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PAYDAY LENDING: DO OUTRAGEOUS PRICES NECESSARILY MEAN OUTRAGEOUS PROFITS?

*Aaron Huckstep**

I. INTRODUCTION

The payday lending industry has suffered from a poor public perception based at least in part on inconclusive data. The public, hearing horror stories of payday loans gone wrong, appears to believe that the entire industry needs to be regulated. One assumption for regulation is that payday lenders make an enormous profit from their services.¹ This assumption is grounded in the relatively high cost of short-term credit obtained through payday lenders.² As a response to poor public perception, the industry has searched to justify itself, falling on the explanation that operating costs and loan losses require the high fees associated with their loans. Without hard data indicating that payday lenders are making extraordinary profits, however, this call for regulation is without foundation. To date, no conclusive data has been presented to either justify or refute the claims of either consumer groups or the industry.

This article does not suggest that payday lending is a desirable service, or that the industry should be entirely free from regulation.

* Senior Staff, Moss Adams LLP, Albuquerque, New Mexico; Graduate, University of Colorado at Boulder School of Law, May 2006. The author thanks Professors Nathalie Martin and Frederick Hart of the University of New Mexico School of Law, Professor Mark Loewenstein of the University of Colorado School of Law, and University of New Mexico School of Law alumnus Justin Breen for their comments on earlier drafts of this article.

1. See Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* 1 (FDIC Center for Financial Research Working Paper, Paper No. 2005/09, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=771624 (last visited April 18, 2006). Specifically, Flannery & Samolyk indicate that “policymakers and consumer advocates suspect that . . . AFS [Alternative Financial Services including payday lending] providers sometimes sell overpriced financial services to the people who can least afford them.” *Id.*

2. *Id.*

Rather, this article intends to provide the reader with an objective financial analysis, along with conclusions, of seven publicly traded payday lenders. The payday lenders in this study have been analyzed against six commercial lenders and one large company with a similar business model.³ The study shows that, despite the common belief, payday lending firms do not always make extraordinary profits. In fact, when compared to many other well-known lending institutions, payday lenders may fall far short in terms of profitability.⁴ If that is the case, then the call for regulation should be based solely in principle, moral, or other subjective reasoning—not on high fees.⁵

This article attempts to shed light upon two specific aspects of the payday lending industry. First, it will provide more information regarding the typical payday borrower.⁶ Next, it provides insightful financial data regarding the typical payday lending company.⁷ New information regarding the typical borrower is available from the Colorado study as well as from an in-depth investigation by the Federal Deposit Insurance Corporation (“FDIC”).⁸ Additionally, this article discusses the financial and operating results of individual stores within one publicly-traded payday lender.⁹ Finally, by reviewing the operating results of seven publicly-traded payday lenders, this article provides profitability information upon a relatively unexplored market.¹⁰

II. THE HISTORY AND BACKGROUND OF PAYDAY LENDING

A. The Emergence of Payday Lending

Methods of providing short-term financial solutions to others are not new. In the early twentieth century, “salary buyers” offered to purchase a consumer’s paycheck in advance at a discount.¹¹ For instance, a lender would give the borrower \$20 today for the right to

3. See *infra* Part V.

4. See *infra* Part V.

5. See *infra* Part VI.

6. See *infra* Part IV.

7. See discussion *infra* Part V.

8. See Paul Chessin, *Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado’s Deferred Deposit Loan Act*, 83 DENV. U. L. REV. 387, 391 (2005). See generally Flannery & Samolyk, *supra* note 1, at 1.

9. See discussion *infra* Part V.

10. See *infra* Part V.C–D.

11. Chessin, *supra* note 8, at 391.

receive the borrower's next paycheck of \$24.¹² This market arose for a number of reasons: with many people moving from rural to urban areas, and with a significant influx of immigrants, there was a large supply of manpower for a small number of jobs. As a result, meeting cash-needs was challenging for many people. Banks were not offering small-dollar short-term cash loans because they were considered too "risky." Additionally, few of the borrowers had assets with which to secure a loan.¹³ The salary-buying industry arose to meet the needs of this underserved market.¹⁴

In the 1980s, new factors created a similar need for short-term cash loans. The deregulation of the banking industry, the absence of traditional small loan providers and the elimination of interest rate caps set the stage for the emergence of payday lending.¹⁵ As banks eliminated less profitable services (such as short-term loan services), families and individuals in need of short-term cash flow were left with nowhere to turn.¹⁶ While the payday lending market emerged at about this time, many consider the father of "modern" payday lending to be W. Allan Jones, who opened his first Check-Into-Cash operation in Cleveland, Tennessee, in 1993.¹⁷

The payday lending industry is marked by exceptional growth throughout the country. Recent statistics indicate that the number of payday lending stores rose from 10,000 in 2000 to 22,000 in 2004—an annual growth rate of 30%.¹⁸ In 2002, these stores processed roughly 180 million transactions¹⁹ and in 2003, provided "roughly \$40 billion" in loans.²⁰

Although many original payday lenders were "mom and pop" shops, the industry has consolidated significantly.²¹ Today, seven of the

12. *Id.* at 392.

13. Frances B. Smith, *Payday Lending – Lessons From History*, CONSUMER'S RESEARCH MAGAZINE, April 2003, at 34.

14. *Id.*

15. Scott Andrew Schaaf, *From Checks to Cash: The Regulation of the Payday Lending Industry*, 5 N.C. BANKING INST. 339, 340 (2001).

16. *Id.*

17. Charles A. Bruch, *Taking the Pay Out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged By Payday Lenders*, 69 U. CIN. L. REV. 1257, 1270 (2001).

18. Flannery & Samolyk, *supra* note 1, at 1.

19. Schaaf, *supra* note 15, at 340.

20. Flannery & Samolyk, *supra* note 1, at 1.

21. *Id.*

largest payday lenders now have publicly traded stock.²² Large banks have also quietly re-entered the market through partnerships with payday lenders.²³ Although recent FDIC guidelines have changed the financial outlook for some of these companies, there is still a prospect for continued growth in the industry.²⁴

B. Payday Lending in a Nutshell

The payday lending industry asserts that payday loans are designed to meet short-term cash needs for emergencies such as medical bills or car repairs.²⁵ A basic payday lending transaction is fairly straightforward. In order to qualify for a loan, the borrower usually needs only a bank account and a job.²⁶ The borrower writes a check for a set amount, gives the check to the payday lender, and receives cash of some value less than the face amount of the check. The difference between the face value of the check and the amount of cash received represents the service charge on the loan.²⁷ The check serves as the only form of security on the loan.²⁸ The payday lender agrees not to deposit the check for a short period of time (typically two weeks or until payday). On the due date, a borrower with sufficient funds can allow

22. Lawrence Meyers, *Can Payday Lenders Survive?*, The Motley Fool, May 16, 2005, available at http://www.fool.com/news/commentary/2005/commentary_05051604.htm, last visited April 17, 2006.

23. Kari Lydersen, *Payday Profiteers: Payday Lenders Target the Working Poor*, MULTINATIONAL MONITOR, Oct. 1, 2001, at 9. The payday lending industry's growth and profitability has caught the attention of many mainstream lenders. Examples cited include the purchase of payday lending businesses by Citigroup and Chase Manhattan Bank. Given the focus of this article, the Author has not investigated whether Citigroup and Chase Manhattan Bank currently provide payday lending services.

