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Nine Myths about Payday Lending

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Executive Summary

The debate over Issue 5, which concerns the regulation of the payday lending industry in the state, is not only a good case study about payday lending but also about the free market and sound public policy.

Much like free speech, support for the free market matters little if you only support the ability to sell goods and services you would use. If you claim to be a supporter of the free market and yet support banning a service with which you personally disagree, your commitment to freedom is not very strong. Conservatives in Ohio who have embraced the ban on payday lending seem to forget this basic fact.

For those on the Left, who traditionally have less respect for the free market, the debate over Issue 5 should also be troubling from a public policy perspective. Good public policy should be based on facts, not anecdotes, and the goals of the legislation being proposed should be clearly stated and able to be achieved.

The campaign to demonize payday lending in Ohio is remarkable for the scarcity of facts as

well as the dishonesty or ignorance about the ends of the "reform" legislation.

In this policy brief we will examine some of the common myths being circulated about payday lending over the past year in the state of Ohio. All are easily dispelled by looking at readily available scholarly literature.



Myth 1: Payday lenders trap borrowers in a "cycle of debt."

Claim: "Their profits rely on trapping consumers in a vicious cycle of debt..."¹

Fact: Any "cycle of debt" payday borrowers experience is not caused by payday loans. It is caused by their prior financial situation, a situation from which a payday loan may actually help them escape.

Opponents of payday lending make it seem like borrowers without any financial problems go into payday loans stores, borrow money they don't need, and then are trapped in a cycle of repeated payday borrowing to pay off the original loan. That is not the reality. It is certainly true that some payday borrowers may have trouble paying off a loan on time. There are not clear numbers indicating how many borrowers are affected in this way. But the inability to repay the loan on time is a *symptom* of the problems that caused them to seek the loan in the first place. That is, it is not the payday loan that causes these borrowers' financial problems; instead, it is these borrowers' financial problems that cause them to take a payday loan.

As surveys indicate, people generally obtain payday loans because of some emergency.² There is a real financial need that is being met by these loans. Of course, one may ask why someone would need to turn to a high-interest lender in order to meet that need. This is at the heart of the debate over payday lending. If someone has decided to choose a payday lender to meet that need, this is an implicit admission that he or she thinks the other options available are *worse* than obtaining a payday loan. Essentially, this person's financial situation is in such a condition that what may be an unattractive option to many people is the best option available for them.

Eliminating payday loans will not help this person's financial situation. Instead, it will merely mean that the best option out of all the available options for this person is eliminated. The underlying financial condition that drove this person to take a payday loan will still be present and, as research we cite below has found, that condition worsens when payday lending is forbidden.

Myth 2: Payday lenders charge 391% interest rates.

Claim: "Old Ohio law allowed interest rates as high as 391% for a two-week loan."³

Fact: The law allowed loans with rates as high as 15% for a two-week loan.

This is a common mistake made by many in this debate. The idea that an annual percentage rate (APR) is the same as any percentage rate is common but untrue. The Truth in Lending Act requires that the interest on loans be disclosed as an APR, and was intended to allow borrowers to transparently compare different loans using the same standard. That works well when dealing with long-term loans like mortgages and car loans, but it causes confusion when applied to short-term loans like payday cash advances.

The way the 391% APR is calculated is by assuming that a person borrows \$100 and pays \$15 every two weeks on it for a year.⁴ That is not how payday lending works, however. A person borrows \$100 and pays \$15 in fees and interest two weeks later. They do not keep paying \$15 every two weeks for a year on that original \$100. Calculating the APR on this short-term loan means that you must multiply a one-time payment twenty-six times, and that is not consistent with the way the average payday loan borrower uses this short-term service.

The only accurate way of calculating the interest rate on a payday loan is to say that it is 15%. When you pay back \$115 to borrow \$100 it does not add up to 391%. There is a subtle but important difference between a "percentage rate" and an "annual percentage rate." Reporters and advocates who ignore this difference are not doing their homework or are just being sloppy.

Myth 3: Payday lenders make "obscene" profits.

Claim: "The lenders, when they could charge 391% APRs, had been pleased as punch and obscenely profitable."⁵

Fact: As a percentage of revenues, profit margins for payday lending stores are lower than many other businesses, averaging between 3% and 8% profitability.

Contrary to what many believe, earning a profit (even an abnormally high profit) is not in itself an excuse to ban a product or service from the market. Profits earned in competitive markets are simply a reflection of producers' ability to efficiently combine scarce resources to satisfy consumers' demands.

