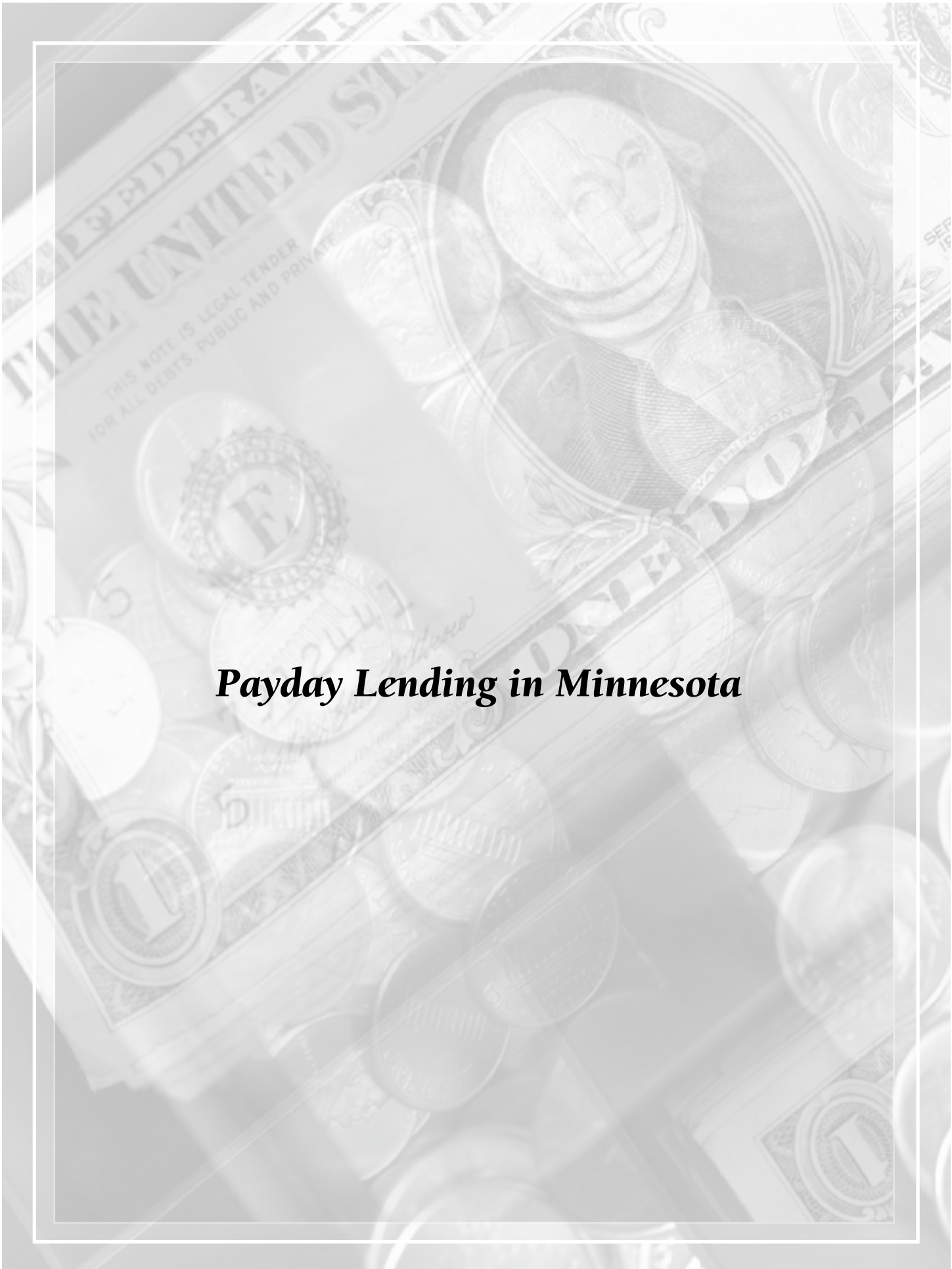

Payday Lending in Minnesota

Background

In the United States there are more than 23,000 payday lending stores, outnumbering the combined total of McDonald's, Burger King, Sears, J.C. Penney, and Target stores.[1] It may be difficult to believe there are this many until one scans the streetscape and tallies the numerous lending outlets in low-income neighborhoods. None of these lenders make conventional loans. Instead, they offer small loan amounts for short periods of time, usually until the borrower's next paycheck, hence the term "payday loan." While some borrowers undoubtedly benefit from this otherwise unavailable source of short-term, small-amount credit, the payday lending business model fosters harmful serial borrowing and the allowable interest rates drain assets from financially vulnerable people.