24. Flannery & Samolyk, *supra* note 1, at 1.

25. Lydersen, *supra* note 23, at 9. It is important to note that payday borrowers are not required to explain their planned use of borrowed funds, and there are no restrictions on the use of borrowed funds. Also, payday lenders do not inquire about whether the borrower is experiencing a financial emergency. The intended use for emergencies is one justification for the service provided by payday lending institutions.

26. Bruch, *supra* note 17, at 1258.

27. "The typical payday loan is a two-week loan for around \$250 to \$300, and the typical fees on these loans range from \$15 to \$20 per \$100 borrowed." Flannery et al, *supra* note 1, at 1. Note that on a \$300 loan, total fees would range from \$45 to \$60, an annualized rate of between 390% and 520% (rate per 100 * 26 [the fee is assessed every two weeks, or 26 times per year]).

28. Bruch, *supra* note 17, at 1258.

the lender to deposit the original check or pay the loan off with cash.²⁹ Theoretically, this is how all payday lending transactions should work.³⁰

In reality, most borrowers do not have the funds to pay off the original loan. If this is the case, the options are far less favorable for the borrower. One option is to process a “rollover” or “renewal,” effectively extending the loan for another two-week period in exchange for a cash payment of additional interest and extension fees.³¹ Another is for the lender to deposit the borrower’s original check, leaving the borrower to deal with the high cost of bouncing a check, while still owing the payday lender.³² Finally, the borrower could begin a vicious cycle: obtain a new loan from a different payday lender, and use the new funds to pay off the old debt.³³

If payday lending is used as a short-term emergency support system, the results are not offensive. A common analogy is to compare payday lending to a taxi cab ride: A taxi provides a very cost-effective method to travel between short distances, but can be alarmingly expensive for longer trips.³⁴ Similarly, payday lending is effective for short-term borrowing, but can lead to objectionable results if used as a longer-term credit crutch. The payday lending industry agrees that “these loans are not intended to provide long-term credit, but rather to provide a cost-effective way of funding an unexpected short-run cash deficiency.”³⁵ While that may be the industry’s intention, it is clearly not the way large numbers of consumers use the service.

C. Why the Uproar?

Payday loan rollovers and renewals nearly always play a role in real-life examples of payday lending gone bad.³⁶ When a borrower does not have sufficient cash to repay a loan, one easy option is to rollover or renew the loan for another term by paying additional interest or extension fees.³⁷ “Rollovers involve payment of only additional fees;

29. *Id.*

30. Lydersen, *supra* note 23, at 9.

31. Bruch, *supra* note 17, at 1258.

32. *Id.*

33. *Id.*

34. *Pay Dirt*, THE ECONOMIST, Vol. 351, Issue 8122, pg. 28, June 5, 1999.

35. Flannery & Samolyk, *supra* note 1, at 1.

36. Schaaf, *supra* note 15, at 345; Flannery & Samolyk, *supra* note 1, at 20.

37. Bruch, *supra* note 17, at 1258.

the renewal requires repayment of the loan in full before a new loan is extended.”³⁸ Thus, the new loan must be for enough to pay the original loan plus the new fees. The fees associated with the original loan, when expressed as an annual percentage rate (“APR”), are astronomical: from 390% to 7,300%, with an average of 500%.³⁹ In a transaction with no rollovers, the associated fees might seem reasonable compared to the service provided. With multiple rollovers, however, the loan term is increased to a point where the fees associated with the transaction truly approach these APRs, leading to public outrage. Moreover, payday borrowers are not necessarily those voicing outrage. In fact, one study claims that “[c]ustomers have very favorable attitudes towards payday advance companies.”⁴⁰

As a result of the increased public scrutiny on payday lenders, many charges have been levied against the industry. Specifically, payday lending is often referred to as “predatory lending,” a phrase that lacks a common definition.⁴¹ Freddie Mac has defined predatory lending as:

[A] process, often starting with misleading sales tactics, that culminates in the origination of a loan to a borrower who is paying too much in fees, interest or insurance, may not fully understand or was not made aware of all the provisions of the contract, and may not have the financial capacity to repay the loan.⁴²

With fees translating into APRs at rates far higher than traditional lending mechanisms, payday lenders are easy targets for opponents of predatory lending.

The problems do not stop with high APRs. Many opponents of payday lending accuse the industry of “strategically locating near populations of vulnerable borrowers, such as military bases and low-

38. Flannery & Samolyk, *supra* note 1, at 4, n.10.

39. Bruch, *supra* note 17, at 1258.

40. Gregory Elliehausen & Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand* 35, Credit Research Ctr., Georgetown Univ., Monograph No. 35 (2001). This article was funded by the Consumer Financial Services Association, a major trade association representing the payday lending industry.

41. Caroline Wilson, *Faces in the Fight Against Predatory Lending*, COMMUNITY BANKER, October 1, 2001, at 22.

42. *Id.* at 23.

income neighborhoods.”⁴³ In addition, many industry opponents charge that lenders’ business practices exploit borrowers by providing incentives to rollover or renew loans.⁴⁴

D. Alternatives to Payday Lending—Is it a Necessary Evil?

Unfortunately, there are not many viable alternatives to payday lending.⁴⁵ Pawn shops are an often-used alternative, but are only available to those who have goods and who are willing to part with those goods.⁴⁶ Title pawns are also available to those borrowers who own a car.⁴⁷ The risk of default on these loans is very high in real terms, however, since the car may serve as transportation to or from work. Upon default, borrowers face not only loss of the car, but potentially the loss of a job, leaving them worse off than where they started.⁴⁸ Rent-to-Own facilities also offer a potential resource to borrowers who plan to use the borrowed funds to purchase some appliance for their home.⁴⁹ In addition, credit cards are available to those with a relatively clean credit history.

Recently, some state credit unions have begun offering short-term loan services with relatively low costs.⁵⁰ Bounce-protection programs are available to people who use a bank offering the service, although they can be very costly.⁵¹ Another alternative to payday loans is to borrow from family members, although this may be used less frequently because of the associated stress and humiliation.⁵² Depending on the borrower’s situation, each of these alternatives may come with its own set of monetary or other social costs. In the end, choosing a payday loan may be the most convenient and cost-effective alternative for some people.⁵³

43. Flannery & Samolyk, *supra* note 1, at 4.

44. Chessin, *supra* note 8, at 418.

45. Flannery & Samolyk, *supra* note 1, at 4.

46. Bruch, *supra* note 17, at 1266.

47. *Id.* at 1268.

48. *Id.*

49. *Id.* at 1269.

50. Elizabeth Willoughby, *Bankwest v. Baker: Is it a Mayday for Payday Lenders in Rent-A-Charter Arrangements?*, 9 N.C. BANKING INST. 269, 278 (2005).

51. *High Fees, High Risk? FDIC issues examination guidance for controversial area of bank involvement in payday lending*, BANK MARKETING, Oct. 1, 2003, at 10.

52. *Pay Dirt*, *supra* note 34, at 28.

