

Commentary

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Regulations Targeting Payday Lenders Won't Solve Financial Problems

By Calvin Harris II

The nation's current economic crisis has made it difficult for even dependable borrowers to get credit. Recognizing that some people facing their own fiscal challenges may find quick-fix options to be attractive, the Saint Louis Board of Aldermen is debating a proposal that would restrict the opening of new payday loan firms and check cashing operations near schools and residential areas throughout the city. The plan would also prohibit new stores from opening near existing operations of this type.

While it might be argued that the proposed limits would prevent low-income people from worsening their financial woes, this type of one-size-fits-all regulation fails to account for the many diverse needs of people dealing with different kinds of financial trouble.

Payday loans are advances intended to cover borrowers' short-term expenses until their next paycheck. While the number of payday loan sites around Saint Louis has decreased, both in the city and around the county, the stores remain ever-present in areas where residents are the most financially vulnerable. Payday lenders focus on marketing their services to consumers who have little access to traditional forms of credit. In the state of Missouri, the fees and interest charged by such lenders ranges from 422 percent to as high as 1,950 percent.

However high these rates may seem, analysis offers an explanation through the concept of "adverse selection." This occurs when potential loan recipients are unable or unwilling to provide information that relates to their likelihood of repayment. Unfortunately, most payday loan seekers have credit histories showing that they present great risks to lenders. Unlike bank lenders, which require a verification of income, payday lenders are often unable to verify backgrounds — they are left wondering which borrowers are likely to repay and which aren't.

Payday loans generally represent a credit source of last resort for those borrowers most likely to be rejected for bank loans, so the very fact that someone seeks a payday loan may itself be seen as an indication of risk. In order to remain in business at all, payday lenders

Summary

Payday loans carry extremely high interest rates, leading some Saint Louis officials to seek a regulatory fix limiting new stores. However, the suggested limits would not change the underlying need for emergency funds faced by many without access to traditional forms of credit. Limiting competition would leave them more vulnerable.

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must charge high fees so that they collect enough money from repaying borrowers to compensate for the loans that end in default. Many borrowers would still consider taking out an ultra-high-interest loan for a short time to be cheaper than bouncing checks and paying overdraft fees.

People interested in ending the cycle of poverty in our cities may be concerned about the high cost of payday loans, but we must not ignore the basics of supply and demand. Restricting the opening of new payday loan sites would only decrease competition in the field, thus increasing the rates and clientele of existing stores. In either case, though, the market for risky loans will still bear high rates. Former Show-Me Institute policy analyst Justin Hauke pointed out in a 2007 commentary that many people “fail to consider ... that if lenders are earning abnormally high profits, why don’t new lenders enter the market and compete rates down to lower levels?”

The likely alternative to payday loan stores would be a burgeoning new black market for lending, which would be even more risky and expensive. Any drug dealer off the street with a lot of ready cash could easily take the place of payday loan stores, and the violence we see in black market industries like the drug trade would certainly spill over as an enforcement mechanism for repayment. Instead of high interest rates, punitive measures would take the form of high-interest pain. This would not likely improve available opportunities for low-income citizens.

Those who want to confront the root of the problem could start by encouraging and promoting programs that help people better signal credit trustworthiness by bringing more order to their finances. “Finding Paths to Prosperity,” which is sponsored by the Corporation for Enterprise Development’s Financial Literacy Initiative, offers a curriculum geared toward individual development account (IDA) programs. “Money Smart,” offered by the Federal Deposit Insurance Corporation, aims to enable effective use of banking services.

Although it’s tempting to see government regulation as a solution to the financial problems that many people face, it’s important to remember that the existence of payday lending firms is a rational response to a market need — a symptom, not a cause. Doing away with them won’t solve the underlying economic problems, and may even make them worse.

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