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

Robert DeYoung, Federal Deposit Insurance Corporation*

Ronnie Phillips, Networks Financial Institute and Colorado State University

This presentation does not necessarily reflect the views or positions of the Federal Deposit Insurance Corporation.
What is a Payday Loan? (1)

• A short-term, small denomination consumer loan, collateralized by a post-dated personal check.

• **Example**: 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):
  – 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.

\[
\text{GAP} = \text{Legal Maximum Charge} - \text{Actual Charge.}
\]
## Summary Statistics on Payday Loans

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

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