53. Flannery & Samolyk, *supra* note 1, at 4.

E. The Results of the Uproar

The controversy over payday lending has had multiple ripple effects, with state regulation being the most visible. Some states have enacted laws that “effectively prohibit[]” payday lending.⁵⁴ Other states have enacted laws or regulations specifically addressing payday loans.⁵⁵ Finally, in a small number of states, including New Mexico, payday lenders are subject to little or no state regulation.⁵⁶ In the face of both regulation and bad press, industry representatives remain resolute that they are providing a needed service.⁵⁷ Noting that the payday lending controversy is “as misinformed and as vicious a fight as you’ll ever see,” one bank vice president described his bank’s entry into the payday lending market as “ugly.”⁵⁸ In fact, negative publicity has led some banks to leave the market entirely.⁵⁹

III. INDUSTRY JUSTIFICATIONS FOR THE COST OF PAYDAY SERVICES

The payday lending industry generally justifies the relatively high cost of their services with two justifications. Before offering these, however, industry representatives often assert that their high fees are commensurate with the value of the service they provide to consumers.⁶⁰ First, the industry argues that payday firms’ services are necessarily expensive because the firms’ operating costs are extraordinarily high.⁶¹ While a traditional borrower (someone searching for a car loan or a home loan) might search out the lender with the lowest interest rate or associated fees, most payday borrowers choose their lender based on convenience.⁶² The cost of providing convenience is high: to compete in a local area, payday lenders must operate a high density of stores, and

54. Schaaf, *supra* note 15, at 356.

55. *Id.*

56. *See Id.*

57. Carmen M. Butler & Niloufar A. Park, *Mayday Payday: Can Corporate Social Responsibility Save Payday Lenders?*, 3 RUTGERS J. L. & URB. POL’Y 119, 123 (2005).

58. Michael W. Lynch, *Legal Loan Sharking or Essential Service? The Great “Payday Loan” Controversy*, REASON, Apr. 1, 2002, at 38.

59. Dean Foust, *Easy Money*, BUSINESS WEEK, Apr. 24, 2000, at 107 (discussing the planned exit strategy of Chicago-based Banco Popular from the payday lending market).

60. Butler & Park, *supra* note 57, at 123.

61. Flannery & Samolyk, *supra* note 1, at 4.

62. *Id.* at 10. *See also* Schaaf, *supra* note 15, at 344.

keep those stores open beyond normal business hours.⁶³ These two factors translate into high occupancy costs (rent) and high wage costs (more employees for longer hours). While this means convenience for borrowers, it is possible that service fees are only high enough to offset these operating costs and provide some profit.

Their second justification is a high incidence of default on payday loans.⁶⁴ A default occurs when the lender determines that it will not collect the remaining outstanding loan balance. When the loan is “written off” in an accounting sense, the loan is recorded as an expense.⁶⁵ Loan defaults are a lender’s cost of doing business, regardless of what type of market the lender is serving.⁶⁶ The payday loan industry contends that their loan losses are high enough to justify the cost of their services.

In order for these justifications to be valid, the loss rates of payday lenders must be much higher than the loss rates of traditional lenders such as banks. If a traditional lender (e.g., a bank) can provide loans at what is perceived as a reasonable price, yet has the same loss rate as a payday lender, then loan losses cannot justify the payday lender’s higher fees—i.e., if the other lenders can provide the service profitably, then the payday lenders should be able to as well, at a reasonable price.

According to one study, payday lending customers typically earn \$28,000 per year.⁶⁷ Furthermore, to obtain a loan, payday lenders require only that the borrower have a checking account and a paycheck.⁶⁸ Given these two factors, it is not unreasonable to think that the payday lender’s incidence of default would be much higher than a traditional lender. Unfortunately for payday lenders, however, both of these justifications are impossible to verify on a nationwide basis.⁶⁹ A large portion of payday lending firms are privately held, meaning that

63. See Schaaf, *supra* note 15, at 344.

64. Flannery & Samolyk, *supra* note 1, at 4.

65. See generally www2.fdic.gov/qbp/Glossary.asp?menuitem=GLOSSARY (last visited Aug. 23, 2006). This site offers a number of definitions for terms related to the lending industry. Specifically, the definitions for “net charge-offs” and “reserves for losses” indicate the associated liabilities for loan write-offs.

66. *Id.*

67. See Chessin, *supra* note 8, at 405. This information is based on demographic data collected from borrowers between July 2001 and December 2004 in the State of Colorado. The study encompassed over 22,000 separate loan transactions. Data from other individual states is not available for the purpose of comparison.

68. Bruch, *supra* note 17, at 1258.

69. Flannery & Samolyk, *supra* note 1, at 4.

their financial results are not publicly disclosed.⁷⁰

Previous articles have cast doubt upon these industry justifications. Typically, these articles predict or suggest methods to equalize the payday lending market—a conclusion that inherently assumes the market is not already perfect. “Equalization” in this context means bringing the price of payday lending down, eliminating inefficient payday lending operators and letting the market function with healthy competition—this, overall, lowers the high cost of short-term credit for borrowers.⁷¹

In a perfect market, competitive forces will eliminate excessive profits.⁷² Gas stations serve as a simple example: if two gas stations are located at the same busy intersection, their prices are advertised for the public to see. This eliminates the possibility that one of the two gas stations can obtain excessive profits, since the consumers are fully informed of the gas stations’ prices. Antitrust laws prevent the gas stations from cooperatively setting high prices, so the chance that both are achieving excessive profits is very low. To remain competitive, the stations must set prices as low as possible so that they do not lose business to the neighboring station, but high enough so that they earn a fair profit for providing gas. In this example, the result is that consumers purchasing from one of these stations obtain gas at an equilibrium price: the price where supply meets demand, and where neither gas station is reaping an excessive profit.⁷³

In the payday lending market, assuming that excessive profits are possible, competitive market forces should bring the cost of payday loans down to an equilibrium price—a price at which payday lenders are allowed a reasonable profit, and excessive profits are eliminated. If the current price of a payday loan were at a fair equilibrium, then a perfectly-informed public should not have animosity towards the industry. If, however, the current fees charged by payday lenders are unreasonable then payday lenders should, by definition, be earning excessive profits.

In April 2005, one North Carolina Banking Institute (“NCBI”) article suggested that greater bank involvement in the payday lending

70. *Id.*

71. Michael Bertics, *Fixing Payday Lending: The Potential of Greater Bank Involvement*, 9 N.C. BANKING INST. 133 (2005).

72. *Id.*

73. See <http://www.investopedia.com/terms/e/equilibrium.asp> (last visited Aug. 23, 2006). This example is a simple demonstration of the market equilibrium concept.

market would lead to price equilibrium.⁷⁴ This article suggested that the payday lending market is imperfect: although the price charged by payday lenders is stable, the market suffers from a lack of disclosure regarding comparable fees between payday lenders. Consumers are prevented from making a selection based on price (e.g., unlike the gas stations in the previous example, payday lenders do not advertise their fees).⁷⁵ An imperfect market will persist “when . . . certain factors . . . create an incentive for sellers to engage in tacit price collusion”⁷⁶ The article goes on to describe these factors individually, concluding that the payday lending market exhibits many of them.⁷⁷ It then suggests that mainstream banks could enter the market and capitalize by fully disclosing the prices for their loans.⁷⁸ By bringing information to the market, the article suggests the payday lending market will equalize itself.

The NCBI article makes at least two important assertions. First, it asserts that the justifications offered by the payday lending industry for their high prices are, at best, suspect. Second, the article asserts that the typical payday borrower’s characteristics remain undefined. Furthermore, according to the article, payday lenders would not be able to reap excessive profits in a perfect market⁷⁹ and thus—regulatory roadblocks aside—banks could succeed by simply disclosing their loan pricing.⁸⁰ This claim assumes, however, that price is a key factor in the borrower’s selection process.

Another important article by Carmen M. Butler and Niloufar A. Park (“Butler & Park”) has also cast doubt upon the payday lending industry’s justifications for high fees.⁸¹ Butler & Park suggests that the payday lending industry should be regulated through a combination of internal and external reform, and argues that internal reform should be based on the concept of corporate social responsibility—the idea that a company should contribute more to society than it costs society.⁸² Based on an in-depth investigation of one publicly-traded payday

74. Bertics, *supra* note 71, at 133.

75. *Id.* at 143.