Definitions of Usury

Usury is the practice of making loans with excessive or exploitive interest rates. The term may be used in a moral sense — condemning taking advantage of others' desperation — or in a legal sense — exceeding the maximum interest rate allowed by law. Most states have usury statutes and regulations that cap interest rates on most loans and/or revolving (credit card) balances. In a strict legal sense, only interest violating these laws is usurious. However, if laws and regulations fail to address exploitive and abusive lending practices, loans that are technically legal may be morally usurious. In this case the lending laws should be reevaluated.

Usury laws echo the sacred texts and the wisdom of the Abrahamic faith traditions. The Bible declares, "If you lend money to one of my people among you who is needy, do not treat it like a business deal; charge no interest" (Exodus 22:25). The Qur'an takes a principled stance against predatory lending — charging any interest at all is sinful according to Allah, as it is the responsibility of financial professionals to help people get out of debt as soon as possible, rather than deepening and profiting from their debt (Surah 2:275-281).

In the Compendium of the Social Doctrine of the Church[2], the Catholic Church teaches that "usury is a scourge that is also a reality in our time and that has a stranglehold on many people's lives. Although the quest for equitable profit is acceptable in economic and financial activity, recourse to usury is to be morally condemned."

The practices of most payday lenders are very similar to those condemned in the sacred texts and teachings of Judaism, Islam, and Christianity in that they encourage the borrower to stay in debt for increasing periods of time. As people of faith, we oppose usurious practices that exploit people's financial problems for profit and leave the consumer worse off at the end of the loan period. Ironically, some of these very practices are

[1] Michael A. Stegman, Payday Lending, *Journal of Economic Perspectives* Volume 21, Number 1-Winter 2007, pages 169-170.

[2] *Compendium of the Social Doctrine of the Church*, Paragraph 341.

perfectly legal under current usury laws. JRLC is focused on expanding awareness about the true costs of these predatory loans, encouraging alternatives for access to short-term credit, and supporting legislation that will ensure adequate and enforceable protections for consumers.

Payday Lending is Growing More Widespread

Payday loans are short-term, high-interest loans that require full payback within a short period of time, usually on the date of the borrower's next paycheck. Lenders typically charge a flat fee for a small loan that is due when the customer receives their next paycheck. For example, under Minnesota law, in order to borrow $100, the borrower needs to repay, depending on the lender, between $115 and $145 at the end of two weeks. The fees charged equate to annual percentage rates (APR)[3] ranging from 391% to 1,170%.

The process of taking out a payday loan is quick and relatively easy.[4] Payday lenders are obligated to follow Truth in Lending requirements[5] and disclose the APR, but this deters few borrowers. Payday lenders mostly describe the cost of their loans in terms of fees, not interest. Because most borrowers are in a financial emergency and do not have access to alternative forms of short-term credit, most customers lack choices. A recently released report by the Pew Charitable Trusts estimates that, despite their exorbitant costs, 5.5% of American adults have used payday loans within the last five years[6]. In Minnesota, the typical payday borrower takes an average of 10 loans per year, often spending substantially more on interest than on the original principal.[7]

Current economic conditions make this issue more urgent than ever. Payday loans are used more frequently during periods of recession when credit becomes tight. Between 2007 and 2012, the number of payday loans taken by Minnesotans more than doubled, from 172,000 to 371,000.

Two significant problems accompany the use of payday lending in Minnesota. First, a few lenders have

[3] The annual percentage rate, or APR, is the interest rate of a loan over an entire year. In the case of shorter term loans like payday loans, the APR indicates what the interest rate of the loan would be over one year. It is a standard measure that allows for comparison between different loans.

[4] Payday lenders do not require a credit check, and the approval process usually takes less than an hour. The borrower typically fills out a form with: home address; a valid checking account; a driver's license and Social Security number; two pay stubs to verify employment, wages, pay dates, and earnings of at least $1,000 a month. For examples, see the links at http://www.fastfind.com/Loans/PaydayLoans.aspx.

