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The effect of state bans of payday lending on consumer credit delinquencies

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ABSTRACT

The debt trap hypothesis implicates payday loans as a factor exacerbating consumers' financial distress. Accordingly, restricting access to payday loans would be expected to reduce delinquencies on mainstream credit products. We test this implication of the hypothesis by analyzing delinquencies on revolving, retail, and installment credit in Georgia, North Carolina, and Oregon. These states reduced availability of payday loans by either banning them outright or capping the fees charged by payday lenders at a low level. We find small, mostly positive, but often insignificant changes in delinquencies after the payday loan bans. In Georgia, however, we find mixed evidence: an increase in revolving credit delinquencies but a decrease in installment credit delinquencies. These findings suggest that payday loans may cause little harm while providing benefits, albeit small ones, to some consumers. With more states and the federal Consumer Financial Protection Bureau considering payday regulations that may limit availability of a product that appears to benefit some consumers, further study and caution are warranted.

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1. Introduction

A payday loan is a short-term loan of a small dollar amount. For a typical payday loan of \$300, a borrower writes a postdated check for \$345, which consists of the principal amount plus \$45 in fees (\$15 per \$100 borrowed). The borrower then receives \$300. The loan is due in the next pay period (commonly 14 days), and on the due date, the borrower repays the loan amount plus fees, or the lender recovers the principal and fees by depositing the check. In some states, the borrower can renew the loan by paying another \$45 fee. In this example, the annual percentage rate (APR) is 391.05% (a periodic rate of 15% per period \times 365/14 periods in a year). The fee would be the same regardless of the term to maturity, but the APR increases as the time until the next payday becomes shorter.

Demand for small short-term loans is strong. Since its emergence in the early 1990s, the payday lending industry's annual loan volume had grown to nearly \$50 billion in 2012 (Hecht, 2013). This volume is more than the amount of consumer credit held by

nonfinancial businesses, as reported in the Federal Reserve's G.19 statistical release. The payday loan trade association estimates that about 19 million households use payday loans annually, which is about 17% of U.S. households and 23% of households in states that allow payday lending.¹

The payday loan business is controversial; the triple-digit APR itself attracts criticism.² Perhaps more significant is the criticism that the single-payment structure of payday loans makes them difficult to repay.³ Critics contend that payday loan consumers often find it necessary to renew their loans when they mature because they cannot repay the entire balance. Each time a loan is renewed, the borrower incurs relatively high fees, the burden of which over

¹ See <http://cfsaa.com/about-the-payday-advance-industry.aspx>. The number of households may be higher if Internet lenders are included.

² Because a large part of operating costs is fixed and the loan amount is small, payday loans are relatively costly to originate (Ernst and Young, 2009; Flannery and Samolyk, 2005). That small loans have relatively high costs is not unique to payday loans; The National Commission on Consumer Finance (1972) reported a similar finding for installment loans at consumer finance companies. Commission analyses showed that breakeven APRs were inversely related to loan size. At very small loan sizes, breakeven APRs exceeded 100%. Analyses also indicated that breakeven APRs were inversely related to term to maturity.

³ For example, see Pew Charitable Trusts (2013), Center for Responsible Lending (2013), and Consumer Financial Protection Bureau (2016).

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time exacerbates customers' financial difficulties. That a considerable number of payday loan customers repeatedly use payday loans over a prolonged period is cited as evidence that a problem exists. This problem is sometimes characterized as the payday loan "debt trap" (Center for Responsible Lending, 2013; Consumer Financial Protection Bureau, 2016).

The perception that a debt trap problem exists has stimulated action. Regulatory responses include limits on or prohibition of renewals, mandatory minimum intervals between successive payday loans, limits on the number of payday loans per year, and the requirement that payday lenders offer installment payment plans. A few states have eliminated the product through either rate ceilings that make payday loans unprofitable or outright prohibition. The payday loan industry, through its trade organization, also addresses the issue in industry guidelines, which include a maximum of four renewals and an installment payment option for customers who have difficulty repaying their loans. The federal Consumer Financial Protection Bureau (2013) collected its own data on the frequency of use and concluded that its findings raise substantial consumer protection concerns: "The potential for consumer harm and the data gathered to date are persuasive that further attention is warranted" (p. 45). This conclusion led the bureau to propose a rule that it argues "would put an end to the risky practices . . . that trap consumers in debt they cannot afford" (Consumer Financial Protection Bureau, 2016, p. 3).⁴

The case for a payday debt trap has not been settled. A considerable number of payday loan customers do not use payday loans often or for extended periods (Elliehausen, 2009). Moreover, frequent or extended use is not necessarily evidence of the problem. Consumers living from paycheck to paycheck may be vulnerable to even small shocks, and alternatives to a payday loan may be more costly than the payday loan.⁵ Bertrand and Morse (2011) proposed that payday loan customers may exhibit a repayment optimism bias and provided experimental evidence suggesting that disclosures of the sum of fees from repeated rollovers may reduce the likelihood of obtaining another loan over the next four months. But other evidence indicates that when they take a payday loan, many customers may fully understand how long it will take them to repay. A recent study found that most customers of a large payday lender correctly estimated when they would repay their loan (Mann, 2014). These considerations suggest that for many consumers, payday loans may not be a debt trap. While some consumers undoubtedly do have difficulty repaying payday loans, others likely benefit from payday lending. That some customers may have difficulties while others benefit leads Caskey (2010), a leading authority on fringe lending, to ask: "Do payday lenders, on net, exacerbate or relieve customers' financial difficulties?"

