

EXECUTIVE SUMMARY

Payday loans are very high-cost, short-term loans that ensnare borrowers in a debt trap. As public awareness of the dangers of payday loans has grown, a number of institutions have begun offering alternative products that promise to be more beneficial to the borrower. But payday loan alternatives are not all created equal. Some are considerably more affordable and safer than payday loans. Others differ little from the loans offered by traditional payday lenders.

Several myths surround payday loan alternatives:

- *The myth that any alternative that is slightly cheaper than a traditional payday loan is a good alternative.* An affordable alternative must be just that: affordable.
- *The myth that any loan that does not give the lender excessive profits is a responsible loan.* Loans should be judged by their impact on the borrower, not on the lender's bottom line.
- *The myth that a payday loan alternative needs to look like a payday loan.* That claim is a self-serving justification for offering a loan with such a high fee structure and short repayment period that it is unaffordable.
- *The myth that expensive loans must be tolerated because there is demand for them and we should not restrict access to credit.* Harmful forms of credit should be restricted.

The dangers of payday loans are well documented. Payday loans lead to repeat borrowing and escalating cost. Taking out a payday loan increases the likelihood that the borrower

will lose a bank account, file for bankruptcy, be subject to eviction, delay medical care, face a utility cutoff, and become delinquent on a credit card.

To be truly affordable and avoid the pitfalls of traditional payday loans, an alternative product must:

- Have an annual percentage rate (APR), including fees, of 36% or less;
- Have a term of at least 90 days, or one month per \$100 borrowed;
- Require multiple installment payments rather than a single balloon payment;
- Not require that the borrower turn over a post-dated check or electronic access to a bank account.

The 36% rate has been the widely accepted benchmark for small loans for over a century and retains broad acceptance today. But though the rate is clearly the most important of these criteria, it is not sufficient. The other terms are also critical for the borrower to have a reasonable chance of repaying the loan without immediately needing to take out a new loan and without endangering the ability to pay for necessities. Taken together, these criteria also force the lender to truly consider the borrower's ability to pay the loan before it is made.

Many of the best alternatives also have a savings component or offer financial education. These features enhance the loans but are neither necessary nor sufficient.

Evaluation of a number of payday loan alternatives finds many that meet these criteria, others that need improvement, and some that are essentially payday loans themselves.

Credit unions dominate the field of the best alternatives. Many credit unions offer products that meet all of our criteria, and a number of others come close. A few banks offer affordable small loans, and many offer reasonably priced overdraft lines of credit that can fit the needs of payday loan borrowers. The larger banks, however, tend not to promote their low-priced lines of credit and prefer to market more expensive fee-based overdraft loans. Nonbank lenders are also emerging with viable payday loan alternatives.

A number of other alternatives are considerably cheaper than a traditional payday loan but fall short of being a safe and affordable alternative. Many payday borrowers have access to credit cards, most of which meet our criteria, though we put them in the “needs

improvement” category because other features can make them dangerous. Some credit union small loans are admittedly better than a payday loan but are considerably too expensive and have too short a repayment period.

Finally, a number of credit unions, banks, and bank prepaid cards offer triple-digit, short-term products that are payday loans, plain and simple. Whether they are called payday loans, “direct deposit account advances,” or something else, these loans pose the same dangers of repeat lending and an escalating debt trap. Some of these triple-digit loans are even offered by federal credit unions that manipulate the APR to conform to their 18% legal usury cap.

A full list of the products we evaluated is found at the end of this report.