Payday lenders need incentives to ‘do the right thing,’ Baylor grad says

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DALLAS—Texas needs comprehensive payday lending reform that creates market incentives for lenders to “do the right thing,” a recent Baylor University graduate concluded in her senior thesis.

Molly Francis initially learned about issues surrounding payday lending at her home congregation, Wilshire Baptist Church in Dallas.

In cooperation with its New Baptist Covenant partner congregation, Friendship-West Baptist Church in Dallas, Wilshire has worked with the Cooperative Baptist Fellowship to develop a model for congregational advocacy regarding payday and auto-title lending. Pastor George Mason at Wilshire also has been involved in the national Faith for Just Lending coalition.

As part of the Baylor Business Fellows program in the Hankamer School of Business, Francis needed to complete a research thesis prior to graduation.

“When it came time for me to pick a research topic, I didn’t really have an interest in a purely business topic. Something with a social justice bent was more up my alley,” she said.

As she researched the history of payday lending, Francis learned the industry evolved to adapt to legal regulations specific to each state.

“It’s hard to talk about on a national scale, because it is so different in each state,” she said.

Role of third parties

A key development occurred when the U.S. Fifth Circuit Court of Appeals ruled payments to credit service organizations are not considered interest and therefore are not bound by usury laws.

"Because credit service organizations may extend credit to consumers, acting as an intermediary between the independent third party—who owns the capital—and the borrower, payday lenders could avoid being held accountable for usury," Francis said. "Payday lenders in Texas immediately began converting to credit service organizations."

Many consumers do not recognize a third party is involved, since they deal directly with the payday lenders operating as credit service organizations that charge brokerage fees, she noted.

Turns the broker and lender relationship 'upside-down'

The payday lending business model "effectively turns upside-down the normal relationship between a broker and lender" in customary financial transactions, Francis observed.

"Elsewhere, the broker functions as an agent of the lender and is paid through a commission or fees. The principal maintains the risk of borrower default, and the broker has nothing to do with it. The principal seeks a high return for taking on a risky borrower, but the broker likely is compensated the same amount, regardless of risk," she said.

"However, in the new payday lending model, the payday lender acting as CSO takes on the risk of customer default and guarantees the principal to the third-party lender. It is simply a formality that the third party provides the funds. In all other respects, the payday lender acts like a lender."

Targeting the working poor

In Texas, payday lenders concentrate their storefront operations in areas with a high proportion of minority residents and people who live in poverty, Francis observed.

“Payday lenders know where their customers live, and they situate their stores accordingly,” she said.

Typical payday lending customers are the working poor, whose low income and lack of credit history cut them off from mainstream banks but who need help covering expenses until their next paycheck, she noted. Most often, borrowers roll over their loans multiple times.

“Texas is an especially permissive state for regulating rollovers, so Texas consumers are particularly prone to getting trapped in this cycle of debt,” Francis said.

Colorado as model for reform

Christians in Texas should lead the way in advocating for comprehensive payday lending reform that limits the ability of lenders to roll over the same customer loans repeatedly, she said, pointing to legislation Colorado enacted in 2010 as a good model.

The Colorado law reduced fees and limited payments to an affordable percentage of the borrower’s income. As a result, about three-fourths of the loans are repaid within six months, and 18 percent are paid in full within one month. The industry saw a 23 percent decline in defaults per borrower and a 48 percent decrease in bounced-check fees charged by lenders.

Consequently, “payday loan businesses have become more efficient and have served more customers at lower prices,” a study by the Pew Charitable Trusts said. In fact, the number of unique borrowers served by the average Colorado payday-lending store nearly doubled in the years since the reforms went into effect.

“This is exactly the outcome Texas should be working toward—aligning the profits of the industry with the benefit of the customer so the payday lenders are incentivized to do the right thing,” Francis concluded in her thesis.

While the legislative reforms in Colorado brought about consolidation in the marketplace, with about half of the payday loan stores closing, those that remained operate on a more efficient and just business model, she noted.

“Colorado’s success is a hopeful example of what Texas should strive for,” she said. “It proves there is room for the market to consolidate without wiping out the industry or eliminating credit for low-income individuals.”

Credit union model

Francis also finds hope in nongovernmental solutions, such as the salary advance loans the North Carolina State Employees’ Credit Union has offered since 2001.

The advance loans are limited to $500 for 30 days, at an annual percentage rate of 12 percent. A small percentage of loan proceeds go into borrowers’ deposit accounts, and when the account reaches an amount the $500 maximum credit ceiling, the loan drops to a significantly lower share-secured rate.

“Customers often roll over these loans just like they do payday loans, but the fee structure does not busy the consumer in overwhelming debt,” Francis said. “And in time, the required savings from each account accumulates into enough money that the customer in the future may dip into their own savings without taking out another loan.”

The credit union also offers financial counseling and education to help members attain long-term financial stability.

While Francis holds out little hope most churches could function directly as lenders, she sees opportunities for congregations to work in partnership with credit unions—perhaps focused on residents of a specific apartment complex or neighborhood—to provide financial literacy classes and mentoring programs.

“Product innovation is generally driven by mission-oriented credit unions, not large for-profit banks, which is why credit unions might be better equipped to provide a payday loan alternative,” she said.