Running head: Payday

PAYDAY LENDERS:

Marketing to Low-Income Adults

Elizabeth Prosser
IMC – Roosevelt University
July 1, 2008

Paper completed for 452, Summer 2008

In today's economy where credit scores are dropping and prices are rising, more and more Americans are finding it difficult to sustain funds until their next payday. Payday lenders have stepped in to supply the "solution" to their dilemma. Payday loans are short-term loans offered for a relatively low amount; eighty percent are less than $300 (Stegman, 2007). Sounds like a reasonable solution until you whip out your magnifying glass and examine the fine print. Most payday loans charge a fee per $100 borrowed. The fees, however, are just the beginning. The interest rate to borrow money from a payday lending organization is exorbitant. Many average 400% and the highest I was able to locate online was 1564.28% offered via EZPayday Cash online. With rates this high, bankruptcy is just around the corner for the majority of payday loan consumers.

Payday Lending Synopsis

America is not a stranger to the concept of short-term loans. During the Great Depression, borrowing against a postdated check to make ends meet was a necessity to a large number of people. Without this option, many families would have starved. The payday loan industry has come a long way since the Great Depression, more so in the last 15 years. In 2004, the payday loan market was estimated at $50 billion with 25 thousand payday outlets spread out across the United States. (Stegman, 2007) Clearly there is a market for short term loans, but the major players are stand-alone shops with little regulation from state to state. Research by Stegman and Faris (2008) showed three contributing factors to the demand for payday loans. The first is the increase of direct deposit options at consumer financial institutions. The companies that previously cashed checks are losing business, and therefore finding a different type of business in the payday loan market. The second contributing factor is the lack of regulation from state legislators concerning the fees and high interest rates payday lending institutions can charge. The final contributing factor, and in my opinion the strongest, is the growing number of consumers with low or poor credit. The average payday loan borrower is

25 to 40 years old and has an annual income below $50,000. (Rosario, 2005) When compared with adults living in the U.S., the average payday loan borrower is also three times more likely to have been denied credit within the past five years. The question to ask is: Is it ethical to exploit low income adults by charging high interest rates and encouraging a constant cycle of debt?

Payday lenders are often considered modern day loan sharks. The Federal Trade Commission (FTC) has even issued a consumer alert on their website, to help educate consumers who may be at risk of borrowing from these predatory loan sources. The alert urges consumers to find an alternative and provides a list of friendlier options. An excerpt from the alert is below (www.ftc.gov):

> *"The ads are on the radio, television, the Internet, even in the mail. They refer to payday loans, cash advance loans, check advance loans, post-dated check loans, or deferred deposit loans. The Federal Trade Commission, the nation's consumer protection agency, says that regardless of their name, these small, short-term, high-rate loans by check cashers, finance companies and others all come at a very high price."*

The typical payday loan borrower will pay a fee per $100 borrowed then attempt to pay back the funds borrowed plus interest. If there are not enough funds to cover the payment owed when the lender automatically deducts from the consumer's financial account, the consumer is not only dinged a fee from the payday lender but also from their financial institution. Thus, a vicious cycle begins. And if, God forbid, they are able to make payments on time and still struggling to make ends meet they are offered an opportunity to extend the loan or borrow more. Thereby, adding to the amount owed, increasing interest and paying borrowing fees all over again. It's an industry that essentially makes the poor poorer and contributes to the decline of credit in America.

www.stoppaydaylenders.com

The cartoon above pokes fun at the unsettling truth that the business model for payday lending is designed to encourage repeat borrowing. According to Stegman (2007), about 40% of payday loan customers nationally rolled over more than five loans in the preceding 12 months. So what came first for the average payday loan borrower, the payday loan or the debt?

Stakeholders

When analyzing the ethics of an organization, industry or practice it's essential to weigh the different perspectives from various stakeholders. Stakeholders are any person or group of persons that are directly or indirectly affected by the objective of said organization, industry or practice. (Laczniak & Murphy, 1993) The primary stakeholders in the payday lending industry are stockholders, employees of payday lending companies, vendors/suppliers to payday lending companies, regulators and finally payday loan consumers.

The stockholders stand to gain a great deal of income from the industry. With interest rates averaging 400%, the profits collected are substantial. The employees of payday loan suppliers receive the backlash from the community, and defend the practice by stating that without payday lending many consumers would be in worse shape than they are with the short-term loan. More directly, without the option of payday lending many employees would be without a job. If a law were to be passed banning payday loans, a vast group of employees would be out of work. The vendors/suppliers that contribute to the business of payday loans would also be directly affected by any adjustments to the industry. If the changes made were costly to the payday loan company, the transactions with the vendors would be downsized or cut, therefore putting more employees out of a job. If no changes are made and the practices are allowed to continue, payday loan companies will continue to be profitable and that good fortune would spill onto their vendors and/or suppliers.

