

Transcript

Payday Loans

I think most of us have a sense that payday loans are probably not the best source for a loan, that they probably charge a lot of money to those people who need that cash really badly. And what I want to do in this video is, one, explain what they are, but even more, do a little bit of math to understand really how bad of an interest that they do charge.

So the way that works is, let's say that I need to buy my wife a nice gift for her birthday that's tomorrow and I want to borrow \$500. So I want to borrow \$500. I would suspect that most people aren't borrowing it for some type of a gift; they're desperate to make the rent or pay the utilities or buy food or who knows what else. But whatever your reason, you need to borrow \$500 and I would suspect that you have very little in your bank account, otherwise you wouldn't go to the payday lender. And they say, all right Sal, we're open to lending you \$500 and we're not going to do all of this deep research on how good of a credit you are and all of that, but we want a couple of things. One, we want to know your pay stub and your pay date. They're going to want to see your pay stub, they're going to they want to know when you're going to get paid, so I guess we call it your payday. And they might want some recent bank statements. And the whole reason why they want these things is they want to know even though your credit might be horrible, that you're going to get your salary or you're going to get a payment from your employer, probably in two weeks on your payday, and then you're going to be good to pay back to the \$500. And to ensure this – so one, they're going to make sure that you have a job, that in your pay stub maybe you make \$1,000 every two weeks or maybe you make \$2,000 every two weeks so that you're good for this. So maybe you maybe make \$1,500 every two weeks, so they like to see that. Maybe your payday is two weeks from the day that you're borrowing it, borrowing the money. So two weeks from today. And then your bank statement shows that your bank account kind of goes up \$1,500 and you pay the rent and the food and then it goes back close to zero, then it goes up to \$1,500, but they want to see that this \$1,500 is hitting periodically. And they say: you know what we are going to do? We're going to give you the \$500 today.

You need to write us a check. We want you to write a check for not \$500. For every \$100 you borrow, I want you to pay us back another \$25. So \$25 extra. And at first you might say that's not bad, that's 25% interest. It's high; maybe it compares to some interest, some credit cards. But this isn't

25% a year, this is 25% for two weeks. And at the end of this video, we're going to do a little bit of math on what that actually turns into on an APR, or an effective APR basis. And these numbers are not crazy; these are actually very typical for payday loans.

So if I'm borrowing \$500, I have to give them back the \$500 in two weeks plus \$25 for every \$100. So I'm borrowing \$500, so I'm going to have to do plus five times 25 or \$125. So I'm going to write them a check for \$500 plus a \$125, so that's \$625. I'm going to write a check, but obviously I don't have the money in my bank account right now, otherwise I wouldn't even be going to the payday loan. What I'm going to do on the date, I'm going to forward-date this check. I'm going to put the date – let's say this is the first of the month – instead of, let's say, it's

January 1, I'm going to put January 16 and whatever year I might be doing it.

So I've forwarded it; this is two weeks from today. Two weeks in the future, and then I'm going to sign the check and I'll write it's for a payday loan and I'll write \$625 etc., etc., then I have my little information here. And I'm going to give them this check and what they're going to say is we're not going to cash this; we're just going to keep this nice little check for us and when your payday hits you have an option. You can come back to us and give us \$625 in cash and then we will give you back this check that is uncashed or if you don't show up, we are just going to cash this check.

So one of these two things are going to happen. But effectively, if you didn't lie to them, they're going to essentially charge you \$625. And you can imagine it is risky for the lender, because these are people with, you know, they maybe shady pay stubs and obviously they're desperate, so they weren't good at managing their finances, but they're doing their best to ensure that once that payday comes in, once that payment from the employer comes in, that they get first dibs was on the money before the person can pay their rent or their utilities or their food. And so that's the general idea behind it.

Now we started off saying this is probably not a good idea and you got a sense of that, because we're essentially paying 25% interest for every two weeks, not for every year. But let's think about what that is on an APR basis. So let's say we're paying \$25 for every \$100, that's really 25 percent. When you say percent, that root means hundred, right? Century, 100 years. So percent, it literally means per 100 – 25 per 100; so this is literally 25%

interest or we could write it the traditional way: this is 25% interest per two weeks.

So if we were just to calculate a simple APR, a simple annual percentage interest rate – and you might want to watch the video on that to understand that that just takes your 25% and then multiplies by the number of periods in the year – so we have 52 weeks per year, but this is every two weeks. So instead of multiplying it by 52 weeks, we're going to multiply by there's 26 two-week periods in the year. So times 26 two-week periods per year. And this is 25% per two weeks. When you multiply this out, this is equal to – let's get the calculator out – I'll just multiply the numbers, I won't do the decimals; 25 times 26 equal to 650%. We're paying an APR of 650%.

So if you thought the credit card companies were charging a lot of interest, charging you a mid-teens interest rate or 20% rate, this is 650%. It's an order of magnitude or above what even credit cards charge. So this is a really, really, crazy annual percentage rate, and this was just a simple annual percentage rate where we multiplied it by 26; this isn't the effective annual percentage rate, or the actual mathematically correct one. To do that, we would actually have to take – and you might want to watch the video on this – if you were to let that just

compound, and you can imagine if you're the payday lender, you are essentially getting that compounding if you keep lending your money out and if you lend the interest you get from the last person, and you lend that out the same rate.

To figure out that effective annual percent rate, you do 1.25^{26} , 25% plus 1 to the 26th power. We have 26 of these periods in a year. And what is that going to be equal to? So we have 1.25^{26} to the 26th power. And then we get this crazy number, we're going to want to subtract a 1 from it, not that it's going to change much of our math. So minus 1, and we get, well let me be very clear – essentially this is 329 times our money. So this, if this was a one here, that would be 100%. So let me just be clear, this number right here, that number right there, is such a high number it's hard to fathom. If you were to actually let money compound at this rate, and usually they would make you at least roll over the principal, so this may or may not be accurate but that actual payday lender, if they actually are able to roll over the money at this rate, they're going to have 329 times their money. Or if you write it as a percent, it would literally be 32,987. Literally, 32,987%. Or after a year, you'll essentially have to pay roughly 330 times your money back to the payday lender. And obviously they don't let you compound like

that, but this just gives you a sense of how ridiculous this interest rate is. I mean, you might have heard of the term usury.

In the past, usury really meant any kind of interest, but now, in our current cultural context, we associate it with just an unreasonable level of interest, and that threshold might be different for some people. Some people might say it's unreasonable to pay 20% interest, or 30% interest, or 40% annual interest. But I think everyone would agree that whether you look at 650% or 33,000%, these are usurious and unreasonable interest rates. So you really, at all costs, unless your life depends on it, you want to avoid these payday loans.