



**institute on race and poverty**  
**Research, Education and Advocacy**

# **Segregated Communities: Segregated Finance Summary Report**

**An Analysis of Race, Income and Small  
Consumer Loans in Minneapolis-St. Paul, MN,  
Portland, OR and Seattle, WA**

**A Report to the Northwest Area Foundation**

**November 2009**

## **Segregated Communities: Segregated Finance<sup>1</sup>**

The racial composition of neighborhoods is related to access to good, affordable credit. In low income communities of color, high cost loans— both in the home mortgage market and small consumer loan market—are much more common than they are in white and middle-class communities. Poor people of color pay more for loans—an extra cost that many families can ill-afford.

Previous work by the Institute on Race and Poverty documented a dual credit market in the Twin Cities mortgage markets—where even high-income people living in neighborhoods of color were overwhelmingly likely to apply for and receive subprime loans while people living in white segregated communities were overwhelmingly likely to apply for and receive prime loans.

*Segregated Communities: Segregated Finance* examines the geographic and legal landscape of high-cost consumer credit in the three largest metropolitan regions in the North West Area Foundation's service area: Minneapolis-St. Paul, Seattle, and Portland. The study of race, geography and consumer credit is a response to the recent explosion of high-cost small consumer loans made by non-traditional (i.e. non-bank) lenders. In the 1990s, payday lending was a somewhat rare phenomenon. Today, there are now more payday lenders in the United States than McDonald's, Burger King, Sears, J.C. Penney, and Target stores combined.<sup>2</sup> A growing discontent about the economic effects of these high cost loans mirrors this growth in payday lending. In particular, payday lending is suspected of having its greatest impact in segregated neighborhoods of color- where individuals have historically had a hard time accessing traditional credit and where people are most vulnerable to economic upheaval. The relative racial effects of high-cost consumer loans can be constrained by state payday lending regulations and the geography of metropolitan regions, which can lead to a greater or lesser concentration of payday lenders in a metropolitan region.

### **The Cost of Payday Lending**

The social cost of payday lending is enormous. Payday borrowing is associated with delayed medical care,<sup>3</sup> increased evictions,<sup>4</sup> credit card delinquencies,<sup>5</sup> involuntary bank account closures,<sup>6</sup> and bankruptcy.<sup>7</sup> Paige Skiba of Vanderbilt law school and Jeremy Tobacman of the Wharton School found that receiving a payday loan for the first time increases a borrower's risk of entering bankruptcy by 2.48 percentage points.<sup>8</sup> Likewise, Michael Barr of Michigan Law School found that payday borrowers, compared to similarly-situated non-payday borrowers, were three times more likely to enter bankruptcy, twice as likely to be evicted, and three times more likely to have their utilities shut off.<sup>9</sup>

#### *What are payday loans?*

Payday loans are, by definition, small consumer loans; state law usually sets the maximum loan amount. Loans generally range from \$300 to \$500. In exchange for the loan, the borrower turns over a postdated check for the total amount of the loan and fee. The fee for a typical \$325 payday loan is set by state law, but averages about \$52, meaning that a consumer turns over a \$372 post-dated check to secure the loan.<sup>10</sup> Because most borrowers renew (or “turn over”) their loans,

repaying the fees at each renewal, the average payday borrower enters a cycle of at least five loans prior to default or payoff.<sup>11</sup>

Loan turnover occurs because borrowers cannot afford to pay back the loan in its entirety when it becomes due. This is a frequent occurrence, payday customers are often unable to repay loans when they come due, and, as stated above, the average borrower renews the loan five times prior to payoff. This is not surprising given the very short term of the loan (usually about two weeks) and the financial profile of the borrowers. In some states that allow unrestricted payday lending, to renew payday loans borrowers pay another finance fee and renew the loan. In states that ostensibly prohibit turnover, however, the loans tend to be renewed just the same, albeit through a slightly different process: The borrower repays the entirety of the loan, the payday lender then reissues the loan and returns the money with subtraction of additional finance charges.<sup>12</sup>

The Center for Responsible Lending estimates that of the 17 million Americans who took out payday loans in 2006, 12 million borrowers became trapped in a cycle of repeat loans for at least five lending periods. The Center calculated that this amounts to \$4.2 billion dollars in excess fees every year.<sup>13</sup>

### *Who uses payday loans?*

Alternative financial services providers, such as payday lenders, check cashers, and pawn shops, provide banking services to banked and unbanked people who are poorly served by the traditional banking structure. These families are, by definition, low income, have few assets and many have poor or no credit, meaning that they have little money to invest in banks, and that lenders define them as high-risk. When these families experience financial shortfalls, because of unexpected bills (usually car repairs or medical expenses) or unexpected income short falls (job loss or hour reduction), they are often unable to meet all of their financial obligations. For these families, the tradeoffs become untenable: Pay for the car repair, pay for the electric bill, or pay the rent. For the working poor who are facing impossible financial decisions, payday lending seems like a rescue plan.

While the unbanked, Americans without bank accounts, has been the focus of a number of studies concerning access to credit, payday lending is a problem that affects families with bank account. In fact, the vast majority of low-income Americans—more than 75 percent—have bank accounts.<sup>14</sup> These banked households, however, face a banking and credit system that is poorly equipped to help them manage their family finances. The financial services that low income households with bank accounts receive are expensive—families often pay very high overdraft and minimum balance fees because low income families have constrained family incomes and a limited supply of credit.<sup>15</sup> Low-income families with bank accounts often turn to high-cost payday lenders to fulfill their day-to-day banking needs, such as cashing checks and paying bills.

