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Causes and consequences of using payday loans

This research does not necessarily represent the views of the Federal Reserve

Research Questions

- Why do people use payday loans?
- Do payday loans improve or worsen financial well-being?

Data: Merge payday loan applicants to their credit history

- First-time payday loan applicants from one large payday lender
  - Applications span 2001-2004
- Match applicants to their credit records
  - FRBNY/Equifax Consumer Credit Panel
  - Snapshot every quarter, 1999:1 – 2010:1

What is a payday loan (PDL)?

- Small, short-term loan (advance on paycheck)
  - $100-$1000 loan
  - 1-4 week term
  - Typical cost: $15-$30 per $100 borrowed
    - → 390-780% APR for a 2 week loan
- Volume: $30-50 billion/year

Concern: bad choice → bad outcomes

- Over-optimism or misunderstandings at play?
  - People use payday loans despite having cheaper alternatives (Agarwal et al 2009)
  - People underestimate debt service; think credit cards are more expensive (Bertrand and Morse 2011; Pew 2012)
- Some research finds harmful effects of PDLs (e.g. bankruptcy, loss of bank accounts) while other research finds benefits (e.g. mitigates foreclosures due to income shocks)

Why do people use payday loans?

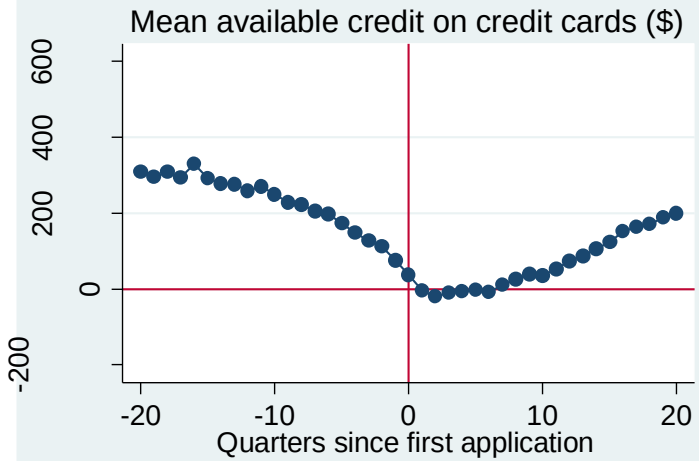
- Desperation!(?)

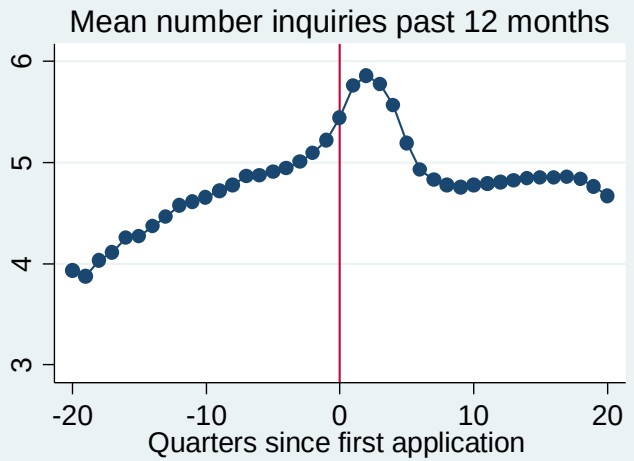
Credit record information in quarter before first payday loan application

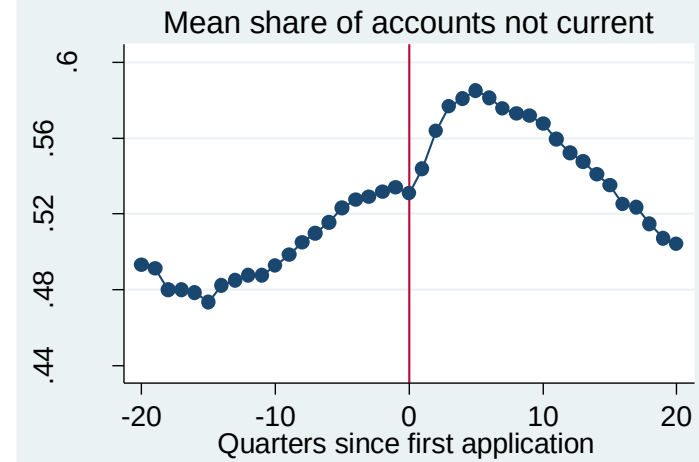
	Payday applicants			General population		
	mean	median	N	mean	median	N
Number of open accounts	3.8	3	38,220	5.0	4	103,766
Share of accounts not current	0.53	0.5	33,084	0.13	0	93,912
Has one or more credit cards	0.59	1	38,220	0.75	1	103,766
Total limit for cardholders ($)	3,050	1,154	22,556	18,914	11,000	78,146
Total balance for cardholders ($)	2,921	1,340	22,556	5,128	1,586	78,146
Number inquiries past 12 months	5.2	4	38,220	1.7	1	103,766
Num new acnts past 12 months	1.4	1	38,123	1.1	1	103,606
Equifax credit score	513	517	38,220	680	702	103,766
Total debt ($)	19,656	5,977	38,220	49,605	9,120	103,766

