Payday Lending Literature Review

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Payday Lending Literature Review
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Payday lending is controversial and has been studied from many different angles. Of particular focus to this literature review are studies that focus on whether payday loans help or harm the consumer. Academic articles written since 2008 were identified using keywords with two academic databases, Econlit and Public Affairs Information Service, PAIS. Thirty one articles were identified, much of it focused on the U.S., and the most relevant were summarized and grouped according to the following issues: comprehensive analyses; harmful debt cycles caused by repeated renewals of payday loans; location and services of banks and credit unions that can help or harm the consumer; and other studies.

1. Comprehensive Analyses

Several of the academic articles presented a comprehensive assessment of the literature and data regarding payday lending. These studies came from academic journals and central bankers. For instance, Stegman (2007) indicates that the majority of payday loan customers have jobs or another reliable income source, and all have bank accounts, since this is a precondition of getting a payday loan. The majority of payday loan customers earn $15,000 to $40,000, with somewhat higher household incomes. A strong majority has a high-school education or more but often consumers are not financially educated. Consumers borrow from payday lenders because they do not have convenient access to a lower-cost source of credit and they want or need to make an expenditure for which they do not have sufficient cash on hand. Stegman believes that payday lending reflects society's harmful addiction to credit and their inability to save money. People with the lowest incomes also had the least information about their credit scores and many people who use payday loans have no idea about the amount of APR they are paying. Stegman believes that as long as there is a strong demand for credit in the form of

payday loans among high-risk, low-income borrowers the focus should be more on educating the consumer than imposing restrictions or bans on the payday lenders.

Caskey (2010), in his review of the current literature available on payday loans, indicates that despite the high cost of payday loans, if most customers only borrowed in an emergency situation and then repaid the loans out of their next paycheck, the loans would not be highly controversial or harmful to the consumer. Critics of payday loans emphasize that the loans are costly when they lead to a harmful cycle of unmanageable debt for those that continually renew them. Caskey argues that despite the research efforts of many economists there is still no definitive answer to the question of whether payday lenders help or harm consumers. Caskey is not certain that we will ever get an absolute answer to this question, but hopes that there will be more definitive answers from experimental approaches rather than quasi-experimental approaches or simulations.[2] Caskey indicates that a study like this one is unlikely to be undertaken because it would cause deliberate hardship for the group that was denied the payday loan which is an ethical problem. Payday lenders would not likely agree to participate in such a study as it would not benefit them financially to deny consumers payday loans. Caskey calls for more research on this topic and says that there is still hope for an answer in the future.

Edmiston's (2012) review of available literature and data[3] leads him to argue that the advantages of payday loans outweigh the disadvantages. Regarding the advantages he finds that clients can be harmed by not having access to payday loans because they have nowhere else to go for a short term loan and/or they may seek more costly alternatives.[4] Banks generally do not make small loans and if they do the interest rate is high. Credit cards are not helpful because the client may need cash and cash advances

[2] In an ideal study that would provide a definitive answer as to whether payday loans help or harm the consumer, one group would randomly receive a payday loan and another group would randomly be denied a payday loan. The researcher would then track indicators of financial stress over time across the two groups. If the participants in the study were a large group there would definitely be similarities between the two groups thus ensuring randomness.

[3] Edmiston (2012) uses data from the TransUnion Credit Bureau and the Consumer Credit Research Foundation as well as unemployment rates of the Bureau of Labor Statistics and Economic Analysis.

on a credit card are very expensive. Moreover if the client defaults on the credit card it goes on their credit history whereas payday lenders often do not report on defaulted loans. If they overcharge on their credit card, the fee/interest charge can be more expensive than a payday loan fees plus their credit standing receives a black mark. The client may choose to write an NSF check but that is a criminal activity and is more costly in the long run than a payday loan and again the credit rating is damaged. Pawning items or going to money lenders is another avenue, but the client may not have anything valuable to pawn and dealing with a loan shark is dangerous and there is the possibility of violence against the client if they do not pay. Additionally, Edmiston notes that payday loan customers want easy and quick approval for the funds and very little paperwork and payday lenders provide this. Customers like the ready cash or cash card, lack of credit checks, and access to the long hours and convenient locations of payday lenders. Consumers may need cash specifically, rather than purchasing power more generally in order to pay utility bills etc.

