Pay day lending is not harmful to low income borrowers

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According to the Consumer Financial Protection Bureau and consumer advocacy groups, payday lenders pose a threat to low income borrowers. But aside from the paternalism (and whiff of classism) inherent in the CFPB's recent regulatory proposal, the arguments against payday lending just don't stack up. If anything, they show that payday lenders provide a needed service that protects many people from hardship.

Starting at the top, one of the most prevalent arguments against payday lending is that it traps low income people in a cycle of debt. After taking out one loan, borrowers are unable to pay it back when it's due two weeks later and so "roll it over," taking out a new loan and paying a new fee to pay off the first loan, rinse repeat for a period of months.

A study by the Pew Charitable Trusts found that the average payday loan borrower is in debt to a payday lender five months out of the year. Instead of showing that payday loans are traps, however, the fact that borrowers are in debt five months out of the year (and out of debt seven) shows that (1) people do pay off the loans; and (2) they go back. In other industries, the presence of a lot of repeat customers is an indication that the business is doing something right: people keep coming back for more. In fact, payday lending is no different.

But this argument also ignores the way that borrowers may be using the loans. Although payday loans are often advertised as a way to handle emergency expenses, the same Pew study found that 69 percent of borrowers use them for routine expenses like rent, food, and clothing. There is another source of credit that is often used both for emergencies and daily expenses, one that is often not paid in full when it comes due, and that is can be used to smooth cash flow: the credit card.

The fact that payday borrowers may use multiple loans in a year and that they use them for routine expenses suggests that these borrowers are using the funds to smooth the household's income. This makes sense for a population that is especially likely to have irregular income due

to working part time jobs on an hourly basis. That same Pew study found that 81percent borrowers said that if they did not have access to payday loans they would cut down on expenses such as clothes and food. The fact that people buy food with their loans is not an argument for abolishing them; people having enough to eat is a good thing.

But what about the fee? Sure, middle and upper income families use credit cards, but those cards carry only about a 15 percent interest rate on average. The average payday loan costs about $15 for each $100 borrowed. As an annual interest rate (APR), that comes out to almost 400 percent. But the $15 fee is not an interest rate; it's a fee for the expense involved in providing the loan. Getting to a fee of $400 (i.e., 400 percent of the original loan amount) assumes that the borrower takes out a new $100 loan every two weeks; it's not an interest rate on a single $100 loan.

Thinking of the fee another way, if you pay $3 every Friday night to take $40 out of an ATM, that would also get you close to 400 percent on an annualized basis if you were to pretend that paying $3 every week was the rate you were paying for the same $40. Of course the $3 fee is the fee you pay for each $40, just as the $15 fee the borrower pays is the fee for each $100 loan. While no one likes ATM fees, no one considers them comparable to a credit card's APR.

Also, the fact that payday lenders' business model requires them to have many borrowers who roll over the loan (another argument often put forward by the anti-payday set) suggests not that payday lenders are predatory but that their profit margins are very slim. In places that have capped fees at an amount that would, if calculated as an APR, come out to about 40 percent, payday lending has all but vanished.

Ultimately, payday loans may not be pretty. They may not be something that people choose over other options. But for the people who need them, they can be a lifeline. If the goal – and it is a good one – is to improve the lives of low income Americans, the solution is not taking away a credit product many use willingly. The solution, if one is needed, is to create new, better products. In the meantime, let people have access to what's currently available: payday loans.

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