

PAYDAY LENDING: THOUGHTS ON REGULATION & ACADEMIC LITERATURE

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Opening Thought: Coping

Lusardi & Tufano's paper published in Brookings: ["Half of Americans can't cope."](#)

- *What does that mean? Can't cope.*
- *They have to cope, they just don't know how they would.*

*If **distress** finance products were set up to help*

(i) people that need to cope

(ii) in a way that helps with coping,

wouldn't that be better?

How can we improve the mechanisms to get there?

Slides “Fuzzy” Outline...

- Characterization of payday loan (PDL) market
 - *Concepts: Literature, needs, welfare, heterogeneity of borrowers*
- Characterization of PDL product
 - *Concepts: Ability to pay, terms*

Characterization of the PDL Market

Characterization 1:

Demand exists by the population for some kind of distress finance.

- a) Revealed preference: 3 -10% of the population uses distress finance products every year
- b) In every survey with which I am familiar (by academics, think tanks, even those stridently against payday loans), users of payday loans express that they are happy that the service exists.

Are PDLs perfect? Surely not, but people say there needs to be some product

Characterization of the PDL Market

Characterization 2:

Failure of knowledge: We have spent too much time arguing about how bad payday loans are and not spend enough time understanding:

1. What gets people into distress
2. What people do to cope once in distress
3. To what extent people would avoid getting into distress if they knew that access to distress finance were not available

Characterization of the PDL Market

Characterization 3

- The well-being impact to using a PDL varies by individual and circumstance:
 - *Some people have genuine need for bridge loans, even if expensive*
 - *Other use the PDL product in circumstances when avoidance of any new debt or utilization of a different finance would be better*

- It is not productive to keep arguing about good/bad.
 - *Rather, it would be very productive to figure out PRODUCT IMPROVEMENTS that do more sorting.*
 - Sorting means that some people should be sorted out
 - But the mechanism should be optimal for both those that sort in and those that sort out

Welfare: Good or Bad. Some Literature

- In 2005 - 2007: a first generation set of working papers about payday lending asked whether payday lending is welfare improving.
 - *Morgan Strain (2008), Morse (2011), Skiba Tobacman (2015), Meltzer (2011), Zinman (2010)*
 - Answer: Mixed
 - *Later papers fail to find much negative impact on financial well-being relative to a control (e.g., Bhutta (2014), Bhutta, Skiba, Tobacman (2015))*
- *Issue is heterogeneity in using payday loans for bridge loan vs habit /LT borrowing*

More on Characterization Point #3

- When Might a PDL be welfare-improving
 - *Must be maxed out on other (cheaper) finance*
 - Convenience should not dictate use
 - *MUST BE ABLE TO PAY BACK A LOAN IN A SHORT TIME PERIOD*
 - Income must imply slack
 - *Must be able to resolve other distress so that reoccurrence does not happen (otherwise bankruptcy might be optimal)*
 - *For most individuals, must be willing to adjust consumption-savings behavior or rebalance assets or commitments to resolve distress setting, given that most people are already living month-to-month making ends meet*

More on Characterization Point #3

- When Might a PDL be welfare-destroying
 - *Could have borrowed on some other form of finance*
 - *Using a PDL for non-necessity*
 - *Using a PDL for long-term solution*
 - *Continues to revolve even when cash is available*
 - *For those taking actions knowing that a PDL is a backdrop /safety net*

The Yes/No question applicability

Example of yes/no relevance: Ban in U.S. for payday loans for military:

- *Carrell Zinman (2014): welfare destroying in Air Force data*
- *But recently Carter Skimmyhorn (2016), Zaki (2016) more micro data from Army fail to find harm.*
- But neither the UK nor U.S. (federal) governments are currently entertaining the yes/no question. Some States are.
- Why?... We are back to the issue that the product is distasteful and yet clearly there is demand for distress finance
 - *Up to 10% of UK population*
 - *5+% of U.S. population*

Characterization of the PDL Market

Characterization 4

- The optimal form of distress loans may (or may not) emerge from storefronts
 - *Most advocates say that we need to “bank” the unbanked*
 - *This does not seem obvious at all to me. Consider:*
 - The extent to which bank products cater to those with wealth and are expensive for those in distress or in certain income brackets.
 - The extent to which either traditional or non-traditional financial products cater to behavioral biases or cognitive limitations of individuals.
 - The extent to which banks or non-banks can package services to those in distress or in certain income brackets that can be viable for the financier.
 - *Probably: Banks are not set up cost-wise/ fee-wise to serve lower income households*

Characterization of the PDL Market

Characterization 4

■ Storefronts?

