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
  - Temptation, 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
    - 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 $5 \times 18\% = 90\%$ 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”
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