76. *Id.* at 142.

77. *Id.*

78. *Id.* at 150.

79. *Id.* at 142.

80. *Id.* at 150.

81. Butler & Park, *supra* note 57, at 119.

82. *Id.*

lending company, Advance America, the article indicates that payday lenders “provide substantial income and a favorable rate of return on investment.”⁸³ Overall, the article serves as an indictment of the industry’s justifications for high prices. It assumes, however, like the NCBI article, that price is a major factor in selecting a payday lender.⁸⁴

Together, these two articles suggest that the industry’s justifications for their fees should be viewed with great skepticism. Both, however, indicate that borrowers’ behavior is inadequately understood.⁸⁵ For states or the federal government to create an effective solution to the perceived problems with payday lenders, more information must be known about both the borrowers and the lending firms in this market. The remainder of this article attempts to provide additional information on both subjects.

IV. THE TYPICAL PAYDAY BORROWER

The typical payday loan borrower is not easy to describe. While much anecdotal evidence exists regarding the demographic of payday borrowers, there is relatively little unbiased and consistent large-scale data available.⁸⁶ Many think that payday lenders largely serve low-income individuals who have little or no access to traditional methods of credit such as credit cards. In addition, the typical payday borrower is thought to have few liquid assets or savings.⁸⁷ Payday loan borrowers are also thought to have a relatively higher debt-to-income ratio, and are often thought to be in “financial distress.”⁸⁸ These borrowers have been described in some articles simply as “poor people.”⁸⁹ While these are reasonable intuitive guesses, they can be refuted. One study indicates that most payday loan borrowers are middle-class, have access to other forms of credit, have steady jobs, and use payday loans exactly as intended—for short-term emergency cash flow problems.⁹⁰ These contradictions exist because much of the available data relating to borrowers are “bound up with advocacy positions for or against the

83. *Id.* at 125.

84. *Id.* at 123.

85. *Id.* See also Bertics, *supra* note 71, at 150.

86. Flannery & Samolyk, *supra* note 1, at 4.

87. Foust, *supra* note 59.

88. Payday Lending, *supra* note 13. See also Bruch, *supra* note 17, at 1279.

89. Jeff Hinkle, *Bad Rep or Bad Rap?*, AMERICAN INDIAN REPORT, June 2002, at 8.

90. Elliehausen & Lawrence, *supra* note 40, at 33.

industry” and thus is of questionable reliability.⁹¹

A sampling of the data provides a picture of the inconsistency. A 2001 study by Georgetown University’s Credit Research Center at the McDonough School of Business indicated that 66% of borrowers use payday loans as they are intended—as an emergency cash flow fix.⁹² The same report indicates that 60.1% of borrowers renewed their loans less than five times in the past year.⁹³ Further, 41.7% of the borrowers own homes⁹⁴ and 100% have steady incomes and checking accounts.⁹⁵ Alternatively, a recent study from Indiana indicates that 66% of borrowers roll over their loans more than 10 times per year.⁹⁶ The Center for Responsible Lending further identified these inconsistencies in a December 2004 Research Report.⁹⁷ The inconsistencies are not limited to the number of loans or the number of rollovers per year. The industry argues that the average borrower has a \$35,000 annual income.⁹⁸ The 2001 Georgetown study indicates that over half of borrowers have incomes between \$25,000 and \$49,999,⁹⁹ while studies from Wisconsin, Illinois, and California point to an average annual income of around \$25,000 per year.¹⁰⁰

The Georgetown study was funded by the Community Financial Services Association (“CFSA”), a major trade association of the payday

91. Flannery & Samolyck, *supra* note 1, at 6.

92. COMMUNITY FINANCIAL SERVICES ASSOCIATION OF AMERICA, 2002, *available at* <http://www.cfsa.net/mediareports/Reports/RecapofResearchReportStats.doc> (last visited April 18, 2006). The Community Financial Services Association of America (CFSA) is the “only national membership trade association that provides services exclusively to the Deferred Presentment industry. . . . CFSA members represent approximately two-thirds of this market segment with over 8,000 stores nationwide.” <http://www.cfsa.net>, (last visited Aug. 24, 2006). It is important to note that this report was created and distributed by a party that is not independent with relation to the payday lending debate.

93. Elliehausen & Lawrence, *supra* note 40, at 38-39.

94. *Id.* at 42.

95. *Id.* at 50.

96. Shane Harris, *A Few Bucks Until Payday*, *Governing Magazine*, Dec. 2000, at 44, 46.

97. Michael S. Barr, *Banking the Poor*, 21 *YALE J. ON REG.* 121, 153 (2004), *available at* http://www.assetbuilding.org/AssetBuilding/Download_Docs/Doc_File_698_1.pdf.

98. Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 *MINN. L. REV.* 1, 99 (2002).

99. Elliehausen & Lawrence, *supra* note 40, at 28.

100. Johnson, *supra* note 98, at 99.

lending industry.¹⁰¹ Although perhaps tainted by the CFSA's involvement, the study's results paint an interesting and relatively benign picture of the typical payday borrower. For instance, the study found that more than half of the respondents had at least a high school diploma or some college education.¹⁰² Only 6.2% of the respondents had no high school diploma.¹⁰³ In terms of income, the respondents were "less likely than the general population to have either low or higher incomes."¹⁰⁴ Furthermore, according to the Georgetown study, the majority of borrowers used payday lenders in the manner intended: as a short-term cash flow fix.¹⁰⁵ 65.7% reported using the loans for an emergency cash crisis.¹⁰⁶ Interestingly, 34.8% reported using payday loans no more than four times per year and 22.5% reported using the loans 14 times or more per year.¹⁰⁷ 36.4% of borrowers were under 35 years of age,¹⁰⁸ and more than half were married.¹⁰⁹ Just under 25% reported being unmarried with children.¹¹⁰

Outside of demographics, the study also provides some insight into borrowers' feelings regarding the availability of credit and the payday lending option. For instance, over 82% of responding borrowers agreed that most people benefit from the use of credit.¹¹¹ But almost 72% agreed that the government should impose an interest rate cap on lenders, even if it means that fewer consumers will benefit from the credit.¹¹² Just over 92% of respondents felt that payday lenders provide a useful service,¹¹³ although more than 75% also felt that the government should limit their fees.¹¹⁴ Finally, over 91% of respondents reported using some other form of consumer credit—nearly 10 percentage-points higher than the average population.¹¹⁵

101. *Id.* at 27-29.

102. Elliehausen & Lawrence, *supra* note 40, at 33.

103. *Id.*

104. *Id.* at 28.

105. *Id.* at 47.

106. *Id.*

107. *Id.* at 38-39.

108. *Id.* at 29-30.

109. *Id.* at 30.

110. *Id.*

111. *Id.* at 33-34.

112. *Id.* at 34-35.

113. *Id.* at 35.

114. *Id.*

115. *Id.* at 41.