Most payday borrowers do have several options other than payday loans, including negotiations with utility companies, loans from friends or family, or even pay advances from their employers. Payday lending is often, however, the most convenient, albeit the most expensive, method of overcoming financial shortfalls. The problem is that these loans usually often become middle-to-long term debt, with disabling costs. The average borrower pays back about \$793 for a \$325 loan.<sup>16</sup>

### *The Effective and Ineffective Regulation of Payday loans*

As recently as the 1980s, payday lending was effectively prohibited in most states. The ban on payday loans arose in the first part of the twentieth century in an effort to control loan sharking. Loan sharking was the practice of issuing short-term, high cost loans that carried with triple digit interest rates. These loans often became long-term, debt. While loan sharks usually did not resort to violence to secure repayment of these loans, they did turn to the courts to force repayment. These lenders used a variety of fictions to make the loans, and often characterized them as “salary assignments.”<sup>17</sup>

The Russell Sage Foundation’s Uniform Small Loan Law, adopted by most states in the 1930s, largely eliminated the practice of salary assignment and loan sharking. Under the law, states licensed small consumer lenders and allowed both small lenders and mainstream lenders to make short term loans with interest rates ranging from 24 to 42 percent per year. These regulations stayed in place through the 1970s. After the Supreme Court’s decision in *National First Bank v. Omaha Service Corporation*, however, federal and state chartered banks were effectively no longer constrained by usury laws.

After *First National Bank v. Omaha*, small consumer lenders began to lobby state legislators to legalize very high interest rates on payday loans. Payday loans are, effectively, salary assignments, the borrower promises to turn over future earnings for a present loan. Salary assignment, however, is illegal under federal law.<sup>18</sup> State legislators, instead legalized a form of salary assignment where borrowers give lenders a post-dated check, rather than a promise of future earnings to secure the loan. Further, instead of legalizing triple-digit interest rates, states legalized fees on loans that amounted to triple-digit interest rates.<sup>19</sup>

Payday lenders argue that high maximum APRs on payday loans should not worry states because the high loan rates will be driven down by market competition. Research, however, has shown that this is not the case. Payday loan fees (or interest rates) usually end-up with loan prices near the statutory maximum—even when there is ample market competition.<sup>20</sup>

### **Payday loan Regulation in Minnesota, Oregon, and Washington**

Washington allows the highest charges and interest rates for payday lenders of the three states. A fee on a \$325 loan is \$48.75 and the APR for a two week loan is 348 percent in Washington, this fee twice that of what is allowed in Oregon. Oregon has the most stringent requirements for payday lenders, setting a minimum loan period of 31 days and limiting fees to 36 percent APR plus a one-time fee of \$30 or \$10 for every \$100 of the loan, whichever is less.<sup>21</sup> Minnesota has lower fees on initial loans than the other two states, but effectively has larger APRs than Oregon because of Minnesota allows additional fees on turnover loans. Moreover, in Minnesota small lenders that are regulated as industry and thrifts actually charge a higher fee and have much higher APRs than regulated small lenders.

<b>Fees and Interest Rates of Payday Lenders</b>			
	Fee on a \$325 Payday Loan	Minimum loan term	APR 2 week loan
Minnesota	\$ 24.50 (small lender)	none	197 %
	\$33.94 (thrift)		272 %
Washington	\$ 48.75	7 days	348 %
Oregon	\$ 39.94	31 days	149 %

Minnesota, Oregon, and Washington all require lenders to comply with federal Truth-in Lending disclosures. In all states, this includes informing the customer of the APR, through posted signs, materials given to consumer at the time of the loan or both. Minnesota even requires lenders to tell borrowers that they could get the same loan for less elsewhere. Yet, the number of payday lenders—and payday borrowers—is steadily increasing.

The impact that state law and regulation has on the how many payday lenders there are in a region and how they are distributed across neighborhoods becomes more complex in areas that are near state borders. For instance, the Portland, Oregon metropolitan region straddles the State of Washington and more lenient payday lender regulations in Washington has led to a proliferation in payday lenders in the Washington State portion of the Portland region.

Lenient payday lending regulation can also lead to a proliferation in payday lending stores in areas that lack conventional lenders such as banks and credit unions. In such cases, payday lenders could be more apt to locate in places that lack conventional lenders, such as low-income neighborhoods and neighborhoods that are predominately people of color.

### *Segregated Communities and Lender Locations: The Geography of Payday Lending*

A leading reason people choose a lending establishment is location. According to the Federal Reserve Board's Survey of Consumer Finances, in 2007 almost half of those surveyed said that the location of the institution was the top reason for choosing a place for their main checking account, a reason that has increased in importance over the last ten years.<sup>22</sup> Surveys of people using non-traditional lenders, such as check cashers, also often reported using an establishment because of its convenient location.<sup>23</sup>

Given that people often choose lenders according to their location, it is important to consider whether different types of lenders are distributed evenly across a region or whether they favor certain neighborhoods. This study compares the geographical distribution of payday lenders, check cashers, and banks by race and income in Minneapolis-St. Paul, Portland and Seattle.

There are major differences across the three regions in the neighborhood shares of lenders by income and race. Lower income neighborhoods in Portland and Seattle showed much greater access to conventional lenders than in Minneapolis-St. Paul. However, non-conventional lenders tend to be disproportionately in lower-income neighborhoods in all three metros. Racial segregation, sprawl, and legal regulation of payday lenders strongly effect the distribution of payday lenders.

Segregated communities of color have poor access to neighborhood banks and have far more non-conventional types of lenders that charge much higher rates for small loans. Racially segregated communities of color tend to have fewer banks, more check cashers and payday lenders, especially in Minneapolis-St. Paul where non-white segregated census tracts are more numerous and concentrated in the lower-income core of the region. In contrast, there are fewer segregated neighborhoods in Portland and Seattle, and racially integrated areas, places with an abundance of banks.

Low-income neighborhoods have an abundance of all types of lenders, both bank and payday establishments. The abundance of lenders in low income neighborhoods is due in large part to their central locations near regional job centers and in areas near or accessible to higher income neighborhoods. This is particularly true in Portland and Seattle. The advantages of a central location, however, diminish when potential high income customers are distant from the core of the region. This is the case in Minneapolis-St. Paul where there are far fewer banks in the residential portions of the central cities and low income neighborhoods.

The fact that there is more urban sprawl and social separation in Minneapolis-St. Paul helps to explain the difference in shares of banks in the regions' low income neighborhoods. In Portland and Seattle, banks gain an accessibility advantage by being centrally located. While those central locations are often in lower income neighborhoods where many customers have smaller borrowing capacity, they are in close proximity to higher income neighborhoods where there are more credit worthy customers. In Minneapolis-St. Paul the advantage of being centrally located is offset by the fact that central locations are often distant from higher income neighborhoods.