[5] Disclosures must meet the requirements of Regulation Z (12C.F.R. part 226). http://mn.gov/commerce/banking-and-finance/financial-institutions/finance-companies/payday-lenders/payday-lenders-faqs.jsp

[6] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), page 4.

[7] Unpublished public data furnished by Minnesota Department of Commerce.

discovered an unintended loophole in the law that allows them to evade the Payday Lending Law, enacted in 1995 to regulate this type of lending, and charge significantly higher rates than otherwise permissible.

Second is the especially problematic – and inevitable – consequence of the use of the payday product: repeat borrowing. By design, payday loans trap consumers in a downward spiral of debt. Frequently, borrowers find themselves unable to pay their loans back in time because of the high rates and the fact that payday lenders do very little to check credit worthiness.

Even though payday lending is a form of subprime lending there are no enforceable underwriting standards for the payday loan industry. Minnesota's Predatory Subprime Mortgage Lending Law (Minn. Stat. § 58.13, subd. 1(23)) and the federal Dodd-Frank Act (15 U.S.C § 1639c(a)) each have requirements that lenders verify a borrower's reasonable ability to repay the loan, but no such requirement exists in the payday loan market, not even for "touch and go" loans or for known repeat borrowers.

Borrowers who are unable to repay the loan in full have few choices. In other states, they "roll over" the loan, meaning that they simply pay the interest, leaving the principal amount untouched and still owed. Rollovers are illegal in Minnesota. However, what is not illegal and what typically transpires with a borrower who is unable to repay the loan is what is known as a "touch and go" loan, whereby the borrower repays the old loan plus the interest using the proceeds from a new loan. The effect of the "touch and go" loan and the rollover is identical: the borrower walks out of the payday lender having simply paid the interest and is still obligated for the loan amount plus the new interest amount.

Why Do People Use Payday Loans?

Low- and moderate-income families sometimes need and desire small, short-term, loans. Mainstream lenders do not offer this form of credit on a conventional, installment repayment basis, and, in fact, have recently begun offering the same type of product that the payday lenders offer: a high interest advance on a paycheck, payable in full on payday. A few mission-driven organizations and credit unions around the country offer better alternatives to payday loans, but they are not sufficiently capitalized to provide a large number of loans and provide competition for the payday lending industry.

Payday lenders claim that their loans are not intended for long-term financial solutions. It is true that some payday borrowers do indeed use the payday product as a bridge loan over a temporary financial bump. However, the Pew Charitable Trusts report reveals that in fact nearly 70% of payday borrowers use payday loans not for emergencies but to cover ordinary expenses and that the average borrower is indebted to the payday lender for at least five months of the year[8].

[8] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), pages 13-14.

Payday lenders use misleading and deceptive messages to sell their products[9]. If a customer inquires about the interest rate charged for a loan, the lender will typically claim that they don't charge interest but rather a flat fee, and their marketing materials minimize the potential penalties for overdue loans.[10] However, when these fees and penalties are translated into a standardized APR, the interest rate can top 1000%.

The payday lending industry claims that the APR is an unfair measure for short-term loans because the origination cost is spread over so little time. But most borrowers are repeat borrowers and carry their debt over several loan periods. About 20% of Minnesotans who have taken out payday loans take out 20 or more within a single year, 50% take out 10 or more, and 70% take out five or more. Clearly, most payday loans are issued for longer-term financing rather than short-term credit, as the industry claims. This pattern of repeat borrowing over the course of a single year suggests that the APR is a true measure for payday loans.

Regulations

Payday lending is primarily regulated at the state level, although an important federal law was enacted several years ago to protect military service members from what the United States Department of Defense characterized as predatory payday loans. In 2007, at the request of the Department of Defense, Congress imposed a 36% interest rate cap on loans to military personnel and their families in response to compelling evidence that payday lenders were targeting service members and concentrating their stores in areas surrounding military bases.[11] The Department of Defense's report examining the effects of the 2007 Military Lending Act found decreased use of payday loans by service members, who instead turned to military aid societies and banks and credit unions affiliated with the military. These institutions have in turn provided increased access to affordable, small loans for service members. Evidence suggests the law may have compelled some payday lenders located near

[9] Ron Elwood, Legal Services Advocacy Project, *The Devil is in the Details: Is Payday Lending a Godsend, a Necessary Evil, or an Enticement into Financial Hell* (2012), pages 18-20.