The researchers conclude that payday loan borrowers base their decisions on the ease of the process, the ability to obtain fast approvals, and the convenience of the store location.¹¹⁶ It is important to note that this list does not include the cost of services, although two previously-discussed articles insinuated that cost was an important factor in the borrower's mind when selecting a payday lender.¹¹⁷

The Georgetown study seems to contradict the conventional wisdom. Based on this study, borrowers have multiple options for obtaining credit,¹¹⁸ but choose to use the payday lender even though they recognize that the fees are high.¹¹⁹ Borrowers also seem to be using payday loans as the industry intends,¹²⁰ although almost a quarter of users do have a high number of payday loans per year.¹²¹ Overall, though, this study does not raise red flags regarding the service and charges provided by the payday lending industry.¹²² While users do feel like price controls would be valuable, this must be taken in context. For instance, it is likely that most people who buy gasoline for their car wish for the government to place a cap on the price of a gallon of gasoline, simply because it would benefit them.¹²³

In 2001, the North Carolina Banking Institute published an article that indicates a more alarming trend among payday borrowers. According to the article, a *Wall Street Journal* industry analyst claimed that the average borrower "makes 11 transactions [per] year."¹²⁴ Another study indicated the average was 10 transactions per year.¹²⁵ Similarly, one other study indicated an average of over 12 times per year.¹²⁶ In 2005, another article indicated that, in Illinois, 20% of

116. Flannery & Samolyk, *supra* note 1, at 6.

117. Butler & Park, *supra* note 57, at 123; Bertics, *supra* note 71, at 150.

118. Elliehausen & Lawrence, *supra* note 40, at 41-43.

119. *Id.* at 48-50.

120. *Id.* at 47.

121. *Id.* at 38-39.

122. One interesting factor that is not analyzed in this data is gender. Studies from Wisconsin and Illinois have reported that a majority of payday borrowers are female. See Johnson, *supra* note 98, at 100.

123. See <http://www.investopedia.com/terms/h/homoeconomicus.asp> (last visited Aug. 23, 2006) (explaining the common theory regarding individuals as rational-self maximizers: on an individual basis, people make choices that provide the most financial benefit to their own lives).

124. Schaaf, *supra* note 15, at 346.

125. *Id.*

126. *Id.*

borrowers take out 20 or more loans per year.¹²⁷

Experience in Colorado calls into question the Georgetown results, and lends credence to the North Carolina Banking Institute figures. In 2000, Colorado enacted the Deferred Deposit Loan Act as an attempt to combat the “high-cost” payday loan.¹²⁸ The regulations required payday lenders within the state to collect and report demographic data regarding borrowers.¹²⁹

Based on data collected between July 2001 and December 2004, the demographics of payday borrowers in Colorado indicate that the typical borrower was a 36 year old single woman making just over \$28,000 per year.¹³⁰ Sixty-two percent of borrowers were between the ages of 20 and 39 years old, and 55% were women.¹³¹ Married borrowers accounted for 47% of the total loans, and more than 22% of borrowers had been employed at their current job for less than six months.¹³² Sixty-three percent of borrowers made less than \$30,000 per year, and only one-quarter of one percent, or 0.24%, made more than \$50,000 per year.¹³³ On average, the borrower took out just over 9 loans per year, from the same lender. This does not account for loans taken out from different lenders.¹³⁴ Moreover, 20% of borrowers took out 16 or more loans with the same lender within a 12 month period.¹³⁵ These repeat borrowers constituted over 46% of all loans written by a particular lender.¹³⁶ Interestingly, 18.85% of loans were renewals, a figure that increased over the years analyzed from 19.56% in 2003 to 20.28% in 2004.¹³⁷ Similarly, 34.4% of loans were rollovers.¹³⁸ This figure has been increasing in recent years: 34.7% in 2003, and 37.48% in 2004.¹³⁹ Based on this information, the study concludes that there is “a gaping disconnect between the theory and expressed purpose of payday

127. Willoughby, *supra* note 50, at 272.

128. Chessin, *supra* note 8, at 387.

129. *Id.*

130. *Id.* at 404-05.

131. *Id.* at 405.

132. *Id.*

133. *Id.* at 406-07.

134. *Id.* at 410.

135. *Id.* at 411.

136. *Id.*

137. *Id.* at 413.

138. *Id.*

139. *Id.*

loans . . . and their reality.”¹⁴⁰

In comparing the Georgetown and Colorado studies, it appears that the design of the Georgetown study limits its usefulness. By grouping the income bracket between \$25,000 and \$49,999, the Georgetown study missed an opportunity to provide valuable information regarding subcategories within this income bracket. For instance, the Colorado study indicates that the average income of borrowers is \$28,000.¹⁴¹ Other studies mentioned above provide consistent results, with average incomes near \$25,000.¹⁴² The Georgetown study might well indicate similar results, but it does not provide readers with an average income but rather an income bracket.¹⁴³

The Georgetown study is clearly contradicted by the Colorado study with respect to the use of payday loans by individuals in the income bracket above \$50,000. The Georgetown study claims that 25% of respondents had incomes above \$50,000, while the Colorado study indicates that only 0.24% of respondents are within this income bracket.¹⁴⁴ Common sense could support the Colorado results because it appears that the conventional wisdom is correct in this regard: payday lenders are clearly serving lower-income individuals with much more frequency than higher-income individuals.

While the Colorado study does not indicate how borrowers used payday loan funds, both the Georgetown and Colorado studies suggest that a high percentage of borrowers use payday loans for non-emergency reasons. Although the Georgetown study claims that a majority of borrowers use funds for emergency reasons, the high percentage of borrowers having at least 7 loans per year (almost 50%) indicates that either the borrowers had a drastic financial emergency, a high incidence of emergencies, or are using the payday loan as a longer-term cash flow crutch.¹⁴⁵ This is bolstered by the high percentage of borrowers who incur more than 14 loans per year (22%).¹⁴⁶

Although the Georgetown study does not calculate an average

140. *Id.* at 418.

141. *Id.* at 406.

142. Johnson, *supra* note 98, at 99.

143. Perhaps, for instance, most of the Georgetown respondents are included within the \$25,000-\$29,999 subcategory of the \$25,000-\$49,999 category. Without more information, one cannot ascertain the reliability of the Georgetown study.

144. Elliehausen & Lawrence, *supra* note 40, at 29; Chessin, *supra* note 8, at 406.

145. Elliehausen & Lawrence, *supra* note 40, at 39.

146. *Id.*

number of loans per borrower per year, calculations from the study's data indicate that the average number of loans would be near 10. Similarly, the Colorado study shows that the average borrower takes out 9 payday loans per year, and that about 20% take out at least 16 loans per year.¹⁴⁷ Again, this information suggests that borrowers, on average, are not using payday loans exclusively (or even remotely) for emergency reasons. The industry's suggestion that the product is designed to be used for emergencies may be correct in theory, but it ignores the reality: payday borrowers are using the product with a frequency that suggests their only "emergency" is that their bank account is low. This is not intended to suggest that a lack of funds is a trivial thing; the industry's justifications, however, clearly paint a different picture of "emergency." Nevertheless, it does appear that lower-income people have a need for a relatively short-term unsecured financial vehicle. Some states have completely outlawed payday lending; yet this only leaves the intended borrower with an unfulfilled need and an incentive to find alternatives that are scarce and possibly illegal.¹⁴⁸

It would be valuable to know with certainty how payday borrowers use the proceeds from the loan. If it were known, for example, that borrowers used the funds for non-essential items, then a systematic campaign of consumer-education might be implemented in response. Similarly, it would be helpful to know what conditions bring payday borrowers to the breaking point—the point at which they decide to obtain their first payday loan. It is entirely possible that the rise in payday loans is a result of the wide-spread decrease in personal savings. Without a deeper understanding of this subject, however, any constructive responses to payday lending may be destined for failure. Thus, since its wholesale elimination does not appear to be a viable solution, it is time for a closer examination of the source of payday lending's profitability.

