

Payday Lending and Personal Bankruptcy

Do payday loan customers form a growing share of bankruptcy petitioners, as many media reports claim? This paper attempts to answer that question and others by analyzing a sample of 3600 bankruptcy petitions filed in selected U.S. counties. From the petitions we can determine the share of debtors that files with payday loans; whether that proportion has been increasing in recent years; how these petitioners compare to other debtors; and whether payday loans are a significant factor in the financial crisis these debtors experience.

Robert Mayer, Loyola University Chicago¹

Introduction

Payday loans are the most expensive form of legal consumer credit available today. These small, short-term loans are advanced against a post-dated check, which the lender holds until the borrower's next payday in exchange for a fee. The fee typically ranges from \$15 to \$30 for every \$100 lent. Calculated as an annual percentage rate, the interest on a payday loan usually exceeds 400% (Consumer Federation of America, 2001). When a \$250 loan with a 20% fee is rolled over twice--a not infrequent occurrence--the borrower will pay \$150 in interest, without having reduced the principal owed at all.

All but nonexistent a decade ago, the payday advance industry has grown rapidly in many states and is projected to originate \$25 billion in loans this year (Community Financial Services Association of America, 2003). That growth, and the hefty interest rates charged, have fueled suspicion that payday lending is "contributing to record-high levels of personal bankruptcy in the United States" (Moss, 2000: 1727). A spate of newspaper articles from across the nation reports anecdotal evidence that bankruptcy petitioners are seeking protection from payday lenders in growing numbers. A bankruptcy judge in Missouri has "seen cases of people getting into financial trouble after getting mired in a cycle of payday loans" (Gainey, 2002: C1). In Tennessee "bankruptcy officials said payday lending companies increasingly are showing up as creditors in bankruptcy cases here and around the country" (Wissner, 1999: 1). In Ohio a credit counselor "noticed more people involved with payday loans." "It throws them into bankruptcy," she said. "They end up with four, five or six loans going at the same time" (Roberson, 2002: 1).

The claim that payday lending contributes to the growth of personal bankruptcy is plausible because studies show that the expansion of consumer credit tracks well with increases in bankruptcy filings (Stavins, 2000). Advocates for the payday advance industry, however, insist that their service is "not a substantial factor in consumer bankruptcy" (McCain, 1999: 1). After all, a \$250 loan is only a drop in the ocean of debt in which the typical petitioner is drowning. And that loan may actually prevent bankruptcy by covering an emergency expense. "Absent payday loans," one sympathizer claims, "some borrowers ... face possible bankruptcy" (Smith, 2003: 35).

The lines are sharply drawn in this debate, but the two sides have not attempted to prove their assertions empirically. As is all too frequently the case, this policy debate is occurring in an empirical vacuum, where anecdote or ideological expectations about what must be true substitute for facts.

This paper is a first attempt to shed empirical light on the relationship between payday lending and personal bankruptcy. It reports the results of a survey of 3600 bankruptcy petitions filed in selected U.S. counties between 2000 and 2002. The data analysis attempts to answer three questions about debtors who seek protection from payday lenders. First, do such debtors represent a sizable and growing share of bankruptcy petitioners? Second, does the typical payday loan (PDL) debtor go bankrupt more quickly, with a lower debt-income ratio than other petitioners? And third, does PDL debt constitute a crushing burden for these debtors in relation to net monthly income? As we shall see, the answers are mixed.

Data and Methods

This research project was feasible only because bankruptcy case filings have become available in most court districts through the internet. For a fee, which can be waived by the court, reproductions of all of the documents can be accessed and printed from a remote site. This replaces the old, cumbersome paper system, which made data collection on this scale prohibitively time-consuming (Westbrook, 2002).

