STUDY SUMMARY

Understanding Borrowers' Decisions: Payday Loans in the United States

Payday loans—small short-term loans with high interest rates that become due at the time of the borrower's next paycheck—are a common form of lending to people with low income in the United States. Do borrowers taking out these loans make rational decisions, or do they borrow more than they expect or would like to in the long run? Researchers partnered with a large payday lender in Indiana to conduct an evaluation to better understand consumers' decision-making. The results suggest that average borrowers can anticipate their probability of taking loans in the future. However, people focus too much on the present when making decisions about payday loans, a behavior that they would like to change.

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COUNTRY
United States

PARTNER

PROGRAM AREAS
Financial Inclusion, US Finance

TOPICS
Consumer Protection, Financial Capability

TIMELINE
Not available

Policy Issue

Payday loans—short-term loans with high interest due at the time of the borrower's next paycheck—are a common form of lending to people with low incomes in the United States. These loans are usually for USD$500 or less and often have an annual interest rate of around 400 percent, more than ten times higher than the norm for US lending.[1] While most financial loans require a certain credit score and/or collateral, payday loans tend not to; generally, borrowers need only present a bank account and proof of income. Proponents of payday lending argue that these loans provide credit to people who otherwise would not be able to access it in a time of need. Critics argue that the loans prey on people who are economically vulnerable, forcing them into expensive debt traps as they take on new loans to pay off older ones.

A question relevant to this debate is whether consumers are acting in their own best interest when they take out payday loans. If borrowers have self-control problems, are over-optimistic about their future financial situation, or for some other reasons do not anticipate their high likelihood of repeat borrowing, they could underestimate the costs of repaying a loan. However, if borrowers have a good understanding of their self-control, future financial situation, and other aspects, payday loans may actually improve welfare despite their expensive nature.

Evaluation Context

Payday loans are available in 32 US states and banned in 18. In 2016, Americans took out $35 billion in these loans and paid $6 billion in interest and fees.[1] Nationally, over 80 percent of payday loans are either renewed or rolled over with another payday loan within the next eight weeks.[2]

This evaluation is taking place in the state of Indiana, where the regulatory environment, for payday loans is typical of other US states. Indiana disbursed 1.2 million payday loans for a total of $430 million in 2017. State law caps loan sizes at $605 and caps the marginal interest and fees at 15 percent of the loan amount for loans up to $250, 13 percent on the incremental amount borrowed from $251-$400, and 10 percent on the incremental amount borrowed above $400. The major payday lenders in Indiana charge those maximum allowed amounts on all loans, including the large national payday lender with whom researchers partnered for this study.

To take out a payday loan, borrowers must present identification, proof of income, and a post-dated check for the amount of the loan plus interest. Payday lenders do minimal underwriting, sometimes checking data from a subprime credit bureau. When the loan comes due, borrowers can repay (either in person or by allowing the lender to successfully cash the check) or default. After borrowers repay the principal and interest owed on a loan, they can immediately get another loan. In some states, loans can be "rolled over" without paying the full amount due, but Indiana law does not allow this.

In 2017, the Consumer Financial Protection Bureau announced new regulations for payday lenders. The rules would require lenders to ensure that customers seeking a loan had the ability to repay it before being offered one and prevent lenders from making more than two unsuccessful attempts to debit a borrower’s bank account. However, as of late 2019, the bureau canceled the rule.

Details of the Intervention

Researchers partnered with a large payday lender in Indiana to better understand consumers’ decision-making about payday loans. The research team implemented a survey evaluation to measure payday borrowers’ self-control for making rational long-term financial decisions and their self-awareness about their own self-control. Researchers then used these responses to consider the implications of three commonly proposed payday lending regulations on consumer welfare. The survey ran at 41 of the lender’s stores in Indiana from January-March 2019 and had over 1,200 respondents included in data analysis.

Immediately before or after taking out a payday loan, borrowers participating in the study took a survey questionnaire offering choices between three rewards they would potentially receive twelve weeks later:

- **Incentive for being debt-free**: individuals would receive a US$ 100 cash payment if they did not take out any more loans for eight weeks
- **Money for Sure:** individuals would receive a “Money For Sure” reward, a cash payment regardless of their future behavior. Borrowers were asked to repeatedly choose between the US$ 100 debt-free incentive option and different amounts of “Money For Sure” (from what researchers call a “multiple price list”), taking into account their estimated probability of taking out another loan in the next eight weeks.
- **Flip a Coin:** This group was offered a 50 percent chance of winning $100 or nothing. Similar to the Money for Sure option, respondents went through a series of adaptive questions beginning with a tradeoff between flipping a coin to receive US$ 100 and receiving US$ 0 for sure. This helped researchers measure individuals’ risk aversion.

After the survey was complete, the iPad informed participants of whether they had been selected for one of types of rewards or received nothing (the comparison group). The probabilities of receiving the debt-free incentive, one randomly chosen value of their Money for Sure responses, or nothing were 44 percent, 2 percent, and 54 percent, respectively. Participants also received a reminder of the reward via email four weeks after the survey.

Researchers combined the survey data with administrative data from the lender covering individuals' income, an internal credit score on a scale from 0-1000, pay cycle length, loan length, and loan amount. They also leveraged a state-wide database of borrowing from all payday lenders and nationwide subprime credit bureau data.

Results and Policy Lessons

The evaluation revealed that the average borrower almost fully anticipates repeat borrowing. Among the people who did not receive any rewards (the comparison group), 70 percent said they would borrow again. When comparing with administrative data, 74 percent of the people did borrow, confirming that on average people can anticipate their likelihood of repeat borrowing.

However, researchers found this is not true among the most inexperienced borrowers, those who had taken out three or fewer loans from the lender in the six months prior to the intervention. On average, these borrowers underestimate their future borrowing probability by 20 percentage points.

People who received the incentive were less likely to predict correctly their probability of taking out a payday loan in the future. The average borrower predicted that the US$100 debt-free incentive would reduce the probability of taking out another loan within the next eight weeks to 50 percent. In reality, however, those offered the debt-free incentive took out another loan 70 percent of the time. This suggests that experience under normal conditions can help borrowers predict their behavior under normal conditions, but it does not help them predict their behavior under unfamiliar conditions.

On average, borrowers value the no-borrowing incentive 30 percent more than they would if had perfect self-control or if they are risk-neutral, suggesting people are present-focused and aware of this bias. Qualitative data also suggests that people focus too much on the present when taking payday loans. Fifty-four percent of the respondents said they "would very much" want to give themselves extra motivation to avoid payday loans in the future, and only 10 percent said they didn't want extra motivation.

Researchers use these results to model the potential welfare implications of three commonly proposed payday loan reforms: a payday lending ban, a rollover restriction that disallows borrowing for 30 days after three consecutive loans, and a loan size cap. The results suggest that loan bans and tighter loan size caps could both reduce welfare. However, rollover restrictions appear to benefit borrowers. This encourages faster repayment, consistent with study participants' desires to motivate themselves to avoid reborrowing.

Sources

[1] Consumer Financial Protection Bureau (CFPB), 2017. "What is a payday loan?" https://www.consumerfinance.gov/ask-cfpb/what-is-a-payday-loan-en-1567/.

[2] Wilson, Eric and Eva Wolkowitz. 2017. “2017 Financially Underserved Market Size Study.” Center for Financial Services Innovation.

[3] Consumer Financial Protection Bureau, 2016. “Payday Loans, Auto Title Loans, and High-Cost Installment Loans: Highlights from CFPB Research.” Consumer Financial Protection Bureau.

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