Sprawl and social separation in Minneapolis-St. Paul also contribute to racial disparities in accessibility of conventional credit. There are disproportionately small shares of banks and disproportionately large shares of non-conventional lenders in Minneapolis-St. Paul's non-white segregated neighborhoods, tracts that also are more numerous than in Portland or Seattle. In comparison, Portland had very few segregated tracts and Seattle's segregated tracts, also less numerous, had similar shares of population and lenders of all types.

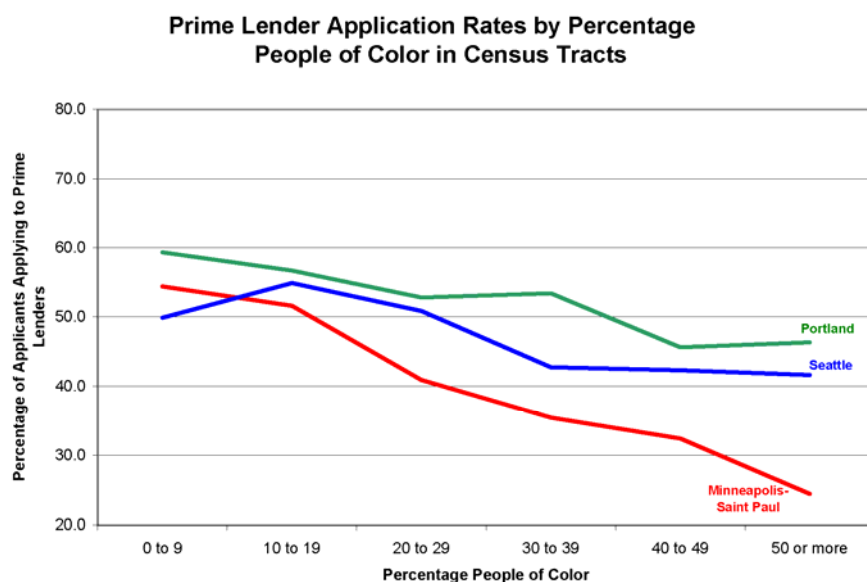
The regulation of small loan establishments also greatly impacts the number and distribution of payday stores in a region. The State of Washington has more leniently regulated payday lenders and as a result, Seattle has many more payday establishments than credit unions, twice as many per capita payday lenders as Portland and four times as many as Minneapolis-St. Paul.

The leniency of regulation in Washington has also affected the distribution of payday lenders in Portland, which is partly in the state. The Washington portion of the Portland metropolitan area contains only 18 percent of the region's population, but over 57 percent of the region's payday

lenders. Notably, payday lenders in all three metropolitan areas are located nearby major highway corridors, in an attempt to service residents from distant communities

### *Where the Banks Aren't: Neighborhood Prime Lending and Race*

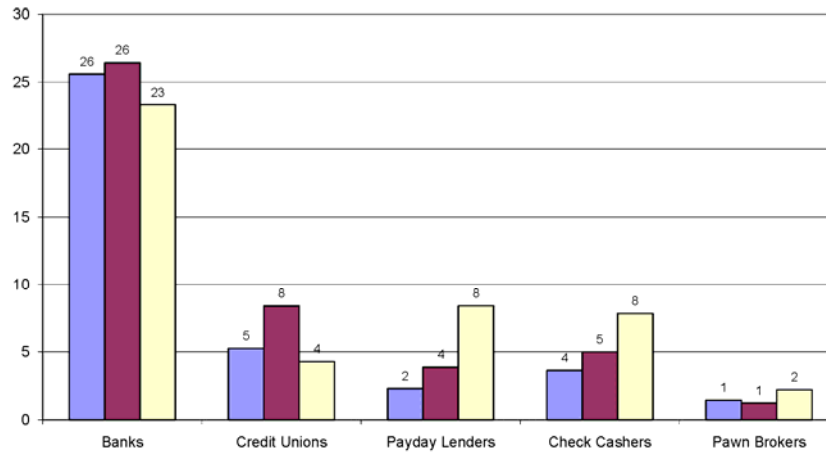
The Minneapolis-St. Paul metro shows a trade-off between neighborhood diversity and prime lender application rates that is clearly stronger than in the other two metropolitan areas. The difference lies largely in the region's neighborhoods with the highest non-white shares. Prime lender rates are similar across the metros at high incomes, but the rates decline much more sharply as racial diversity increases in the Twin Cities. The result is that prime lender application rates are distinctly lower in Minneapolis-St. Paul than in the other two metros in non-white segregated neighborhoods.



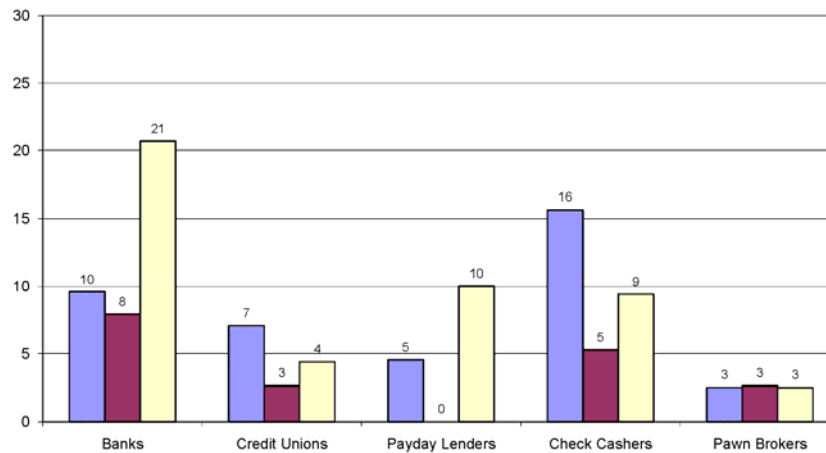
### *Equal Access to Credit*

Families living in segregated communities of color are disproportionately unlikely to apply for prime loans, to live near a traditional bank, and disproportionately more likely to live near a non-conventional or payday lender. The racial composition of neighborhoods is related to access to good, affordable credit. In low income communities of color, high cost loans— both in the home mortgage market and small consumer loan market—are much more common than they are in white and middle-class communities. Poor people of color pay more for loans—an extra cost that many families can ill-afford. Some of this cost can be attributed to the higher risk involved in lending to some low income people. However, civil rights laws are implicated in this lending to the extent the banks make their services less available or market higher cost loans specifically marketed to communities of color. One civil rights law, the Community Reinvestment Act, can be used proactively to encourage banks to make low-cost loans available in communities of color.