The idea that payday lenders earn large profits is one that appears often in editorials and other attacks on payday lending. Of course, none of these attacks

contain any information on how much profit payday lenders make. Instead, they simply claim that profits are "excessive" or "obscene." This leaves the impression that payday lenders are an abnormally profitable business, much more so than other businesses. The truth, however, is that while payday lending is certainly profitable, the profit margins for the average payday lender are fairly low and comparable to the profits earned in other lines of business.

As one study of this issue put it:

...despite common belief, payday lending firms do not always make extraordinary profits. In fact, when compared to many other well-known lending institutions, payday lenders may fall far short in terms of profitability.⁶

The study compiles data on payday lending and concludes the following about the average store's profit margin: "For pure payday lenders, the average profit margin was 3.57%. When pawn operators are included the figure more than doubles to 7.63%."⁷

Is this "excessive" or "obscene?" It's hard to say, since there is no clear definition to those terms. However, it is useful to compare this profit margin to the profit margin of other businesses:

Contrary to conventional wisdom, these firms fall far short of profits for mainstream commercial lenders. In addition, profit margins of payday lenders are far below those of Starbucks. The profit margins of Starbucks for the measured time period were just over 9%. This is almost 2% more than all payday lenders, and more than double the pure-payday lenders. These figures indicate that arguments against payday lending, couched in terms of preventing excessive profits, are unfounded. If companies should be limited to a certain profitability measure, citizens would be better off fighting Starbucks than their local payday lender.

Comparing the profit margins of payday lenders to mainstream commercial lenders supports this perspective. The comparison lenders had a profit margin of 13.04%-much higher than even Starbucks. This was over three times the percentage for pure payday lenders, and almost twice as much when including hybrid operators.⁸

It would be hard to argue that the profit margins of payday lenders are excessive or obscene without also arguing the same for the profit margins of most other companies. Yet, we wouldn't likely see anti-payday-lending groups trying to outlaw Starbucks.

If payday lenders are not "obscenely" profitable, why do they charge such high fees? As another study put it, "To a great extent, the 'high' APRs implied by payday loan fees can be justified by the fixed costs of keeping stores open and the relatively high default losses suffered on these loans." That is, it costs a lot to provide short-term, unsecured loans to people who may not pay back some or all of their outstanding balance. Most of the "high" fees go back into the business so that consumers can continue to have access to the type of lending they demand:

Wages and occupancy costs (rent, maintenance, utilities, and taxes) tend to account for roughly half of the average store's operating costs—more for mature stores—with local advertising (by the store) accounting for another 5% (notably more for new stores). Not surprisingly, loan losses are a prominent dimension of payday store costs, constituting an average of 24.8% of operating expenses for young stores and 21.1% for mature stores. This aspect of store costs differs quite substantially from those incurred by mainstream lenders.¹⁰

When you go into a car repair shop to have work done on your car, you are charged a fee. We all understand that car parts cost money and diagnostic machinery costs a lot of money. While we may wish we could pay less for a car repair, we accept the fact that the cost of providing this service is high, in part because of the high demand for it. A payday lender is in exactly the same position. To provide the service highly demanded by the customer, this lender must pay to bid scarce resources out of other uses. *That* is where the "high" fees and interest for the loan go.

Myth 4: Ohio politicians reformed, not banned, payday lending.

Claim: "We did not ban payday lending, we reformed payday lending."¹¹

Fact: Lawmakers who passed this law either knew or should have known that limiting payday loans to 28% APR means lenders could not make a profit. Thus, it is a ban masquerading as "reform."

The very nature of offering short-term, unsecured loans at a convenient location for borrowers necessitates higher interest rates than other loans. Ohio law limiting payday loan interest rates to 28% APR means that lenders will only be able to charge \$1.07 per \$100 for a two-week loan.¹² That is simply not enough money to keep a lender in business.

The APR on payday loans must, of necessity, be significantly higher than the APR on conventional higher-balance and longer-term loans due to the much smaller economies of scale on small-balance loans. The fixed costs of originating a note loan are roughly the same, regardless the size of the loan. That is, it would require roughly the same fixed capital and labor inputs for a lender to offer, say, a \$1,000 non-collateralized loan for 12 months that it does to offer a \$500 payday loan for 31 days. However, the larger and longer term loan can generate more revenue for the lender at a relatively low APR and still allow the lender to remain profitable due to the size and duration of the loan, whereas the smaller and shorter-term loan would generate only a fraction of the revenue necessary to cover fixed and variable costs at the same APR.