[10] Christopher Peterson, Truth, Understanding, and High Cost Consumer Credit: The Historical Context of TILA, 55 Fla. L. Rev. 807, 896 (2003) Asserts that payday lenders systematically delay divulging accurate comparative price information such as the annual percentage rate of their loans. Also, Megan S. Knize, *Payday Lending in Louisiana, Mississippi, and Arkansas: Toward Effective Protections for Borrowers,* 69 La. L. Rev. 317, 326 (2009). Quotes a former manager of a payday loan store admitting that "she and her coworkers… would not talk about [the APR] or explain what it meant."

[11] Department of Defense, *Final Rule: Limitations on Terms of Consumer Credit Extended to Service Members, Federal Register,* Vol 72, August 31, 2007, at 50580. http://www.gpo.gov/fdsys/pkg/FR-2007-08-31/pdf/07-4264.pdf

military bases to close. The report also found that a few payday lenders seemed to be modifying their products in order to evade the new regulations, but others simply stopped offering payday loans to service members.[12]

It appears the Military Lending Act has been successful in protecting service members and their families from the predatory practices of payday lenders. Except for the closure of some storefronts near military bases, the impact on the payday lending industry has been minimal because the interest rate cap applies only to a small subset of potential borrowers. Payday lenders are still able to profit at the expense of non-military customers.

Payday lenders in Minnesota are not required to inquire whether the borrower is an active service member or a dependent of the member and may not know whether they are in compliance with federal law.

While the federal Military Lending Act applies only to payday loans issued to service members and their dependents, individual states have employed a variety of approaches to regulate the payday loan industry as a whole. Fifteen states plus the District of Columbia effectively ban the practice altogether. The other states allow payday lending, some capping rates at various levels and others instituting no cap whatsoever. Payday lendersclaim that restrictive regulation drives borrowers to online lenders, but that claim has been refuted inthe Pew study that found online lending to be nearly as common in states permitting payday lending as in states restricting or banning it.[13]

North Carolina ended storefront payday lending in 2006. In late 2007, the Center for Community Capital at the University of North Carolina-Chapel Hill issued a report for the North Carolina Commissioner of Banks studying the effects of the payday lending ban on low-income households. The report found that most people, including those who had previously used payday loans, felt that prohibiting payday lending had not affected their households. Moreover, they overwhelmingly believed payday lending was a bad practice, even those who had taken out payday loans before.[14] In the absence of payday loans, households facing an unexpected financial hardship used a variety of other options including not paying an expense or paying it late, tapping into savings, borrowing from friends and family, using a credit card, and obtaining a bank loan. Most of these households used more than one option to meet their financial obligations.[15] The report concluded that by-and-large low-income North Carolinians do not

[12] Department of Defense, *Report on Implementation of Limitations on Terms of Consumer Credit Extended to Service Members and Dependents,* July 22, 2008.

[13] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), page 22.

[14] UNC Center for Community Capital, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options* (2007), page 5.

[15] *Ibid.*, page 6-7.

miss payday lending and are able to find other sources of funds but that there is still demand for alternative affordable small loan products[16].

In Minnesota, payday lenders are required to register as Small Loan Lenders with the Minnesota Department of Commerce in order to make small consumer loans to Minnesota residents. Under the Payday Lending Law (formally the Consumer Small Loan Act), loan fees and amounts are capped. Payday lenders can lend up to $350, and the costs of borrowing depend on the amount loaned as shown in the following chart:

Minnesota Payday Loan Caps [17]

Amount of Loan	Maximum Charge
$50 or less	$5.50
$51 to $100	10% of loan, plus $5.00
$101 to $250	7% of loan (minimum $10), plus $5.00
$251 to $350	6% of loan (minimum $17.50), plus $5.00

Regulatory Loophole

However, a few lenders have found a way to evade these caps. If a lender has sufficient net worth to qualify as an "Industrial Loan and Thrift," it enjoys the authority to use a different set of statutes under which it may offer loans.[18] Those laws, contained in Chapter 53 of the Minnesota Statutes, provide the authority to charge significantly higher rates for the same payday loan that lenders that do not qualify as Industrial Loan and Thrifts are prohibited from charging under the Payday Lending Law.