**Lending Establishments per 100,000 People**



**Lending Establishments per 100,000 People in Segregated Census Tracts (> = 50% People of Color)**



The lack of traditional banks lenders in communities of color could violate the Equal Credit Opportunity Act, which bans credit discrimination on the basis of race, color, religion, national origin, sex, marital status, or age. The ECOA could be violated by banks extension of credit to payday lenders that target communities of color. This arrangement is similar to banks’ extension of credit to mortgage brokers—and federal regulators have warned banks that this practice could violate fair lending laws.<sup>24</sup> Further, anti-discrimination law can be violated when a bank has both payday and other short term lending programs that carry considerably dissimilar rates of interest or pricing structures.<sup>25</sup> For instance, banks decisions not to enter the lending market in a community of color, but to provide a line of credit to payday lenders that do—effectively leading to one sort of credit for communities of color and another for white communities—could be argued violate the ECOA.

Community Revitalization Act (CRA) was designed to eliminate redlining and encourage investment in impacted communities by “encourag[ing] regulated financial institutions to help meet the credit needs of their entire communities, including low- and moderate-income

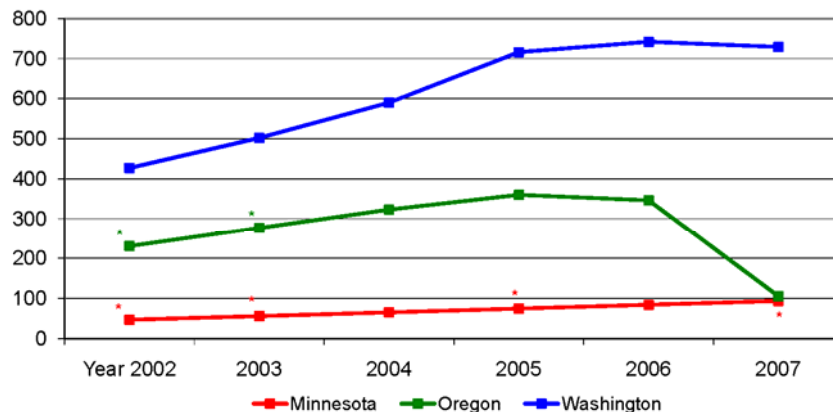
neighborhoods, consistent with safe and sound operations.”<sup>26</sup> Research shows that the CRA has effectively increased fair and affordable credit opportunities to low and moderate income communities.<sup>27</sup> In recent years, federal agencies have begun promoting affordable small, short term consumer loans through the CRA.<sup>28</sup> In 2008, the FDIC launched the Small Dollar Loan Pilot program. The program rewards banks that make payday-sized loans at affordable interest rates. The APR on these loans is capped at 36 percent and must contain an automatic savings component. The FDIC states that lending programs that help move families away from payday loans “would be considered particularly responsive to community needs.”<sup>29</sup>

### *Payday Lending Reform*

At its worst payday lending is comparable to early twentieth century loan sharking. At its best, it is comparable to micro finance projects carried out in the global South.<sup>30</sup> While the practice is not exactly loan sharking—no one will actually come break your legs if you do not pay back your payday loan (although they may harass you and/or take you to court)—the practice is also far from the microfinance model which is intended to allow families to start businesses and increase their long-term standard of living. Payday lending is associated with a host of public and private costs including an increased risk of bankruptcy.<sup>31</sup>

In the 1990s, the Consumer Federation of America and USPIRG began to raise the alarm about the costs of payday lending.<sup>32</sup> These concerns and growing public discomfort about the debt-trap created by payday loans has led most states that permit payday lending to enact some sort of regulation. Several states, including Oregon, have capped the interest rate on payday loans. Others, like Washington, have attempted to limit rollovers. While the bans on roll-over and “cooling off” periods between payday loans tend to be easier to pass in state legislatures—these bills tend to be supported by the payday loan industry—rate caps are the most effective means of reducing the cost of payday lending.

**Number of Payday Lenders in Selected States,  
2002-2007**



Star \* \* denotes that figure is an annual estimate

Sources:

Oregon Department of Consumer and Business Services, Washington State Department of Financial Institutions, Minneapolis Star-Tribune and MN Congress Members Davnie and Pappas (2008)

*Effective State Regulation: Rate Caps*

In 2001, North Carolina, one of the first states to legalize payday lending, became the first to re-ban it. In 2007, Oregon passed rate caps that effectively ban traditional payday loans. In the wake of these bans, several industry-sponsored studies examined their effects. These studies tended to find that consumers were worse off.<sup>33</sup> Studies by other academics and advocacy groups tend to refute the industry-sponsored studies and find that the rate-caps had little effect on the borrowing habits of consumers.<sup>34</sup>

North Carolina allowed its payday lending legislation to sunset in 2001, effectively capping the interest on small loans, those under \$600, at 36%.<sup>35</sup> North Carolina's Attorney General then aggressively prosecuted payday lenders, such as Advance America, that continued to do business in the state.<sup>36</sup> By 2006, the last payday lenders operating in the state agreed to end operations.<sup>37</sup> Because North Carolina was a pioneer with both the advent of payday lending and its abolishment, and because the state has been particularly persistent about actually ending payday lending within the state, North Carolina's experience has been extensively studied. In fact, The Center for Responsible Lending, one of the advocacy groups that first blew the whistle on payday lending is located in Durham, North Carolina. In 2005, the Center released a report finding concentrations of payday lenders in communities of color in North Carolina.<sup>38</sup>