Thus, by necessity, if the payday lender in this example is to expect to profit and remain in business, it must charge a significantly higher APR. Banks and other traditional lenders, because they are regulated by state usury laws, cannot charge the higher rates necessary to cover costs for a small-balance short term loan, and have thus essentially vacated the short-term small-loan marketplace. This has left payday lending firms to fill the void in the small-loan market, providing a valued service to cash advance customers who are apparently satisfied with the services they receive by evidence of their willingness to pay the significantly higher APR.

As the narrow profit margin of payday lenders illustrates, the higher APR does not imply they are earning rates of profit equivalent to this APR. The Ohio legislation reduces the revenues flowing to the payday loan industry in Ohio by an average of approximately 90%. It is clear that lowering the APR on these loans will effectively kill payday lending in Ohio. Politicians who claim that the law lowering the APR in Ohio is merely a "reform" and not a ban are either being disingenuous or are woefully ignorant of the mechanics of the payday loan industry.

Myth 5: The average payday borrower takes out multiple loans.

Claim: "...the typical payday loan customer will take out more than 12 such loans in a given year..."¹³

Fact: It is difficult to tell how many loans the average customer seeks and obtains due to lack of good data.

While advocates opposed to payday lending like to talk with confidence about the "average borrower," in reality they have very little idea about that average borrower. The idea that this typical borrower takes out a certain number of loans a year bolsters the claim that payday lending traps borrowers in a debt cycle. One study is "Trapped by Design," published by the Ohio *Coalition for Responsible Lending*.¹⁴ Another is "Trapped by Debt" by *Policy Matters Ohio*.¹⁵ But these studies are plagued with problems and cannot be relied upon to paint an accurate picture of a typical borrower.

The main problem with the two Ohio studies on the payday lending industry is poor research methodology. Both studies mix and match different data sets from several different sources that fail to support their claim that payday lending causes debt traps among Ohio consumers. Both studies, lacking data on actual payday loan borrowers, analyze the characteristics of payday loan stores in Ohio and then attempt to attribute characteristics of payday loan stores to payday loan consumers in Ohio.

In research terminology, the error committed by these studies is known as the "ecological fallacy;" attributing characteristics of one unit of analysis (a payday loan store) to a completely different unit of analysis (payday loan customers). In simple terms, both studies erroneously argue that growth in the number of payday loan stores and/or growth in the number of loans per storefront *ipso facto* causes payday loan customers to experience debt traps. Yet, without data on actual payday loan customers, one could not confidently say whether this was true or not.

In addition to the ecological fallacy, the "Trapped by Debt" study issued by the Ohio Coalition for Responsible Lending further lacks a random sample of payday loan stores. Instead, the author chooses only the four largest payday loan firms in Ohio, assuming that these four largest companies are "representative" by comparing them to the similar findings of other studies in different states. The author then makes speculative assumptions and extrapolations with the data. Even though smaller payday loan companies in Ohio would surely differ from the largest on any number of important measures, the author claims confidently that "this sample is representative." In reality, the study is likely plagued by severe sample bias.

Unfortunately, advocates and legislators continue to rely on these severely flawed studies to talk about how

many loans the typical consumer takes out in a year. The reality is that they do not have accurate data to back up their assertions.

Myth 6: Payday lending "strips" money from the community.

*Claim: "In 2007 alone, payday lenders siphoned over \$300 million in fees from Ohio consumers, negatively impacted hundreds of thousands of Ohio families, their communities and the economy at large."*¹⁶

Fact: It is a mistake to assume that payday loans impose only costs while failing to consider the benefits received by those who use these loans.

The claim that payday loans "siphon" money from Ohio consumers simply because consumers use and pay for them shows a fundamental misunderstanding of how this (or any) economic transaction works. One cannot talk about costs without also identifying either the individual or aggregate benefits that Ohio consumers receive from these loans. Payday loans, like any other financial product, impose a cost on the borrower (reflected in the fee or interest rate) that is intended to cover the total opportunity costs borne by payday loan firms. Yet, the benefits of these loans to payday borrowers clearly exceed the costs, or else they would not continue to use them. It is also very likely that this transaction has a net positive benefit for the overall Ohio economy. That is, the benefits surely exceed the costs not only for the borrower and the lender, but for others as well. Examples of additional beneficiaries of payday lending in Ohio might include utility companies, auto repair shops, pharmacies, and other retailers who receive timely payment from customers who might otherwise pay late or not at all in the absence of a payday loan option.