V. PAYDAY LENDING: COSTLY AND NOT PROFITABLE?

When asked to justify the high fees associated with payday lending,

147. Chessin, *supra* note 8, at 410-11.

148. Taking an optimistic perspective, the author does note that one possible result stemming from a state regulating or completely outlawing payday lending is that potential borrowers would engage in more effective financial planning. This may lead to a reduction in the need for short-term infusions of cash such as that provided by payday lenders.

industry representatives fall back on two key financial aspects of the industry. First, operating costs are very high for a payday lender. Second, the incidence of losses (i.e. loans that are never repaid) is much higher than that of a mainstream financial institution.¹⁴⁹ Analyzing the truth of these contentions is difficult: most payday lending firms will not voluntarily disclose the financial results of their operations.¹⁵⁰ Unless a company is publicly traded, it is nearly impossible to obtain relevant and complete financial data. As a result, this article is focused on one study involving financial information voluntarily disclosed by two payday lenders, and on the Author's own study involving financial analysis of seven publicly-traded payday lenders.¹⁵¹

A. Expenses of Payday Lenders

In 2005, two FDIC employees (“Flannery & Samolyk”) published an insightful study regarding the costs of payday lending.¹⁵² After obtaining “proprietary store-level data” from two large payday lending companies, Flannery & Samolyk performed a comprehensive financial analysis of store operations and profitability.¹⁵³ Their objective was to test whether or not operating expenses and loan losses were truly high enough to justify the high service fees charged by payday lenders.¹⁵⁴ In the end, they determined that “fixed operating costs and loan loss rates do justify a large part of the high APRs charged on payday advance loans.”¹⁵⁵

Flannery & Samolyk found that default rates and loan losses of payday lenders are much higher than typical credit losses at mainstream financial institutions.¹⁵⁶ Loan losses occur when a specific loan is deemed uncollectible or in default. At that time, the lender will effectively record the loan balance as an expense, commonly referred to as “writing the loan off.” For ease of comparison, loan losses can be measured as a percentage of total revenues. In their study, Flannery & Samolyk found that the ratio of mean loan losses to total revenue

149. Flannery & Samolyk, *supra* note 1, at 4.

150. *Id.* at 1.

151. *Id.* at 7; *see also infra* Part V.B.

152. *See generally* Flannery & Samolyk, *supra* note 1, at 7.

153. *Id.* at 7.

154. *Id.* at 1.

155. *Id.*

156. *Id.* at 2.

amounted to 15.1%.¹⁵⁷ Flannery & Samolyk also found that loan losses as a percentage of store operating costs for “young” stores (those operating for at least 1 year and not more than 4 years) was 24.8%.¹⁵⁸ Although they indicate that this is “substantially” higher than the customary loan loss rates at mainstream financial institutions, they do not provide any comparative data.¹⁵⁹

The Flannery & Samolyk data also indicate that new stores are profitable only after several years of operation when loan-origination finally reaches a certain volume.¹⁶⁰ The typical store employs three full-time workers, each earning approximately \$30,000 per year including benefits.¹⁶¹ Fixed costs are increased by maintaining longer hours of operation relative to those of typical financial institutions.¹⁶² Since the Flannery & Samolyk study indicates that customers are not shopping based on price, but rather on convenience,¹⁶³ the added costs of longer hours and full-time employees are necessary to obtain, serve, and retain their customers.

The most successful payday lending stores offset these fixed operating costs by processing a large volume of loans.¹⁶⁴ As the number of loans processed increases, store profitability increases as well.¹⁶⁵ Therefore, repeat borrowers, the source of a heated policy debate, do not inherently increase a store’s profitability—they simply add to the loan volume of a particular store.¹⁶⁶ Flannery & Samolyk document some interesting findings with respect to repeat borrowers and store profitability. For both young (defined as operating between 1 and 4 years) and mature (defined as operating for more than 4 years) stores, 46% of total loan volume came from renewals or rollovers.¹⁶⁷ For mature stores, more than 30% of borrowers received 12 or more loans per year.¹⁶⁸ These figures relate to a specific store versus a company as

157. *Id.* at 16.

158. *Id.* at 10.

159. *Id.* at 2.

160. *Id.* at 2.

161. *Id.* at 9.

162. Schaaf, *supra* note 15, at 345.

163. Flannery & Samolyk, *supra* note 1, at 10; *see also* Schaaf, *supra* note 15, at 345.

164. Flannery & Samolyk, *supra* note 1, at 10.

165. *Id.*

166. *Id.*

167. *Id.* at 12.

168. *Id.*

a whole. Even while faced with these fixed operating costs and high loan losses, a typical payday lending store creates 33.2% profit before accounting for regional or corporate expenses.¹⁶⁹ This means that for every dollar charged in fees, the store itself will profit more than 33 cents—before accounting for regional or corporate shared administrative costs.

The Flannery study could be improved by providing a comprehensive comparison of payday lenders with those of another commercial lender or other franchise-type business. Without more, the numbers lack a benchmark. For instance, the payday lending industry argues that high loan losses and high fixed operating costs drive the high cost of lending.¹⁷⁰ There is no evidence, however, that payday loan losses are higher than loss rates for typical commercial lenders. Although Flannery & Samolyk make the claim, there is no hard data provided to support it.¹⁷¹ Assuming, for the sake of argument, that the payday lender loss rates are normal for all lenders, then the industry's justifications for high fees is not sufficient. The same could be true of payday lenders' fixed operating costs—if they are consistent with other franchised businesses, the industry's justification rings hollow.

B. Comparing Payday Lenders to Mainstream Lenders

To provide more insight into the relative costs and profitability of payday lending, this article analyzes financial data from seven publicly-traded payday lenders. A comparative analysis was performed for six publicly-traded commercial lenders and one publicly-traded company with a business model similar to payday lenders. The results of this study are based on a comparison between these two groups of companies.

1. Methodology

This study began by identifying the seven publicly-traded payday lending companies. These companies, listed in Exhibit 1, are the only publicly-traded companies whose primary or secondary line of business consists of originating payday loans. Within this group, three companies' primary line of business is pawn. Exhibit 1 also indicates

169. *Id.* at 18.

170. *Id.* at 4.

171. *Id.* at 10.

the percentage of revenues which are derived from pawn services.

Next, six comparison companies were selected based on experience and relative success in the commercial lending industry. All six companies, listed Exhibit 2, are also publicly traded. One of the six, Collegiate Funding, is specifically focused on servicing student loans. In addition to these six, Starbucks Corp. (“Starbucks”) was selected to provide comparison data for store and regional expenses as a percentage of revenue, primarily due to similarities in its business model.¹⁷²

The source data for this financial analysis was obtained from the Securities and Exchange Commission (“SEC”). Publicly traded companies are required to file certain information with the SEC which is available online through the SEC’s Electronic Data Gathering, Analysis and Retrieval system (“EDGAR”). This study does not include comparisons of any privately held payday lending firms because, as Flannery & Samolyk noted, the information for such firms is simply not available to the public.¹⁷³ Financial information was obtained from the SEC for both the payday lenders and the comparison companies.¹⁷⁴ A recent 10-Q (a quarterly report of financial results filed with the SEC) was selected for each company. In all cases, an attempt was made to select the same quarter for the sake of consistency.