After the lending ban, advocacy groups, industry groups, and scholars examined the outcome of the payday loan ban for North Carolina consumers. The Center for Community Capital at the University of North Carolina examined the availability of credit for North Carolina families, and found that very few households were impacted by the end of payday lending.<sup>39</sup> The study also found that former payday borrowers were pleased with the payday ban.<sup>40</sup>

Donald Morgan Strain, a researcher affiliated with the Federal Reserve Bank of New York, and Michael Stain, however, found more bounced checks, complaints to federal authorities about lenders and debt collectors, and more federal bankruptcy filings in North Carolina and Georgia (both of which had payday bans) than in states that allowed high-cost payday lending.<sup>41</sup> The Morgan study has been criticized for failing to note that the regional check processing centers, where the researchers got their data on bounced checks, are regional processing centers.<sup>42</sup> This means that half the data on bounced checks used to illustrate the increase in bounced checks in North Carolina actually came from states that allow payday lending.<sup>43</sup>

Similarly, Morgan and Strain study's data concerning bankruptcy filings do not account for the broad changes in the bankruptcy code that occurred during the study.<sup>44</sup> The data about the increase in complaints about debt collectors was also problematic: the Fair Debt Collection Practices Act allows consumers to complain about third party debt collectors, but not about the lender.<sup>45</sup> Since many payday lenders keep their collection efforts in-house, these complaints were not collected by the FTC, the federal regulator.<sup>46</sup>

Overall, it appears that North Carolina's regulation has lowered the number of high cost loans taken out in the state without substantially increasing bank overdrafts or other problematic alternatives to payday loans.

*Ineffective State Regulations: Turn-over limits and cooling-off periods*

Other states, like Washington have implemented a bevy of payday lending regulations short of rate-caps. These regulations have included limits on the number of payday loans a borrower can have outstanding, cooling-off periods between loans, and lender disclosure requirements. Many of these reforms have been advocated by payday lenders as alternatives to rate-caps.<sup>47</sup> However, research by the Center for Responsible Lending found that only interest rate caps at or around 36 percent, the amount set by North Carolina and the federal government’s cap for lending to military families, prevents borrowers from becoming trapped in cycles of repeat borrowing or loan flipping.<sup>48</sup> Other measures, including those used in Minnesota and Washington, such as renewable bans, cooling-off periods, payment plans, loan caps based on borrower’s income, state-wide databases, and regulations that narrowly target only payday loans have not stopped payday loan roll-overs.

*Unproven , but popular, regulation: Consumer Disclosures*

Payday and other high cost lenders, along with some economists, often argue that regulation of loan terms and bank locations is unnecessary. The solution, they argue, is consumer education. Provide consumers with information about good and bad loans and rational consumers will make the choices that are best for their families. The purpose of the federal Truth in Lending Act (TILA) is to create informed consumers by requiring lenders to provide true estimates of loan costs. The act reads: “The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this title to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.”<sup>49</sup> The act applies to most loans and requires disclosure of the cost of the loan in terms of APR.

Most payday lenders comply with TILA, and many state laws including the laws of Minnesota,<sup>50</sup> Oregon,<sup>51</sup> and Washington<sup>52</sup> either require TILA disclosures or require TILA plus even more disclosures. For example, Minnesota requires payday lenders to post signs stating that borrowers could get the same loan for less elsewhere.<sup>53</sup> All three states require conspicuous posting of fees and charges, both on websites and offices, as well as on customers’ receipts. Payday lenders have largely supported these provisions, in part, perhaps, because they do not work.<sup>54</sup>

TILA and state laws exceeding TILA give consumers volumes of information about the cost of the respective loans and give information that creates the possibility of consumers comparison shopping for loans. However, there is little evidence that providing consumers with “disclosure and unfettered choice” leads to financially sound consumer choices.<sup>55</sup> While consumer disclosures appear to be a tool to strengthen consumer rights there is little evidence that either consumer disclosures or consumer education leads to better financial decision-making.<sup>56</sup>

In the case of payday lending, it is even less likely that in-store disclosures or consumer education campaigns will effectively steer families away from unaffordable payday loans. Consumers who seek payday loans are already facing serious, unexpected financial shortfalls.

Even economists do not expect rational market decisions from payday borrowers<sup>57</sup>—payday borrowers borrow from these lenders because they overestimate their ability to repay loans.<sup>58</sup>

While requiring payday lenders to comply with federal truth in lending regulations may make states think that they are giving borrowers the tools to make sound decisions, the truth is that borrowers facing a financial shock are usually not in a position to effectively evaluate the relative costs and benefits of taking out these loans. The social costs of these debt-traps were the reason why salary assignments (otherwise known as loans sharking) were prohibited over 100 years ago in most states.

### *Effectively Unregulated: Internet Lending*

While high-cost payday loans are generally unavailable at store fronts in many states, these high cost loans are available on the internet. Internet payday loans, tout fast-approval, no background checks, and immediate cash. A 2004 survey by the Consumer Federation of America of internet payday lenders found that internet disclosures often misstate APR's, do not include the finance fees in the APR, and generally make it difficult for consumers to access the true cost of the payday loan.<sup>59</sup> Many internet sites allow renewal without limits and some actually automatically refinance loans.<sup>60</sup>

Most states, including Oregon and Washington, in theory regulate payday lenders under the same rules as payday lenders within the state.<sup>61</sup> In practice, states have difficulty regulating payday lenders. While a few states have convinced courts to apply their consumer protection laws and payday lending regulations to payday lenders,<sup>62</sup> in practice, internet payday lenders offer loans to consumers, even in states that ban payday lending.<sup>63</sup> In a few states, state attorney generals have obtained “cease and desist” court orders against payday lenders. However, payday lenders, much like online gambling sites, continue to make loans to consumers in these states. While the loan companies may not be able to collect on these loans in court, most payday customers pay most of the loan and added fees before defaulting.<sup>64</sup> Further, since many of these on-line lenders have mandatory arbitration clauses in their consumer contracts and some even require consumers to agree not to participate in class action lawsuits against the lenders; it is difficult for individual consumers to challenge the legality of the lenders practices by filing restraining or other orders in courts.<sup>65</sup>