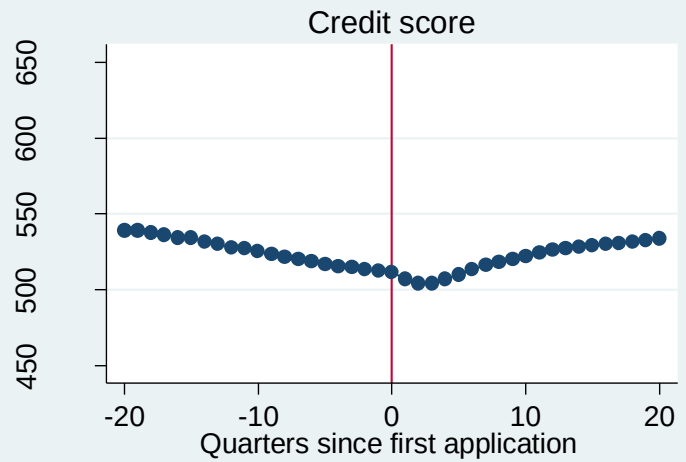
Source: FRBNY/Equifax Consumer Credit Panel

Applicants are in really bad shape at time of application, and never are in good shape





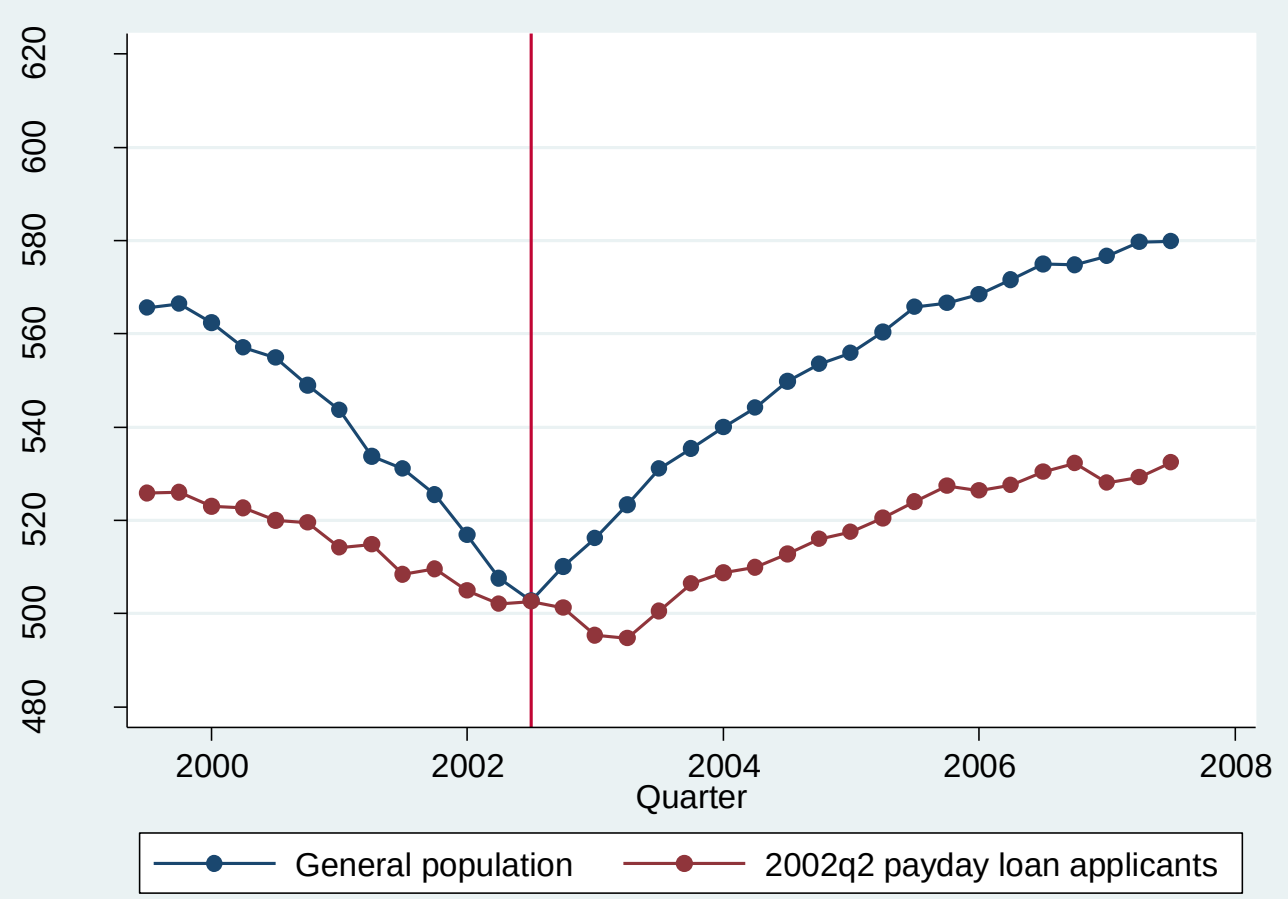