Once the company data was collected, certain analytical ratios were defined for comparison. These ratios are identified and explained in Exhibit 3. Each of these ratios was selected with a focus on testing

172. Most large payday lending companies, including the seven investigated in this study, operate a high density of stores within a broad range of geographic locations. In a major metropolitan area, a payday lending company will have multiple locations. Similarly, Starbucks typically operates a high density of stores in a specific geographic location as well, with a high number of locations per major metropolitan city. Financially, both Starbucks and payday lenders review results on a per-store basis as well as on an overall basis. In addition, and perhaps most importantly, Starbucks encounters similar types of fixed operating costs, such as rent and other store-specific expenses. These similar expenses allow for a good comparison to test the assertion that payday lenders’ fixed operating costs are high.

173. *Id.* at 2.

174. The EDGAR database must be accessed through the website of the Securities and Exchange Commission. It can be found at www.sec.gov/index.htm. To search the EDGAR database from this site, the user must select the link labeled “Filings and Forms.” On the next page, the user must select the link labeled “Search for Company Filings.” Finally, the user can now perform a general search for companies and other filers. Search options include Standard Industrial Classification (SIC) code, ticker symbol, and name. Once the company is selected, any specific SEC filing can be obtained, provided that it has been entered into the EDGAR database.

whether or not payday lenders earn a significant profit compared to other lending entities. Also, certain ratios were selected to determine whether the loan loss experienced at payday lenders is consistent with the experience of other commercial lenders. Each ratio has been computed using two groups of the seven payday lenders. The first group, titled “Pure PDL,” includes only the four publicly-traded payday lenders whose primary line of business is payday lending—it excludes the three payday lenders with significant pawn operations. The next group, titled “PDL and Hybrid,” is calculated using financial data from all seven publicly traded payday lenders. The results for commercial lenders have been compared to the “Pure PDL” group information to facilitate understanding the true differences between these industries.

2. Shortcomings

This study has several shortcomings that stem from the nature of the comparisons. In all cases, every effort has been made to provide the correct and most equal comparison. Although this study is not perfect, it provides a solid entry point for a student hoping to do further research on the topic. First, the study uses financial data from one three-month period of time. For all but three companies, the study used the same period of time in the hopes that economic events occurring before or during this span of time would affect all companies equally. It is important to note that this “timespan” problem is inherent in any analytical study. Over time, financial performance (and thus ratios analyzing that performance) will undoubtedly change. By looking at one single period of time, however, trends should fall out to provide insight into a comparison of these companies.

Second, there is no standard form of disclosure for publicly traded companies. For instance, the line item “store expense” on an income statement might include different items for Company A versus Company B, even though those companies are in the same industry. In cases where this problem was clear, manual calculations were made to ensure the comparisons took into account consistent expense and revenue information.

Third, “quality of earnings,” is one factor that is unique to publicly-traded companies. In an effort to meet industry analyst expectations for quarterly ratios like earnings per share, publicly traded companies sometimes adjust reserves, or contingent liability accounts, to meet projected earnings. A reduction in a reserve account will reduce

previously-recorded expenses, leading to higher earnings. Conversely, an increased reserve account (resulting from recording an expense) will reduce earnings. Loan losses, discussed at length throughout this article, are just such a reserve. There is no reason to suggest that a quality of earnings issue exists in this case; quality of earnings can be a natural shortcoming when dealing with publicly traded companies.¹⁷⁵

Fourth, the payday lending industry and the commercial lending industry are serving neither the same customers nor the same markets. Therefore, because these industries are different, a certain portion of the difference between ratios can be explained by this industry differential. Defining how much is quite another matter. Certain ratios are affected by industry differences more than others. For instance, loan losses should be less for commercial lenders who perform more due diligence on borrowers. However, ratios such as profit margin, should provide a solid footing for comparison regardless of industry.

Fifth, a company's financial ratios reflect the quality of company management. If there is a poor management team leading a company, chances are good that their ratios will not be as strong as a neighbor company, in the same industry and selling the same goods, which has a great management team. This is a flaw that is inherent in any analysis that deals with financial data; a study cannot measure the impact of a poor management team.

Finally, this study reviews data at a high-level of generality from publicly-traded payday lenders and does not review any data from privately-held payday lenders. Reviewing Exhibit 1, this study includes data from nearly 8,000 payday lending stores. By comparison, Flannery & Samolyk reviewed data from 300 stores from two major payday lenders—600 stores in total.¹⁷⁶ Recent estimates peg the number of payday lending stores nationwide at 22,000 in 2004.¹⁷⁷ Thus, this study covers nearly 36% of the total payday lending stores across the nation. Although it does not include privately-held firms, the data is sufficient to provide insight into the payday lending industry.¹⁷⁸

175. See generally <http://www.investopedia.com/terms/q/qualityofearnings.asp>, last visited August 18, 2006, for a definition of Quality of Earnings. Quality of earnings concerns can arise related to almost any estimated reserve (liability) account, such as loan losses at payday lenders.

176. Flannery & Samolyk, *supra* note 1, at 7.

177. *Id.* at 1.

178. Despite these potential shortcomings, this study's results are fairly consistent with the findings of Flannery & Samolyk for certain financial ratios.

3. Conclusion

This study finds that the industry's proffered justifications for high service fees, and by extension high APRs, may be justified by both high store expenses and high loan losses. In addition, this study finds that payday lender profit margins are less than half that of their mainstream lending counterparts. The study also indicates that pawn operations significantly enhance the profitability of payday lending companies.

C. Profitability Analysis

Payday lending operations averaged a 7.63% profit margin on average revenue per store of just over \$80,000. For the "Pure PDLs," average revenue per store was reduced to \$63,233. A review of the source data indicates that there is a difference between pure payday lenders and pawn operators with respect to this ratio. The best-performing pure payday lender generated \$6,000 less in revenues per store when compared to the lowest-ranking pawn operator.

This trend continues with average operating margins. For payday lenders, average operating margins indicate revenue before accounting for administrative or headquarters expenses. In essence, this is a measure of revenue after accounting for store operating costs. For pure payday lenders, average per-store operating margins (revenues less costs of store operations) are 24.64%. For those with pawn operations, the figure jumps to 31.99%. It is interesting to note that Flannery & Samolyk made similar findings: average operating profits at stores studied was calculated at 33.2%, very close to the 31.99% figure presented above.

Similarly, average profit margins also indicate that pawn operations contribute to firm profitability. Profit margins indicate the percentage of gross revenue that truly is profit for the firm—the percentage of gross revenue that remains after subtracting out all associated costs for the period. For pure payday lenders, the average profit margin was 3.57%. When including pawn operators, this figure more than doubles to 7.63%.

These figures indicate that payday lenders are not overly profitable organizations. Contrary to conventional wisdom, these firms fall far short of profits for mainstream commercial lenders. In addition, profit margins of payday lenders are far below those of Starbucks. The profit margins of Starbucks for the measured time period were just over 9%. This is almost 2% more than all payday lenders, and more than double

the pure-payday lenders. These figures indicate that arguments against payday lending, couched in terms of preventing excessive profits, are unfounded. If companies should be limited to a certain profitability measure, citizens would be better off fighting Starbucks than their local payday lender.¹⁷⁹

Comparing the profit margins of payday lenders to mainstream commercial lenders supports this perspective. The comparison lenders had a profit margin of 13.04%—much higher than even Starbucks. This was over three times the percentage for pure payday lenders, and almost twice as much when including hybrid operators. These profits are not being made by small, unknown or niche lenders. These are mainstream companies with widely-recognized names: Capital One, GE Capital, HSBC, Money Tree, and American Express Credit.¹⁸⁰

D. Expense Analysis

These findings seem hard to understand in light of the service fees charged by payday lenders. According to the Flannery & Samolyk study's data, the average fee charged by payday lenders is \$17.71 per \$100 advanced.¹⁸¹ An analysis of expenses related to payday lending operations sheds some light on this problem. First, the industry's contention that operating expenses are high is bolstered by this study. Store expenses account for 75% and 68% of gross revenues for pure payday and hybrid payday operators, respectively. The same figure for

179. The author does recognize that payday lending may create and perpetuate financial harm for many borrowers. The intent of this article is to question the assertion that payday lenders generate excessive profits. If payday lenders are not generating excessive profits, then industry regulation should be based on some other foundation such as a moral or ethical principle. Claims that payday lenders generate excessive profits, if unfounded, mislead the debate over payday lending.

