Could Restrictions on Payday Lending Hurt Consumers?

By Kelly D. Edmiston

The payday loan, or more generally, the deferred deposit loan, is among the most contentious forms of credit. It typically signifies a small-dollar, short-term, unsecured loan to a high-risk borrower, often resulting in an effective annual percentage rate of 390 percent—a rate well in excess of usury limits set by many states.

Consumer advocates argue that payday loans take advantage of vulnerable, uninformed borrowers and often create "debt spirals." Debt spirals arise from repeated payday borrowing, using new loans to pay off old ones, and often paying many times the original loan amount in interest. In the wake of the 2008 financial crisis, many policymakers are considering strengthening consumer protections on payday lending.

A substantial volume of literature has examined the dangers of payday lending, yet few studies have focused on any unintended consequences of restricting such lending. Thus, the question arises: Could restrictions on payday lending have adverse effects?

This article examines payday lending and provides new empirical evidence on how restrictions could affect consumers. The first section discusses why many states restrict the practice of payday lending and

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describes the pattern of restrictions. The second section explores ways in which restrictions might adversely affect consumers. The third section reviews the limited existing evidence on such effects and provides new evidence.

The analysis shows that restrictions could deny some consumers access to credit, limit their ability to maintain formal credit standing, or force them to seek more costly credit alternatives. Thus, any policy decisions to restrict payday lending should weigh these potential costs against the potential benefits.

I. MOTIVATION FOR PAYDAY LENDING REGULATION

Payday lending came under fire almost as soon as it surfaced, and consumer advocates have kept pressure on lenders and policymakers ever since. Chief among the concerns are the high cost of payday loans, the tendency for payday loans to contribute to consumer debt spirals, and the targeting of payday lending to financially vulnerable populations. These concerns often justify calls for additional regulation of payday lending.

The costs of payday borrowing

Consumer advocates feel that payday loans are a menace to consumers for a number of reasons, but chief among these is their high cost. Most states have established legal limits on the rate of interest that can be charged on a loan, usually 6 to 12 percent (Glaeser and Scheinkman). In many cases, however, lenders are not subject to these laws. For example, the Depository Institutions Deregulation and Monetary Control Act of 1980 eliminated usury limits for most loans made by banks. Some payday lenders have partnered with banks to take advantage of looser usury laws (Chin). Other lenders or types of loans are subject to their own specific laws.

While payday lenders often charge fees rather than interest payments, in effect these charges are interest. Comparing the terms of varying types of loans requires computing an effective, or implied, annual interest rate. For payday loans, this computation is straightforward. A typical payday loan charges $15 per $100 borrowed. If the term of the loan is two weeks, then the effective annual interest rate is 390 percent. By comparison, in 2010 the average annual interest

rate (APR) on credit cards, the traditional source for rapid short-term loans, was 14.7 percent (Simon). Thus, the fee on a typical payday loan is more than 25 times greater than the interest on a typical credit card.

Of course, a payday loan provides cash. Most credit card fees on cash advances, if considered short-term loans, are costly as well. The fee for cash advances on many credit cards has recently climbed to 4 or 5 percent (Blumenthal). In addition, higher interest rates, which average 25 percent, generally apply to cash advances (Blumenthal). Thus, on a two-week loan, the effective annual interest rate would average from 129 to 155 percent. In addition, cash advances are typically not subject to the interest grace period associated with purchases.

Presumably, a potential payday loan borrower would use a credit card if available. A 2009 study found that most payday borrowers with credit cards have "substantial credit card liquidity." Yet borrowers often choose not to use their credit card (Agarwal and others). Such financial behavior could result from a lack of information, at least for some borrowers. While the typical APR on a payday loan is 390 percent, about one-third of the respondents to a 2007 survey of payday loan customers reported an implausibly low APR on their most recent payday loan of less than 30 percent, and half reported an APR of less than 200 percent (Elliehausen). About 95 percent of the respondents gave an accurate report of the finance fee in dollar terms. Thus, many borrowers appear to have a problem translating the fee into an APR.[1]

Other, more informed, consumers may choose a payday loan over available traditional credit for sensible reasons. Such behavior is similar to that of consumers who use credit cards to make purchases when they have available low-earning liquid assets. For example, many households hold cash in savings or money market accounts that currently earn less than 1 percent. Yet they often choose to roll over large amounts of credit card debt from month to month, paying an average interest rate of about 15 percent. The pecuniary losses associated with this pattern of behavior can be quite large. Some researchers argue that households recognize a need to have money readily available when using a credit card is not an option—for example, when making rent payments (Telyukova and Wright). Similar logic may explain why some borrowers resort to payday loans even if they have credit cards.

Another potential explanation for this credit puzzle is that payday lenders are misleading consumers. There is limited evidence for this explanation. The Center for Responsible Lending suggested in 2001 that much of the misinformation about payday loan interest rates can be attributed to intentional misrepresentation on the part of lenders. The report quotes a payday lender's business plan:[2]

> *Remember, in your response to clients' questions regarding your fees, [say] "We charge $15 per $100 advanced." Sounds like 15%, but in reality since it is an 8 day loan, the true annual percentage rate is 805%!*

Further, an evaluation of payday lending in Colorado revealed that most promotional finance fees from payday lenders are provided for the first loan only, at least in that state (Chessin). Given that payday customers often have trouble repaying loans without additional borrowing, typically from the same lender, promoting fees in this way could lead borrowers into a series of renewals that rapidly increase the cost of the loan.

A reasonable argument could be made that payday lenders take advantage of customers who have few other options—and perhaps no options with favorable terms. Evaluating this argument rests largely on examining the profitability of payday lenders. If payday lenders' costs justify their high prices, then the argument may not be sound.

Payday lenders typically offer two justifications for their high fees (Huckstep). First, their operating costs are especially high. For example, because an important attribute of payday lending for customers is convenience, payday lenders must maintain a high density of stores and remain open beyond normal business hours. Second, the incidence of default on payday loans is high. A 2005 FDIC study reported that the mean ratio of loan losses to total revenue for the two large payday lenders studied was 15.1 percent (Flannery and Samolyk). Overall, this study and Huckstep's research suggest that large fees on payday loans may be warranted. Further, evidence has shown that firm-level returns of payday lenders differ little from typical financial firms (Skiba and Tobacman 2007a). Thus, while some payday lenders may take advantage of borrowers in some ways, payday lenders in general are not gouging borrowers.[3]

Debt spirals

While profitability may not be excessive among payday lenders generally, data suggest that the bulk of lenders' profits come from repeat borrowers (Chin). The payday business model may therefore rest on activities that may not be in the best interest of most consumers.