The term "financial difficulty" covers a broad range of potential problems—bounced checks, late utility payments, credit delinquencies of various degrees of seriousness and defaults, and so forth. Several researchers have sought to collect empirical evidence to answer this question. They have considered a variety of outcomes,

and their findings are mixed. For example, Morse's (2011) evidence suggests that access to payday loans may enhance financial resilience following natural disasters; for instance, California communities with payday loan offices experienced fewer foreclosures in the aftermath of earthquakes than communities without payday loan offices. Morgan, Strain, and Seblani (2012) found an increase in returned checks and complaints about debt collection and a decrease in Chapter 13 bankruptcy filings following payday loan bans in Georgia and North Carolina. In contrast, Campbell, Martinez-Jerez, and Tufano (2012) found a decrease in involuntary account closures after the Georgia payday ban. Skiba and Tobacman (2011) found that marginally accepted payday loan applicants in Texas were subsequently more likely to file for bankruptcy than marginally rejected applicants. Zinman's (2010) analysis of consumer survey data showed that in the wake of a rate ceiling that effectively banned payday loans in Oregon, survey respondents in the state were more likely to report a deterioration in self-assessed financial situations than respondents in neighboring Washington State. Melzer (2011) also analyzed consumer survey data, which showed that access to payday loans was associated with greater self-assessed difficulty in paying bills. In an analysis similar to that of Melzer, using credit bureau data, Bhutta (2014) found evidence that access to payday loans reduces the incidence of accounts going into collection but has little effect on credit bureau scores.⁶

Several factors may contribute to these seemingly disparate empirical results. Access to payday loans may help in some cases but not in others. A \$300 payday loan may help avoid an occasional bounced check or late utility payment but may not provide enough funds to resolve serious debt problems, for example. Thus, the finding that payday loans have little effect on credit scores (a prediction of serious delinquency) is not inconsistent with findings of fewer returned checks, involuntary bank account closings, and accounts going into collection. In some cases, outcome variables such as unemployment, bankruptcy, and foreclosure are far removed from payday loan experiences; that payday loans could have a large effect on these outcomes seems unlikely.⁷ Other outcome variables are somewhat vague and subject to interpretation (for example, self-assessed financial situation).⁸ Availability of other high-rate credit products that can be substituted for payday credit (pawn credit, for example) may mitigate effects of payday bans (Bhutta, Goldin, & Homonoff, 2015).⁹ Moreover, it is not clear that differences in outcomes are due solely to payday loan availability. For example, states in the South and West tend to allow payday loans, but these regions have also had historically higher levels of delinquencies than New England and the Mid-Atlantic, which mostly do not allow payday lending. This difference in loan performance was also true before the emergence of the payday loan industry (Elliehausen, 1999). Although significant efforts have been made

⁶ These studies illustrate the variety of different outcome variables considered and efforts to identify payday access. Several more similar empirical studies exist. They include Bhutta et al. (2015b), Fusaro and Cirillo (2011), Edmiston (2011), and Carrell and Zinman (2014).

⁷ Examining a sample of 3006 bankruptcy petitions, Mayer (2004) found that payday loans were listed in 9% of petitions. Payday loans accounted for a very small percentage of unsecured debt in petitions with payday loans, 6% or less for half of these petitions and 1% or less for 40% of these petitions. Credit cards accounted for by far most of the unsecured debts.

⁸ Noting the difference between his evidence based on credit records and Melzer's results based on self-reported stress, Bhutta (2014) speculated that psychological stress associated with the difficulty of paying loans does not progress to actual derogatory items in credit records.

⁹ In contrast, Carter (2015) found little effect of payday loan restrictions (in the form of limits on rollovers) on the use of pawnshop loans. Carter did find that some consumers use both payday loans and pawn loans and that the use of both loan types occurs among lower-income consumers in states that have less restrictive payday rollover restrictions.

⁴ The proposed rule would require a payday lender to determine that the borrower is able to repay loans before extending credit or, alternatively, limit the size and number of loans that a consumer could obtain in any 12-month period. The proposed rule would apply to payday loans, auto title loans, deposit advance products, and certain high-rate installment loans.

⁵ For example, not paying a utility bill risks a service disconnection. To restore service, a consumer has to pay the bill, a late fee, and a reconnection fee. In addition, utilities normally require a one- or two-month deposit, and the consumer experiences an interruption in service until the service is reconnected. Writing a check to pay a utility bill without having sufficient funds in the account incurs overdraft fees charged by the bank and a nonsufficient funds fee charged by the utility. In addition, the utility may require payment in cash if a consumer repeatedly writes checks with insufficient funds. Frequent overdrafts may also cause the bank to close a consumer's checking account.

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