Those opposed to payday lending, however, make no mention of benefits received by borrowers in the form of convenient small-balance short-term loans, choosing a one-sided analysis that includes only the costs. This would be like adding up the aggregate costs of all owner-occupied and rental housing in Ohio, ignoring the benefits of housing and housing services to tenants and home-owners, and then arguing that the cost of housing in Ohio was an excessive burden on the Ohio economy. This is simply absurd.

If these advocates really cared about accuracy, they would conduct a true cost-benefit analysis. This analysis would include any potential additional costs beyond the price of the payday loan (such as

externalities imposed on third parties, if any), and then would compare the total social costs of payday lending with the estimated benefits to both the actual users of payday loans as well as any potential spillover benefits to third parties. Then, and only then, could one compare the marginal social costs with the marginal social benefits of payday lending. That would allow one to determine whether there is a net benefit or net cost to the Ohio economy from payday loans. We know of no such studies of this nature, and thus the claims that these loans pose a burden on our economy have no basis in fact.

Myth 7: Payday lenders "prey" on their borrowers.

*Claim: "We've allowed a small group of lenders to enslave, essentially, in a debt way, our most vulnerable population, those that are poor, those who can't make ends meet."*¹⁷

Fact: Payday lenders are like any other business — they provide a product that consumers freely buy.

The idea that payday lenders are "predators" or that they are enslaving their customers reflects a fundamental misunderstanding of how free market transactions work. Both parties in an economic transaction gain from the exchange. Each views what he is receiving as more valuable than what he is giving up. That is, both parties see the trade as a way to make themselves better off. No one enters into a market exchange with the object of making himself poorer or less well off.

Milton and Rose Friedman put it quite well when they said, "The key insight of Adam Smith's *Wealth of Nations* is misleadingly simple: if an exchange between two parties is voluntary, it will not take place unless both believe they will benefit from it."¹⁸

This is easier to understand when discussing purchasing something like a television. The \$1000 someone pays for a flat-screen TV at Sam's Club indicates that this person values that television at or above \$1000. If he or she valued it at less than this amount, then he or she would not have paid it. Payday lending is no different, although it gets more confusing because the lender is loaning money rather than selling a television. We tend to think of money as being worth only the amount printed on the face of a bill. But the true value of, say, \$100 now may be worth more than that same \$100 in the future for that same person.

For instance, if it costs \$100 to repair someone's car, he or she may be willing to spend in excess of \$100 to obtain that repair immediately. That is, the value of the repair may exceed \$100. If going without the car would result in being fired from a job or missing out on an important trip, that person may be willing to pay much more than \$100 for that repair. If \$100 is not readily available, they may go to a payday lender and pay \$15 to obtain that \$100 immediately. That person values that cash in the present at more than \$100 and is willing to pay a higher future price to have it.

As economists have long understood, values are subjective. In the case of payday lending, time preferences, a form of valuation between present and future goods, are also subjective. Those with relatively high time preferences are going to be willing to pay more in the future to obtain goods (or cash) in the present than those with relatively low time preferences, all else equal. In this sense, then, there is no such thing as an "excessively high" fee. It is entirely subjective to each voluntary participant in the transaction.

In a voluntary economic transaction, no one is predator and no one is prey. Merely because some people are willing to pay what other people may regard as a high fee to obtain fast cash does not mean that borrowers are being exploited. It merely means that the borrower's view of the present value of the loan differs from those criticizing the transaction.

If one really wanted to talk about exploitation, it could easily be argued that the borrowers prey on payday lenders. With a default rate of around 20%, the average lender experiences far more delinquent loans than do other financial institutions.¹⁹ These borrowers essentially steal money from lenders when they do not repay it. And yet, we would not likely hear any condemnations of "predatory borrowing."

Myth 8: Payday lenders charge usurious rates, which are condemned in the Bible.

Claim: "Payday lending is modern-day usury."²⁰

Fact: In the Bible, "usury" means the charging of any interest, not just "excessive" interest.

The Mosaic Law in the Old Testament certainly condemns usury. The Old Testament prophets likewise attack usurers. Governor Strickland and some faith leaders in Ohio trot out these condemnations to attack payday lenders, saying that their "excessive" interest rates are sinful. But this type of normative attack is not

an accurate representation of the actual text of the Bible, nor does it contribute to a rational debate on the economics of payday lending.

The fact is that usury in the Bible means the charging of any interest. The idea that usury means the charging of "excessive" interest, however that is defined, is a later invention. As these Bible verses indicate, the Biblical prohibitions on usury applied to any interest charged for money lent by one Israelite to another:

Exodus 22:35: If you lend money to any of My people who are poor among you, you shall not be like a moneylender to him; you shall not charge him interest.