Edmiston notes the potential disadvantages of payday loans. Most payday loan clients lack financial education and do not know that they are paying a 400 percent APR. These consumers might choose an alternative product if they had more knowledge. Borrowers who get into a series of renewals lead them into more and more debt. Debt spirals cause more Chapter 13 bankruptcies because clients are already stressed financially when they start borrowing and repeated payday loans drive them deeper into the cycle of debt. He notes that in a study from the Center for Responsible Lending, it was found that more than 75% of payday loans are being made by repeat borrowers thus increasing the likelihood of a debt spiral and unmanageable debt. Edmiston notes evidence that payday lenders main profits come

[4] Edmiston noted a report by the Center for Responsible Lending (North Carolina) notes several alternatives to payday lending that arguably offer better terms to consumers than payday loans (2007). The alternatives suggested are: payment plans with creditors; advances from employers; credit counseling; emergency assistance programs; credit union loans; cash advances on credit cards; small consumer loans. Edmiston states that if these options were available to the low-income consumer, they would be better options than a payday loan. However, most of these options are not available to the low-income client and if they were, most low-income clients do not have ready access to them.

from repeat borrowers who are paying more and more fees and interest. These are the clients that are being harmed by payday lending.

Melzer (2012) using a longitudinal US survey[5] finds that the effects of credit access among low-income households and the high-cost of payday loans increases the financial distress and harms some consumers. Payday loans can lead consumers to increased difficulties paying their mortgages and utility bills and cause an increase in bankruptcies. Melzer looks at the spillover costs of payday lending and finds that households with convenient access to payday lending outlets are more likely to use food stamps and less likely to pay child support raising the question of whether payday loan users also use food banks more. Melzer concludes that taxpayers are also being harmed by having to pick up some of the spillover costs of payday loans. As well family members of payday loan users who are dependent on child support payments may also be harmed by lack of funds to meet their daily needs.

Using data from an online payday lender making loans in 2006, Li (2012) found that decreasing the maximum interest rate that may be charged on a payday loan decreased the probability of default on the loan. As well, reducing the maximum amount that the consumer could borrow decreased the amount the consumer chose to borrow, decreased the length of time the consumer held the loan and decreased the probability of default on the loan. Forcing consumers to repay the entire loan on the next payday rather than allowing a loan to be renewed indefinitely resulted in fewer renewals, lower payday lender revenue and a 3% increased likelihood of default on the loan. The conclusion that can be made is that continuous renewals of payday loans are harmful to the consumer in that they encourage an unmanageable cycle of debt. However, if the loan must be repaid on the next payday, the consumer is more likely to default on the loan which is harmful to the payday lender. The consumer was helped by a

[5] Melzer used the Census Bureau's Survey of Income and Program Participation (SIPP) as the primary data source for this analysis. SIPP is the primary longitudinal survey that tracks household well-being and public program participation over a four year period.

maximum amount that could be borrowed, a lower interest rate on the payday loan, and shorter term that the loan could be carried.

2. Harmful debt cycles caused by repeated renewals of payday loans

Some of the studies focused particularly on the question of the link between payday lending and a debt spiral. For instance, Morgan, Strain, Seblani (2012) note payday lending's popularity is suggested by the fact that at 24,000 stores, payday lenders now outnumber Starbucks and McDonald's combined. It is controversial because many consumers who take out repeated payday loans fall into an unmanageable cycle of debt and are harmed by this practice.

Using regression analysis from 8 states with payday loan bans and 11 states with payday loan enabling regulations they conclude in their study that Chapter 13 bankruptcy rates decrease when payday loans are banned. This is consistent with results from Skiba and Tobacman (2009) and Morgan and Strain (2007). Advantages of payday loan access for consumers include less pressure from other creditors and collection agencies and that consumers are also less likely to write bounced checks if they have access to payday loans.

The Pew Charitable Trust (2012) conducted a national telephone survey for their 'Pew Safe Small-Dollar Loans Research Project.' A total of 451 adults completed the full-length payday loan survey after the researchers screened almost 50,000 respondents who answered only two questions. The data were analyzed using a logistic regression analysis of the likelihood of payday loan usage by select demographics. The results of the survey showed that,

> [Payday loans] are a highly controversial form of credit, as borrowers find fast relief but often struggle for months to repay obligations marketed as lasting only weeks. While

> proponents argue that payday lending is a vital way to help underserved people solve temporary cash-flow problems, opponents claim that the practice preys on overburdened people with expensive debt that is usually impossible to retire on the borrower's next payday (Pew Charitable Trust, 2012, p.4).