Source: FRBNY/Equifax Consumer Credit Panel

Payday applicants' credit scores are persistently low

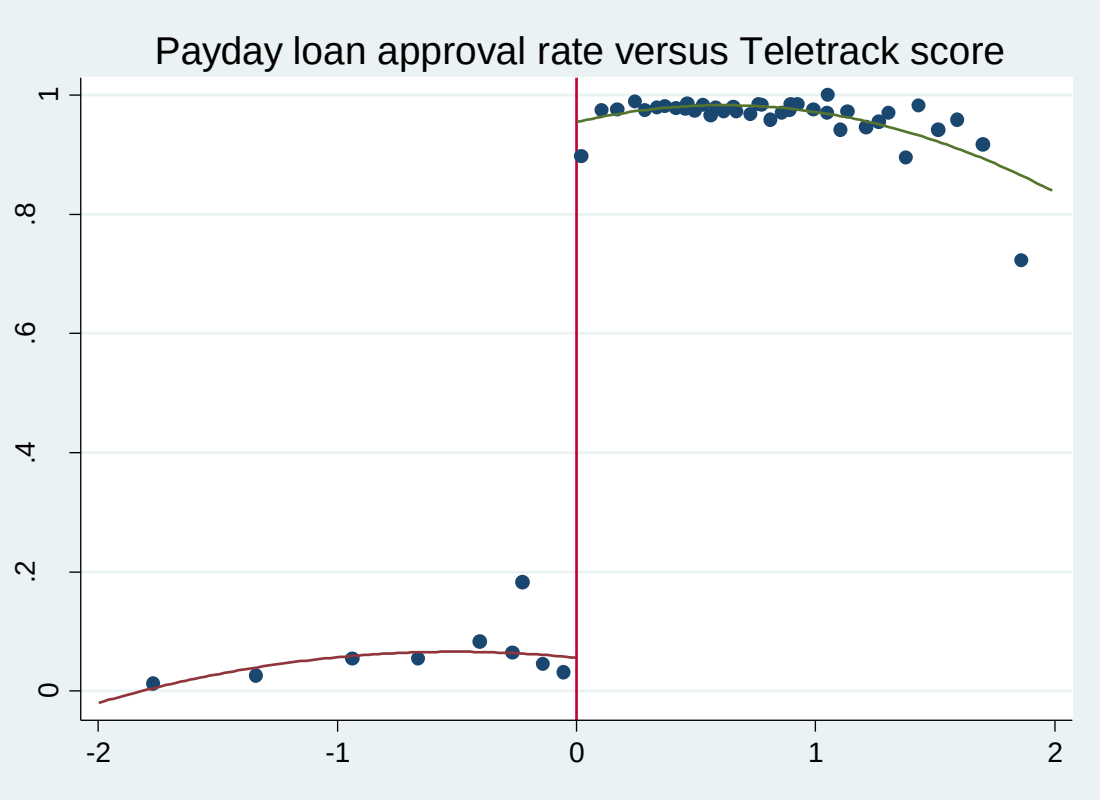
- Applicants in 2002:2 *vs.* random sample of consumers with the same scores at time of application