– *What about platform finance*

1. Ask oneself: Why do 10-15% of the UK population use PDLs vs 3-8% of the U.S?

■ My Hypothesis: App-based (or online)

■ Why?

– *Maybe shaming removed (Japanese PDL stores are famously hidden)*

– *Maybe just trouble? Trouble may filter out those working on impulse*

■ If so.... 24-hour waiting policy like gun-buying?

2. Evidence on what platform debt is>

Lending Club Stats from Morse (2015, Annual Review of F.E.)

Type of Loan	Annual Income	Loan Amount	Interest Rate	Term Months	Count	% of Sample	Payments
Car	65,993	8,556	0.134	39.2	185	0.8%	\$267.29
Credit Card	74,017	15,406	0.134	39.8	5,680	25.0%	\$475.58
Debt Consolidation	75,468	16,350	0.141	41.6	13,797	60.8%	\$492.27
Home Improvement	87,893	15,056	0.129	41.8	1,120	4.9%	\$444.33
House	82,617	16,912	0.139	41.7	138	0.6%	\$506.25
Major Purchase	78,365	9,740	0.129	39.4	443	2.0%	\$301.56
Medical	73,325	8,375	0.191	38.0	122	0.5%	\$289.11
Moving	76,911	8,325	0.193	37.6	73	0.3%	\$290.08
Other	68,913	9,702	0.197	40.0	696	3.1%	\$324.56
Renewable Energy	99,977	12,602	0.194	42.5	11	0.0%	\$401.91
Small Business	92,278	17,023	0.193	40.9	253	1.1%	\$557.48
Vacation	63,913	6,003	0.190	36.9	55	0.2%	\$211.76
Wedding	70,315	11,703	0.194	39.4	134	0.6%	\$394.56
Total	75,674	15,542	0.141	41.0	22,707	100.0%	\$473.86

Take Away : Platform Loans have been overwhelmingly consolidations for people with high debt..

Lending Club Stats from Morse (2015, Annual Review of F.E.)

Census Income Quintile	Annual Income	Loan Amount	Interest Rate	Term Months	Loan-to-Income	Payment-to-Income	Count	% of Sample
1st	19,944	4,722	18.1%	36.2	0.237	0.100	423	1.9%
2nd	32,425	8,478	16.0%	36.8	0.261	0.107	2,464	10.9%
3rd	50,314	13,206	14.8%	40.8	0.262	0.097	7,694	33.9%
4th	80,216	17,636	13.6%	42.2	0.220	0.078	8,158	35.9%
5th	148,303	21,305	12.4%	42.1	0.144	0.050	3,968	17.5%
Total	75,674	15,542	14.1%	41.0	0.205	0.075	22,707	100.0%

Take Away 1: These are large, expensive debt-to-income loans.

Take Away 2: The borrowers are not low income.

Characterization of the PDL Product

Product Characterization 1

Ability-to-pay

- FINRA survey: 56% of Americans spend = to (38%) or > than (18%) their incomes
- How is such a person supposed to payback a loan?
- With this in mind, is it optimal for people to be approved for a PDL? It depends.
 1. *If bankruptcy is an option that would get them out of distress (e.g., households with sustainable income but lot of debt), then it may be optimal for **an infeasible-to-payback type** to **fail ability-to-pay tests and get relief from courts***
- *Note: even paying fees for bankruptcy is hard (Gross, Notowidigdo and Wang, 2013 “Liquidity Constraints and Consumer Bankruptcy: Evidence from Tax Rebates”)*