Federal and state regulators are faced with a difficult challenge. Do they place more restrictions on this division of lending or do they continue with the regulations currently in place? Many state regulators are responding to the demand for interest rate caps and illegalizing of payday loan outlets. These decisions are unpopular with the payday loan organizations, but very popular with the consumers more importantly to them known as "voters." Because of the unsavory payday lending practices, the federal government is getting involved as well. In addition to the ban of "rent-a-bank" practices by the Federal Deposit Insurance Corporation (FDIC) in 2005, the Unites States Congress established the Military Lending Act to protect active military men and women. (Baylor, 2008) The Military Lending Act will be discussed in more detail later in the report.

The borrowers of payday lending are a substantial primary stakeholder in the industry. Many are finding it difficult to live within their means and are looking for a "fix" for their situation. Payday lending appears to be the attractive solution and does have immediate rewards yet long-term consequences. The hardship many borrowers are faced with is the ability to pay back the short-term loan plus the interest and fees. If caps were placed on the interest rates, consumers would not be in so deep a hole. However, if the payday lending were illegal what other options does this group of consumers have? As the FTC has pointed out on their website, there are alternatives but chronic borrowers may not be aware of them or willing to go in the more financially responsible and time-consuming direction.

The secondary stakeholders are the consumer advocates, communities housing payday loan outlets and media. Consumer advocates are putting pressure on regulators and payday loan corporations to change their practice to protect consumers from this type of predatory lending and improve their credit problems. The communities in which the payday loan outlets are housed are typically prevalent in low-income communities. Many communities are fighting back by issuing zoning ordinances to help protect residents of that community from the constant temptation of “fast cash.” It’s fair to say the outlets also offer jobs for residents of the community, but the outlets are doing more harm than good to the residents overall. Lastly, the media focuses on the ethical and financial pitfalls of the payday loan industry. Many articles, news segments and books are written explaining the downward spiral of payday loan advances and how consumers are exploited to generate more profits for the employees in the corner offices. I suspect that with the absence of payday loan outlets, the media would find another topic to focus on. However, with the presence of payday loan outlets the media will always have a story because this one keeps evolving.

The organization has a responsibility to maintain a business that is profitable to the stakeholders, consistent for the employees, fair for the vendors/suppliers, and in line with the regulators. To the consumers, the organization’s main goal appears to be convenience. I believe the organization has an obligation to provide education and incentive to improve finances where the consumers are concerned. If the payday loan industry claims to be beneficial then it should back that claim and start actively moving borrowers in the right direction.

As for the secondary stakeholders, the organization has a responsibility to respond to consumer advocate groups, abide by community requests and communicate with the media regarding any changes in policies or practices.

Common Marketing Tactics

According to Adler (2006), the FDIC is planning a major initiative to encourage banks to offer alternatives to payday lending for underserved consumers. The “underserved consumers” are defined as consumers in rural areas, minority and low-income neighborhoods, military bases and areas with large immigrant populations.

The payday loan process and locations are designed to be convenient and quick. Most payday loan facilities claim that the consumer can have the cash the same day and that there is no credit check. Typically all the consumer needs to get a payday loan is a bank account and direct deposit. Especially with today’s economy, there is a demand for this type of service. Payday lenders have made it easier to access cash by providing more accessible location with longer operating hours and shorter teller lines. Financial institutions, such as banks or credit unions, aren’t meeting this demand largely because of the high risk and low reputation that comes with this business practice.

The hard working middle-class Americans that are targeted generally do not have a “cushion” of liquid assets. (Stegman & Faris, 2003) They are “credit challenged” and are either struggling with too many financial obligations, such as single mothers, or have not reached their peak financial earnings like a typical family just starting out. According to

Stegman and Faris (2003), the payday loan outlets favor working-class neighborhoods over poor communities. These outlets also disproportionately favor high-minority neighborhoods. Their accommodating accessibility and ease of use make it easier for consumers in a financial bind to overlook the interest rate and fees associated.

When a consumer needs money immediately, it is unlikely they will allow time for price shopping. Although disclosure regulations for payday loan businesses require lenders to provide the annual percentage rate to the consumer, it is unlikely the amount that will be paid back is fully understood by their target market. The typical payday loan borrower in the United States repays $793 on a $325 loan. (Baylor, 2008) This is a calculation that requires a reasonable understanding of the payday loan practice and interest calculations. Studies in the United States have shown that most people do not understand the Annual Percentage Rate disclosures and that interest rates are too abstract. (Stegman, 2007)

The benefits of borrowing from a payday loan outlet are minimal in terms of how many but large in terms of significance to the consumer population: easy and quick. These benefits make up the bulk of marketing messages delivered to consumers in the target market. A Cash America Television advertisement captures the spirit of the marketing methods by stating “some things can’t wait until payday.” (Mann & Hawkins, 2007) It’s a phrase many consumers from all walks of life have stated. Its glosses over the fact that there is a consequence to this method of borrowing and only highlights how much you can borrow and how quick you will have it to fix the things that essentially “can’t wait until payday.” Examples of other marketing messages are as follows:

www.myseonetwork.com www.dmiblog.com

www.samedaypayday.com

All advertisements shown above echo the same theme that getting the cash you need is easy and that virtually anyone is approved. To the struggling consumer, it appears to be a painless option. However as the old saying goes, "if it sounds too good to be true, it probably is."