The sample drawn for this project was not national in scope but focused on a particular subset of counties. Because state regulation of payday lending varies considerably, we would expect large differences across the states

in the proportion of debtors with payday loans. In 19 states today payday lending is illegal because traditional usury caps on small consumer loans have not been lifted (Consumer Federation of America, 2001). Another 24 states permit payday advances but restrict them in various ways, by capping fees, curbing rollovers, and so forth. The sample for this project, however, was drawn from a third group of states: those which in 2000 regulated payday lending in the most minimal way. In these states, payday lenders are licensed, but no limits are placed on the interest rate or renewals. If payday lending does contribute to bankruptcy, one would expect to find it especially in these seven states, where the industry is least restricted. My sample, then, is skewed to what are presumably the “worst case” scenarios. It would be surprising if states with greater regulation had a worse record than the ones I examined; it would suggest that their regulations are ineffective or even counterproductive.

Of these seven states, data was drawn from only three: Illinois, New Mexico, and Wisconsin. These states are more populous than the other four (Idaho, South Dakota, New Hampshire, and Delaware), and they have more licensed payday lenders. Their bankruptcy filings are also organized in a way that makes it easier to focus on specific counties where more payday lending transactions occur.

In each of the three states data was drawn only from the most populous county, which not coincidentally also had the largest number of licensed payday lenders. Payday lending is chiefly an urban phenomenon. The most rural counties in these states have no licensed payday lenders at all, and the number of outlets rises directly with population density. My sample, then, focuses on the purest cases of payday lending--where regulation is minimal, customers are plentiful, and access is convenient. If payday lending does indeed drive borrowers bankrupt, the problem ought to be greatest and most visible in these counties.

The test cases for this project are Cook County in Illinois (Chicago), Bernalillo County in New Mexico (Albuquerque), and Milwaukee County in Wisconsin (Milwaukee). A random sample of petitions filed in 2000, 2001, and 2002 was drawn for each county. Samples from earlier years would almost certainly have shown large increases in the proportion of petitions listing payday loans since payday lending burst on the scene after 1995 in Illinois and Wisconsin, and only two years earlier in New Mexico. By 2000, however, the industry had matured in these states, and the growth rate of new outlets eased. While not yet saturated--since the volume of loans continues to rise--the market had stabilized, making the first years of this decade a more reasonable time frame to examine.

Four hundred cases were selected from each county for each year--a total of 3600. The sample was random and evenly dispersed through the year. There is no reason to believe that debtors with payday loans file in unusual numbers on a particular day in the week or season in the year, and in my sample those debtors were indeed evenly spread across time. Given the proportion of payday-loan petitions found, the confidence interval for each sample was always less than $\pm 3\%$; when the samples are aggregated, the confidence interval is less than $\pm 2\%$.

Detailed financial information was recorded from all of the Illinois and New Mexico petitions--2400 in all. When aggregating those cases across years, the figures were adjusted for the metropolitan-area inflation rate and stated in year 2000 dollars. From the petitions it was possible to determine gross and net monthly household income, monthly household expenditures, the previous year's gross household income, assets (real and personal), debts (secured and unsecured), debt-income ratios, employment status, length of current employment, sex of the debtor(s), marital status, household size, number of dependents, and chapter filed. For those petitions listing one or more payday loans, additional information was gathered about the absolute and relative size of specific categories of debt (mortgage debt, auto loans, medical debt, utilities, installment loans, credit card and store credit debt, and payday loans). Unfortunately, the petitions do not ask debtors to identify themselves by race or ethnicity, and the question about age is usually left blank. Information about the date debts were incurred is often incomplete, and the interest rate on loans of various sorts is not requested. Significant gaps remain, then, in the profile we can build of debtors, but bankruptcy petitions are a rare source of data about one subset of a population that is otherwise difficult to study.

The data collected from the petitions permits us to test three hypotheses about the relationship between payday lending and personal bankruptcy:

1. PDL debtors constitute a growing share of bankruptcy petitioners;
2. PDL debtors go bankrupt more quickly, with lower debt-income ratios than do other bankruptcy petitioners;
3. The median PDL debtor is heavily burdened with short-term debt, owing more than 25% of net monthly income to payday lenders.

Results

Hypothesis 1.