State-by-state attempts at regulating internet payday lending have been less than totally effective because of the pervasive nature of the internet. States' refusals to enforce payday lenders debt collection attempts can go part-way to ending payday lending over the internet, but federal laws regulating payday lending over the internet would be more effective. There is some strong recent precedent for federal regulation of certain types of payday lending. In 2006, the federal government banned payday loans with APRs exceeding 36 percent to active-duty military families (the regulation emerged from a finding by the Department of Defense that payday lending was hurting military readiness).<sup>66</sup>

### *Beyond Banks: Fixing the Safety Net*

The income gap between the rich and the poor in the United States has been growing since the 1970s. While the income of the richest 25 percent of Americans has steadily increased, incomes for the bottom 25 percent have held steady.<sup>67</sup> The wealth gap, the gap in net household assets minus debts, is even larger. By 2004, the bottom quintile of American households had no net wealth.<sup>68</sup> Survey research conducted by the Kaiser Commission found that many low and middle income families had trouble affording necessities, such as food, transportation, child care, and housing.<sup>69</sup> The cost of household expenses combined with increasing income instability makes it difficult, if not impossible for households to generate enough savings to create a safety net.<sup>70</sup>

There is obviously a need for small consumer loans and short-term loans need to be somewhat costly in order for them to be economically feasible for business. The very fact, however, that large numbers of families turn to payday loans to pay basic expenses means that many families are living at the very edge of their budgets and unexpected expenses are sending families into long-term debt. For example, in 2004, the Oregon Division of Finance and Corporate Security found that Oregonians were regularly using payday loans to purchase groceries.<sup>71</sup> While this disclosure shocked many Oregonians, in truth many American families' paychecks do not cover household expenses, much less economic shocks like large medical bills or loss of employment. Simply making the debt less expensive will not stabilize these families.

High—or moderate—cost loans cannot resolve the problem of increasing economic insecurity for lower and even middle income Americans.<sup>72</sup> Payday and other predatory lending and the attendant consequences for families and communities will remain until we make real fixes to the social safety-net. While many failures of the social safety net cause stress to low and moderate income families, the cost of health care emergencies appears to have a disproportionate and severe effect of families' financial stability.

The average payday borrower is low income, earning less than 200 percent of the federal poverty level for a family of four (\$42,800 in 2008). Borrowers also tend to be young, unmarried women who have a high school, but not a college degree.<sup>73</sup> This is constant with the profile of the payday borrower who earns enough to warrant checking account—meaning that they are not the poorest of the poor, they are the working poor. These are the people who make too much money to qualify for Medicaid and who work in jobs that are relatively unlikely to come with good health insurance.<sup>74</sup>

Percentage Uninsured by Race and Income in Three States, 2005			
	Total	% of Poverty Line	
		> 250%	<= 250%
<b>Minnesota</b>			
Black	14.7	8.8	18.5
Hispanic	28.2	16.7	35.4
White	8.0	5.0	17.6
All Other Races	14.1	7.8	21.1
Total	9.5	5.5	19.6
<b>Oregon</b>			
	Total	% of Poverty Line	
		> 250%	<= 250%
Black	22.0	13.5	28.7
Hispanic	37.8	22.0	44.9
White	15.6	9.1	28.0
All Other Races	21.8	13.1	32.7
Total	18.7	10.1	31.8
<b>Washington</b>			
	Total	% of Poverty Line	
		> 250%	<= 250%
Black	17.5	12.1	22.8
Hispanic	28.8	17.5	35.3
White	12.0	7.3	23.8
All Other Races	16.6	10.1	26.2
Total	14.3	8.2	26.2

Source: U.S. Census Bureau, Small Area Health Estimates

According to the U.S. Census Bureau in Minnesota, 9.5 percent of the population is uninsured, while in Washington 14.3 percent and in Oregon 18.7 percent are uninsured. People with low to moderate incomes have even higher uninsured rates. For those with incomes less than 250 percent of the poverty line, 19.6 percent in Minnesota, 26.2 percent in Washington and 31.8 percent in Oregon are uninsured. There are also racial disparities, especially for Hispanics who are more than twice as likely to be un-insured than whites in all three states. In all three states, Blacks and Asians also lag behind whites in health insurance coverage. Being underinsured or uninsured is, of course, predictive of having difficulty paying medical bills and of acquiring medical debt.

Medical bills and medical debt are “tied to a market for a service that is often life-saving and for which the customer is, by definition, vulnerable.”<sup>75</sup> The pressure to pay off medical

bill is intense; consumers often believe that failure to pay medical bills will limit their access to future medical care.<sup>76</sup> In one national survey, one quarter of respondents had been unable to pay for food, heat, or rent because of medical debt.<sup>77</sup> The extreme financial pressures put on individuals as a result of medical debt, could lead people to take out exploitative or predatory loans, leading to a spiral of bad debt.<sup>78</sup>

Medical debt, and correspondingly, un-insurance and underinsurance are a driving part of American’s need for small consumer loans and people’s willingness to take-out extremely high-cost loans. The cost of health care and medical debt is a driving force in mortgage foreclosures, bankruptcy, and probably acquiring payday debt. While banning payday loans might turn the uninsured and underinsured to more affordable types of credit, medical debt for the working poor will continue to be a driving force in the acquisition of debt and a force that drives families to acquire predatory debt unless something is done to reduce the cost of healthcare for the working poor.

### *Conclusion and Recommendations*

Payday lending – entails a high costs for families and metropolitan regions. While there is a definite need for short term credit, payday lending practices drive families deeply in debt. Payday lending is associated with a host of negative consequences, including delayed medical care,<sup>79</sup> increased evictions,<sup>80</sup> credit card delinquencies,<sup>81</sup> involuntary bank account closures,<sup>82</sup> and bankruptcy.<sup>83</sup>

The racial composition of neighborhoods is related to access to good, affordable credit. In the metropolitan areas of Minneapolis-St. Paul, Portland and Seattle, families living in segregated, communities of color are disproportionately unlikely to apply for prime loans, to live near a traditional bank, and disproportionately more likely to live near a non-conventional or payday lender. In low-income communities of color, high cost loans— both in the home mortgage market and small consumer loan market—are much more common than they are in white and middle-class communities. Poor people of color pay more for loans—an extra cost that many families can ill-afford.