In recent years, the payday loan industry has reached out to a new medium in order to reach more financially challenged people. It now has a firm grasp on the Internet in the form of pop-up ads and Internet-only payday loan operators. Most will promise consumers the funds in under an hour. Typically, the consumer is asked to fax over a few documents to prove income and direct deposit set up. However, there are quite a few that do not require proof. An estimated $500 million in revenues has been achieved through Internet payday loans. (Stegman, 2007) The Internet is a cost-effective channel for payday loan outlets and an even more convenient option for payday loan borrowers.

One example of where the government has stepped in to protect its consumers is in the form of marketing to military personnel. According to Stegman (2007), active-duty military personnel are three times more likely than civilians to have taken out a payday loan because of their demographics, family stage, low salaries, steady paycheck and financial demands. In 2007, Congress ordered a ban of payday lenders for active-duty military personnel and their families. (Stegman, 2007) Prior to this ban, marketing to military personnel included outlet business names suggesting military connection like "Armed Forces Loans." Former military personnel were used to solicit soldiers as borrowers and numerous facilities were built around military bases. (www.responsiblelending.org) These types of practices and the financial stress it created for military personnel who needed to focus on a critical objective, prompted Congress to pass the ban.

Hopefully now that the implications of marketing and lending to this vulnerable segment (military personnel) are recognized by the U.S. government, we are a step closer to protecting other vulnerable consumers.

Frameworks

The framework I will use for the purpose of drawing a conclusion on the payday lending ethical dilemma is Rion's five-stage model developed in 1990. It will be examined from the perspective of a Marketing Representative working for a payday loan corporation. According to SME Financial Systems, Rion's approach incorporates integrated judgment, meaning a rationale or analysis with different perspectives and various applications in mind.

Stage One – Why is this bothering me?

The Annual Percentage Rate and fees associated with this type of loan is considerably high for any consumer. Yes, the interest rate is posted where consumers can see it, but how do I know the borrower clearly understands the implications of the loan? The information is provided, but it is not clear. Borrowers are signing a contract because they need the money right away. Their need for money is clouding their judgment and the advertisements are marketed to this group of borrowers.

Stage Two – Who else matters?

In other words, what impact does this behavior have on the major stakeholders? I understand this is a business and ultimately the goal is to make money in order to survive as a company and support employees. The need for this business will not go away if payday lending goes away. That is a guarantee. Thus, it is safe to say the stockholders will continue to thrive. I can also guarantee that the employees on the front lines that talk to borrowers on a regular basis are faced with many high- stress situations. You can’t provide a business such as this without high stress and pressure situations derived from frustrated and angry borrowers. If it were a more respectable product aimed at improving a borrower’s financial situation, the stress and guilt would lessen a great deal

As a business there is also a duty to the consumer. The products and services offered should benefit the consumer and contribute to the economy. It’s true that the consumer receives the immediate benefit of receiving cash on the spot when they need to bridge the gap to their next paycheck, but will a payday loan help them in the long run? The payday loans and marketing messages are designed for repeat borrowers and rollovers, resulting in more debt for the borrower. Typical payday loan borrowers have poor credit. Instead of building the credit to increase their borrowing options in the future, payday loans are making it worse and creating more stress for an already frustrated group of consumers.

Stage three – Is it my problem?

As a Marketing Representative for a payday lender, I should know better than to borrow this type of loan. But let's step back and take a look at the bigger picture. If consumers continue to borrow from high interest payday loans the average for credit scores in the United States will continue to decline. More and more Americans will be evicted from their homes and the housing market will narrow as a result of less eligible borrowers. Ultimately, the economy and communities surrounding payday loan outlets will not endure if consumers are unable to support themselves financially. Yes, it is my problem.

What if someone I cared for found himself in the payday loan debt cycle? Knowing what I do about the payday loan process, I have an obligation to disclose the information in advertisements to educate borrowers clearly and thoroughly. I have a moral obligation to respect others and to promote quality products only.

Stage four – What do others think?

Most people unconnected to the payday loan industry firmly stand against their practices. It is widely recognized that there is a need for this type of product. However, the means to provide it are deplorable. Advocacy groups and organizations such as the FTC are speaking out against payday lenders and are releasing information to educate consumers on the alternatives available. As mentioned previously, Congress issued a ban against payday loans for military personnel. Although State and Federal regulations imposed on the industry have been far and few between, consumers and groups are speaking out and demanding more restrictions. Overall, the response is not favorable.