Table 1 lists the number and percentage of PDL debtors for each county in each year. Aggregating the samples together, 9.1% of the petitions listed payday loans. The lowest percentage was recorded in Cook County in 2000 (7.3%); the highest in Bernalillo County in 2002 (11.5%). The highest totals for all three counties were recorded in 2002, but the increases are within the confidence interval in each case ($\pm 3\%$ at the 95% confidence level). Hence there are no statistically significant differences across the cells. Over time and space, the proportion of PDL debtors in these worst-case scenarios varied little.

Table 1
Petitioners with Payday Loans.

County	2000	2001	2002	Totals
Bernalillo	38/400 (9.5%)	36/400 (9.0%)	46/400 (11.5%)	120/1200 (10.0%)
Cook	29/400 (7.3%)	32/400 (8.0%)	37/400 (9.3%)	98/1200 (8.2%)
Milwaukee	35/400 (8.8%)	32/400 (8.0%)	41/400 (10.3%)	108/1200 (9.0%)
Totals	102/1200 (8.5%)	100/1200 (8.3%)	124/1200 (10.3%)	326/3600 (9.1%)

As was true across the nation, the number of personal bankruptcies increased each year in these counties. Thus the number of petitioners with payday loans also likely grew in each county. In Cook County, for example, there may have been 840 additional debtors in 2002 with these loans, if my samples mirrored the total populations. But that increase did not outstrip the growth in petitioners without payday loans; both groups appear to have increased at the same pace. Based on my sample, then, we could not say that payday lending drove the increase in personal bankruptcies in these counties, as media reports have suggested. While more and more debtors have these loans, the share of this group is not growing in relation to the total pool.

Hypothesis 2.

Table 2 lists the variables for which data was gathered from the petitions for Cook and Bernalillo counties. Table 3 reports the mean for each variable for the two subgroups. To test whether the differences between the means are significant, an analysis of variance was performed, controlling for county and year. The F statistic and level of significance are reported for each variable.

Hypothesis 2 is concerned with the debt-income ratios of bankruptcy petitioners. Past research has shown that the debt-income ratios of those who go bankrupt tend to be much higher than those who do not (Sullivan, Warren & Westbrook, 1989, 2000). This stands to reason. But there appears to be no literature on differences in these ratios *within* the pool of petitioners themselves. Those with higher debt-income ratios delay bankruptcy by carrying more debt in relation to income before succumbing, while those with lower ratios fail more quickly. They seem weaker and less efficient in managing debt. While their bankruptcy results in less debt being written off, which is good for businesses and consumers, the fact that they go bankrupt at all is surprising because it seems that they should be able to carry more debt given their level of income. The question is what drives these debtors bankrupt “before their time.”

Hypothesis 2 tests whether carrying short-term, high-interest payday loans is associated with lower debt-income ratios. Regression analysis was performed to assess how the PDL variable relates to the two debt-income ratios (Ratio 1 and Ratio 2), controlling for other factors that distinguish the two groups of debtors and that might explain differences in the ratios. Adjusted gross monthly household income is included because the debt-income ratios tend to fall for my sample as income rises; while debt generally rises with income, it does not keep even pace. The natural log of that variable was used to render the relationship with the dependent variables linear.

Table 4 reports the results for each regression. Although not the most powerful factor in either equation, the PDL variable is associated with lower debt-income ratios when we control for the other factors. If we translate the coefficients, PDL debtors went bankrupt with half a year’s gross household income *less* in total debt. In other words, without the payday loans, they should have been able to carry debt equivalent to another 6 months of gross household income (\$15,000). Two-thirds of that “lost” debt was unsecured (\$10,000), a sum twice as large as the median store and credit card debt (\$3952) carried by this group.

Hypothesis 2, then, is sustained. PDL debtors do go bankrupt more quickly, with less debt than we might expect given their level of income.

Table 2
Variables.