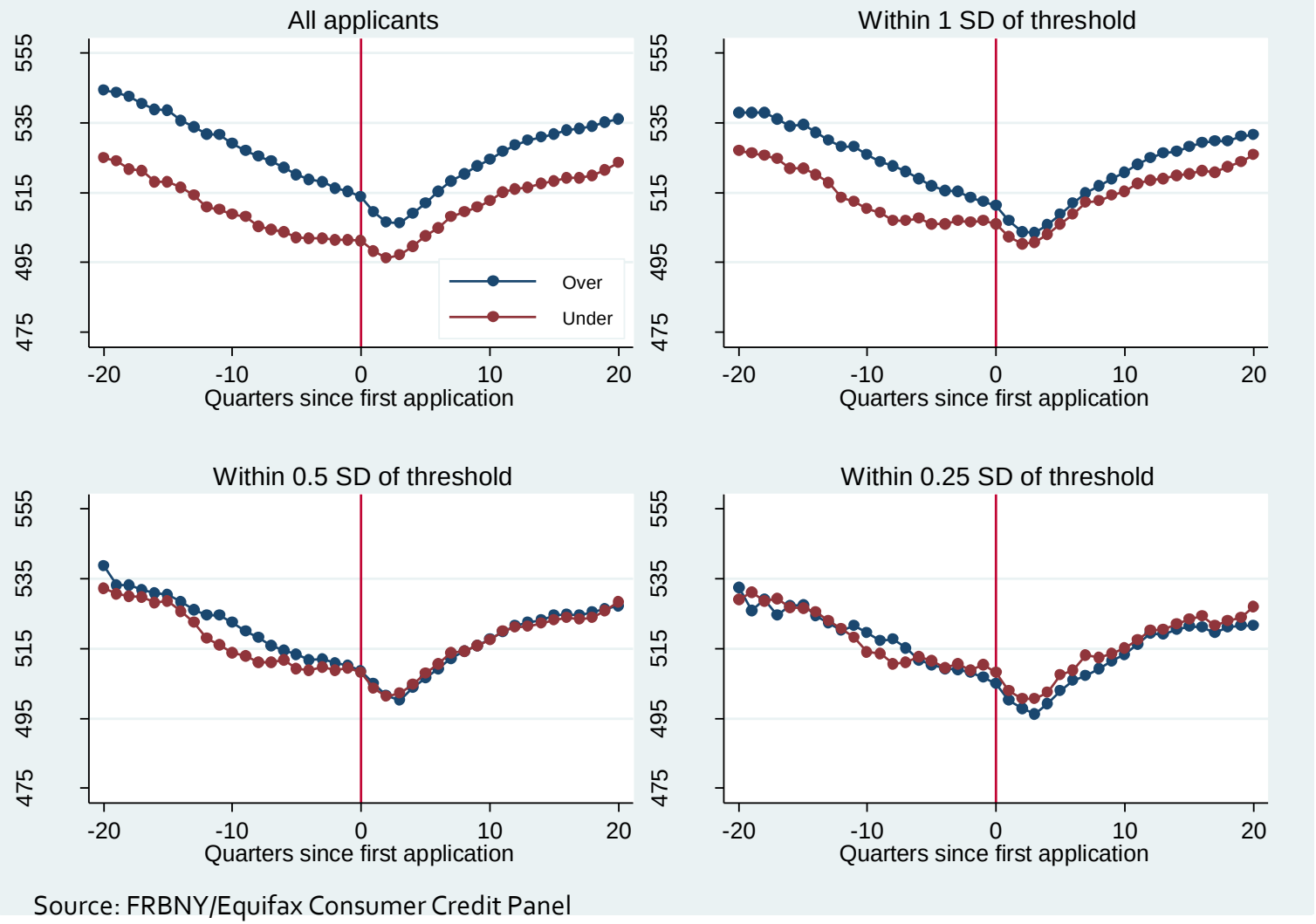
Source: FRBNY/Equifax Consumer Credit Panel

Does getting a payday loan affect borrowers' credit scores?

