The Cost Of Fast Cash For Students: Payday Loans Versus Credit Card Cash Advances

Charles P. Corcoran, University of Wisconsin – River Falls, USA

ABSTRACT

When asked if they, a friend or a family member has borrowed cash quickly, spur-of-the-moment, with little or no credit checking or collateral, many respond affirmatively. Twenty-one of eighty-two students (25.6%) from my Spring, 2007, Personal Finance course have first-hand knowledge of a credit card cash advance, while seven of eighty-two students (8.5%) have first-hand knowledge of a payday loan transaction. Two of eighty-two students (2.4%) claim to know of instances of both methods of obtaining cash quickly. While both methods of borrowing should be avoided, should an emergency loan be necessary, the cost of a credit card cash advance is significantly lower than the cost of a payday loan.

THE COSTS OF PAYDAY LOANS

Payday loans offer short-term cash advances on their customer's next paycheck for fees starting around $15 per $100 borrowed. These loans carry APRs that generally range from 391% to 443% (Stephens, 2003). By requiring full repayment within a short period of time, generally two weeks, with no option to make payments in installments, lenders compel payday borrowers to return again and again, renewing a loan for another large fee without being able to pay down the principal. This loan flipping is the foundation of the payday lending business model. Even as the costly nature of payday lending has become clear, the industry continues to grow at a significant pace. Payday loan volume is at least $28 billion a year, growing by well over 100% over a recent five year period (Stegman and Feris, 2003). In nearby Hudson, Wisconsin, three payday lenders have opened in the past five years.

The payday lending industry's growth is based on their successful lobbying for legalized loan flipping, creating a chronic borrowing condition (Fox, 2004). A report by the Center for Responsible Lending found that the one-time, two-week loan that payday lenders market is virtually nonexistent (Ernst, Farris, King, 2003). In the report, only one percent of payday loans go to borrowers who take out one loan per year and walk away free and clear after paying it off. The industry relies almost entirely on revenue from borrowers caught in a debt trap; ninety-one percent of payday loans go to borrowers with five or more loan transactions per year. The data show that payday loans are, in fact, designed to be renewed.

Contrary to prudent lending practices, payday lenders do not make loans based on the borrower's ability to repay. Borrowers need only a checking account and a pay stub verifying employment to qualify for a payday loan, which averages about $300 (Advance America, 2007). The loans are secured by the borrower's signed personal check, which is dated on the borrower's next payday. The lender may submit this "live" check to the bank for payment should the borrower default. But most borrowers are unable to pay the loan back in full when it is due and still have enough cash to make it to their next payday.

Payday lending costs borrowers $4.2 billion in predatory fees (King, Parrish, Tanik, 2006). The prospect of bouncing the check left in the hands of the lender, often accompanied by fear of criminal prosecution for writing a "bad check," puts tremendous pressure on the borrower to avoid default. So the borrower generally pays another fee, typically $50 on a $300 loan, to renew or float the loan for another pay period. This transaction is called a rollover.

Or the lender may close out the loan and reopen it quickly to the same effect, called a back-to-back transaction. Back-to-back transactions and rollovers cost the borrower exactly the same amount, typically $50 every payday until they can pay off the loan in full and walk away. However renewals are accomplished, over time the borrower finds it harder to pay off the loan principal for good as fees are stripped from their earnings every payday. They are frequently trapped paying this interest for months or even years, and many go to a second or third payday lender in an often fruitless attempt to escape the trap (www.responsiblelending.org., 2007). The process of loan flipping creates the long-term cycle of credit dependency. Table 1 indicates the average cost of a payday loan, including an average of eight flips (King, et.al, 2006).

Table 1: Average principal and interest paid back on payday loan

Average principal (from state regulator data):	$325
Typical fee for $325 loan:	$52
Average transactions per year:	9
Total interest for original loan + 8 flips	$468
Annual percentage rate	416%

By obscuring the long-term nature of their loans, payday lenders were initially successful in convincing state legislators to exempt their product from existing small loan laws. Many states have annual interest rate caps of 36% or less for small loans, but have authorized rates far higher rates for payday loans on the grounds that these are emergency two-week loans, not long-term obligations. Other states recognized the costly nature of payday loans and refuse to grant payday lenders exemptions from small loan laws, prompting some payday lenders to disguise their loans as other products in order to continue illegal lending practices (Cooper, 2004).