Stage five – Am I being true to myself?

If a newspaper approached me for an interview on payday practices, I would decline. I would not want my name linked to the product offered as it currently stands in the market. It clearly preys on vulnerable consumers and does not improve their financial picture. The business is not providing a service to the economy except to make those that stand to gain within the industry richer.

The Golden Rule to "do unto others as you would have them do unto you" is absent within this industry. I would not want to be blind sided into an unsound loan with exorbitant interest. I would not want to be blind sided into any decision that can be construed as detrimental.

Implications for Practitioners in the Field

Stricter regulations are imperative. Today, 13 states, such as Arkansas, Georgia and New Jersey, have banned payday lending. Some states have placed caps on the interest rates. Illinois put forth regulations for payday loans under 120 days, but the payday lenders have responded by extending the loans past 120 days increasing the amount owed for borrowers.

Practitioners in the field will most likely be required to provide educational tools for borrowers as well. If there are any ethical practitioners in the industry now, they should provide education to borrowers before it is mandated. It is ridiculous to assume the consumers targeted will weigh their options and fully understand the terms agreed to when they sign a contract for fast cash. The disclosure requirements will grow and if there is more regulation imposed on the practice it could potentially widen the market because more financial institutions may opt to begin providing this type of product if it brought more educated borrowers.

If, however, the industry continues the “race to the bottom” practitioners in the field will have the stigma attached with promoting an unrespectable business. This isn’t the first industry to have unethical marketing practices to reach a bottom line, but it’s not good company to be in and is difficult to salvage.

Solution

As previously mentioned, many States have imposed more regulations on the payday lenders. However, the move to completely ban them is a mistake. The FDIC is encouraging banks and credit unions to develop products similar to payday loans to meet the demand, because they recognize that there will most likely always be a demand.

One example of a credit union who did it right is North Carolina State Employee’s Credit Union. They developed a product called the Salary Advance Loan (SALO) in 2001, a loan product that not only bridges the payday gap but also builds savings. The product has grown and the typical monthly volume is $12-13 million. (Stegman, 2007) Any member who has not caused a loss to the credit union, is not in bankruptcy and has direct deposit is eligible for a SALO. The maximum amount for a SALO is $500. The amount borrowed is automatically repaid on the member’s next payday via automatic transfer from their direct deposit. The current interest rate for a SALO is 12% and there are no fees associated. The Credit Union has earned about $2.5 million in interest income and experienced a net loss of $1 million resulting in $1.5 million of net income. A Salary Advance Cash Account is also established with the loan and requires that 5% of every SALO be deposited into this account. If a member withdraws from the Salary Advance Cash Account, they are unable to borrow a

SALO for six months. The money in the account belongs to the member and was established to build savings so the member would not have to borrow a loan when they were unable to make ends meet. The Salary Advance Cash Accounts exceed $7 million total, and some members have saved over $1,000 or more.

The SALO product proves that it is possible to satisfy the demand, market to individuals that need it and still be able to sleep with a clear conscience. To market a loan with interest rates averaging 400% can never be considered ethical. It's unreasonable and predatory. It is our responsibility to educate consumers and positively contribute to society. There is a clear lack of this objective within this industry.

www.stoppaydaypredators.org

REFERENCES

Adler J., (2006). Underbanked initiative near rollout: FDIC. *American Banker, 171* (201), 1-4.

Baylor, Don. (2008). The hidden costs of payday lending. *Texas Business Review,* 1-4.

Laczniak, Gene R., & Murphy, Patrick E. (1993). *Ethical marketing decisions: The higher road.* New Jersey: Prentice Hall.

Mann, Ronald J., & Hawkins, Jim. (2007). Just until payday. *UCLA Law Review, 855.*

Payday loans equal very costly cash: Consumer urged to consider the alternatives. (n.d.), Retrieved June 21, 2008, from http://www.ftc.gov/bcp/edu/pubs/consumer/alerts/alt060.shtm

Rosario, Angelina. (2005). The average profile of customers opting for a payday loan cash advance. Article posted to Infonexus.org.

SME Financial Systems. Decision making frameworks. *Business Resources*, 1-9.

Soldiers at risk: military personnel vulnerable to payday loans. (n.d.), Retrieved June 27, 2008 from http://www.responsiblelending.org/issues/payday/briefs/page.jsp?itemID=28546770

Stegman, Michael A., & Faris, Roberts. (2003). Payday lending: A business model that encourages chronic borrowing. *Economic Development Quarterly, 17* (1), 8.

Stegman, Michael A. (2007). Payday lending. *Journal of Economic Perspectives, 21* (1), 169-190.