According to a recent report by the Center for Responsible Lending, only 2 percent of payday loans are extended to nonrepeat borrowers (Parrish and King). More than three-quarters of payday loans are made to borrowers who have paid off another payday loan within the previous two weeks. The remainder consists of initial loans to repeat borrowers and repeat loans that occur more than two weeks after the previous loan. Another study of 145,000 payday loan applications found that, on average, those approved for a payday loan subsequently applied for 8.8 additional payday loans (Skiba and Tobacman 2007b). Most states have limits on loan rollovers, which involve extending the due date of the loan in exchange for an additional fee. But payday borrowers (in consort with lenders) may circumvent these restrictions by repaying the loan in full and then opening a new loan in its place. A few states place restrictions on such renewals. The problem with multiple renewals is that borrowers can find themselves in an unmanageable cycle of debt.

Debt spirals can cause serious problems for consumers. A recent study found that loan approval for first-time payday loan applicants, despite the small $300 average size of a first-time loan, increases Chapter 13 bankruptcy filing rates by roughly 2.5 percentage points over two years (Skiba and Tobacman 2009). The study suggested that two factors drive the effect. Borrowers typically are already stressed when they begin paying on their payday loans. And payday loan applicants typically borrow repeatedly.

Targeting of at-risk populations

Another common complaint is that payday lenders target financially vulnerable populations, particularly low-income people and minorities.[4] One study found that payday lenders specifically target neighborhoods with higher shares of poor and minority residents. One of the reasons that payday lenders locate disproportionately in

minority areas is that minorities are more likely to have low incomes. However, another study found that payday lenders disproportionately locate in African-American and Latino neighborhoods even after income and other factors are considered in the analysis (Li and others). A report by the Consumer Federation of America and the U.S. Public Interest Research Group quoted a payday lender business plan that suggests that "welfare-to-work women" provide a "fertile market."

Although a payday loan customer is typically financially vulnerable, payday lenders are not necessarily targeting their customers inappropriately. Identifying the motivations of lenders and customers is difficult. Payday lenders may create demand for their product by targeting financially vulnerable populations, or they may simply be locating their stores where markets exist.

Overview of state payday lending regulations

Concerns over high costs, unmanageable debt spirals, and the targeting of financially vulnerable populations have led some states to regulate payday lending. Most of the regulations have focused on restricting access to payday loans, either directly or indirectly.[5] Some states restrict access directly, by making such loans unavailable, such as through a ban. By the end of 2008, 10 states and the District of Columbia had instituted outright bans on payday lending. Other states have passed regulations that indirectly ban payday lending by making it unprofitable. For example, in Massachusetts, the Small Loan Act Caps interest at 23 percent per year.

In states that allow payday lending, regulations may indirectly restrict or effectively ban the practice. A variety of such regulations exists. Most states legislate maximum loan amounts, usually from $300 to $500. The limits that states impose on fees vary widely. In most states, the maximum fee allowable leaves the APR potentially well into three digits, limiting the effectiveness of restrictions on payday lending. Other states, however, severely limit fees, effectively banning payday lending. For example, in Arkansas, the maximum fee on a $100 two-week loan is $0.65. Other states, such as Ohio and Oregon, have less-severe, but still restrictive, limits on fees. How effectively those states' restrictions limit payday lending is not yet clear.

Many common payday lending regulations are intended to protect consumers from both lenders and themselves—but they are unlikely to severely restrict access to payday loans. Among these regulations are minimum and maximum terms, maximum rollovers, rights of rescission, and limits on collateral requirements. A minority of states has legislated a minimum term for payday loans. The minimum term is typically seven to 14 days. A number of states have legislated maximum terms, which are typically 31 days but range from 14 to 60 days. Few states currently limit rollovers, but over the last several years rollover limits have emerged as the most common new way to restrict payday lending, generally limiting rollovers to one. Rights of rescission, which give the borrower time to reconsider his loan, also are becoming more common. In most states, payday lenders cannot require collateral for the loans they make. Finally, nearly half of all states require payday lenders to offer payment plans to those unable to repay their loans.

II. HOW COULD PAYDAY LENDING RESTRICTIONS HARM CONSUMERS?

Much of the concern about payday loans centers on their high cost. Yet, restricting payday lending could deny consumer access to credit, limit their ability to maintain formal credit standing, or force them to seek more costly alternatives. This section explores the potential adverse effects on consumers of restricting payday lending.

Potential costs of limiting access to payday lending

The most obvious and important cost of restricting payday lending would be the potential *loss of credit access* for consumers who may not have other sources of credit. Fully 50 percent of respondents to the 2007 payday loan customer survey responded that, when they secured their most recent payday loan, it was their only choice for short-term funds (Elliehausen). This assessment may have been inaccurate in some cases, but lack of knowledge about credit alternatives has the same effect as a true lack of access.

Lack of access to credit can be costly to would-be borrowers. For example, without credit a broken-down car may not be repaired, at least for a while. Without transportation to work, the consumer could lose significant income, possibly a job, and almost certainly the ability

to manage normal daily activities. Missed car payments that lead to repossession could have the same effects. A payday loan might also be the only reasonable option to provide for basic needs. For example, missed utilities payments can lead to disconnected services. At a less-essential level, a lack of access to credit may keep a small business owner from meeting unexpected expenditures or short-term revenue shortfalls. For example, failing to make a payment on time can result in loss of credit standing with an important supplier.

Without access to lenders, many financially constrained consumers may turn to family and friends. Payday lenders, however, report that many of their borrowers are reluctant to reveal their financial situation to others, or they have exhausted access to such loans (Caskey 2002). Others may not have family or friends with the financial means to help them.

Restricting payday lending might also damage a would-be borrower's *credit standing* with traditional lenders. When faced with unanticipated changes in income or expenses, a borrower may be forced to miss loan payments or even default on a loan. Unlike traditional lenders, however, payday lenders typically do not report to credit agencies. In the event that finances do not improve over the course of the loan period, defaulting on a payday loan would typically not harm the borrower's formal credit standing. Thus, from this perspective, payday loans may be less risky than traditional loans.