The research found that a payday loan generally involves a two week term but in many cases borrowers are often indebted for that same loan for at least 5 months of the year because of renewals. The study finds that twelve million Americans use payday loans annually and on average a borrower takes 8 payday loans of approximately $375 per year. That same borrower will spend $520 on interest. The study also found that most borrowers use payday loans, not for emergencies but for ordinary living expenses. When asked by the survey what borrowers would do if they could not get a payday loan 81% said they would cut back on expenses, delay paying bills and ask friends and family for money or sell some of their possessions. This study finds it problematic that payday loans are marketed as a short term solution to a cash flow crunch when in reality 7 out of 10 people use payday loans to deal with recurring expenses. Pew's research finds that less educated people, minority groups and low-income people are most likely to use payday loans. The study concluded that the payday loan practice is harmful to the repeat payday loan borrower.

Parrish and King (2009) look at whether new payday loans are generated by previous payday loan debt. They hypothesize that paying off a payday loan leaves the client with no money for other needs thus generating the need for another payday loan. In previous research, the Center for Responsible Lending has found that the average borrower takes out 9 payday loans per year. Furthermore, 90% of payday loan activity is generated by consumers who take

out 5 or more loans per year and over 60% of payday loan activity is generated by consumers who take out 12 or more loans per year. This activity is called "churning." Consumers who only take out one loan per year account for only 2 percent of the payday loan activity. Parrish and King say that 'churning' of existing borrowers' loans every two weeks accounts for 75% of all payday loan volume. They argue that payday lenders often lure the client into the debt trap by offering the first payday loan either free or at a greatly discounted rate. Parrish and King indicate that a 36% APR is the cap that is needed in order to protect families and make sure they can pay back their loan in a timely way. They also believe that there should be a limit on the amount of time each year that a client is allowed to be indebted to a payday lender, and that there should be more alternatives to payday loans such as small loans and emergency savings that could be accessed with the client needs them.

3. The location and services of banks and credit unions that can help or harm the consumer

Several of the academic studies examined the location or services offered by mainstream and fringe banks. These studies were motivated to understand the financial services context in which payday lending operates. There are many studies of this type for the US and we report on just two here. We spend more space in this section reporting on studies on the Canadian context.

Studies in the US (Graves 2003, Temkin and Sawyer 2004) and the UK (Leyshon and Thrift 1997) have often identified a spatial bias in terms of mainstream bank branch closures and fringe bank outlet openings disproportionately affecting low-income locales. In a recent study of the US payday lender location, Li *et al.* (2009) consider the problem of racial profiling in the location of payday lender outlets. Their research found that in California and elsewhere in the United States, African Americans and Latinos make up a disproportionate share of payday loan borrowers. Using a regression analysis

model, and even when controlling for all other variables, race and ethnicity were among the most important factors explaining payday lending storefront locations. These same communities have also shared a disproportionate burden of the subprime mortgage foreclosures, lost equity and devalued properties in the United States. Li *et al.* conclude that racial profiling is a harmful practice that payday lenders engage in when locating themselves in low-income neighborhoods.

To examine small loan products offered by Financial Institutions in the US Stango (2012) conducted a telephone survey and looked at a credit union industry report published by the National Credit Union. He looks at whether credit unions can offer a lower cost alternative to payday lenders and be viable in this market. He finds that very few credit unions offer an alternative to payday loans even though there are no laws stopping them from doing so. The loans from the credit unions would be as costly as those of a payday loan and consumers prefer the less restrictive terms of a payday loan. Stango also concludes that banks would be no different than credit unions in their lack of desire to engage with the payday loan market as their fees and interest rates are generally higher than credit unions.

Analyses regarding bank and payday loan locations in Canada are more limited. Early studies found evidence of location bias issues in some major Canadian cities.[6] More recent studies examine location strategies in major cities in Canada. Simpson and Buckland (2013) look at the migration of banks and credit unions from the inner city to the suburbs of Toronto and the partial re-populating of the inner city with payday loan outlets and pawnshops. Applying density gradients to financial institution locations in Toronto from 1981 to 2006 Simpson and Buckland find that mainstream financial institutions (particularly banks but also credit unions) have migrated to the suburbs and that this has