Characterization of the PDL Product

Product Characterization 1

Ability-to-pay

- Is it optimal for people to be approved for a PDL? It depends.
 2. *If an infeasible-to-payback individual is not indebted (i.e., court can't help much) but is characterized by*
 - Insufficient income to cover local expenses
 - Realistic expense commitments
 - *Then it is hard to argue that some bridge finance should not be available for these folks. Payback structure needs to be longer-term with costs spread over duration.*

Characterization of the PDL Product

Product Characterization 1

Ability-to-pay

- Is it optimal for people to be approved for a PDL? It depends.
 3. *If an individual is has some feasibility in income slack to make paybacks by reducing consumption commitments or restructure other debt*
- *Then bridge finance might best be aligned with encouraging those adjustments. Shorter-term installments, for instance.*

Characterization of the PDL Product

Product Characterization 1

Ability-to-pay

- Is it optimal for people to be approved for a PDL? It depends.
 4. *If an individual looks like characterization 3, but is using PDL to support temptation consumption habits.*
 - *Then it might be optimal (paternalistically) to make the PDL product less desirable in habit-support or moral hazard framing. It is difficult to induce a sorting.*
 - Suggestion: Delay in PDL issuances. (not tried, to my knowledge)
 - Suggestion: Restrictions on use per half-year – requires coordinated State database

Characterization of the PDL Product

Product Characterization 2

Saving-for-Payback Behavior

- In a study I published in the Journal of Finance in 2011, we find that people can change their saving-for payback behavior if they are encouraged to think about the **forward-looking dollar costs of borrowing**.
 - Implemented in disclosure rules in Texas, Ontario
 - *If a person has \$100 in her pocket and an outstanding loan of \$400, she should use the cash to lower the principle as much as she can, rolling over a smaller loan.*
 - *In practice, this is not the behavior observed.*
 - People often defer paying back a payday loan until they possess the entire sum.
 - If the loan product forced principle payback, the evidence suggests that people would hold the debt a shorter period of time.

Characterization of the PDL Product

Product Characterization 2

Saving-for-Payback Behavior

- One suggestion I made to the CFPB was to experiment with dollar rebates (as a proportion of the principal) to induce saving-for-payback
 - *This is theoretically not the optimal design because the cost is born when the borrower has the lower ability to pay,*
 - *But, if the promise of a rebate induces a change in behavior*
 - *And the lender cannot ex ante sort individuals and offer them a lower interest rate, it could be a way to de facto provide lower rates to lower risk types*
 - *Could run experiments to test*

Characterization of the PDL Product

Product Characterization 3

Maturity Matters

- People don't select maturity based on rates (Atanassio, et al (2008),
- People select based on payments size
 - *Hertzberg, Liberman, Paravisini: "ADVERSE SELECTION ON MATURITY: EVIDENCE FROM ON-LINE CONSUMER CREDIT" (2017)*
 - Payment match for their ability-to-pay
 - *Lower risk can make lower installment payments*
 - *To use maturity self-selection to make loans cheaper for "single use" bridge loan borrowers to recover requires short maturity cheaper rates + ability-to-pay calculations + penalties (to make sure high-risk do not try to disguise themselves as high ability-to-pay types)*
 - *And lenders need to be willing to price this way*

Next generation: Use the literature on people's use of borrowing to improve product design

- A very incomplete list of literature which could enable thinking about product design for pareto policy improvements across heterogeneity of borrowers
- Studies of why people get into trouble
 - *Smoothing issues/making ends meet: Stephens (2003), Parsons-van Wesep (2013), Leary-Wang (2016)*
 - *Preferences: Laibson (1997), Meier-Sprenger (2010), Kuchler (2012)*
 - *Neglect: Berman, Tran, Lynch, Zauberman (2015)*
 - *Aging: Agrawal, Driscoll, Gabaix, Laibson (2009)*
 - *Cognition/Focus: Morse Bertrand (2011), Stango Zinman (2011), etc.*
- Studies of marginal use of income (helicopter drop studies)
 - *Johnson, Parker, Souleles (2006;2013 w/ McClelland); Agrawal, Liu, Souleles ('07); Bertrand Morse ('09)*
- Studies of consumer loan contract form
 - *E.g., 1980s literature from Stiglitz Weiss, Hertzberg, Lieberman, Paravisini ('15); Carter, Skiba, Sydnor ('13)*