In addition, a borrower could potentially stave off another creditor with the proceeds of a payday loan. Most personal finance experts would strongly discourage such a practice, as much better options often exist, such as negotiating with the creditor. Still, when faced with a sudden expense or shortfall in income, a payday loan could protect the borrower's credit standing. Moreover, a payday loan fee may be lower than a late payment fee. For example, the typical late payment fee on a credit card is $39 (Saha-Bubna). Recent changes to Federal Reserve Regulation Z limit late fees to $25, but that figure is still greater than the fees typically associated with small payday loans.

Another way payday lending can help a borrower protect his credit standing is by reducing the number of outstanding loans reported to credit bureaus or trimming the degree to which other credit is tapped. For most consumers, the cost to credit standing of a more traditional loan would not exceed the higher cost of a payday loan, but for some it

would. As explained below, the effective interest rates associated with cash advances or over-the-limit charges on credit cards can be as high as payday loan rates, potentially resulting in a negative mark on a credit report.

Finally, restricting payday lending might force borrowers to seek *more costly credit alternatives*. While a payday loan under normal circumstances is costly to the borrower, its terms could be more favorable than those of other sources of credit. Clearly, if access to a traditional lender such as a bank is available, most would-be payday borrowers would be better off seeking short-term funds there. But few banks make small-dollar loans. Even if they did, few typical payday loan borrowers would have sufficient credit standing to acquire such a loan.

Credit cards are the traditional source for low-cost, short-term loans. But, according to the 2007 payday loan customer survey, almost half of payday loan borrowers do not have access to a credit card. Of those who have credit cards, 40 percent would exceed their credit limit with a charge the size of their most recent payday loan. About one-third of respondents to the 2007 survey revealed that their credit card limit was sufficient to cover their most recent payday loan—but they still chose not to use their credit card (Elliehausen). Sometimes cash is needed, requiring a credit card cash advance, which is a less-attractive option than using a credit card to make a purchase.

Lacking other options, a card-holding consumer facing a personal financial shock may decide to make an over-the-limit credit card purchase or advance. The fees associated with charging more than the credit limit on a credit card are in many cases significantly higher than the fee on an equivalent payday loan.[6] As of March 2010, the average over-the-limit fee was between $36 and $39. On a two-week, $100 loan, typical of most payday loans, the effective rate of interest could exceed 1,000 percent.

Several other alternatives to payday loans offer arguably less-favorable terms than payday loans. One such option is to bounce a check. Assuming that the borrower does not have overdraft protection through a savings account or line of credit, the bank on which the check is drawn may either return the check to the presenter or cover the check, leaving the account holder with a negative balance. In the latter case, the bank is, in essence, making a loan to the account holder, which typically results in a substantial fee.[7] In 2010, bounced check fees averaged $30.47

(Bell). One study calculated the median interest rate on these loans to be well in excess of 4,000 percent, or up to 20 times that of payday loans (Fusaro). The highest rates result from bouncing multiple checks for small amounts, where a fee is charged for each bounced check. Further, knowingly passing a fraudulent check is illegal and could result in substantial civil and criminal penalties. Finally, bounced checks can seriously impair the borrower's credit standing, although they typically are not reported to credit bureaus. Of course, bouncing a check written to a payday lender, if deposited, would cause the borrower to pay both payday loan fees and bounced check charges.

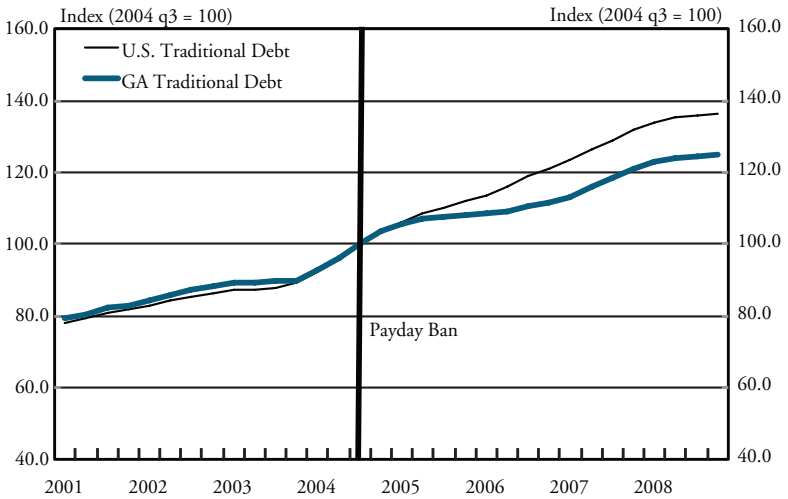
Another nontraditional source of credit is pawnbroking, or the related concept of title lending. A 1991 estimate suggested that as much as 10 percent of the American population was served by pawnshops annually (Caskey 1991). A 2006 analysis of pawnbroking compiled a list of monthly interest rate ceilings for all 50 states and the District of Columbia (Shackman and Tenney). The median cap on interest rates was 15 percent monthly, which is similar to the typical payday loan charge. Many of the caps were much higher, however.

A final avenue for short-term funds is a loan shark (Simon and White). Broadly, a loan shark lends small sums at an interest rate above the established legal rate. Over time, however, the term has come to have a more narrow meaning. Specifically, the term is usually associated with lending at exorbitant rates, with payment commonly enforced by threats of violence (*West's Encyclopedia of American Law*). Loan sharking is often associated with organized crime. Because it is an underground activity, little research is available on loan sharking. Reportedly, interest rates are commonly as high as 20 percent per week (American Bar Association). These rates, not to mention threats of violence to ensure payment, suggest that these loans would only be attractive to the most desperate borrowers with no other options.

A report by the Center for Responsible Lending notes several alternatives to payday lending that arguably offer better terms than payday loans (2007). Among the alternatives are payment plans with creditors, advances from employers, credit counseling, emergency assistance programs, credit union loans, cash advances on credit cards, military loans, and small consumer loans. In large part, these alternatives, if accessible, offer better options for most financially strapped consumers.