- Teletrack score determines payday loan approval
- Compare applicants just above/below approval threshold
- **Note: payday loans don't *directly* affect credit scores**



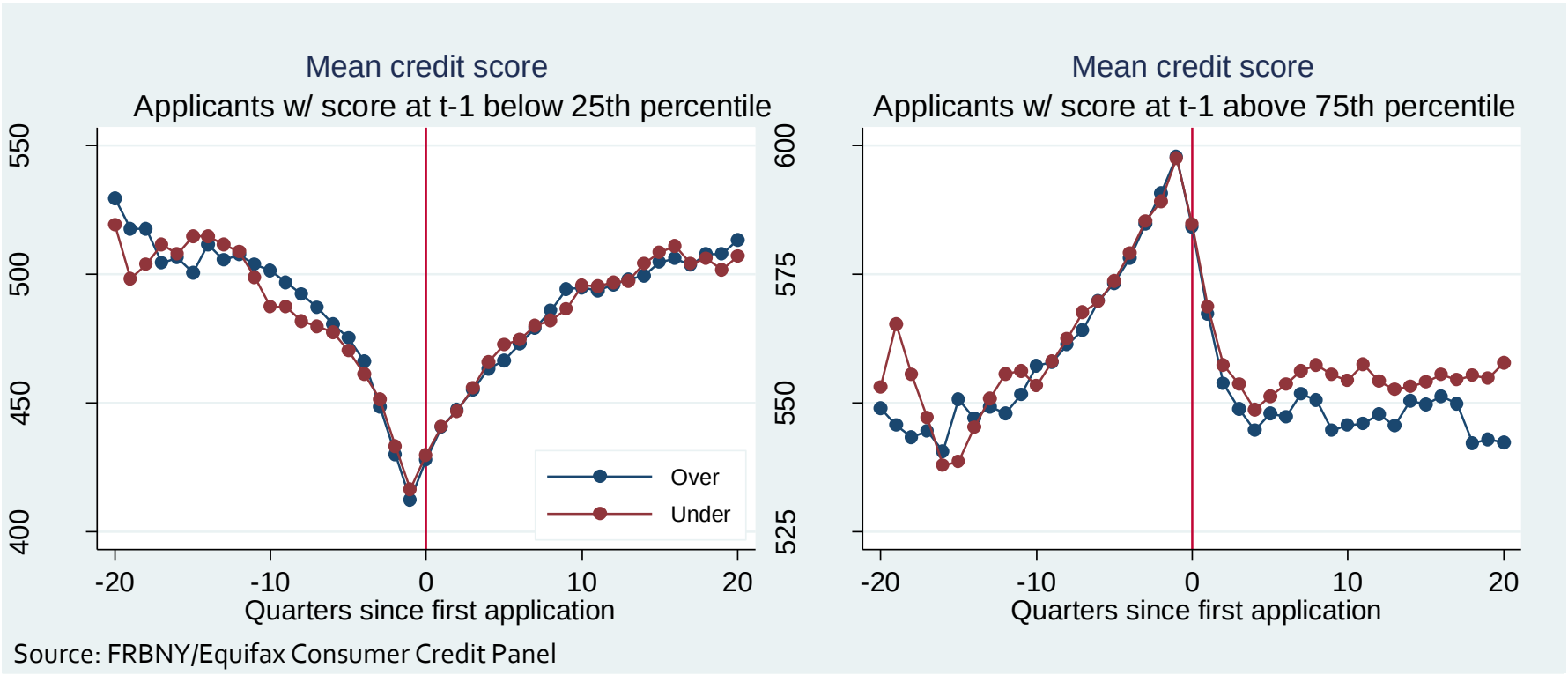
Credit scores of approved vs. denied applicants over time



Source: FRBNY/Equifax Consumer Credit Panel

What happens to those with the best and worst credit scores?

- The effect of getting a payday loan for those in the top/bottom quartile of the applicant credit score distribution just before application



Source: FRBNY/Equifax Consumer Credit Panel

Conclusions

- Payday loans seem to be a last resort:
  - Credit card lines are exhausted
  - Intense search for cheaper credit is unsuccessful
- Payday applicants have persistent financial problems

  →Difficulties forming/committing to a budget
- No evidence that getting a payday loan has a substantive effect (positive or negative) on financial well-being, as measured by credit scores