The Industrial Loan and Thrift model originated with the "Morris Plan" bank (named after Virginia banker Arthur J. Morris). The mission of the Morris Plan banks was to provide credit to those who might not qualify for conventional loans, but at rates that were still affordable and not exploitive. During the Great Depression, Industrial Loan and Thrifts became a source of credit for desperate homeowners hoping to prevent foreclosure.[19]

---

[16] *Ibid.*, page 20.

[17] Minnesota Statutes Section 47.60.19 Minnesota Statues Section 53.02: Industrial Loan and Thrift Companies: Capital.

[18] Minnesota Statues Section 53.02: Industrial Loan and Thrift Companies: Capital.

[19] Ron Elwood, Legal Services Advocacy Project, *History Repeats Itself: A New Generation of Payday Lenders Exploit a Legal Loophole to Pick Minnesotans' Pockets* (2012), pages 18-19.

In Minnesota, Payday America and two other lenders operate under the Industrial Loan and Thrift loophole, while more than 25 other payday lenders make loans under the Payday Lending Law[20]. Because the three aforementioned companies have sufficient capital to qualify as Industrial Loan and Thrifts under Minnesota law, they are able to charge borrowers even more exploitive interests on payday loans than are permitted by Minnesota's Payday Lending Law. For example, an institution regulated by the Payday Lending Law may charge a maximum fee of $15 on a $100 payday loan, yielding an APR of 391%[21]. For the same $100 loan, Payday America charges a fee of $28.28, which translates to an APR of 737%[22]. This exceeds the limit imposed by the Payday Lending Law, but as an Industrial Loan and Thrift, Payday America is able to charge this kind of fee.

Moving Forward

The exploitation of the Industrial Loan and Thrifts loophole and the prevalence of serial borrowing raise important questions about moving forward on this issue. First, for any reforms to have effect, legislation that closes this loophole and places all payday lenders on equal footing should be enacted.

Second, the issue of repeat borrowing and its devastating effect on household finances and the ability to achieve financial stability must be addressed. Some states have limited the number of loans an individual borrower is able to take out during a single year. This regulation has been enacted in Washington State, where a database exists to ensure that no one is able to take out more than eight loans during a single year. In response to this law, the top Washington State payday lender closed 30 of its storefronts, acknowledging that it is too difficult to remain profitable.[23] This confirms that the industry's claim that it only seeks to provide access to short-term credit is a myth, and that the payday lending business model relies heavily on repeat customers carrying debt over longer periods of time.

Some community groups, credit unions, and congregations are exploring ways to offer new, more affordable short-term credit in their communities. For example, Holy Trinity Lutheran Church near Lake

[20] Ron Elwood, Legal Services Advocacy Project, *History Repeats Itself: A New Generation of Payday Lenders Exploit a Legal Loophole to Pick Minnesotans' Pockets* (2012), pages 3-4.

[21] Minnesota Statutes Section 47.60 Subd. 2 (3).

[22] Payday America Rate Calculator. http://www.paydayamerica.com/our-rates-and-fees/.24

[23] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), page 15.

Street in Minneapolis has a committee of volunteers who are looking at the negative effects of payday lenders in their neighborhood, what regulations they feel are lacking, and how they might offer alternative loan products to their neighbors.

In Pittsburgh, Pennsylvania a non-profit payday lender, Grace Period[24], started when two volunteers were moved by a series of sermons at their church, the Allegheny Center Alliance Church. They initially wanted to start a credit union to serve the neighborhood, but when that proved difficult, they partnered with the Pittsburgh Central Federal Credit Union. Grace Period now offers a no-interest "borrowing club" alternative for their community, loaning over $1.5 million annually, a few hundred dollars at a time. Grace Period operates both on-line and at two office locations. Its goal is to educate the community about the danger of predatory lenders and to prove that their community doesn't need exploitive payday loan operations.