Chart 1

INDEBTEDNESS FOLLOWING GEORGIA'S PAYDAY LENDING BAN



Note: Each index takes a value of 100 on the third quarter of 2004, and preceding and succeeding numbers represent the value on that date compared to the third quarter of 2004, in percentage terms. Thus, by the fourth quarter of 2008, the average outstanding (traditional) debt in the United States as a whole had increased by 36 percent (from 100 to 136), while increasing by 24 percent in Georgia.
Source: TransUnion, Trend Data

A very relevant question, however, is whether payday borrowers have access to these alternatives. These options are appropriate for some payday borrowers, although for some, access is quite limited.

A look at Georgia data around the time of its payday lending ban provides some fairly strong evidence that bans on payday lending do not send borrowers to traditional lenders (Chart 1). Indeed, the opposite is observed. The growth in traditional lending fell off in Georgia relative to the nation following the ban. Specifically, by the fourth quarter of 2008, the average outstanding (traditional) debt in the nation had increased 36 percent, while increasing only 25 percent in Georgia. The divergence began around the time payday loans were banned in Georgia in 2004. If consumers shifted to traditional lending following the payday loan ban, one would expect growth in traditional lending to have at least kept pace with U.S. growth.

Restrictions to payday lending could also potentially harm consumers by eliminating a popular convenience. Convenience is cited

by many payday borrowers as a factor in their decision to seek a payday loan rather than some other, perhaps less costly, means of short-term financing. In the 2007 customer survey, about 28 percent of respondents named "quick easy process," "fast approval," and "little paper work" as the *most important* reasons for choosing a payday loan over another source. A survey of the use of alternative service providers by low-income consumers in Georgia found that the immediacy of funds, the absence of credit checks, and convenience (both in terms of hours of operation and location) were typical reasons for using those services (Koonce-Lewis and others).

III. EVIDENCE

The previous section outlined a number of ways that payday lending restrictions could potentially harm consumers. This section reviews the existing evidence on the unintended consequences of payday lending restrictions. The section then provides new evidence derived from an examination of consumer credit data.

Existing evidence on payday lender regulation and borrower outcomes

The early existing evidence, which predates payday lending, examined consumer impacts of restrictions on credit cards. Much of this evidence was reviewed in a study by Canner and Fergus, including a study of four states that suggested imposing interest rate ceilings would substantially reduce the availability of bank credit card accounts (Dunkleberg and others). The evidence also suggested lower-income consumers would bear the greatest burden of these effects. Other studies have pointed to reduced access to credit under more heavily regulated consumer credit markets.

More-recent studies have focused on consumer outcomes of payday lending. One study similar to the analysis in this article found that after payday loans were banned in Georgia and North Carolina, households bounced more checks, complained more to the Federal Trade Commission about lenders and debt collectors, and filed for Chapter 7 bankruptcy more often than households in states where payday lending was permitted (Morgan and Strain). Specifically, they found that following the payday loan ban in Georgia, the returned check rate in the Federal Reserve's Atlanta check processing center increased 13 percent. In comparison,

returned check rates declined at other check processing centers. Results for the Charlotte center following North Carolina's payday loan ban told a similar story. Complaints against debt collectors increased 64 percent in Georgia and more than one-third in North Carolina. Again, these patterns were significantly different than those found in comparison states.

Using survey data in Oregon and Washington, another study found that the imposition of an interest rate cap in Oregon led to a sharp reduction in access to payday lending and that former payday borrowers shifted into "incomplete and plausibly inferior substitutes," such as bank overdrafts and late bill payments (Zinman). In another study, researchers conducted a laboratory experiment to gauge the degree to which access to payday loans would hinder or help consumers weather personal expenditure shocks (Wilson and others). They found that payday loans helped subjects absorb expenditure shocks relative to a comparison group without access to payday loans (although those who demanded more than a threshold level of payday loans did worse than the comparison group).

The relationship between payday lending and social problems has been studied as well. A research team recently conducted a field experiment in South Africa to gauge the consumer impact of credit extended at an annual rate of 200 percent (Karlan and Zinman). These loans, which were similar in structure to payday loans, were found to produce significant net benefits to borrowers along several dimensions. Among these were employment, income, and a measure of subjective well-being. For example, the share of people who reported leaving a job during the study period was 2.8 percentage points less for those involved in the experiment. Moreover, those who were given access to the loans borrowed more overall than the comparison group, suggesting that the loans loosened binding liquidity constraints.

Another study related access to payday lending to community welfare measures (specifically, foreclosure rates and small property crime) following natural disasters (Morse). For both of these measures, the presence of payday lenders in a community was associated with greater resilience (fewer "bad" outcomes) following a disaster. An earlier version of the paper in 2007 showed that access to payday lenders in the face of natural disasters improved other welfare measures as well: births, deaths, and admissions to drug/alcohol treatment centers. Other re-

search has found that legalized payday lending over a period of time has reduced rates of crime (Luea).

New evidence

New evidence on the effects of payday lending restrictions comes from analyzing two questions. First, do restrictions on payday lending harm a borrower's formal credit standing? Second, do such restrictions limit access to credit overall or compel consumers to use other nontraditional credit sources less favorable than payday lending?

The restrictions considered here are the most severe, as they either directly or effectively ban all payday lending in the state. Payday lending is considered accessible in counties without such state restrictions and inaccessible in counties with such restrictions. Data from consumer credit reports provided by the TransUnion credit bureau are used to examine these questions of credit standing and access.[8]

The analysis is unique in the literature in two ways. First, it employs a dataset with a much larger and broader sample, incorporating data across all states, over time, aggregated from the individual consumer level. Second, the analysis uses a previously unemployed set of measures of consumer welfare, such as credit scores and loan delinquency rates.

Access to payday lending and credit standing. The first question explores the relationship between access to payday lending and formal credit standing. The premise is that, without access to payday lending, many borrowers who become mired in debt might be less able to manage their finances and make payments, which could easily result in a lower credit standing. The analysis uses two measures of formal credit standing to test this premise: credit scores and late bill payments.

Credit scores provide the most direct measure of formal credit standing. Analyzing these data reveals that consumers in counties under restrictive state payday lending laws were more likely to have low credit scores than consumers in counties where payday lending is legal. Low credit scores are defined here as those in the bottom 5 percent, 10 percent, or 25 percent of credit scores nationally. These percentiles correspond to scores below 421, 492, and 594, respectively.

