Strategic Pricing of Payday Loans: Evidence from Colorado, 2000-2005

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What is a Payday Loan? (1)

- A short-term, small denomination consumer loan, collateralized by a post-dated personal check.
- <u>Example</u>: A two-week loan for $300.
    - Borrower gives lender a post-dated check for $350.
    - Lender gives borrower $300.
    - No cash out-of-pocket at time of loan.

(1) Pay off the loan:

- Borrower gives lender $350 cash (equivalently, payday lender deposits the check after two weeks).

(2) Roll over the loan for another two weeks:

- Borrower pays $50 fee (cash) on first loan. First check is redeemed -- borrower writes a new post-dated check for $350.

(3) Default on loan.

Annual percentage rate (APR) for this loan is 435%.

What is a Payday Loan? (2)

- Obvious, but key: Borrower must have a regular paycheck and a bank account.
- Borrower brings a check, recent pay stub, copy of recent bank statement, ID, and proof of stable residence.
- Credit checks for first-time borrowers (e.g., TeleTrack focuses on fringe banking).
- Borrower has incentive to roll over loan rather than default:
  - Defaulting on the loan triggers a bounced check, NSF fees, hit to credit rating.
  - The customer loses access to payments services if account is closed.

What is a Payday Loan? (3)

- Industry segment has grown rapidly:
  - New technologies reduced the cost of producing payday loans (e.g., check-clearing, credit bureaus).
  - Demand for payday loans increased with aggressive pricing by banks of account overdrafts and bounced checks.
  - Pawn shops have lost substantial market share to payday lenders.
- Some estimates, from Flannery and Samolyk (2006):
  - 300 payday stores in 1994…21,500 payday stores in 2004.
  - 10 million customers, 150 million loans, $40 billion loans annually.
  - Entire industry volume equivalent to a large community bank.
- A handful of large publicly traded chains have over 500 stores (e.g., Advance America, Check N’ Go, Check Info).

What is a Payday Loan? (4)

- 20 states apply existing usury laws to payday loans, which effectively bars profitable entry.
- 23 states passed “enabling legislation” that allows payday lending but imposes limits on fees, size, rollovers, etc.
  - Some of these states collect data, but quality and availability varies across states. No federal regulation of payday lenders.
- Federal regulation precludes depository institutions (banks, thrifts, credit unions) from offering payday loans.
  - High default rates raise (a) safety and soundness concerns as well as (b) consumer protection concerns.
  - OCC and Fed ban their banks from affiliating with payday lenders.
  - FDIC limits payday loans to 6 per year. Given current technology, this effectively makes the product unprofitable.

Why This Study?

The high price of payday loans is well documented. ***We are interested in how payday lenders arrive at these prices.***

- Does regulation act as a focal point, increasing prices?
- Do lenders increase prices after “relationship” is formed?
- Does competition reduce prices?
- Does the presence of commercial banks support prices?
- Are prices higher for chronic borrowers?
- Are prices higher in minority and/or low-income markets?

Data

- Enabling legislation was passed in Colorado on April 18, 2000, the Deferred Deposit Loan Act (DDLA).
- DDLA limits rollovers, but not “same-day-as-payoff” loans.
- DDLA requires clear disclosure of fees, rates, and terms.
- Maximum loan principal is $500. Maximum finance charge:
  - 20 percent of loan principal up to $300,
  - 7.5 percent of principal between $300 and $500.
- AG collects data on lender's 30 most recent loans. We use data on 24,972 loans, June 2000 to August 2005.

GAP = Legal Maximum Charge – Actual Charge.

Summary Statistics on Payday Loans

	89.9% of loans at price ceiling	10.1% of loans below price ceiling
GAP	--	$7.64
%GAP	--	3.32%
AMOUNT	$293.53	$290.81
TERM (days)	17.0 days	15.2 days**
CHARGE	$53.07	$45.38**
APR	463.6%	421.1%
“ROLLOVER”	55.8%	49.6%**
LOANS IN YEAR	9.3 loans	10.1 loans**
MULT LOANS	2.7%	6.9%**

Estimation Method

1. Because GAP is truncated, we use a Tobit model to test our main hypotheses.
2. Loan-level demographic variables are not available. So we assume that borrowers live near their lenders.
   - Use ZIP codes of payday lenders to define "local market."
   - Use local Census data as proxy for borrower demographics.
3. Payday lenders are found in only 22 percent of the ZIP code markets in Colorado.
   - Payday lenders may be choosing markets based on income, race, or some other variable we use in our tests.
   - We use a first-stage Heckman process to estimate probability that payday lenders locate in market j.

Summary Statistics on ZIP Code Markets

	371 ZIPS w/o payday lenders	105 ZIPS w/ payday lenders
% white	89.8%	81.4%**
% black	0.9%	4.1%**
% hispanic	12.4%	19.1%**
Income per HH	$43,109	$42,817
House value	$156,903	$149,629
Urban location	35%	79%**
% of state population	0.10%	0.61%**
Branches per capita	0.2679	0.4053*

Results (1)

- Payday lenders are more likely to locate:
  - in densely populated markets,
  - in markets with lots of bank branches per person,
  - in low income markets (but not in minority markets).
- Evidence consistent with focal point pricing:
  - Estimated GAP declines by $1.43 from 2000 to 2005.
  - An additional lender amplified the effect by about 29 cents.
- Evidence consistent with “relationship” pricing, but small:
  - Estimated GAP was 6 cents smaller for repeat borrowers.
- NOTE: “Focal point” and “relationship” pricing not illegal.
  - Antitrust needs a smoking gun. State provided the focal point.
  - Some will argue that relationship pricing can enhance social welfare: Increased profitability allows access to credit.

Results (2)

- Higher prices in markets more thoroughly served by payday lenders.
- Higher prices in markets more thoroughly served by commercial bank branches.
- Prices slightly higher in predominantly minority markets:
  - Std dev increase in %BLACK yields 6-cent increase in GAP.
  - Std dev increase in %HISPANIC yields 10-cent increase in GAP.
- Prices slightly lower in high-income neighborhoods:
  - $10,000 increase in income per capita INCOMEPERHH yields 10-cent GAP decrease.
- GAP is 38 cents larger in the first quarter. A post-Christmas discount to attract newly illiquid customers?

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* This presentation does not necessarily reflect the views or positions of the Federal Deposit Insurance Corporation.