[6] Data for Winnipeg found that fringe banks were largely located in neighborhoods with lower incomes (Buckland *et al.*, 2003). This trend was found to be similar in the inner-cities in Toronto and Vancouver (Stratcom, 2005). Buckland *et al.* (2003) found an inversion of types of banks over a 23 year period. In Winnipeg's North End there were 22 mainstream bank branches and one pawnshop in 1980; by 2003 there were only 5 banks and18 fringe banks. Buckland *et al.* (2007) found further evidence for Toronto, Vancouver and Winnipeg that where mainstream banks close, fringe banks open and most of the mainstream banks have been closing in lower income neighborhoods.

been at least partially filled by so-called fringe financial institutions, especially payday lenders. Regression analysis found that census tracts with low-income are less attractive to mainstream banks over time and more attractive to fringe banks. What is clear from the data is that the banks and credit unions have left the areas where the lower income residents are most abundant. They concede that some of the void left by the exit of banks and credit unions may be picked up by ATM's and online banking but many low-income residents may not have access to these technologies. Low-income residents in the inner city may only have access to payday lenders and pawnshops thus limiting their ability to save, borrow at reasonable rates and be economically upwardly mobile. They conclude that this trend is harmful to the consumer and that more research is needed.

Brennan *et al.* (2011) and Brennan (2012) also considers the problem of mainstream banks moving out of the inner city to the suburbs. The study looks at the changes in bank and payday loan locations in Winnipeg over a 30 year period from 1980 to 2009. Brennan explores how the numbers of banks, credit unions and payday loan outlets have changed their distribution over time and how they have located themselves with respect to the average income of the neighborhood. Using GIS methods,[7] the results demonstrated that bank branches, in total, have declined in Winnipeg but credit unions have increased in numbers. Both mainstream banks and credit unions are located in more affluent neighborhoods and payday loan outlets are located in less affluent neighborhoods. In the early 2000's, payday lenders began to expand into the suburban areas of Winnipeg and locate themselves near mainstream banks and credit unions. The authors concluded that it is problematic to think that payday lenders with their small loans, check-cashing and bill payment service have become the only banking

[7] The study maps the locations of banks, credit unions, and payday lenders using a Geographic Information System (GIS). Pearson's chi-square goodness-of-fit statistical procedure is used to test the hypothesis that there is no statistically significant difference in the proportion of each of the three selected financial institutions, banks, credit unions, and payday lenders. Households studied were located in Winnipeg with both below and above average household income. Location analysis using distance buffers is used to test a second hypothesis that payday lenders are solely located in areas where there is an absence or reduced presence of bank and credit union branches.

option for low-income people in some neighborhoods. Two-tier banking based on income where affluent people get more for less and less affluent people get less for more is both harmful and troubling. The study concludes by calling for more mainstream bank and credit union branches to move back into low-income neighborhoods and to deliver cost effective services to those individuals.

Buckland, Hamilton and Reimer (2006) noted the prospect of a growing number of community banking projects in Canada.[8] Buckland (2009), using an environmental scan method, looks at affordable credit options for low-income consumers in Australia, Belgium, Canada, France, Germany, the United Kingdom and the United States. Affordable credit is products with fees that are closer to mainstream bank fees with single or low-double digit APRs and are linked in other ways to a mainstream bank such as financial literacy programs. Buckland found that there is a surprising number and diversity of affordable loans schemes for vulnerable people in the seven countries he studied. Two principal types of loan services were identified: social consumer micro-loans and regular consumer micro-loans. The regular consumer micro-loan is often offered solely by the financial institutions. The social consumer micro-loan is often a team effort involving financial institutions, nonprofits, and government.[9] One

[8] They documented the rise of community banking in Vancouver, Toronto and Winnipeg. These projects included Pigeon Park Savings in Vancouver's disadvantaged Downtown Eastside. Pigeon Park offers a basic bank account with an overdraft and savings account option. RBC has worked with St. Christopher House and other neighborhood organizations to design The Cash and Save based in Parkdale, a disadvantaged neighborhood in Toronto. The Community Financial Services Centre (CFSC) in Winnipeg's North End is a final example of a special outlet designed for a disadvantaged neighborhood. The CFSC provides access to financial management training and basic accounts at Assiniboine Credit Union. They note that new information technologies and products may offer improved options for the unbanked, e.g., secured credit cards. However, at present, these credit cards do not help the lowest income clients because in some cases the client has to deposit $600 to have a secured credit card of $500. As well, many things such as utilities and small items cannot be paid for with a credit card reducing the usefulness of a secured credit card.