Results from the analysis are provided in Table 1. The figures in Table 1 reflect differences in the share of consumers with low credit scores in counties where payday lending is accessible, as determined

by state laws and regulations, and in counties where payday lending is not accessible. In the first row, the figure -0.42 percent means that, after accounting for differences in income and unemployment, the share of consumers with credit scores in the bottom 5 percent nationally is 0.42 percentage point lower in payday loan counties than in counties where payday lending is restricted. Thus, a lack of access to payday lending is associated with lower credit scores.

Often the debate over payday lending focuses on low-income consumers because low-income consumers are most likely to borrow from payday lenders. Thus, a similar analysis was undertaken for low-income counties specifically, defined here as those with per capita income less than 50 percent of area median income.[9] The results indicate that, after accounting for differences in income and unemployment, the share of consumers with the weakest credit scores was 0.36 percentage point lower in low-income payday loan counties than in low-income counties without legal access to payday lending. Again, evidence suggests that a lack of access to payday lending is associated with lower credit scores.

Similar analyses also were undertaken using the share of consumers with credit scores in the bottom 10 percentile group and the bottom 25 percentile group. The shares of consumers in the 10th and 25th percentile groups were 0.89 and 1.08 percentage points lower, respectively, in counties with access to payday lending than in counties where payday lending was restricted.

Average credit standing also can be measured by the share of the population with late bill payments. The measure of late bill payments is 60 or more days past due on a credit account. The analysis first examined late bill payments across all categories of credit and then across more-narrow credit categories. The results reveal that consumers living in counties where payday lending is legally accessible were less likely to have late bill payments than consumers in counties under restrictive state payday lending laws and regulations (Table 1).

The analysis reveals that the share of consumers in payday loan counties with late bill payments was 0.36 percentage point lower than the share of consumers with late bill payments in counties where payday lending was restricted. That is, about 4.9 percent of the population had late bill payments in any given quarter in counties where payday lending was accessible, compared to 5.3 percent in counties where payday lending was

Table 1
ACCESS TO PAYDAY LENDING AND CREDIT STANDING

	Difference in the share of consumers in counties with access to payday lending and without access to payday lending	
Compiled Credit Report Item	All Counties	Low-Income Counties
Credit Score < 421	-0.42%	-0.36%
	(-19.4)	(-10.5)
Credit Score <493	-0.89%	-0.73%
	(-18.9)	(-10.1)
Credit Score <594	-1.08%	-0.89%
	(-20.5)	(-11.6)
Any Credit Account 60+ Days Past Due	-0.36%	-0.43%
	(-18.2)	(-12.1)
Bank Card Account 60+ Days Past Due	-0.08%	-0.08%
	(-9.71)	(-8.96)
Installment Account 60+ Days Past Due	-0.31%	-0.51%
	(-15.1)	(-14.3)
Captive Auto Finance Account 60+ Days Past Due	-0.01%	-0.02%
	(-5.5)	(-7.7)

Notes: T-statistics in parentheses.
All results are significant at the 5 percent level or better.
Information was unavailable on nonbank card revolving accounts past due.

not accessible. These results are consistent across narrow credit categories. Where payday lending was allowed, the share of borrowers with late (nonauto) installment loan payments was 0.31 percentage point lower in payday loan counties. The share of borrowers with late bank card payments was 0.08 percentage point lower in payday loan counties.[10]

Although the magnitudes of these results may seem small, in percentage terms the results are quite significant. For example, on average, about 2 percent of consumers had overdue bank cards during the period of this analysis. Thus, a 0.08 percentage point difference means that the share of consumers with late bank card bills was 4 percent (0.08/2.0) lower in payday loan counties.

The results are similar when the analysis is restricted to low-income counties. For example, the share of consumers in low-income payday loan counties with past-due bill payments was 0.51 percentage point lower than in low-income counties where payday lending was severely restricted.

New evidence: Access to payday lending and alternative credit utilization

Payday lending restrictions may also limit access to credit overall or compel consumers to use other nontraditional credit sources less favorable than payday lending. This potential effect cannot be examined directly using credit bureau data because most nontraditional credit activities fail to show up on credit reports. For example, bounced checks generally do not appear on credit reports, unless the vendor employs a collection agency to recover the funds. Moreover, loans from pawnbrokers and loan sharks as well as cash advances and over-the-limit credit card purchases are not found on credit reports.

The effects of restrictions can be determined indirectly, however, using the credit bureau data. If traditional forms of credit, such as credit cards, consumer finance companies, and installment credit, are used more often with payday lending restrictions in place, credit reports will show a higher utilization rate. Conversely, if higher utilization is not observed where payday lending is restricted, would-be payday borrowers either secured credit through another type of nontraditional lender (such as a pawn broker) or were unable to secure credit.[11] In this case, restrictions on payday lending could harm consumers by restricting access to credit.

One important measure of the use of traditional forms of credit is the number of accounts held by the consumer, which in most cases represents individual loans. The results do not show additional accounts from traditional lenders in counties where payday lending is severely restricted, and therefore they are inconsistent with substitution between payday lending and more traditional forms of lending. That is, the results suggest that those living where payday lending is inaccessible because of restrictive laws and regulations typically tap other nontraditional forms of credit in lieu of payday lenders or do not have access to credit at all.

The detailed results from the analysis of payday lending restrictions and number of credit accounts are provided in Table 2, Panel A. The interpretation of the results is similar to Table 1. Looking at all active credit accounts, consumers in counties with access to payday lending held 0.08 more traditional accounts than consumers in counties with no payday lending. The difference is small, meaning it is rather insignificant economically. But if these more traditional forms of credit were

substitutes for payday lending, the number should have been negative and significantly larger. That is, those with access to payday lending should have used traditional forms of credit *less often*, which would have been partly reflected in *fewer accounts*. When only lower-income counties are considered, such differences are somewhat larger. On average, consumers in low-income counties with access to payday lending held 0.2 more accounts than consumers in low-income counties without access to payday lenders.[12]

The results are largely the same across types of accounts and are driven largely by the number of bank cards. The exception to the general finding is (non bank card) revolving accounts, where fewer traditional accounts were held by consumers with access to payday lending. Only one in eight consumers held revolving credit accounts, however.

