserve Chairman Alan Greenspan, a greater degree of financial literacy cannot only improve the financial status of families but also "help avoid or ameliorate the negative consequences of uninformed decisions" (Federal Reserve Board, 2001).

All community institutions, including schools and faith-based organizations, need to do a better job of helping families learn how to manage their finances, use credit more responsibly, and, regardless of race or income, have access to all available credit options. Because family money management is critical to many public priorities—reforming welfare, fostering community and economic development, increasing homeownership, and facilitating savings and asset building by the working poor—the federal and state governments should make financial education a greater priority. The fact that chronic borrowing from payday lenders has become a necessity for so many former welfare recipients speaks volumes about the need to incorporate financial services and consumer credit issues into North Carolina's and other states' welfare reform programs.

RECOMMENDATIONS

Although some might argue that the way to deal with abuses discussed in this article is for North Carolina to join the states that ban payday lending outright, we do not agree that this is the best approach. The reality is that decent, hard-working families who end up with too much month left at the end of their money will go underground if necessary to get help. Consider this observation from the owner of a check cashing company in a state that prohibits payday lending. He sees the neighborhood loan shark turn up in one of his busiest stores every Friday afternoon to extend credit and receive payments from customers who have just cashed their paychecks. “Everyone knows the rules of the game,” the proprietor says. “The loan shark charges 20% for a 2-week loan” (personal communication, May 2001)

The reality is that decent, hard-working families who end up with too much month left at the end of their money will go underground if necessary to get help.

There are no simple answers. However, we think the North Carolina General Assembly should reauthorize payday lending in legislation that embodies several reforms discussed earlier, including imposing a 31-day minimum loan term, creating a 60-day cooling-off period between loans to the same consumer, prohibiting individual customers from simultaneously borrowing from more than one lender (when they apply for a new loan, requiring the customer to sign an oath that they do not have any other payday loans outstanding), and subjecting payday lenders who serve as agents for out-of-state banks to the same fees and regulations as those who do direct lending.

The new legislation should also broaden the banking commissioner’s data collection authority and the reporting obligations of licensees. The books of lenders should be examined on a regular basis, with special attention paid to back-to-back transactions, including those at multiple locations.

To help enforce the customer ban against multiple loans outstanding from more than one lender, the banking commission should look into how existing credit-reporting technology might be adapted for regulatory purposes. As we discussed earlier, many payday lenders already incorporate tracking technology into their risk management systems, and the banking commission could require licensed companies to report all payday loans to a specified agency. Then, after the state decided the number of outstanding payday loans an individual should be permitted to hold at any one time, as well as the minimum time that must elapse before an individual is eligible to take out another loan from the same or different lender, tracking technology could be used as an enforcement tool.

NOTES

1. Estimates vary; see, for example, Blackwell (2000), Community Financial Services of America (n.d.), Consmer Federation of America & U.S. Public Interest Research Group (2001), and Diekmann (2000).
2. Data from the North Carolina Commissioner of Banks 1998, 1999, and January 2001, as well as authors’ calculations.
3. Data from the North Carolina Commissioner of Banks (2000) and authors’ calculations.
4. Note the loan volume figure is for 1998, whereas the company and outlet growth data are for 1999.
5. The former is how Community Financial Services Association of America (n.d.), the payday loan industry trade organization, describes its customer base; the second description is from Elliehausen & Lawrence (2001), and the latter is how the Consumer Federation of America & U.S. Public Interest Research Group (2001) describe the industry’s consumer base.
6. A consumer loan for a fixed amount that usually carries a fixed interest rate with a fixed monthly payment.
7. Although the report is undated, it includes payday loan activity in Illinois as of June 30, 1999.
8. See, for example, The Predatory Lending Consumer Protection Act of 2002, sponsored by U.S. Sen. Paul Sarbanes of Maryland.
9. See, for example, H.R. 1055, Federal Payday Loan Consumer Protection Amendments of 2001, and H.R. 1319, the Payday Borrower Protection Act of 2001.
10. The detailed information about SALO was obtained through interviews with two SECU officials, Bobby Hall, senior executive vice president, and Mark Coburn, the loan administrator overseeing SALO.

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