Other Markets for Coping

Repeat from earlier:

Recent papers fail to find much negative impact on financial well-being relative to a control (e.g., Bhutta (2014), Bhutta, Skiba, Tobacman (2015))

- *Note: Control is not doing well either, how coping?*

■ IMPORTANT:

- *Gathergood, Guttman-Kenney, Hunt (2018): No result except the important finding that people seem to Cope by using “Personal Loans”*
 - **“Personal Loans”** : A category of debt consolidation loans offered in the UK mostly by the banks
 - We don't have these, mostly. They had a “bad taste” originally and became more fringe
 - Platforms are not serving this role (yet) because it is hard to monitor

Regulation & Innovation

- Let's look at some select settings

FCA : UK Regulations as of 2015

- Regulation Approach: **Interest Rate Cap** Modelled after Australians
 - *Cap loan interest rates at 0.8% per day, with total cost cap of 100% of loan.*
 - *eg: take out a £200 loan for 14 days: pay £22, which is APR of 287%*
 - *Cap binds the number of cycles*

 - *Indeed reduced loans*
 - *Pareto-improving / Optimal? -- discuss*

CFPB: U.S. Proposed Regulations 2016

- *Choice 1: Lender assesses ability-to-pay (income, debt, expense estimate) for general consumer-loan products*
 - This seems like an attractive idea, but it may be a sideshow:
 - *Customers will not want product because credit check and reporting from a payday lender will likely negatively affect credit history*
 - *Lender will not want to lose customers to assessment and not want to pay credit agencies fees*
- *Choice 2: Payday loan up to \$500*

CFPB: U.S. Proposed Regulations 2016

- *Choice 1: Lender assesses ability-to-pay (income, debt, expense estimate)*
- *Choice 2: Payday loan up to \$500*
 - Must pay 1/3rd of principle back after each of 3 cycles. Paid off in 3.
 - No renewal for 30 days. Only 6 of these within 12 months. (? Could be better)
 - My view: this is a step (maybe not the best ever step, but a step) toward a behavior adjustment product that also filters out those not liking installment commitment.
 - I'm a big fan of installment product for bridge loans.
 - *Lump sum repayment is often not realistic.*

New Ohio Law

- Maximum loan: \$1,000
- Term : 90 – 365 days
 - *Can be shorter term if monthly payment is < 7 percent of a borrower's monthly net income*
 - *>90 days: Lenders must provide sample repayment schedule based on affordability*
- Set up as installment loan with equal monthly payments
- Fees + interest $\leq 60\% * \text{principal}$
- Interest rate $\leq 28\%$
- *Sum across loans $\leq \$2,500$ principal across several loans.*
- *Lenders charge a monthly maintenance fee = Min (10% loan's principal, \$30)*
- Borrowers would get 72 hours to change their minds
- No front-loaded fees

Thoughts on Ohio

- Note: In general, I think this is a great step forward
- Thinking through if it is *perfect*:
 - *Ability to pay*
 - *Sorting*
 - Maybe... this part seems intentional, but it is unclear yet
 - *Getting term lengths right*
 - *Monthly Fees?*
 - *Altering behavior*
 - *Multiple loans across lenders*
 - *Rewards?*

Experiments / Research

- Delay – 24-hour period before access to cash
- Rebates – provide rebates for early repayment.
 - *Lowers effective interest rate (ex post) for lower-risk type.*
 - *Beneficial if can get people to change saving habit.*
- Suggested Repayment Schedules: I am skeptical from the CARD Act history and my own work.
 - *Importance of mandating versus suggesting repayment plan*
 - *Ohio seems to be a mixture*
- UK-like personal loans with Capital One (e.g.) – a lender that can diversify risk and benefit from relationships to make this feasible