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## The Phony Controversy Over Payday Lending

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Here's a thought that doesn't seem to have occurred to those critics of payday lending, lately including everyone from members of the faculty of Harvard Law School to the attorney general of North Carolina, who seem to be popping up like dandelions these days. Are you ready? **Payday lenders provide consumers with a legitimate, valuable economic service, for which they deserve to earn a reasonable return.**

Did that not make it into Jesse Jackson's testimony in front of the Senate Banking Committee yesterday? No? Even so, it's true.

The payday loan industry's would-be "reformers" are clueless of a basic fact: most borrowers are *not* the ignorant dolts the do-gooders seem to think. Rather, they are rational actors who take out payday loans because they have a near-term cash-flow problem they'd like to resolve as inexpensively as they can. Payday loans provide the best solution. As our own Rick Biggs [argued here](#) last month:

Suppose I'm out of cash, between paychecks, and have a \$100 credit card bill due in two days. I have three choices. I can either *a*) wait until I get paid next week and send in my payment late, *b*) overdraw my checking account--that is, deliberately write a bad check--and hope the bank honors it, or *c*) go to a payday lender, borrow \$100, and pay him back \$115 when I get my next paycheck.

Let's evaluate:

- Option *a* gets me a ding on my credit report and costs me a late fee of around \$35.
- Option *b* will cost me \$30 or more in NSF charges, assuming the bank honors the check, which is no sure thing. Oh, and it's illegal.

- Option *c* keeps my credit file unmarred, is perfectly legal, and costs less in fees than *a* or *b*.

The best choice is obvious. Option *c*--the payday loan option--clearly makes the most economic sense. . . .

Of course! Compared to the alternatives, *payday loans save consumers money*. Not all consumers of course—just those with a very specific near-term liquidity problem.

And in return for that money-saving service, lenders deserve to earn an adequate return. As it happens, payday lending isn't the obscenely profitable business its detractors make it out to be. ROEs of the public companies (there are a handful) range from single-digits to low twenties. That seems eminently fair, and by no means excessive.

What's more—and don't tell *this* to an industry critic, or his head will explode—the fewer regulatory restrictions that are placed on payday lenders, the better deal payday lending is for consumers. Thus the laws of supply and demand apply even in this small corner of the financial-services world. The latest evidence of this, by the way, comes from a study published last month by the New York Fed entitled **"Defining and Detecting Predatory Lending."** Here's its key conclusion:

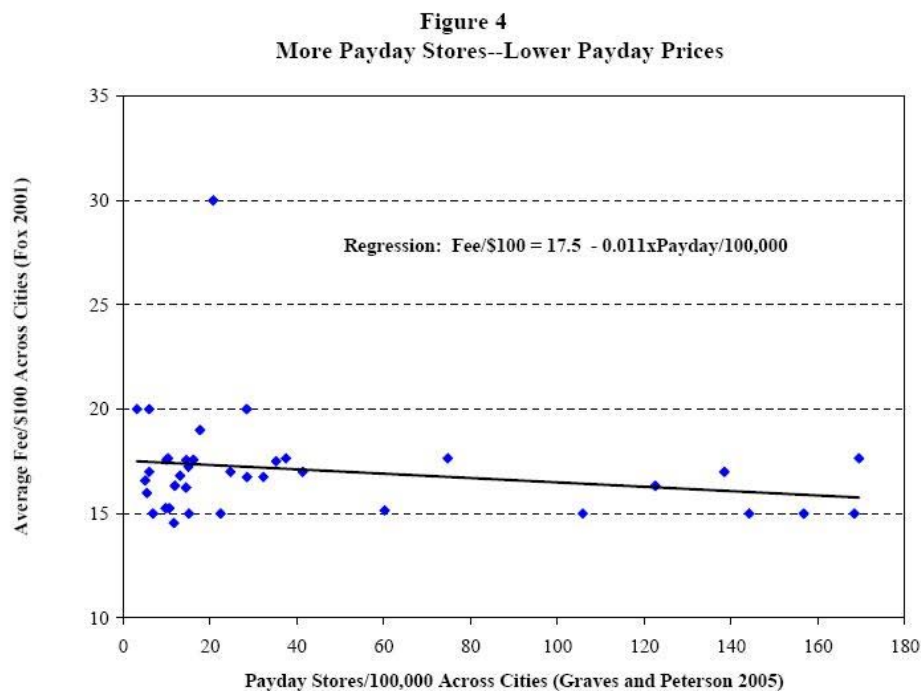
We find that **in states with higher payday loan limits, less educated households and households with uncertain income are less likely to be denied credit but are not more likely to miss a debt payment**. Absent higher delinquency, the extra credit from payday lenders does not fit our definition of predatory. Nevertheless, it is expensive. On that point, we find somewhat lower **payday prices in cities with more payday stores per capita**, consistent with the hypothesis that competition limits payday loan prices.

Translation: regulatory restrictions on payday lending have the *opposite* effect they're intended to have. The restrictions don't appear to improve borrowers' financial health; all they do instead is make credit less accessible and drive up its cost. Observers with even a basic understanding of how free markets work won't be surprised by this.

The Fed study seems to confirm what a lot of us have suspected. Critics

of payday loans (and certain other forms of consumer lending) provide more harm than good to the people they're trying to help. People who want to restrict (or even ban) payday lending have fallen into what we call the "95/5 trap." Their reform schemes would leave 95% or so of payday borrowers, the ones who use the product responsibly and save money with it, materially worse off, while only helping that other 5%, the blockheads who don't have a clue about managing their personal finances. In aggregate, the restrictions' effect on society ends up being decidedly negative.

And as the Fed study shows, the more payday loan outlets in a given market, the less they charge. Study author Donald P. Morgan even provides a chart:



Both logic and now empirical evidence show that payday lending, and other forms of sub-prime finance, provide a legitimate economic benefit. I wish that message would get through to the would-be consumer advocates--not to mention to the people on Wall Street to who "subprime" has become a dirty word.

What do you think? **Let me know!**

/TKB/

*The author is a Manager of a hedge fund and co-founder of bankstocks.com. His fund often buys and sells securities that are the subject of his articles, both before and after the articles are posted. Under no circumstances does this article represent a recommendation to buy or sell stocks. This article is intended to provide insight into the financial services industry and is not a solicitation of any kind. Neither the author nor bankstocks.com can provide investment advice or respond to individual requests for recommendations. However, we encourage your feedback and welcome your comments on any of the articles on this site. Neither the author nor bankstocks.com has undertaken any responsibility to update any portion of this article in response to events which may transpire subsequent to its original publication date.*

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