Everything You Need to Know About Payday Loans

Sure, it's easy money. But these predatory loans are usually more trouble than they're worth.

dollars-money-bills-currency-5
Angela Lang/CNET

OUR EXPERTS

Written by Dori Zinn

TABLE OF CONTENTS

For the millions of Americans living paycheck to paycheck, running out of money is a constant, looming concern. Approximately 12 million people take out short-term, unsecured loans -- sometimes called "payday" loans -- every year, according to the Federal Reserve Bank of St. Louis. And though these loans may help them survive until they receive their next paycheck, they also exact a steep toll. Still, with millions of Americans out of work or facing reduced hours due to the COVID-19 pandemic, many will continue to depend on this dangerous financial tool.

If you don't have a strong credit history, it may be difficult to secure a traditional loan or credit card. But there are plenty of lenders that will let you borrow without a credit check, with few questions asked. The terms will be severe, however, and they'll certainly end up costing you far more than you borrowed. With a deserved reputation for "predatory lending," payday lenders have led many borrowers into a spiral of debt and regret.

If you're short on cash, you're not alone. But before you take out a payday loan, let's review what they are, why you should avoid them -- and who you can borrow money from instead.

Read more: How to repair your credit

What is a payday loan?

A payday loan is a short-term, unsecured loan that usually comes with a high interest rate. Most payday loans come in modest amounts -- typically $500 or less.

With a traditional loan, you receive a lump sum and then start to make payments back over a set amount of time -- from a few months to a few years -- with a "reasonable" rate of interest added on. With a payday loan, the full amount comes due all at once, including the interest and fees. With most, you're required to write a postdated check for the full amount due -- the loan, plus interest and fees -- or give your lender permission to debit the money from your bank account on that date.

Interest rates for payday loans are much higher compared to traditional loans. A standard APR for a personal loan ranges from 6% to 36% -- but may lenders offering payday loans charge annual percentage rates comparable to 400% or more, according to the Consumer Finance Protection Bureau. That noted, some states have limitations on interest and fees -- and in some states, payday loans are altogether prohibited.

It's also worth noting that payday loan lenders tend to target people who live in areas where poverty rates are high and income levels are low -- as well as minorities and economically disadvantaged groups, who may have traditionally had greater difficulty qualifying for conventional loans, according to a study by the St. Louis Fed.

Read more: Five Myths About Your Credit Score and Credit History

Why you should stay away from payday loans

There are twice as many payday loan lenders than McDonald's restaurants in the US -- and borrowing money from one is about as easy as ordering a burger and fries. Getting approved is relatively easy: Many payday loan lenders won't even check your credit, so a tarnished credit history won't be a factor.

That's an advantage for people with poor or limited credit histories. But the high interest rates and strict repayment terms force many into a payday loan trap where they're forced to take out new loans just to pay back existing ones.

If you don't have enough cash to repay your loan by its due date, the lender can automatically trigger a withdrawal from your bank account. And if you don't have enough money in your bank account to cover the charge, you could face an additional hit from an "insufficient funds" penalty. You may also be subject to penalties from the lender if they don't get your money on time.

If your state allows payday loan lenders, you might see them in some parts of your city and not others. For instance, there might be more of them where poverty rates are high and income levels are low. These types of lenders tend to target minority groups as well as those who have very low credit scores who don't otherwise qualify for traditional loans.

Payday loan alternatives

If you're in urgent need of money to cover basic expenses, buy food or pay off high-interest debt, there are other options to consider. Here are a few:

Online lenders

There are lots of personal loans available online that more reasonable interest rates. Even if you have less-than-stellar credit, some lenders may look beyond your credit score when evaluating eligibility.

Check out our recommendations for best loans for bad credit.

Credit unions

If you have an account at a local credit union, you may have an easier qualifying for a personal loan. Most interest rates at credit unions are capped around 18% -- even for those with low credit scores.

Many credit unions also offer payday loan alternatives -- offering small-dollar loans and short repayment terms ranging from one to six months. Many credit unions require you to join before borrowing, but are willing to work with you if you don't have great credit.

Recruit a cosigner

If you can't get a loan from an online lender or credit union, you may want to ask a friend or family-member to cosign a loan. The cosigner should have decent credit; it's their score and credit history will help get you over the eligibility hump. Keep in mind that if you fall behind on payments, not only will your credit history suffer; so, too, will your cosigner's.

Written by
Dori Zinn
Contributing Writer

Read more from Dori

Dori Zinn loves helping people learn and understand money. She's been covering personal finance for a decade and her writing has appeared in Wirecutter, Credit Karma, Huffington Post and more.