Racially segregated communities of color tend to have fewer banks, more check cashers and payday lenders, especially in Minneapolis-St. Paul where non-white segregated census tracts are more numerous and concentrated in the lower-income core of the region. There are major differences across the three regions in the neighborhood shares of lenders by income and race. Lower income neighborhoods in Portland and Seattle showed much greater access to conventional lenders than in Minneapolis-St. Paul. However, non-conventional lenders tend to be disproportionately in lower income neighborhoods in all three metros. Most importantly, in segregated communities of color, there are more unconventional lenders than banks—meaning that people living in segregated neighborhoods have unequal access to traditional credit and traditional financial services.

While the bans on roll-over and “cooling off” periods between payday loans tend to be easier to pass in state legislatures—these bills tend to be supported by the payday loan industry—rate caps are the most effective means of reducing the cost of payday lending.

For low-income borrowers, there is an absence of small loan products to help with such shortfalls. Banks and credit unions do provide an avenue for consumers to absorb financial shortfalls. Banks and credit unions, however, have not often met this demand because their business models make it difficult to make such loans. High—or moderate—cost loans, however, cannot resolve the problem of increasing economic security for lower and even middle income Americans.<sup>84</sup> Payday and other predatory lending and the attendant consequences for families and communities will remain until real fixes to the social safety-net are implemented.

## **Recommendations**

### • **Effectively Regulate Payday Lending**

- Rate caps are, by far, the most effective way to reign in the cost of payday lending: research by the Center for Responsible Lending has concluded that interest rate and fee caps are the most effective way to limit the cost of payday loans.
- Federal regulation is necessary to regulate internet payday lending. States cannot effectively limit payday lending over the internet; therefore, federal action is necessary.
- Minnesota needs to close its industrial thrift loophole: Minnesota’s industrial thrift statute allows payday lenders to charge far in excess of the APRs contemplated by the Minnesota Legislature when it legalized payday lending. The Minnesota Legislature should act quickly to end the circumvention of its consumer regulation.

### • **Encourage Programs that Provide Access to Affordable Credit**

- Expand the CRA pilot program: The CRA small dollar loan pilot program is an excellent start in encouraging traditional lenders to make affordable, small loans to the working poor. This program should be expanded.
- Establishments such as North Carolina State Employees Credit Union have shown that lower cost small loan products can be profitable. Credit unions provide small loans when supported by state agencies and other lenders. State and federal programs that aid the short-term needs of low income borrowers could increase this capability.
- Credit unions that lack resources to provide small loan products can partner with other lenders through the CRA small dollar loan program.

### • **Fix the Safety Net**

- Support policies designed to lower the income gap between the richest Americans and the poorest Americans.
- Support policies that ensure access to necessities for all Americans, including transportation, health care, and childcare.
- Support for universal health care coverage with low individual premiums would curb some of the most severe burdens on the budgets of working families.
- Federal and state poverty relief programs should cover the working poor—those making 150 to 300% of the Federal Poverty Level.

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<sup>2</sup> Karger, 2005.

<sup>3</sup> Melzer (2008).

<sup>4</sup> Barr 2008)

<sup>5</sup> Aragwal et al. (2009)

<sup>6</sup> Campbell et al. (2008).

<sup>7</sup> Skiba and Tobacman (2008).

<sup>8</sup> Skiba and Tobacman (2008).

<sup>9</sup> Barr (2008).

<sup>10</sup> Logan and Walker (2009) at 2.

<sup>11</sup> Center for Responsible Lending (2009);

<sup>12</sup> Occasionally there is a twenty-four hour or more waiting period. Research shows that even in states with waiting periods, payday loans are often renewed because borrowers simply cannot afford to pay them off.

<sup>13</sup> King, 2006.

<sup>14</sup> About 75 percent of families earning less than \$18,900 and about 87 percent of families earning between \$18,000 and \$33,900 per year have bank accounts. Bucks (2006)

<sup>15</sup> See Barr (2008) at 6.

<sup>16</sup> King et al. (2006)

<sup>17</sup> National Consumer Law Center (1995)

<sup>18</sup> 16 C.F.R. § 444.2(a)(3).

<sup>19</sup> Peterson (2008).

<sup>20</sup> Further, in places with high concentrations of payday lenders in Colorado, loan fees (and APRs) were highest. In places with fewer payday lenders, loan prices were somewhat lower- indicating that payday lenders compete with other sources of credit and not necessarily with each other. DeYoung and Phillips (2009).

<sup>21</sup> Oregon Revised Statutes, section 725.615. After the Oregon Legislature passed this legislation, 91 of the state's 354 payday lenders applied for a "conventional" license, in an attempt to circumvent the payday lending restrictions. Oregon Department of Consumer and Business Services, press release, "Oregon takes additional steps to protect consumers from high-cost loans" Sept. 21, 2006. To prevent lenders from evading the new interest rate caps, OSPIRG worked together with groups such as Our Oregon, AARP, SEIU Local 503, Lutheran Advocacy Ministry, Ecumenical Ministries, and Oregon Law Center to advocate a package of bills to extend the interest rate caps to all consumer finance lending. (cite) Oregon both adopted rate caps for all small consumer loans and defined payday lenders as lenders who make ten percent or more of their loans are for durations of less than 60 days. Oregon Revised Statute section 725.600.

<sup>22</sup> Federal Reserve Board (2009),.

<sup>23</sup> Seidman, Hababou and Kramer (2005).

<sup>24</sup> 42 U.S.C. §§ 3601-3619 (2006); 15 U.S.C. § 1691 (2006); 24 C.F.R. § 100.125(b) (2007); 12 C.F.R. § 202.2(l), Official Staff Commentary § 202.2(l).

<sup>25</sup> ECOA regulation B.

