Why Payday Loans and Cash Advances Are So Bad

BY LATOYA IRBY Updated May 31, 2021

Advertisements for payday loans make them seem like a fast, easy, no-nonsense way to get money when you're in a financial bind. They tell you getting $100 is as easy as showing a recent pay stub, a copy of your driver's license, and a blank check. They don't tell you that for many people, paying off that $100 can end up taking months, even years, and costing thousands of dollars.

How Payday Loans Work

Let's say you need to borrow $100 until your next payday. You write the lender a postdated check for the amount of the loan plus the fee. Lenders calculate payday loan fees in one of two ways: as a percentage of the amount you borrow, like 10%, or as a set amount per $1 borrowed, like $15 for every $100 borrowed.

After you write the check, the lender gives you the cash or automatically deposits the loan into your checking account. Then, on your payday, the lender cashes your check unless you extend the loan. Extending the loan, also known as "rolling over" the loan, costs another fee and allows you to keep the loan for another period. You're charged a fee each time you roll over the loan.

What Payday Loans Cost

The Truth in Lending Act requires all lenders, including online payday loan lenders, to disclose the cost of the loan in writing before you sign any agreement to take the loan. They must give you this information in terms of the finance charge and APR (annual percentage rate). Even after reading this information, you might not understand just how expensive payday loans truly are.[1]

For example, if a payday lender charges $17.50 per $100 borrowed, your effective annual percentage rate (APR) on a 10-day loan is nearly 640%. This is 15 times more than some of the most expensive credit card default rates. If you took out a 14-day $300 loan and couldn't repay it for two months, you'd end up paying $210 in payday loan fees. The same scenario with a credit card would result in less than half the fees, even if you ended up with late charges.

A 2004 study reveals a typical payday borrower ends up paying $793 in interest on a $325 loan. Lenders don't charge upfront finance charges that high. Instead, borrowers pay that amount over a period of time by continuously rolling over the loan.[2] Borrowers often find themselves taking out new payday loans to cover old payday loans and ultimately end up owing thousands of dollars on what started out as a few hundred dollars of debt.

Preying on the Poor and the Military

Because payday lenders often target those with lower incomes, many laws are designed to protect certain groups from predatory tactics. For example, military consumers are protected under a federal law that limits annual percentage rates on payday loans to no more than 36%. In addition to this limit, lenders may not have access to checks or bank accounts for the loan. Credit agreements are void if they do not abide by these regulations for military consumers.[1]

Alternatives to Payday Loans

While payday loans often end up being more expensive than they are worth, people do sometimes need money on short notice. Some alternatives to payday loans include:

- A small loan from your bank or credit union
- Cash advance from your credit card (shop around for the best rates and fees)
- A small loan from a family member or friend
- Payday advance from your employer
- Hardship payment plan from your creditors
- Consumer credit counseling
- Emergency hardship programs (typically offered by your state, county, or city's human resource department)

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