Some other states and local jurisdictions have initiated grassroots campaigns to put payday lending restrictions on the ballot. In those states where the question of whether or not to allow payday lending has been put before the voters, without exception the public has voted – and voted overwhelmingly – in favor of banning payday lending.

[24] www.graceperiod.org

Summary

The prevalence and adverse impacts of payday lending are not only legal questions but also moral issues. People of faith and conscience, who value equitable treatment of those with the least means and who abhor exploitation of those experiencing financial hardship, can agree that the current regulatory structure regarding payday lending is unacceptable. Though financially stressed Minnesotans clearly need access to short-term, small-amount credit, allowing its provision at dangerously high rates by a few who evade the law and encourage borrowers to dig themselves deeper into debt is simply unconscionable.

Recommendations

1. Regulate all payday loans in the same way, regardless of the category or license held by the business offering them.
2. Require payday lenders, after making an unreasonable number of consecutive loans (e.g., three loans in a six month period) to convert the next loan into a conventional installment loan to enable the borrower to get off the debt treadmill.
3. Require payday lenders to inquire about the borrower's military status in order to assure compliance with the federal law capping interest rates on payday loans at 36%.
4. Require payday lenders to inquire if borrowers have one or more outstanding payday loans. If so, hold the payday lender to a stricter underwriting standard and require verification that the borrower has a reasonable ability to repay the payday loan.
5. Require payday lenders to provide clear information to consumers by disclosing the true costs of loans.
6. Explore ways for the state to encourage public institutions, private business, philanthropic institutions, and nonprofits to increase accessibility to affordable, short-term credit.

References

Department of Defense, *Final Rule: Limitations on Terms of Consumer Credit Extended to Service Members, Federal Register*, Vol 72, August 31, 2007. www.gpo.gov/fdsys/pkg/FR-2007-08-31/pdf/07-4264.pdf

Department of Defense, *Report on Implementation of Limitations on Terms of Consumer Credit Extended to Service Members and Dependents,* July 22, 2008.

Ron Elwood, Legal Services Advocacy Project, *History Repeats Itself: A New Generation of Payday Lenders Exploit a Legal Loophole to Pick Minnesotans' Pockets* (2012).

Ron Elwood, Legal Services Advocacy Project, P*ayday Lending in Minnesota: 1999-2011* (2012).

Ron Elwood, Legal Services Advocacy Project, *The Devil is in the Details: Is Payday Lending a God-send, a Necessary Evil, or an Enticement into Financial Hell* (2012).

Minnesota Attorney General's Office. www.ag.state.mn.us/Consumer/Publications/PayDayLoans.asp

Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits.* Minnesota Law Review, April, 2008. 92 Minn. L. Rev. 1110.

Pew Charitable Trusts: *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012). www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Payday_Lending_Report.pdf

Louis N. Robinson, *The Morris Plan, 21* The American Economic Review, 222 (1931).

Michael A. Stegman, *Payday Lending,* Journal of Economic Perspectives, Volume 21, Number 1-Winter, 2007.

UNC Center for Community Capital, *North Carolina Consumers After Payday Lending: Attitudes and Experiences with Credit Options* (2007).

Catholic Conference of Ohio, "Payday Lending," www.ohiocathconf.org/i/EJ/payday.htm.

Joint Religious
JRLC
Legislative Coalition

MINNESOTA COUNCIL OF CHURCHES
MINNESOTA CATHOLIC CONFERENCE
JEWISH COMMUNITY RELATIONS COUNCIL
ISLAMIC CENTER OF MINNESOTA

www.jrlc.org

JRLC publishes this paper with the approval of its Sponsoring Organizations:
The Jewish Community Relations Council of Minnesota and the Dakotas, Minnesota Catholic Conference, Minnesota Council of Churches, Islamic Center of Minnesota.

JRLC policy research and publication of this paper made possible by:

Joint Religious Education and Research Fund
Otto Bremer Foundation
St. Joan of Arc Justice Fund
Saint Paul Area Council of Churches
Shakopee Mdewankaton Sioux Community

122 West Franklin Avenue, Suite 315, Minneapolis, MN 55404

Phone: 612.870.3670
Fax: 612.870.3671
E-mail: info@jrlc.org
Website: www.jrlc.org