<sup>26</sup> 12 U.S.C. § 2903(a) (2005).

<sup>27</sup> FDIC Issues Final Guidelines on Affordable Small-Dollar Loans, June 19, 2007.

<sup>28</sup> Affordable Small-Dollar Loan Guidelines, available at <http://www.fdic.gov/SmallDollarLoans/>.

<sup>29</sup> Ibid.

<sup>30</sup> See Douglas McGray, "Check Cashers, Redeemed," New York Times, Nov. 9, 2008.

<sup>31</sup> Skiba (2008).

<sup>32</sup> Consumer Federation of America (1998).

<sup>33</sup> Donald P. Morgan and Michael R. Strain (2007).

<sup>34</sup> Center for Community Capital (2007).

<sup>35</sup> North Carolina Consumer Finance Act. N/C/G/S/ § 53-15.

<sup>36</sup> North Carolina Attorney General, Press Release. March 1, 2006 "Payday Lending on the Way Out in North Carolina: AG Cooper says major payday lenders agree to stop loans."

<sup>37</sup> Ibid.

<sup>38</sup> Kind et al. (2005)

<sup>39</sup> Center for Community Capital (2007).

<sup>40</sup> Ibid at 17.

<sup>41</sup> Morgan and Strain (2007).

<sup>42</sup> Center for Responsible Lending (December 10, 2007).

<sup>43</sup> Ibid.

<sup>44</sup> The study also only controlled the bankruptcy data for unemployment, and not for a host of other usually controlled, relevant factors, such as income, and health insurance rates. Ibid.

<sup>45</sup> 15 U.S.C. §§ 1692-1692.

<sup>46</sup> Ibid.

- <sup>47</sup> See Community Financial Services Association of America, “Best Practices for the Payday Advance Industry,” available at [http://www.cfsa.net/industry\\_best\\_practices.html](http://www.cfsa.net/industry_best_practices.html).
- <sup>48</sup> Urian King and Leslie Parrish, Springing the Debt Trap (2007).
- <sup>49</sup> 15 U.S.C. § 1601 et seq..
- <sup>50</sup> 2008 Minnesota Statutes Section 47.60, subdivision 4(e).
- <sup>51</sup> 2007 Oregon Revised Statutes section 725.345.
- <sup>52</sup> Revised Code of Washington 31.45.060.
- <sup>53</sup> 2008 Minnesota Statutes Section 47.60, subdivision 4(e).
- <sup>54</sup> See Community Financial Services Association of America, “Best Practices for the Payday Advance Industry,” available at [http://www.cfsa.net/industry\\_best\\_practices.html](http://www.cfsa.net/industry_best_practices.html) (last visited July 15, 2009).
- <sup>55</sup> Willies (2008).
- <sup>56</sup> *Ibid.*, Barr et al. (2008).
- <sup>57</sup> Elliehausen and Lawrence (2001).
- <sup>58</sup> Skiba and Tobacman (2008).
- <sup>59</sup> Consumer Federation of America (2004) at 23.
- <sup>60</sup> *Ibid* at 24.
- <sup>61</sup> Revised Code of Washington, section 31.45.105 (1)(d). OR 725.602. Minnesota is one of the very few states that does not currently state that it regulates internet lending. The Minnesota Department of Commerce issued a notice stating its intent to regulate internet payday lending to Minnesota consumers in 2008. This regulation was struck down by an administrative law judge on the grounds that the agency did not go through the proper rulemaking procedure. Since this decision, the state has not attempted to regulate internet lenders.
- <sup>62</sup> Note that attempts by payday lenders to get consumers to agree to the legal fiction that the loan is occurring in a different state than the state in which the consumer is located, have generally been unsuccessful.
- <sup>63</sup> Jean Ann Fox, Anna Petrini, “Internet Payday Lending: How High-priced Lenders Use the Internet to More Borrowers in Debt and Evade State Consumer Protections,” Consumer Federation of America, November 30, 2004 p. 21.
- <sup>64</sup> *Ibid.*
- <sup>65</sup> CFA 2004 at 25.
- <sup>66</sup> Public Law 109-364, the John Warner National Defense Authorization Act for Fiscal Year 2007, Section 670, “Limitations on Terms of Consumer Credit Extended to ServiceMembers and Dependents,” (October 17, 2006.)
- <sup>67</sup> Zhu Xiao Di (Feb. 2007).
- <sup>68</sup> *Ibid.*
- <sup>69</sup> Kaiser Commission (2009).
- <sup>70</sup> Barr (2008).
- <sup>71</sup> Oregon Division of Finance and Corporate Securities, “Payday Loans in Oregon.” (2004).
- <sup>72</sup> Historically, states have developed usury laws during times when the income inequality is high. Glaeser (1994).
- <sup>73</sup> Logan and Weller (2009) (4) Data from the Federal Reserve’s triennial Survey of Consumer Finances.
- <sup>74</sup> Federal Medicaid is generally available for families earning less than 133% of the federal poverty level (FPL). In 2007, the federal poverty line for a family of four was \$20,650. Data available at [www.ssa.gov/policy/docs/statcomps/supplement/2007/medicaid.html](http://www.ssa.gov/policy/docs/statcomps/supplement/2007/medicaid.html). State SCHIP programs offer expanded coverage, but even very generous programs limit eligibility to 250% of FPL for adults without children. Thirty-two thousand dollars is about 250% of the FPL for a family of two. Most uninsured single adults are ineligible for public coverage and have family incomes below 300% of poverty similarly; most uninsured parents have incomes below 300% of poverty. Dubay et al. (2006).
- <sup>75</sup> Siefert (2004) at 789.
- <sup>76</sup> Siefert (2004).
- <sup>77</sup> Collins et al. 2004.
- <sup>78</sup> Seifert (2004).
- <sup>79</sup> Melzer, (2008).
- <sup>80</sup> Michael S. Barr 2008).
- <sup>81</sup> Aragwal et al (2009).
- <sup>82</sup> Campbell et al (2008).
- <sup>83</sup> Skiba and Tobacman (2008).
- <sup>84</sup> Glaeser (1994).