Economics of Consumer Financial Protection: Payday Lending Discussion

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Market Overview

- Typical payday loan scenario: receive $300 cash in exchange for a check for $354 dated two weeks later
- 2-10% of US households borrow on these loans per year; total volume in 2003 = $40 billion (SCF, Stephens, Inc.)
- Physical locations offer check cashing, money orders, pawn loans, etc
- Online market share growing
- Competitive
  - Entry costs low
  - Teletrack reduces incumbents' informational advantage

Mixed Evidence on Impacts

- Morse, Meltzer, Morgan and Strain, Skiba and Tobacman, Zinman
- Caskey review

Biases in Decision-Making

- Extreme impatience, especially in the short term
- Overoptimism
- Low levels of financial literacy
  - Pecuniary mistakes
  - Disclosure

Bias #1: Extreme Impatience

- Consumers exhibit high annualized discount rates
  - Frederick, Loewenstein, and O'Donoghue, *2002*
- Discount rates are higher in the short term than in the long term
  - Tempation, hyperbolic discounting, self-control
- Natural to explore when APR = 468%
- Hard to separately identify shocks
- Signature implication of self-control models: demand for commitment
  - Sophisticated hyperbolics would default quickly

Bias #2: Overoptimism

- Important papers:
  - Dellavigna and Malmendier, “Contract Design and Self-Control,” QJE 2004
  - Gabaix and Laibson, “Shrouded Attributes,” QJE 2006
    - In the presence of naivete, competition does not restore efficiency
- Evidence for overoptimism in the realm of consumer financial decision-making
  - House price expectations (Case and Shiller 2003)
  - Choices of credit cards, and borrowing amounts and durations (Ausubel 1999)

Overoptimism

- Delayed defaults on payday loans (Skiba and Tobacman 2009)
- Typical borrower at a large lender borrows repeatedly
  - And defaults within 1 year
  - Conditional on default, has already paid 5*18% = 90% of original loan's principal as interest
  - Interest payments preserve the option to borrow subsequently
  - But estimated structural model implies the value of this option is small

Bias #3: Low financial literacy

- Lusardi and Mitchell have shown in many papers over the past five years that typical US consumers misunderstand basic financial concepts
  - Inflation
  - Compound interest
  - Value of diversification
- Lusardi and Tufano identify low levels of "Debt Literacy"
  - Especially among payday borrowers
- Debate ongoing about the effects of financial education on financial literacy and outcomes
  - Cole and Shastry (2009) show no impact of state-level mandates to add financial education to high school curricula

Indirect Evidence

- "Pecuniary mistakes" -- use of one financial product when alternatives with lower financial costs are available
  - Eg., borrow on a credit card when you have money in a checking account
- Weaker than showing violations of WARP: differences in transactions costs, convenience, delayed consequences
- A useful calibration
- Pecuniary mistakes by payday borrowers are ~$150/year
  - 5x larger than the SCF credit card "liquid debt puzzle"

Bertrand-Morse

- Randomized field experiment on information disclosure
  - "APR Treatment": Disclose payday loan interest rates in explicit comparison to other interest rates (cf, "Coherent Arbitrariness," Ariely, Loewenstein, and Prelec 2003)
  - "Dollar Treatment": Disclose how fees accumulate for up to three months. Overcoming the "peanuts effect." Also, procrastination (O'Donoghue and Rabin 1999, 2001ab) is more severe when decision periods are short
  - "Refinancing Information Treatment": Direct de-biasing attempt about (average) future use: how long does it take to repay?
- Assessment: wisely designed, carefully implemented; informative about the effect of disclosures
- APR Treatment, Refinancing Information Treatment: small and insignificant effects

Bertrand-Morse Effect Size

- Dollar Treatment: statistically significant reduction in subsequent borrowing frequencies
- Economically, how should we think about a reduction in subsequent borrowing from 54.2% to 48.7%??
  - Per pay cycle over the next four months
- Huge:
  - Can be implemented for zero marginal cost
  - A form of benign/limited/libertarian paternalism
- Tiny:
  - After being confronted– quite baldly– with unattractive features of payday loans, almost half still borrow subsequently, in *each pay cycle*
  - Effect of the Dollar Treatment is biggest– and that does little more than perform multiplication

Opportunities and Questions

- How much and how quickly do consumers learn?
- What events or information cause learning?
- Data
  - Account-level data can be used effectively, even without random variation, especially if information is available on defaults
  - Financial institution partners
- State-level legislation
- CFPB will have full enforcement authority and possibly supervisory authority over payday lending
- FTC Truth-in-Lending oversight