Variable	Definition and Coding
PDL	1 if petition lists one or more payday loans; otherwise 0
NM	1 if petition was filed in New Mexico; otherwise 0
Chapter	1 if filed Chapter 7; otherwise 0
Joint	1 if joint filers; otherwise 0
Female	1 if female filer; otherwise 0
Male	1 if male filer; otherwise 0
Married	1 if married; otherwise 0
Dependents	1 if filer has dependents; otherwise 0
Employed	1 if filer is employed; otherwise 0
Owner	1 if filer is a home owner; otherwise 0
Size	Number of household members
Length	Number of months employed at current job
Gross	Gross monthly household income (adjusted 2000 dollars)
Net	Net monthly household income (adjusted 2000 dollars)
Expend	Monthly expenditures (adjusted 2000 dollars)
Last	Gross income last calendar year (adjusted 2000 dollars)
Real	Value of real property reported (adjusted 2000 dollars)
Personal	Value of personal property reported (adjusted 2000 dollars)
Assets	Value of total assets reported (adjusted 2000 dollars)
Secured	Secured debt reported (adjusted 2000 dollars)
Unsecured	Unsecured debt reported (adjusted 2000 dollars)
Debt	Total debt reported (adjusted 2000 dollars)
Ratio 1	Ratio of unsecured debt to gross yearly household income
Ratio 2	Ratio of total debt to gross yearly household income

Table 3
Mean Characteristics.

Variable	No PDL	PDL	F	N
Chapter	.749	.725	1.420	2400
Joint	.258	.317	2.429	2400
Female	.405	.486	6.267*	2400
Male	.337	.197	16.621**	2400
Married	.397	.403	0.005	2364
Dependents	.500	.644	16.997**	2364
Employed	.804	.871	6.071*	2345
Owner	.497	.326	25.145**	2389
Size	2.410	2.650	5.204*	2364
Length	68.970	67.030	0.021	1782
Gross	\$2686	\$2772	0.599	2359
Net	\$2121	\$2147	0.098	2384
Expend	\$2207	\$2128	1.194	2387
Last	\$31,067	\$30767	0.075	2286
Real	\$117,581	\$98,571	4.881*	1149
Personal	\$17,858	\$12,250	2.389	2388
Assets	\$76,350	\$44,389	21.130**	2388
Secured	\$64,265	\$40,346	22.028**	2387
Unsecured	\$36,264	\$26,818	7.778**	2387
Debt	\$101,861	\$68,757	26.488**	2385
Ratio 1	1.49	.94	9.700*	2262
Ratio 2	3.52	2.17	24.356*	2262

* p < .05

** p < .01

Table 4
Effects of Payday Loans on Debt-Income Ratios.

	Ratio 1 (n=2225)		Ratio 2 (n=2225)	
	B	Std. Error	B	Std. Error
(constant)	13.498***	.716	24.745***	1/113
Gross (log)	-1.516***	.095	-2.920***	.147
Female	-.626***	.134	-.805***	.208
NM	.436***	.094	.856***	.147
Dependents	-.332*	.141	-.268	.219
Male	-.321*	.136	-.347	.212
PDL	-.366*	.157	-.507*	.244
Size	.006	.051	.100	.079
Employed	-.164	.137	-.476*	.213
Owner	-.002	.100	3.364***	.155
		.166		.293

* p < .05 ** p < .01 *** p < .001

Hypothesis 3.

More detailed information about the distribution of debt was gathered for the PDL subset. This data allows us to assess how burdensome the payday loans were for these debtors.

Table 5 reports the mean and median figures. Pooling all three counties together, the middle individual listed two payday loans when filing for bankruptcy; the average was three. Only 40% of the PDL subset had just one loan outstanding against the next paycheck. But there are statistically significant differences between the counties for this variable. The median PDL debtor in Bernalillo County listed three of these loans but the median case in Milwaukee County had just one. Only 47% of the Milwaukee County subset had two or more loans, but 74% of the Bernalillo County group did. With an average of 2.39, Cook County was closer to Milwaukee County. A single mother in Bernalillo County set the record with 23 different payday loans.

Table 5
Payday Loans and Other Debts.