Examining the number of new credit accounts consumers open during a quarter also shows that those without access to payday loans do not go to traditional borrowers. For all counties, an average of 0.2 new credit accounts were obtained per consumer every quarter during the study period, or one new account for each five consumers. Consumers with access to payday lending acquired 0.004 more new accounts in a given quarter than did consumers without access to payday lending. Consumers in low-income counties with access to payday lending acquired 0.01 more new accounts than those in low-income counties without access to payday lending. If payday lending were a substitute for more traditional credit accounts, fewer accounts should have been opened. Thus, the results suggest that consumers without access to payday lending do not acquire additional traditional credit accounts as alternatives to payday loans. The results are consistent across all forms of credit, including revolving credit.

Another important measure of credit utilization is the amount of debt the consumer maintains. For this measure, the results are more consistent with substitution between payday lending and traditional forms of lending. That is, the results suggest that those without access to payday lending may use traditional forms of credit more often. Such a result runs counter to the notion that payday lending restrictions harm consumers by restricting access to credit.

Detailed results are provided in Table 2, Panel B. On average during the study period, those with access to payday lending were in debt

Table 2

ACCESS TO PAYDAY LENDING AND UTILIZATION OF TRADITIONAL CREDIT SOURCES

	Difference in the share of consumers in counties with access to payday lending and without access to payday lending	
Compiled Credit Report Item	All Counties /[a]/	Low-Income Counties
Panel A		
Active Accounts per Consumer	0.075	0.200
	(5.2)	(10.4)
New Accounts per Consumer	0.004	0.010
	(8.9)	(18.3)
Active Bank Card Accounts per Consumer /b/	0.063	0.075
	(22.1)	(27.0)
Active Installment Accounts per Consumer	0.006	-0.006
	(4.7)	(-3.3)
New Installment Accounts per Consumer	0.009	0.010
	(37.6)	(24.5)
Active Revolving Accounts per Consumer	-0.007	-0.001
	(-27.3)	(-4.3)
New Revolving Accounts per Consumer	0.005	0.004
	(9.8)	(5.0)
Panel B /[c]/		
Total Debt per Consumer	-$2,112	$354
	(-16.0)	(3.0)
Total Installment Debt per Consumer	-$383	-$447
	(-20.0)	(-15.8)
Total Revolving Debt per Consumer	-$4	-$14
	(-5.1)	(-11.8)

Notes:
/[a]/ T-statistics in parentheses; all results are significant at the five percent level or better.
/[b]/ The number of active installment accounts per customer.
/[c]/ Data were unavailable on total bank card debt per customer.

to traditional lenders by $2,112 less than those without access to payday lending. Installment debt was $383 percent lower in payday loan counties. Revolving credit was a negligible $4 lower. These results are somewhat surprising given the experience following Georgia's payday lending ban, where the growth in traditional debt leveled off relative to the nation (Chart 1).

In low-income counties, however, consumers with access to payday lending had slightly more traditional debt than consumers without access. The lack of evidence for substitution between payday lending and traditional forms of credit in low-income counties is not surprising, given that many consumers in those communities have little or no access to traditional credit. These results suggests that in low-income counties, restrictions on payday lending may leave consumers without access to credit or access only to potentially more costly lenders.

Overall, the evidence on credit use is mixed.[13] While some consumers living in higher-income communities with payday lending restrictions may tap traditional credit more frequently, they do not acquire additional accounts to do so. The numbers do not reveal a great deal of substitution, as the difference for total debt is less than 6 percent. Moreover, in Georgia, there was no evidence that traditional lending increased following the state's payday loan ban in 2004 (Chart 2). Finally, the option to substitute payday credit with traditional credit does not appear to exist in low-income communities, where many consumers lack access to traditional credit.

In addition to providing evidence suggesting that a ban on payday lending could harm consumers by reducing credit standing or limiting their access to credit, the analysis also considers other, less-restrictive regulations. Among these regulations are maximum loan amounts, maximum terms, and maximum rollovers. The results are consistent with the more-restrictive lending regulations. That is, there is no evidence that traditional credit and payday loan credit are substitutes. In states with greater restrictions on payday lending, consumers do not use more traditional credit.

These results suggest an important follow up question: Why would consumers use payday loans if they had access to generally less costly traditional credit? One reason suggested in Section II is that payday loans are more convenient. Another reason may be a need for cash specifically, rather than purchasing power more generally. Still others may be uninformed borrowers or misleading marketing by some payday lenders.

A shortcoming of the analysis is the lack of information on the pervasiveness of payday lending within counties. While a ban or severe restrictions on payday lending imply a lack of access to such lending, the lack of restrictions does not necessarily imply access. For example, some

counties in states without strict restrictions on payday lending may not have any payday lending establishments. In this case, access to payday lending is restricted even if the law allows it. Most counties, however, have at least one of the 20,000-plus payday lending establishments currently operating in the United States. The increasing availability of Internet-based payday lending may allow lenders to circumvent payday loan restrictions in some states, which also could limit results. Fortunately, in both cases, these limitations would likely lead the current analysis to underestimate the impact of payday lending restrictions on the credit profile of U.S. counties.

IV. CONCLUSIONS

Policymakers in many states have restricted the practice of payday lending. Critics of the practice claim that payday lenders take advantage of borrowers by charging exorbitant fees and targeting at-risk populations. They also claim that payday lending causes borrowers to fall into debt spirals, which create unmanageable cycles of debt.

While these charges may be valid, restricting payday lending may also bring unintended consequences. It is important for policymakers to understand both the potential benefits of restricting payday lending as well as the potential costs.

This article examined the practice of payday lending, why and how many states have restricted it, and how such restrictions might adversely affect some low-income and credit-constrained consumers. The results of its empirical analysis support the idea that restricting payday lending may indeed have costs. The evidence showed that consumers in low-income counties may have limited access to credit in the absence of payday loan options. As a result, they may be forced to seek more costly sources of credit. The evidence also showed that, in counties without access to payday lending, consumers have a lower credit standing than consumers in counties with access.

The preponderance of evidence suggests that some consumers will likely face adverse effects if payday lending is restricted. Therefore, policymakers must carefully weigh the costs of payday lending restrictions against its benefits.

APPENDIX:

DATA, METHODOLOGY, AND EMPIRICAL RESULTS

The primary data employed in this analysis include consumer credit data at the county level for 2001-08 from the TransUnion credit bureau. Data on the history of payday loan legislation comes from the Consumer Credit Research Foundation and other sources. Other data employed are unemployment rates acquired from the U.S. Bureau of Labor Statistics and per capita personal incomes acquired from the U.S. Bureau of Economic Analysis.