Deuteronomy 23:19, 20: You shall not charge interest to your brother -- interest on money or food or anything that is lent out at interest. To a foreigner you may charge interest, but to your brother you shall not charge interest....

There are also verses in some of the prophetic books that talk about not receiving increase or usury.²¹ From the Biblical text it seems clear that the ban on usury has little application to today's debate on payday lending. Those opposed to payday lending do not seem similarly opposed to charging interest in other contexts. They are not, for instance, attacking interest-bearing savings accounts or home mortgages. If they were being true to the Bible, they would necessarily include these practices along with their condemnation of payday lending.

Furthermore, trying to apply the Mosaic Law written for the ancient Israelites to modern times is both theologically and practically problematic. As the verses above indicate, the prohibition on usury was only meant to apply from one Israelite to another. It was also written for a society that did not have our modern economy replete with all the advances made possible through financial innovation. Lending at interest is at the root of our financial system and is what makes possible the economic growth that leads to the tremendous improvements in living standards. This practice is, in large part, responsible for much of our modern economy. It is difficult to see how we would apply this Mosaic Law to our lives with any consistency.

The idea that usury means not interest but "excessive" interest is not Biblical. It is instead an idea that gradually came about as governments legalized the lending of money for interest, then (unfortunately) capped it at a certain percentage rate. Anything above that percentage was called "usury," and invoking the Scriptural usage of the word was simply a convenient way to justify price

controls on interest rates in the banking industry. It has no real basis in the Bible and is, instead, a legal term. Anyone who condemns payday lending for being “usurious” based upon Scripture, yet fails to condemn every other practice of lending money for interest, exhibits a myopic understanding of the Bible.

Myth 9: Consumers will be better off without payday loans.

*Claim: "The lenders and their trumped-up poll chose to ignore the fact that preventing Ohioans from getting ripped off and trapped in debt would be a help to the state's economy."*²²

Fact: Credible research shows that consumers are worse off where payday loans have been banned.

Those seeking to ban payday lending portray their efforts as being motivated by a desire to protect consumers. According to this view, the people who take payday loans do not know what they are doing and need enlightened legislators to stop them from making bad decisions. While those who oppose payday loans may sincerely think that eliminating this product will benefit consumers, the evidence indicates that their good intentions do not lead to the goal they envision.

Donald Morgan and Michael Strain published a study for the New York Federal Reserve Bank which investigated how consumers fare after payday lending was banned in Georgia and North Carolina. Their conclusion:

Compared with households in states where payday lending is permitted, households in Georgia have bounced more checks, complained more to the Federal Trade Commission about lenders and debt collectors, and filed for Chapter 7 bankruptcy protection at a higher rate. North Carolina households have fared about the same. This negative correlation—reduced payday credit supply, increased credit problems—contradicts the debt trap critique of payday lending, but is consistent with the hypothesis that payday credit is preferable to substitutes such as the bounced-check “protection” sold by credit unions and banks or loans from pawnshops.²³

Conclusion

It is up to each Ohioan to vote his or her conscience on Issue 5 which, if approved, would effectively end payday lending in Ohio. But voters have a duty to be educated

on this issue. Unfortunately, the campaign waged by those opposed to payday lending and the media coverage of this issue is replete with a variety of myths which are accepted as facts. When the General Assembly and the Governor signed legislation “reforming” payday lending, their statements indicated that they had little idea of the true facts about the industry. They abdicated their duty to enact good public policy that is based on sound reasoning and solid evidence.

There are many myths about payday lending. Once you begin to look at the studies done about the industry, it is clear that payday lending is not much different from any other form of lending. The “reform” legislation would ban payday lending and leave Ohio consumers worse off. While the appearance of the payday lending industry may be off-putting to some, it is bad public policy to legislate based on appearances rather than the facts. This is a lesson that seems lost on most Ohio policy makers. Hopefully voters can be made to understand what policymakers cannot.

About the Authors

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About the Buckeye Institute

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Our scholars offer free market solutions to Ohio’s most complicated public policy challenges. They advocate growing economic freedom by eliminating the income tax; returning freedom to the workplace by ending compulsory unionization; and, liberating our schools by adopting a universal k-12 voucher.

Regardless of the issue debate, the Buckeye Institute’s operating philosophy is constant: Free markets enable free men and women to find prosperity.

End Notes

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