Misguided Regulation of Payday Loans*

Paige Marta Skiba
Vanderbilt University
November 4, 2011

Abstract

Since payday lenders came on the scene in the 1990’s, regulation of these so-called “preda-
tory” lenders has been swift and often severe. Thirteen states now ban payday loans outright. From an economist’s perspective, high-interest, short-term small loans need not be a bad thing. Payday credit can help borrowers “smooth” consumption, unequivocally improving welfare as consumers borrow from future good times to help cover current shortfalls. These benefits of credit can accrue even at typical payday loan interest rates of 300-600 percent APR. The ques-
tion of whether payday credit actually assists borrowers in this way is an empirical one. In this paper, I review the existing empirical evidence on how borrowers use payday loans. I document the prevalence of rollovers and default, the evidence against moral hazard, the existence of self-
control problems and myopia, and the interaction of payday loans and other types of credit. I then document the disconnect between this collection of evidence and the existing regulatory frameworks, which purport to help consumers avoid misuse of payday loans. These include outright bans, price caps, minimum and maximum loans lengths, minimum and maximum loan sizes, and rollover restrictions. I argue that: 1) outright bans are misguided, 2) larger loans can help borrowers, 3) loan-length restrictions are unneeded and 4) rollover restrictions do make sense.

JEL Codes: D14, D82, D83

*Associate Professor of Law. paige.skiba@vanderbilt.edu. I would like to thank Margaret Blair, Susan Payne Carter and Anna Skiba-Crafts for helpful comments. Katie Fritz dixon, Logan Johnston and Samarn Meyers provided excellent research assistance.
1 Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act,\(^1\) passed in July 2010, rang in a new era of financial regulation. Its reforms will effect financial institutions from big banks to pawnbrokers. Payday loans are no exception. We can expect many changes to the regulatory landscape of these small-dollar, short term loans from the Consumer Financial Protection Bureau, which opened its doors in July 2011. Given that 10 million low-income household use payday loans, these changes will have a significant impact on a large group of people. Payday loans are about the most expensive form of credit consumers can legally obtain. They last just a matter of days and are primarily used by low- and middle-income households. Payday loans are almost universally deemed “predatory” and “usurious” by consumer advocates, policymakers and the media. Senator Lowell Baron (Alabama) has stated, for example, “The consumers being picked on here are the poorest, low-income people. there is no reason why anyone should exploit people with a short-term cash problem.” Other lawmakers have described payday lending as an “immoral practice” (Senator Graff), as a “trap” (Senator Keller, Colorado), as a set of “shackles” (Pastor Haynes of Dallas, Friendship West Baptist Church), as “ruin[ing] lives” (Representative McClure, Arizona), and as imposing “astronomical interest rates” and “unrealistic payment terms” (Senator Hagan, South Carolina). Embracing views like these, many state policymakers have worked hard to curb payday lenders’ operations. Although we can predict even more regulation with the advent of Dodd-Frank and the Consumer Financial Protection Bureau, regulation of payday loans has already taken many forms. In this article, I argue that state and federal regulation of payday lending is largely misguided. I summarize the growing body of microeconomic evidence on borrowers’ use of payday loans and assess their predicted responses to a number of different regulatory schemes: outright bans, price caps, and restrictions on loan sizes, duration, and renewals means about the soundness of those types of regulations. I conclude that most current regulation which restricts access to payday loans does not increase consumers’ welfare. Efforts to curb loan rollovers are the one type of regulation that does make policy sense, because those rollovers unambiguously lead to welfare-damaging behavior in a way that other features of payday loans targeted by lawmakers do not. The mainstream view seems to be that payday loans are abusive. From an economists’ perspective, credit allows consumers to smooth consumption over time, meaning that they borrow from future good times to help make it through current tough times. This is seen as an uncontroversially