The methodology employed in the formal analysis is linear regression. Regression analysis involves estimating the parameters of a mathematical equation that models relationships among three or more variables. Here it is used to predict the effect of factors thought to explain average credit standing across counties, holding the values of other potential explanatory factors constant. As an example, the analysis estimates the effect of access to payday lending on the average number of traditional credit accounts across counties. The form of the regression equations is:

$$\textit{Number of Accounts per person} = \alpha + \alpha_t + \beta_1 \textit{ Payday Access (yes = 1, no = 0)} + \beta_2 \textit{ Per Capita Income} + \beta_3 \textit{ Unemployment Rate} + \varepsilon.$$

The analysis estimates the values for the parameters in this equation, represented by the α's and β's. The key parameter in the analysis is β_1, which in this sample case, shows the average difference in the average number of traditional credit accounts in counties where payday lending is allowed relative to counties where payday lending is not allowed. Results are provided in the Appendix table.

The other variables included in the equation are designed to account for other factors likely affecting differences in credit profiles across counties. Following Morgan and Strain, these are per capita income and the unemployment rate. The parameter α is the average value of the dependent variable (in this example, number of accounts) over all counties across all years. The parameters α_t measure fixed differences in the number of accounts between years, estimated with a series of binary variables. The last parameter, ε, represents determinants

of credit profiles across counties that are not observable and therefore not included in the analysis.

Endogeneity problems potentially exist with this exercise. A variable is said to be endogenous if it is correlated with variables that are excluded from the model. For example, the behavior of consumers could have influenced regulation of payday lending, rather than the reverse. Some effort is made to address these issues in the discussion of the results, and in some cases, additional analyses were undertaken to evaluate any empirical problems. Nevertheless, limits on data availability prevent the estimation of an ideal model. This analysis is a parsimonious exercise that should be considered as a first step in associating payday lending regulations with consumer credit outcomes. While some of the evidence supports the notion that restrictions on payday lending can harm consumers, more research needs to be done for a definitive answer to the question. Specifically, additional data, where available, might lend additional support to this analysis.

Appendix Table A1

REGRESSION RESULTS

All Counties					
Model	Intercept	Payday Allowed (=1)	Per Capita Income	Unemployment Rate	Adjusted R^2
Active Accounts per Consumer (average = 12.1)	9.639 (260.9)	0.075 (5.2)	8.7×10^{-5} (104.0)	-0.1047 (-33.7)	0.20
New Accounts per Consumer (average = 0.20)	0.2291 (224.1)	0.004 (8.9)	4.4×10^{-7} (19.0)	-0.0032 (-36.8)	0.11
Active Bank Card Accounts per Consumer	1.130 (154.9)	0.063 (22.1)	2.6×10^{-5} (157.3)	-0.0581 (-94.8)	0.45
Active Installment Accounts per Consumer	0.9056 (268.7)	0.006 (4.7)	-5.0×10^{-6} (-65.0)	-0.0138 (-48.7)	0.09
New Installment Accounts per Consumer	0.1024 (157.9)	0.009 (37.6)	-1.3×10^{-6} (-90.5)	-9.6×10^{-4} (-17.6)	0.11
Active Revolving Accounts per Consumer	0.1160 (187.9)	-0.007 (-27.3)	1.5×10^{-6} (103.8)	-0.0020 (-39.3)	0.26
New Revolving Accounts per Consumer	0.7306 (512.2)	0.005 (9.8)	5.0×10^{-6} (156.1)	-0.0116 (-96.8)	0.36
Total Debt per Consumer	-$17,789 (-52.4)	-$2,112 (-16.0)	1.869 (243.0)	398.6 (14.0)	0.46
Total Installment Debt per Consumer	$9,985 (203.1)	-$383 (-20.0)	0.0085 (7.6)	-204.1 (-49.4)	0.05
Total Revolving Debt per Consumer	$300 (160.7)	-$4 (-5.1)	-0.0031 (-72.3)	5.643 (35.9)	0.12
Consumers with Credit Score < 421	0.0988 (177.6)	-0.0042 (-19.4)	-1.4×10^{-6} (-108.0)	0.0039 (84.3)	0.24

Appendix Table A1

REGRESSION RESULTS, CONTINUED

Consumers with Credit Score < 493	0.2802 (232.2)	-0.0089 (-18.9)	-3.2×10^{-6} (-118.2)	0.0097 (95.7)	0.28
Consumers with Credit Score < 594	0.4707 (348.7)	-0.0108 (-20.5)	-3.2×10^{-6} (-106.0)	0.0111 (97.6)	0.26
Borrowers Currently 60+ Days Past Due	0.0680 (133.6)	-0.0036 (-18.2)	-8.9×10^{-7} (-77.5)	0.0039 (90.2)	0.26
Bank Card Borrowers Currently 60+ Days Past Due	0.0319 (141.4)	-0.0008 (-9.71)	-3.8×10^{-7} (-74.5)	0.0016 (84.3)	0.31
Installment Borrowers Currently 60+ Days Past Due	0.0538 (102.3)	-0.0031 (-15.1)	-9.6×10^{-7} (-72.5)	0.0037 (83.5)	0.22
Captive Auto Finance Accounts Past Due	0.0024 (41.4)	-1.2×10^{-4} (-5.5)	-3.2×10^{-8} (-24.8)	1.3×10^{-4} (28.3)	0.03
Low-Income Counties					
Active Accounts per Consumer	7.710 (99.7)	0.200 (10.4)	1.5×10^{-4} (52.3)	-0.0465 (-12.5)	0.10
New Accounts per Consumer	0.2064 (90.2)	0.010 (18.3)	8.2×10^{-7} (9.8)	-0.0022 (-19.6)	0.12
Active Bank Card Accounts per Consumer	0.459 (30.5)	0.075 (27.0)	5.1×10^{-5} (92.0)	-0.0380 (92.0)	0.31
Active Installment Accounts per Consumer	1.012 (129.7)	-0.006 (-3.3)	1.1×10^{-5} (-37.1)	-0.0072 (-19.1)	0.05
New Installment Accounts per Consumer	0.1292 (78.6)	0.010 (24.5)	-2.6×10^{-6} (-43.7)	-5.9×10^{-4} (-7.5)	0.07
Active Revolving Accounts per Consumer	0.0735 (58.6)	-0.001 (-4.3)	2.9×10^{-6} (63.3)	-0.0014 (-23.6)	0.31