Variable	Mean	Median	N
Number of payday loans	2.89	2.00	327
PDL amount owed	\$1258	\$880	219
Ratio of PDL amount owed to monthly net household income	.85	.46	218
Ratio of PDL debt to total unsecured debt	.12	.06	219
Ratio of credit card debt to total unsecured debt	.36	.31	218
Ratio of utility debt to total unsecured debt	.07	.03	219
Ratio of other loans to total unsecured debt	.15	.03	218
Ratio of medical debt to total unsecured debt	.07	.01	219

Because debtor schedules are not available online for Milwaukee County, the sample from which the remaining figures are calculated is smaller. The median debtor in Bernalillo and Cook counties owed \$880 to payday lenders; 30% owed more than \$1500. One couple in Bernalillo County owed \$5985 on 21 different payday loans.

The relative weight of payday-advance debt within the category of unsecured debt was also calculated. The median case had more than four times as much credit-card and store-credit debt, but the proportion of PDL debt (.056) ranked ahead of utility debt (.033), other unsecured loans (.031), and medical debt (.009). Still, the payday loans only amounted to 2% of total debt--a mere puddle at the bottom of the bankruptcy bucket.

But payday advances are different from other types of loans because the principal is due in full--usually in 14 days or less. The short time frame increases the weight of this water in the bucket, and if it isn't drained away quickly the accumulated rollover fees will rapidly exceed the amount of the original principal. The best measure of the burden of payday loans, then, is the ratio of this debt to monthly household take-home pay. A ratio above .25 can be deemed high, for net monthly income must also pay for housing, utilities, transportation, food, clothing and other expenses. It is hard to see how working people with a median net monthly household income of \$2000 could

reasonably devote more than \$500 to unsecured, short-term debt. If this ratio is higher, we might conclude that payday loan debt has become crushing for these petitioners, as hypothesis 3 holds.

As Table 5 reports, the median ratio for the subset was .46, or about half of net monthly income. One-fifth owed more than the entire month's household take-home pay. Those figures, striking as they are, understate the problem, for most of these debtors are paid every two weeks. The typical individual therefore owes 92% of the next paycheck in payday loans. No wonder these debtors file for bankruptcy! Only 31% owed less than one-quarter of net household income in PDL debt.

Discussion and Recommendations

To summarize, the first hypothesis is not sustained but the other two are. The proportion of payday-loan debtors did not increase in these worst-case counties, as some media reports would have us believe. But the PDL subset did have lower debt-income ratios, indicating that these debtors went bankrupt sooner, with less debt in relation to income. And most of these petitioners went bankrupt with two or more payday loans and owing nearly all or more of their next paycheck to payday lenders. They had accumulated more of this debt than could possibly be sustained in the short term, where these loans operate.

Of course, these conclusions must be qualified by the limits of the data. The sample is not representative of the nation as a whole or even of any particular state. Key information is not provided by the bankruptcy petitions that might explain these trends. For example, the names and addresses of debtors suggest that many are racial or ethnic minorities, but the petitions do not ask debtors to identify themselves in this way. We do not know, therefore, whether the two subsets differ significantly in their racial composition.

But suppose it is true that payday loans account for the differences identified. It is a fair question to ask whether it is in fact a bad thing for payday-loan debtors to go bankrupt sooner, with less debt. After all, their misery might be reduced and less debt will be written off, which is good for businesses and consumers. Might not payday loans therefore soften the impact of bankruptcy for all?

But that conclusion only follows if we assume that these households would go bankrupt anyway, with or without payday loans. That is a big assumption, however. If their short-term, high-interest debt was replaced with more manageable installment loans, for example, many of these households might avoid this outcome. Their lot might still be difficult, since most have below average incomes, but they would escape an outcome which most people still view as a financial catastrophe. Then debt from more benign creditors would not be written off and businesses and consumers would gain.