\(^1\)H.R. 4173
good thing and includes behaviors like borrowing on credit cards during graduate school with the expectation that after school one will be able to repay the loans with one's future salary; microcredit (small dollar loans initiated in developing countries to provide individuals who are turned away from banks access to credit); small business owners using credit to invest in machinery, etc.; and consumers using credit to buy durable goods (refrigerators, washing machines) that they could not pay for in full up front. Such benefits of consumption smoothing are not lost even at interest rates that many consider usurious. Payday loans are no doubt extremely expensive. Lenders charge $10-$20 per $100, equivalent to 260-520% annualized percentage rate (APR) on a two-week loan. For a typical two-week loan, interest fees are between $10-$20 per $100. APR is calculated as 26 two-week periods per year multiplied by the interest rate. A 15% fee would thus results in 390% APR. But borrowing against future paychecks at such a high APR can be worth it if consumers' marginal utility is raised sufficiently to outweigh the expenditure they will make on interest. For example, if a consumer's car breaks down and she would be fired if she cannot get to work tomorrow, it may be rational for her to borrow at extremely high interest rather than forgo all wage income for the foreseeable future. Accordingly, in the framework for which they are intended, payday loans can increase a borrower's utility. But lawmakers who look down on payday loans and see their short durations and high interest as flaws appear not to have been affected in their decision making by the strong theoretical support for the benefits of credit and the fact that many consumers have no other credit available. Thirteen states have now banned payday lending based on the assumption that it enables borrowing behavior that leads to costly cycles of debt. But there is little evidence that payday loans per se are bad for consumers or that consumers overall are better off without access to payday loans. Payday loans are by no means always utility-enhancing, however. People frequently use payday loans for purposes other than avoiding emergency situations. Research on payday loans makes clear that the typical payday borrower returns to a lender many times, taking out multiple loans and rollovers (Skiba and Tobacman 2008). Further, one can show that repeated use of payday loans is not consistent with the standard rational-actor model. In Skiba 2011 [not the correct way to format] (The Behavioral Economics of Payday Loans), I discuss this argument in more detail. People use payday loans to make seemingly suboptimal expenditures like throwing parties. Behavioral economics identifies this type of behavior, engaging in nonessential spending that is outside one's means as a self-control problem. It is also important to consider the full portfolio of one finances and the cascading effect of earlier expenditures on one's current or future
financial situation. A consumer may show up to the payday lender because of an expensive utility bill, but she may have been unable to pay that bill in the first place because she maxed out her credit card and bought a car she cannot afford, for example. When used in the appropriate circumstances and in moderation, and when paid over a reasonable timeline, payday loans have the potential to increase individuals' utility in a way that is difficult to achieve using any other form of credit. This is especially true because many forms of credit are seldom available to the population that tends to use payday loans. However, payday loans do sometimes seem to invite abuse, leading to a cycle of borrowing with repeated renewals and ballooning interest payments. State legislatures often seek to constrain their use for this reason but better policy would permit payday lending at least to the extent it increased utility and constrain their use only to prevent the truly net negative effects. The question then is what is the right regulation? My analysis suggests that regulation focused on restricting renewals/rollovers makes sense, while other types of regulations are generally overreaching, inhibiting unique opportunities for consumers to increase utility. The current analysis and policy conversation around payday loans tends to ignore the good and demonize payday loans but, as I document below, data show that there is a need for a more nuanced examination because in some circumstances at least, the good may outweigh the bad. Any regulations that constrain payday borrowing beyond this are suspect because they take away or inhibit the use of a tool that low-income people use to smooth their income stream. This is something higher-income may not need because they typically have more buffers against unexpected shocks: savings accounts, traditional credit cards, etc. One could argue that payday loans are dangerous in the same way that credit cards are dangerous: Some people max the credit out to their own detriment. But most people are still glad the mainstream forms of credit exist. Even some states that have not banned payday loans have implemented policies to restrict payday lending in some way. Federal and state regulation of payday loans takes many forms, including outright bans, interest rate caps, limits on renewals, information disclosure rules, regulations specific to military personnel, ceilings and floors on loan amounts, and restrictions on loan duration. Meanwhile, some states have no payday-specific regulation. I explore the consequences (intended or otherwise) of these various constraints on borrowing by analyzing existing empirical evidence on consumers’ use of payday loans. I argue that many attempts at constraining borrowing are misguided and decrease overall welfare of borrowers and potentially also of third parties through negative externalities. The question is not whether to regulate payday loans, but where to find the right balance between
regulation that protects people from the negative effects of payday loans while preserving their
ability to enhance borrowers utility by smoothing income stream. Some things are a given: we
obviously want people to have clear, concise information about the loan terms, APR, etc; we want
lenders to abide the Fair Debt Collection Practices Act, Truth in Lending Act; etc.

Below, I discuss the empirical evidence on payday loan use. A number of facts emerge. Rollovers
are the norm. Default rates are high. There is evidence against moral hazard, and evidence for self-
control problems and myopia. Finally, although payday borrowers are typically credit constrained,
borrowers often use payday loans when cheaper credit is available. I then document the disconnect
between this collection of evidence and the existing regulatory frameworks, which purport to help
consumers avoid misuse of payday loans. These include outright bans, price caps, minimum and
maximum loans lengths, minimum and maximum loan sizes, and rollover restrictions. I argue that:
1) outright bans are misguided, 2) larger loans can help borrowers, 3) loan-length restrictions are
unneeded and 4) rollover restrictions do make sense.