

Evidence Backing Payday Lenders' Risk Argument

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By [William Launder](#)

For years payday lenders have downplayed their profitability, as one might expect from an industry that consumer advocates have long pointed to as predatory.

But recent results from companies in the niche, and research by outsiders, combine to suggest that lenders in the business aren't crying wolf. Analysts and academics who have studied the industry say credit and regulatory risks have taken a heavy toll on the lenders' bottom lines.

This week several lenders said they were likely to close operations in Ohio after the state passed a law capping the annual percentage rate on payday loans at 28%. Lenders typically charge a \$15 fee for a two-week, \$100 loan, but the law reduced the maximum fee for such a loan to \$1.08.

Cash America International Inc., which said it would close 139 stores in Ohio, also issued a profit warning.

A study published in December by researchers at Vanderbilt University Law School and the University of Oxford found that profits in the payday industry are "not high compared to other finance companies."

Returns on equity for seven publicly traded lenders averaged 15.4% from 2005 through mid-2007, the study found. According to the Federal Deposit Insurance Corp., the average return on equity for all banks peaked at 15% in 2003 before falling to 12.3% in 2006 and 8.17% last year.

"You can tweak your underwriting" to reflect the risk of payday loans, "but if somebody passes a 36% or 28% APR [cap], that realistically puts you out of business," said Daniel O'Sullivan, an analyst at Utendahl Capital Partners LP. "There is a lot of expense in terms of loan losses," and lots of loans "get written off entirely."

Elizabeth Pierce, an analyst with Roth Capital Partners LLC, said that when payday lenders leave a state, "there is the loss of revenue, there is management time and distraction throughout the process, and the related one-time store closing costs."

All this is cold comfort to the industry's critics.

Leslie Parrish, a senior researcher for the Center for Responsible Lending, said profit margins for payday lenders are irrelevant, because their product locks some consumers in a cycle of debt. She called the lending a "very inefficient business model" in which "the industry really relies on trapped borrowers for the bulk of its revenues."

Paige Skiba, the Vanderbilt professor who co-authored the study with Jeremy Tobacman, a postdoctoral fellow at Oxford, said in an interview this month that they had no affiliation with the payday industry. The study says lending with "typical compounded interest of 7,295% per year amounts to equity returns of only 10%" for the payday industry. The lenders "face substantial costs which can account for much of the difference between the loans' astonishing interest rates and lenders' ordinary profitability."

Nine percent of the checks that payday lenders require as collateral bounce, the study found, and only about half of those losses were eventually recovered through internal collections.

In the interview, Prof. Skiba said newly opened payday lending stores "hemorrhage" money, citing a 2005 study by the Federal Reserve Bank of Chicago.

But Mr. O'Sullivan said such investments pay off quickly.

Payday stores "are very profitable and throw off a lot of cash flow," because they require very little in the way of capital expenditures and operating costs, he said. "You might spend \$50,000 on leasehold improvements and have \$50,000 in working capital," for each store. "These things start to turn a profit within year one. How many businesses do that?"

Rent-a-Center Inc., whose main business is leasing big-ticket items like furniture and appliances to consumers, began offering payday loans to its customers three years ago. At that time its executives were betting that a vast store network and a well-recognized brand would help the Plano, Tex., company earn higher profits than lenders that had to spend more on start-up costs.

But the advantages have proven "much lower than you might anticipate," Brent Turner, Rent-A-Center's vice president of financial services, said this week. "We thought there have got to be ways to leverage the infrastructure" of a national company with more than 3,000 locations, but "it's pretty difficult to do that" in the payday business.

After operating costs, Rent-a-Center's profit margin per store from lending has been in "the same bracket" as other payday companies, he said — about 9% to 10%.

Jamie Fulmer, a spokesman for Advance America Cash Advance Centers Inc., said the Spartanburg, S.C., lender spends 20% of its revenue to pay for the 3% of loans that go into default after collections. "If you look at what we charge and all the costs associated with this product ... and you drop to the bottom line, there is very little room for anything else," he said.

Advance America said it likely would close 246 branches in Ohio because of the new law. Last year, when similar legislation passed in Oregon and Pennsylvania, the company closed more than 70 locations in those states. It recorded \$4.7 million of closing costs and wrote down nearly \$10.8 million of loans there.