180. One could argue that payday lenders should be held to a higher standard because they cater to a lower-income market than traditional lenders. One comparison company provides services to a relatively similar market (i.e., students) and should arguably be held to a similar standard. Nevertheless, Collegiate Funding Services, a "leading education finance company," had above-average profitability of 14.69%. See <http://www.cfsloans.com/index.cfm?action=aboutUs> (last visited August 25, 2006). One could differentiate Collegiate Funding Services on the basis of borrower's expected future earnings. Either way, this does not change the implication of this study: In light of the data analyzed and presented, arguments against payday lenders on the basis of excessive profits appear to be unfounded.

181. Flannery & Samolyk, *supra* note 1, at 9.

Starbucks, a similar business model, is less than half of either of these, at 32%.

Three primary items account for a majority of store expenses: wages, occupancy costs, and loan losses. High wages are a function of payday lenders' operating hours. With longer hours than traditional lending institutions, it makes sense that these operators would incur a higher cost of wages. In addition, payday lenders operate a high volume of stores, leading to high occupancy costs. In the Flannery & Samolyk study, wages and occupancy costs account for nearly 50% of a store's operating costs.¹⁸² These two cost categories are not a function of the lending operations. Rather, they are a function of the business model. If convenience is the primary factor in selecting a payday lender,¹⁸³ then payday lenders must keep their long hours and high store density if they expect to continue their growth.

Loan losses account for a very high percentage of operating costs as well. This study found that loan losses at pure payday lenders amounted to just over 26% of store operating costs. Including hybrids, this figure dropped to just under 22%. Using Flannery & Samolyk's data, on average loan losses constituted 23% of a store's operating costs.¹⁸⁴ While these costs appear high, it is nearly impossible to compare them with information from any of the comparison companies as the comparison companies do not distinguish store expenses from headquarter or regional expenses.

Calculating bad debt expense as a percentage of revenue, however, does provide a stable basis for comparison. This calculation provides the impact of loan losses on company operations. A low rate indicates good loss experience, or a low incidence of defaults. Higher rates indicate that loan losses are reducing the company's profitability. For pure payday lenders, loan losses amount to just over 20% of revenues. When hybrids are included, this figure drops to 15.5%. In comparison, Flannery & Samolyk calculated loan losses at 15.1%.¹⁸⁵ The mainstream lenders produced a surprising result: loan losses amounted to 16.6% of revenue—close to that of payday lenders.

An alternative perspective sheds some light on this interesting result. Loan losses as a percentage of outstanding loans at payday

182. *Id.* at 10.

183. *Id.*

184. *Id.*

185. *Id.* at 16.

lenders amounted to 25% for pure payday lenders, and 17.6% for hybrid payday lenders. In comparison, loan losses at commercial lenders amounted to just over 5% of outstanding loans. This is consistent with conventional wisdom; although the loan losses in a given period may be close when counting in dollars, the commercial lenders have a significantly larger loan portfolio and are earning a much lower (relative) rate of interest. Whether this means that commercial lenders have a lower incidence of default cannot be ascertained. Without knowing the average loan principal at the comparison companies, it is impossible to measure the default rate. This information would be useful to know, and could be the subject of future investigations.

It is clear that loan losses significantly reduce the profitability of payday lending firms. It does not, however, appear that the payday lending loan losses are unusually high relative to commercial lending in general. These facts tend to weaken the industry's arguments that payday loan losses are very high: the loan losses may be high, but that seems to be a trait of the lending industry generally, rather than a unique trait of payday lending institutions.¹⁸⁶

VI. CONCLUSION

The payday lending industry has experienced high growth and increasing notoriety over the past decade. Calls for regulating the industry are based partially on an assumption that payday lenders

186. While the ratio of loan losses to revenue is insightful, it can be misleading. Loans are not recorded as revenue for any lender, including payday lenders. Loans are recorded as an asset, specifically a receivable. The profits from loans are recorded as revenue, mostly in the nature of interest income or finance charges. To determine the true extent of loan defaults for payday lenders, one must calculate the default rate. These loan loss ratios can provide insight into the percentage of borrowers who default, termed the default rate. This calculation can be demonstrated using average loan statistics. Assuming that the true rate of loan losses as a percentage of revenue (20%) is correct, the average loan for a young store from Flannery & Samolyk was \$230, with an average finance charge of \$38.57. This produces a net loan of \$191.43. Using this information, it is possible to calculate backwards to an expected default rate. Writing off this particular loan, a lender will record an expense of \$191.43. This means that the lender is, on average, going to record \$943 in revenue ($\$191.43/20\%$) before writing off this loan. Based on the average finance charge, this means that the lender will have processed just over 24 transactions before the loan defaults ($\$943/\38.57). This translates to a default rate of nearly 4.1% ($1/24$), much lower than conventional wisdom would have the public believe. This calculation is demonstrated in detail in Exhibit 5.

generate enormous profits from the high cost of borrowing. High profits for payday lenders, however, may be more myth than reality.

Consistent with industry explanations, operating expenses for payday lenders are high. Wages, occupancy costs, and loan losses account for a majority of these high operating costs. These expenses are incurred to promote customer convenience. In order to provide a valuable service, payday lenders choose to keep longer business hours and operate a higher density of stores than traditional lenders such as banks. The cost of convenience is lower profitability. An interesting extension of this research would be to determine whether this trend (buying on convenience) would continue if payday lenders were forced to conspicuously display their lending costs to the public at their place of business.

Additional unbiased study of borrowers and payday lenders would help to find an effective solution to the current situation. Although a large amount of research and scholarly writing regarding payday lending is currently available, most studies can be associated with either a consumer advocate or industry position. This has led to contradictory information and confusion. While this information serves to further the particular ambitions of each side, it does little to advance efforts for fair regulation. If more unbiased information were available, legislators would be presented with a true picture of both payday borrowers and the payday lending industry. This information could lead the payday lending industry and government to cooperative guidelines for providing this necessary service.

Before enacting payday lending legislation, states should refrain from acting in haste. Although the public may harbor animosity toward the industry, legislators would be wise to carefully consider and study the industry's explanations of its operating costs and profitability. Since payday lenders process 180 million transactions per year, amounting to \$40 billion in loaned dollars, state governments should heed the words of Jeremy Bentham:

But the fact is, he cannot get [a loan] at that lower rate The legislator . . . who knows nothing at all about the matter, comes and says to him[,] “[Y]ou shall not have the money: for it would be doing you a mischief to let you borrow it upon such terms.” . . . There may be worse cruelty, but can there be greater folly?¹⁸⁷

187. Frances B. Smith, *Payday Lending – Lessons from History*, CONSUMER'S RESEARCH MAGAZINE, April 1, 2003, at 34.