Though I have painted an unflattering portrait of payday lending practices in this paper, I do not favor driving payday creditors out of business with low rate caps (Mayer, 2003). People in need of emergency cash will try to get it somewhere, and it is better for them if that source is legal and regulated. The interest rate for short-term loans will inevitably be high, but triple-digit rates per se are not the crucial problem with payday loans. If I borrow \$250 for two weeks and pay \$50 for the service, I have paid a hefty price--but that cost by itself will not drive me or anyone into bankruptcy. The threat of bankruptcy only appears if I roll that loan over repeatedly, paying \$50 every two weeks, or if I have several of these loans at once. Even industry advocates have dubbed the rollover problem the Achilles heel of payday lending (Schaaf, 2001: 345). But the problem of multiple loans, which my survey has highlighted, is a second Achilles heel. There is never a good reason for borrowers to have more than one payday loan, and it seems reckless or unconscionable for several creditors to lend against the same paycheck. With multiple loans going, rollovers are all but inevitable, and then the slide to financial ruin must be quick.

Some of the petitions give us enough information to see how the process occurs. Consider the most extreme case: the Bernalillo County single mother with 23 different payday loans. Her Chapter 7 petition, filed in December 2000, carefully lists the date when each loan was acquired. The first appears in February 1998--a \$300 loan still not paid off 34 months later. The next four were contracted in August 1998--a total of \$1260. One or more loans, averaging \$250 each, were made in October and November 1998; June, July, October, and November of 1999; and January, February, March, April, and July of 2000. By the end this petitioner had accumulated \$5675 in payday loans--26% of her total debt and more than four times her net monthly income. It is worth noting that none of the lenders challenged the discharge of this debt. Unfortunately, the petition does not reveal how much the debtor paid in accumulated fees over three years, but the sum is potentially staggering.

In other cases the loans piled up more quickly. Consider another Bernalillo County Chapter 7 petition, also filed in December 2000 by a single female. Her first loan for \$336 was granted in May 2000. Another loan for \$310 was approved the next month. But in July seven different payday lenders advanced money to her. Two more did so in August, and the twelfth loaned another \$370 in September. She declared bankruptcy with \$2533 in payday loans--more than her monthly net income of \$2385. None of the lenders challenged the discharge.

In rare cases the loans multiply suspiciously quickly. The most egregious example is a Chapter 13 petition filed in Cook County in March 2000. Another single female listed 17 payday loans totaling \$4933--more than three times her net monthly income. But 14 of the 17 loans were contracted with different branches of the same chain lender in the two weeks before filing bankruptcy. Borrowing in this way, against a closed checking account, looks like fraud. Understandably, this lender did challenge the discharge of the debt, and after three years of wrangling the petitioner finally agreed to repay all of the principal in \$200 monthly installments.

These are, admittedly, extreme cases. Only 5% of the PDL subset had ten or more loans. But even two loans is one too many when advanced against a single paycheck, and most of the PDL debtors in my sample had at least two loans.

To reduce the risk of bankruptcy, legislators and state regulators should focus not on the interest rate of these loans but on how many borrowers have at one time and how long they are carried. The correct rule is simple: only one payday loan at a time, and that one only for a short period of time. In fact, that is the rule Illinois adopted in 2001, but the data from Cook County suggests that the rule is not being enforced. In 2002, 68% of payday-loan petitioners in that county went bankrupt with more than one of these loans outstanding--as many as in previous years.

We cannot predict how many payday-loan customers would avoid bankruptcy if that rule was enforced. Plenty of them filed with just one loan, and of course many more debtors go bankrupt without any at all. But with just one payday advance the ratio of this debt to net monthly income will certainly fall. In my sample, for debtors with more than one payday loan the median bite these loans took out of monthly take-home pay was four times as big. The median customer with just one loan owed only 17% of net monthly income--about \$350. Modest debts like that did not drive these households under. State regulators ought to require that all of these expensive loans remain short-term, modest, and manageable.²

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Endnotes

¹ Professor, Department of Political Science, Loyola University, 6525 North Sheridan Road, Chicago, IL 60626; Telephone: (773) 508-3047; Fax: (773) 508-3131; rmayer@luc.edu

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