By far the most pervasive method payday lenders have used to circumvent state lending laws is what they call the agency model, also known as "rent-a-bank." Under this arrangement, large payday lending companies typically partner with very small banks located in states with lenient lending laws. The payday lenders claim that their association with the partner bank allows them to preempt state law and make payday loans in states where they would otherwise be illegal.

COST OF CREDIT CARD CASH ADVANCES

Credit card cash advances can provide consumers with convenient and instant access to cash in times of financial need. But this ease and convenience comes with a high price. Fees are computed using two calculation methods. Many card issuers calculate fees on a percentage basis, which typically ranges from 2% to 4%. Other issuers charge "flat fees" for advances. "Flat fees" are not based on the amount of the advance and, therefore, are always the same. An increasing trend is to combine both calculation methods. An example of this would be an issuer that charges x% for an advance, but charges a minimum of $10 regardless of the amount of the advance. Finally, a fee may be charged for advance from an ATM machine.

Often the greatest potential pitfall for consumers who decide to get a cash advance involves finance or interest charges. The interest rate for cash advances is often several points higher than the normal purchase interest rate. Cash advance rates normally range from 20% to 25%. In contrast, the average purchase rate for a standard credit card ranges from 15.88% to 17.30% (www.youngmoney.com/credit, 2007).

Other finance charge pitfalls involve grace periods and the payment method that a card issuer utilizes. Cash advances begin accruing interest immediately and, therefore, do not benefit from a grace period. Thus, even when a card balance is paid in full within the billing cycle, a finance charge will still be assessed for any advances.

A similar pitfall involves the manner in which payments are applied to your account. Most issuers apply payments to card purchases before they apply payments to cash advances (i.e. payments are first applied to purchases).

RESEARCH METHODOLOGY AND FINDINGS

Costs of student credit card cash advances were obtained through fifteen web sites identified through www.bankrate.com. Payday loan cost information was obtained through the three payday lenders in Hudson, Wisconsin, in addition to twenty-seven internet-based payday lenders. The scenario in each case was a $100 loan for two weeks. A two-sample t-test assuming unequal variances was conducted on these sample populations (see Table 2). Variable 1 is the cost of a student credit card cash advance; variable 2 is the cost of a payday loan.

Table 2: T-Test: Two Sample Assuming Unequal Variance

	Variable 1	*Variable 2*
Mean	10.90719	21.12433
Variance	14.48584	49.33049
Observations	15	30
Hypothesized Mean Difference	0	
df	43	
t Stat	-6.32416	
P(T<=t) one-tail	6.17E-08	
t Critical one-tail	1.681071	
P(T<=t) two-tail	1.23E-07	
t Critical two-tail	2.016692	

The rejection region probability as computed by Excel is 1.23E-07. This .000000123 probability definitely warrants rejection of the null hypothesis of no significant difference between means. The mean cost of a student credit card cash advance of $10.91 is significantly less than the cost of an average payday loan of $21.12.

CONCLUSION

Borrowing "on-the-fly" without credit checks or collateral is a costly proposition, to be avoided if at all possible. If it must be done, my research corroborates the literature finding that payday loans are extraordinarily expensive, well exceeding the cost of a cash advance from a student credit card.

REFERENCES

1. Cooper, Roy, (2004), *North Carolina Department of Justice.*
2. Ernst, K., Farris, J., and King, U., (2003), Quantifying the Economic Cost of Predatory Payday Lending, Center for Responsible Lending.
3. Fox, Jean Ann, (March, 2004), Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury, Consumer Federation of America, March 2004.
4. King, U., Parrish, L., and Tanik, O., (2006), Financial Quicksand: Predatory Lending Sinks Borrowers in Debt, Center for Responsible Lending, November 30, 2006.
5. Skillern, Peter, (2002), Small Loans, Big Bucks: An Analysis of the Payday Lending Industry in North Carolina, Community Reinvestment Association of North Carolina.
6. Stegman M., and Faris Robert, (February, 2003), Payday Lending: A Business Model That Encourages Chronic Borrowing, *Economic Development Quarterly*, Vol. 17, No. 1.
7. Stephens, I., (September 26, 2003), Update on the Payday Loan Industry: Observations on Recent Industry Developments.
8. www.advanceamerica.net (July, 2007)
9. www.bankrate.com (July, 2007)
10. www.youngmoney.com/credit_debt/credit_basics/040216_01 (July, 2007)

NOTES