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Reframing the Debate about Payday Lending

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Except for the ten to twelve million people who use them every year, just about everybody hates payday loans. Their detractors include many law professors, consumer advocates, members of the clergy, journalists, policymakers, and even the President! But is all the enmity justified? We show that many elements of the payday lending critique—their "unconscionable" and "spiraling" fees and their "targeting" of minorities—don't hold up under scrutiny and the weight of evidence. After dispensing with those wrong reasons to object to payday lenders, we focus on a possible right reason: the tendency for some borrowers to roll over loans repeatedly. The key question here is whether the borrowers prone to rollovers are systematically overoptimistic about how quickly they will repay their loan. After reviewing the limited and mixed evidence on that point, we conclude that more research on the causes and consequences of rollovers should come before any wholesale reforms of payday credit.

Payday Loan Prices: High but Justified?

The first complaint against payday lenders is their high prices: the typical brick-and-mortar payday

lender charges $15 per $100 borrowed per two weeks, implying an annual interest rate of 391 percent! That's expensive, to be sure, but is it unfair? For economists, the answer depends on whether payday credit markets are competitive: with healthy price competition, fees will be driven down to the point where they just cover costs, including loan losses and overhead.

Judging by their sheer numbers, payday lending is *very* competitive. Critics often fret that payday lenders outnumber Starbucks as if they—payday lenders, not Starbucks—were a plague upon the land. But shouldn't competition among all those payday lenders drive down prices? They seem to. This study estimated that each additional payday firm per 1,000 residents in a given Zip code was associated with a $4 decline in fees (compared with a mean finance charge of about $55). In the later years of the study, the authors found that prices tended to gravitate upward toward price caps, but that seems like a problem with price caps, not competition. And of course, payday lenders also have to compete against other small dollar lenders, including overdraft credit providers (credit unions and banks) and pawnshops.

Competition seems to limit payday lenders' profits as well as their prices. This study and this study found that risk-adjusted returns at publicly traded payday loan companies were comparable to other financial firms. An FDIC study using payday store-level data concluded "that fixed operating costs and loan loss rates do justify a large part of the high APRs charged."

Is a 36 Percent Interest Cap in Order?

Even though payday loan fees seem competitive, many reformers have advocated price caps. The Center for Responsible Lending (CRL), a nonprofit created by a credit union and a staunch foe of payday lending, has recommended capping annual rates at 36 percent "to spring the (debt) trap." The CRL is technically correct, but only because a 36 percent cap eliminates payday loans altogether. If payday lenders earn normal profits when they charge $15 per $100 per two weeks, as the evidence suggests, they must surely lose money at $1.38 per $100 (equivalent to a 36 percent APR.) In fact, Pew Charitable Trusts (p. 20) notes that storefront payday lenders "are not found" in states with a 36 percent cap, and researchersstreat a 36 percent cap as an outright ban. In view of this, "36 percenters" may want to reconsider their position, unless of course their goal is to eliminate payday loans altogether.

"Spiraling" Fees?

A central element of the debt trap critique against payday loans is their "spiraling" fees: "When borrowers don't have the cash come payday, the loan gets flipped into a new loan, piling on more fees into a spiral of debt for the borrower." It's certainly true that payday loan fees add up if the borrower extends the loan (like any debt), but do they spiral? Suppose Jane borrows $300 for two weeks from a payday lender for a fee of $45. If she decides to roll over the loan come payday, she is supposed to pay the $45 fee, and then will owe $345 (the principal plus the fee on the second loan) at the end of the month. If she pays the loan then, she will have paid $90 in fees for a sequence of two $300 payday loans. Payday lenders do not charge refinancing/rollover fees, as with mortgages, and the interest doesn't compound (unless of course she takes out a new loan to pay interest on the first loan). Perhaps it is just semantics, but "spiraling" suggests exponential growth, whereas fees for the typical $300 loan add up linearly over time: total fees = $45 + number of rollovers x $45.

Do Payday Lenders Target Minorities?

It's well documented that payday lenders tend to locate in lower income, minority communities, but

are lenders locating in these areas because of their racial composition or because of their financial characteristics? The evidence suggests the latter. Using Zip code-level data, this study found that racial composition of a Zip code area had little influence on payday lender locations, given financial and demographic conditions. Similarly, using individual-level data, this blog post showed that blacks and Hispanics were no more likely to use payday loans than whites who were experiencing the same financial problems (such as having missed a loan payment or having been rejected for credit elsewhere). The fact is that only people who are having financial problems and can't borrow from mainstream lenders demand payday credit, so payday lenders locate where such people live or work.

Do Economists Agree about the Perils of Payday Lending?

On the contrary, the roughly half-dozen studies published in academic, peer-reviewed journals are thoroughly mixed on "the big question" of whether payday loans help or hurt their users. On the harm side, researchers have found that access to payday loans leads to more difficulty paying bills, more involuntary bank account closures (due to overdrafts), and reduced preparedness by "airmen." On the help side, researchers found that access is associated with reduced foreclosures after natural disasters, fewer bounced checks, and less difficulty paying bills. This studyand this study find that access to payday credit does not affect users' credit scores one way or the other. That's a notable nonresult because if payday loans caused further financial problems, as critics allege, those problems would presumably show up as a falling credit score as borrowers began missing other debt payments—yet it doesn't.

It's All about the Rollovers

So if payday loan fees are competitive and don't spiral, and if lenders don't target minorities, and if the academic research on the pros and cons of payday credit is so mixed, what's left in the critique against payday lenders? Rollovers. Payday lenders often pitch their two-week loans as the solution to short-term financial problems, and, true to form, about half of initial loans (those not taken out within fourteen days of a prior loan) are repaid within a month. Potentially more troubling is the twenty percent of new payday loans that are rolled over six times (three months) so the borrower winds up paying more in fees than the original principal.

Critics see these chronic rollovers as proving the need for reform, and in the end it may. A crucial first question, however, is whether the 20 percent of borrowers who roll over repeatedly are being fooled, either by lenders or by themselves, about how quickly they will repay their loan. Behavioral economists have amassed considerable evidence that, contrary to tenets of classical economists, not all people always act in their own best interest; they can make systematic mistakes ("cognitive errors") that lower their own welfare. If chronic rollovers reflect behavioral problems, capping rollovers would benefit borrowers prone to such problems.

Unfortunately, researchers have only begun to investigate the cause of rollovers, and the evidence thus far is mixed. This study found that counseling prospective borrowers about how the cost of rollovers add up reduced their demand by 11 percent over the subsequent four months. Their finding suggests "cognitive bias" among some customers and implies that capping rollovers might benefit such borrowers (although the authors themselves did not advocate limiting rollovers). By contrast, this more recent study found that the majority of borrowers (61 percent) accurately predicted within two weeks when they would be debt-free. Importantly, the study reported that borrowers who erred were not systematically overoptimistic; underestimates of borrowing terms roughly balanced overestimates. After reviewing the available evidence, one expert in behavioral economics concluded

that the link between overoptimism and overborrowing (that is, rollovers) ". . . is tenuous at best, and arguably non-existent."

Reform or More Research?

Given the mixed evidence on the "big question" and the smaller, but crucial question of whether rollovers reflect overoptimism, more research should precede wholesale reforms. A handful of states already limit rollovers, so they constitute a useful laboratory: how have borrowers fared there compared with their counterparts in "unreformed" states? A delicate welfare calculus should also precede reform: while rollover caps might benefit the minority of borrowers prone to behavioral problems, what will it cost the majority of "classical" borrowers who fully expected to rollover their loans but can't because of a cap? Without answering that question, we can't be sure that reform will do more good than harm.