[9] In this type of loan, financial institutions partner with nonprofits to develop products that are useful to non-typical clientele. The financial institution provides the service, and they sometimes support operating and capital costs. Community organizations link communities with financial institutions, provide financial education, and support clients through the loan process (including repayment). Government support plays a role in many of these services through loan capital or supporting operating costs. The loans are given to low-income households and people who rely on payday loans. Women and young to middle aged people (between 18 and 54 years old) represent the majority of the borrowers. An important aspect of small and affordable loans is their financial viability. Loan losses are reported to be at a reasonable level but some organizations reported that operating costs were higher than for more automated loan schemes. This is due to the staff-intensive nature of the programs.

conclusion is that the social consumer micro-loans are not self-sufficient. However, for the more economically focused consumer microloans the evidence presented here was limited and somewhat mixed.[10] The study concluded that the UK financial inclusion strategy stood out among the seven countries. The strategy has several components including encouraging banks to expand the number of bank accounts they provide, the expansion of credit union system and its ability to provide credit, and the expansion of financial education. Through the Office of Fair Trade in the UK, the government is also examining issues of consumer protection related to financial services. The services in the US and Australia seemed to be the furthest along in the research and development process and so they would be the most helpful for anyone interested in setting up alternatives to payday lending elsewhere.

4. Other Studies

Two other studies raised interesting points regarding payday lending. One considered the role of financial literacy in consumer use of payday loans while the other examined the interaction between payday loans and consumers in a disaster setting. Bertrand and Morse (2011) conducted a field experiment at payday lending outlets. Their findings suggest that information disclosure and financial education surrounding the payday borrowing decision has a significant impact on whether that consumer takes out a payday loan. Getting a consumer to think more long term about adding up the costs of the loan over time reduces the frequency of payday borrowing by 11%.

Morse (2011) examines whether payday loan use helps or harms California consumers facing a personal or natural disaster.[11] Morse defined a disaster as a car or health breakdown, house fire, flood,

[10] The best data available were the qualitative and general results from the FDIC Small-Dollar Loan Pilot Program (FDIC 2009), and from the Woodstock Institute study of the APPLE Program (Williams2007). The former study argued that only a few banks were able to cover program costs and generate a profit while the latter study found that all six participating credit unions had self-supporting programs.

[11] Using zip-code-level data from California Morse runs a series of regressions to examine how payday loan use affects the dependent variables such as foreclosures or changes in property crimes.

earthquake, death etc. Her results were mixed. She found that payday loans helped people through a personal crisis or natural disaster without losing their homes, going bankrupt, writing NSF cheques or resorting to shoplifting to gain access to goods needed to survive. However she also found that payday loans can facilitate ‘temptation’ spending and that this type of behavior sets up a cycle that is very harmful to the consumer in the long term. Her findings suggest that the presence of payday lenders in a community helps some homeowners cope with unexpected financial distress, whether caused by a natural disaster or some other events but that payday lenders hurt the chronically dependent consumer.

5. Discussion

In summary, the academic literature on payday lending cannot definitively say whether it helps or harms consumers. There are two main factors which continue the debate about payday loans. Firstly, at present, there is no large-scale alternative to the payday lending for many low-income consumers who need cash to pay their bills and live their lives. Banks and credit unions have largely left low-income neighborhoods and have not made a serious effort to provide banking services for low-income Canadians because they do not generate a large deposit base or use high end financial products. On the other hand, payday lenders are conveniently located, ask few questions, have long hours and mostly do not report on defaults on loans. Payday loans have been proven to help in a time of crisis for individuals. In places where payday loans are banned, low-income consumers write more NSF checks and are continuously threatened and harassed by debt collectors and creditors.

Secondly, there is evidence that in jurisdictions where clients are repeat borrowers, harm can result. This is because these payday clients repeatedly renew their payday loans and fall into an unmanageable cycle of debt and bankruptcy. They get on a treadmill of relying on small loans that on

their own amount to a relatively small absolute amount of money, but when added up through repeated loans, amount to a substantial amount of money.

Based on evidence in this review of the literature, it seems that payday lending will continue despite the high APR on repeated loans and desperate cycle of debt that many clients fall into for lack of a reasonable alternative. The responsible action at this time is to ensure that the APR rate on payday loans is held to its absolute minimum while not being so stringent as to put the payday lenders out of business. However, it is imperative that researchers continue to work for alternative banking options, particularly for those stuck in a payday loan debt cycle. These alternative banking options need to meet the requirements of low-income Canadians and provide financial education for payday loan clients to insure that they are aware of the APR they are paying on their payday loans.

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