Appendix Table A1

REGRESSION RESULTS, CONTINUED

New Revolving Accounts per Consumer	0.5661 (163.60)	0.004 (5.0)	1.2×10^{-5} (91.7)	-0.0084 (-50.7)	0.34
Total Debt per Consumer	-$1,598 (-3.4)	$354 (3.0)	1.198 (69.2)	-250.5 (-11.1)	0.16
Total Installment Debt per Consumer	$11,313 (99.5)	-$447 (-15.8)	-0.0543 (-13.0)	-172.8 (-31.6)	0.04
Total Revolving Debt per Consumer	$462 (98.9)	-$14 (-11.8)	-0.0093 (-54.0)	4.129 (18.4)	0.10
Consumers with Credit Score < 421	0.1352 (97.9)	-0.0036 (-10.5)	-2.8×10^{-6} (-55.1)	0.0030 (45.5)	0.19
Consumers with Credit Score < 493	0.3894 (134.7)	-0.0073 (-10.1)	-7.5×10^{-6} (-70.9)	0.0070 (50.2)	0.25
Consumers with Credit Score < 594	0.6242 (203.3)	-0.0089 (-11.6)	-9.3×10^{-6} (-81.9)	0.0072 (48.5)	0.28
Borrowers Currently 60+ Days Past Due	0.1148 (81.0)	-0.0043 (-12.1)	-2.8×10^{-6} (-53.5)	0.0034 (49.5)	0.18
Bank Card Borrowers Currently 60+ Days Past Due	0.0570 (92.8)	-5.9×10^{-4} (-3.9)	-1.4×10^{-6} (-62.3)	0.0014 (46.1)	0.26
Installment Borrowers Currently 60+ Days Past Due	0.0955 (66.6)	-0.0051 (-14.3)	-2.6×10^{-6} (-48.8)	0.0035 (51.1)	0.17
Captive Auto Finance Accounts Past Due	0.0045 (43.0)	-2.0×10^{-4} (-7.7)	-1.1×10^{-7} (-29.7)	9.9×10^{-5} (19.7)	0.05

Notes: T-statistics in parentheses.
All results are significant at the 5 percent level or better.

ENDNOTES

[1]A 2000 Federal Reserve update of Regulation Z requires payday lenders to provide an APR to consumers (*Federal Register*).

[2]The Center does not cite the specific source for the quote or the company from which it came.

[3]Some conflicting evidence exists but is limited. An analysis of data from Colorado revealed evidence consistent with competitive pricing in the early part of the 2000s (DeYoung and Phillips). But by the middle of the decade, "strategic pricing practices" and a tendency toward charging fees at the legislated price ceiling were discovered. These practices are consistent with implicit collusion on the part of lenders toward these price points.

[4]Military personnel were formerly thought to be targets as well, as they were especially vulnerable to financial problems because of the military compensation system and their common geographic dislocation (Graves and Peterson). A provision in the Fiscal Year 2007 Military Authorization Act outlawed payday loans to military personnel.

[5]This subsection discusses the history of these regulations, based on research by the Consumer Credit Research Foundation. Various sources exist for researching payday lending regulations across states. Unfortunately, definitions of seemingly obvious terms, such as whether an outright ban of payday lending exists, vary across sources, and therefore so do the results of compiled information. The Consumer Credit Research Foundation's history of the industry is a compendium supplemented by a variety of other sources. In cases where the sources differed on interpretation of the law, personal but knowledgeable judgment was used to arrive at a reasonable consensus view of the regulation.

[6]The Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act) outlaws over-the-limit fees unless the consumer opts in to have the flexibility to charge over the preset limit.

[7]The Federal Reserve imposed new rules in November 2009 that require customers to opt in to "overdraft protection." As of November 2010, about 75 percent of consumers had opted in for overdraft protection (Benoit). Effective July 1, 2011, a new rule issued by the FDIC on November 23, 2010 limiting daily fees for overdrafts takes effect (*Washington Post*).

[8]The data provided by TransUnion Trend data, are county-level aggregates derived from depersonalized credit records.

[9]Area median income is defined as metropolitan median income for counties within metropolitan areas and state median income for rural counties.

[10]There was little difference in the share of consumers with late auto payments across counties.

[11]A limitation of this analytical approach is that it cannot identify borrowers seeking other ways of addressing financial shortfalls, such as negotiating with creditors or borrowing from family or friends. These exceptions are not expected

to be substantial, however. In the 2007 payday loan customer survey, 51 percent of payday borrowers stated that a payday loan was their "only choice," suggesting that these traditional options were not available to them. Further, a smaller percentage of survey respondents said they considered borrowing from a friend or relative (23 percent) than stated they could have borrowed from a friend or relative (28 percent). This observation suggests that much of the payday loan customer base would not seek a loan from a friend or relative even if that friend or relative had the capacity and willingness to make the loan.

[12]One might argue that payday borrowers have a greater proclivity for borrowing overall, and that this may somehow temper the results. However, this evaluation compares consumers where payday lending was accessible to consumers where it was not. It does not compare payday borrowers as individuals with consumers who were not payday loan customers. Thus, the proclivity for payday customers to borrow generally, whether greater than other consumers or not, should not matter for these results. On the contrary, to the extent that public policies reflect the will of the citizenry, one might expect that states with a large number of borrowers would be less likely to eliminate access to payday lending.

[13]A possibility for the mixed results is that average total debt, or some other general measure of traditional credit utilization, influences the decision to restrict payday lending rather than the reverse, as estimated here. That is, payday lending could be more commonly allowed in places where consumers borrow more. An estimate of such a model (results available from the author), however, reveals the reverse. Payday lending tends to be restricted where total debt is higher. More conceptually, there is no reason to suspect that consumers in some counties borrow significantly more than others, once account is taken of differences in income and unemployment, as was done in this analysis. Indeed, an assessment of the data in this analysis bears that out. Once account of was taken of income and unemployment, 99 percent of counties' borrowing levels were within one standard deviation of the mean level of borrowing.

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