



Payday loans and consumer financial health[☆]

Neil Bhutta^{*}

Board of Governors of the Federal Reserve System, 20th and C St NW, Washington, DC 20551, United States



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ABSTRACT

The annualized interest rate for a payday loan often exceeds 10 times that of a typical credit card, yet this market grew immensely in the 1990s and 2000s, elevating concerns about the risk payday loans pose to consumers and whether payday lenders target minority neighborhoods. This paper employs individual credit record data, and Census data on payday lender store locations, to assess these concerns. Taking advantage of several state law changes since 2006 and, following previous work, within-state-year differences in access arising from proximity to states that allow payday loans, I find little to no effect of payday loans on credit scores, new delinquencies, or the likelihood of overdrawing credit lines. The analysis also indicates that neighborhood racial composition has little influence on payday lender store locations conditional on income, wealth and demographic characteristics.

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1. Introduction

For a two-week \$300 payday advance loan, payday lenders typically charge \$45 or more, a cost so high that many believe the loan could not possibly be in the best interest of the borrower. Nevertheless, some estimates indicate that payday loan volume grew more than fivefold to almost \$50 billion from the late 1990s to the mid 2000s (Stegman 2007). With the recent rise of the payday lending industry, questions abound about the characteristics and circumstances of payday loan borrowers, and the ultimate impact of such loans on their welfare. Interest in payday lending has grown among economists in particular because of the possibility that transactions in this market may reflect a market failure due to borrowers' cognitive biases or limitations, or demonstrate divergence in behavior from traditional models (hyperbolic discounting, for example).

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^{*} Tel.: +1 2028727567.

E-mail address: neil.bhutta@frb.gov

Concerns about payday loans have led a number of states to outlaw them. As of 2006, 11 states prohibited or severely restricted payday lending and by 2012 another six states and the District of Columbia did so. At the Federal level, in 2007 Congress and the Department of Defense moved to ban payday lending to members of the military based on the view that such lending traps service members in a cycle of debt and threatens military readiness.¹ And in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act established the Consumer Financial Protection Bureau (CFPB) to help regulate the market for consumer financial products, including the payday loan market. The CFPB has new authority to write and enforce new federal regulations to the extent that they judge payday loans to be “unfair, deceptive or abusive,” and they recently stated that new consumer protections in the payday loan market may be forthcoming if the evidence warrants action (CFPB, 2013).

The academic literature thus far on the financial and welfare consequences of payday loans has been quite mixed. Some studies have found harmful effects of access to payday loans such as elevated rates of bankruptcy (Skiba and Tobacman, 2011), declines in job performance perhaps due to financial stress (Carrell and Zinman, 2013), increased difficulties paying bills (Melzer, 2011),

¹ See “Limitations on Terms of Consumer Credit Extended to Service Members and Dependents: Final Rule,” 72 *Federal Register* No. 169 (August 31, 2007), pp. 50580–50594 (<http://www.gpo.gov/fdsys/pkg/FR-2007-08-31/pdf/07-4264.pdf>).

and higher likelihoods of losing one's bank account (Campbell et al. 2011). In contrast, other studies find evidence that payday loans promote job retention and financial well-being (Zinman, 2010), help consumers smooth through expenditure shocks (Morse, 2011), and reduce consumer complaints against lenders, perhaps because payday loans help people manage cash flow and mitigate debt problems (Morgan et al., 2012). Two of these studies (Zinman, 2010; Morgan et al., 2012) also suggest that restricting access to payday loans leads people to turn to more expensive and less reliable sources of credit such as bank overdrafts and paying bills late.

I add to this literature by using individual-level credit record panel data, and exploiting geographic and temporal variation in access to payday loans arising from state lending laws, to study the effect of payday loans on financial health, measured by credit scores and score changes as well as other credit record variables such as credit delinquency.² Importantly, use of and performance on payday loans generally does not directly affect consumers' traditional credit scores (such as the FICO score) or their credit records because payday lenders rarely report to the national credit bureaus. Rather, payday loans can affect credit scores *indirectly* to the extent that such loans either improve or undermine consumers' ability to manage cash flow and meet their financial obligations in general. If payday loans tend to help borrowers smooth through expenditure or income shocks and help manage payments on other obligations (e.g. Morse, 2011; Morgan et al., 2012), or improve job retention (Zinman, 2010), then access to them would likely lead to higher credit scores. Alternatively, if consumers are enticed by payday loans to over-borrow, or if consumers underestimate the cost of such loans (Bertrand and Morse, 2011), payday loans may tend to exacerbate debt problems and lead to lower scores on average.³

As noted above and as Fig. 1 shows, by 2012 eighteen states, including the District of Columbia, prohibited or severely restricted payday lending, with seven of these bans being implemented between 2006 and 2012 (thus all law changes during my observation period were in the direction of prohibiting, rather than allowing). In addition to a standard state-level differences-in-differences identification strategy, I also follow Melzer's (2011) novel strategy of exploiting within-state variation in access to payday loans due to differences in the proximity of ZIP codes in states that prohibit payday lending to states that allow payday lending. This strategy compares, for example, outcomes of North Carolinians who live in ZIP codes in the middle of the state – far from any payday-allowing state – to North Carolinians who live in ZIPs near the border with South Carolina and can access payday loans by driving across the border. The advantage of this strategy is that it is robust to state-by-year shocks and thus more likely to be immune to identification problems stemming from potentially endogenous state law changes.⁴

² Credit scores are just one dimension of financial health; someone with a high credit score may nonetheless be in poor financial shape if, for instance, their retirement savings are too low. Still, it seems reasonable to infer that someone with a high credit score is in better shape financially than someone with a low credit score, all else equal, from the standpoint that a high credit score reflects debt being well-managed and a low likelihood of default.

³ As Bhutta et al. (2013) show, payday loan applicants tend to have low credit scores (in the low 500s) just before applying. Importantly, negative events such as new delinquencies still have a substantive effect on credit scores even when starting from a score in this range. In addition, payday loans may hamper score recovery even if they do not lead to declines in scores (i.e. cause scores to stagnate at a low level when they might otherwise recover in the absence of payday loans).

⁴ Although there are only seven law changes during my observation period, which places some limitations on power, Melzer's strategy provides additional sources of within-state identifying variation. For example, although Massachusetts had a ban on payday lending throughout my observation period, areas on the border with New Hampshire had access through 2008 and then lost access when New Hampshire banned payday loans.

Like several other papers in the literature, I do not directly observe payday loan use in the data, which presents a potential identification problem. Namely, to the extent that only a narrow segment of the population uses payday loans – both for supply- and demand-related reasons – intention-to-treat estimates using a broad population sample will be significantly attenuated relative to the treatment-on-the-treated estimate of interest. The large, yet detailed dataset I have allows me to address this issue in two ways. First, I run regressions using only a sample of individuals most likely to use payday loans, where identification of likely payday loan borrowers comes from a complementary research project that provides detailed credit record attributes for a sample of payday loan applicants just prior to application (Bhutta et al., forthcoming).

Second, I run the analysis on the subsample of individuals living in ZIP codes where payday lenders actually operate, or *would* operate were they not prohibited by state law. Using Census ZIP code business and demographic data, I empirically identify “payday ZIPs” as commercialized ZIP codes with large, but less affluent, populations. Restricting attention to such ZIP codes helps ensure that individuals in the sample would have access when payday lending is legal (imagine two identical borrowers with demand for a payday loan, but the first lives in a payday ZIP while the second happens to live further away from any commercial area with payday lenders; the first will have easier access and be more likely to take out a payday loan).

Notably, the analysis of payday lender locations fails to indicate that lenders target minority neighborhoods, conditional on economic characteristics of the population. This result is important in its own right because of concerns that payday lenders target minority neighborhoods, leading to a disparate impact among black and Hispanic families. For example, one leading consumer advocacy organization conducted a study on payday lending in California and concluded, “Payday loans are a debt trap—and in California, that trap ensnares more African Americans and Latinos by a staggering margin.”⁵

Surprisingly, this is the first paper to use readily available Census ZIP code business data to analyze the socioeconomic factors correlated with payday lender concentration.⁶ Another recent study by Morgan and Pan (2012) approaches the question of whether payday lenders target minorities from a different angle using household survey data, and also finds no relationship between the race or ethnicity and use of payday loans after controlling for observable socioeconomic characteristics.⁷

Finally, I also test whether access to payday loans interacts with shocks to the local economy. The period studied covers the Great Recession and thus large unemployment shocks at the county level are not uncommon in the data. This test is similar to one in Carrell and Zinman (2013) which finds that the negative effect of payday loans on military personnel performance is elevated in areas with higher unemployment. It is also similar in spirit to Morse (2011), who finds that access to payday loans substantially mitigates foreclosures after natural disasters.

Overall, I find little evidence that payday loans substantively affect credit scores, or the likelihood of large score declines, delinquency or having other debt-management problems as indicated by exceeding credit card limits. In virtually all the regressions I run – regardless of using the full sample or various subsamples,

⁵ See more at: <http://www.responsiblelending.org/media-center/press-releases/archives/payday-lending-strips-247-million-from-california-african-americans-and-latinos.html#sthash.2Q4smt6N.dpuf>.

⁶ Prager (2009) studies the determinants of payday lender concentration using data at the county level. Other studies that analyze location decisions at a more granular level – and have sometimes found evidence of targeting – tend to only have data for one city or county (e.g. Graves 2003).

⁷ See <http://libertystreeteconomics.newyorkfed.org/2012/02/do-payday-lenders-target-minorities.html>.

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