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Banning Payday Loans Lowers Household's Welfare, Study Says

Payday loans are subject of an intense and sometimes even grim debate, in particular in the U.S. Advocates emphasise the role of payday loans in smoothing consumption while opponents have long argued that these lenders exploit poor households and should be banned.

A ban of payday loans can result in welfare losses for households, according to a recent study. "Current regulatory efforts in the U.S. to curtail or even ban the payday loan sectors may potentially harm households," economists Tsung-Hsien Li and Jan Sun from the University of Mannheim argue.

A payday loan is a short-term unsecured loan with a duration of a few weeks for a typically small amount of around 300 dollars. Among individuals in the U.S. who use both credit cards and payday loans, two-thirds have at least 1,000 dollars of credit card liquidity left when taking such a loan, according to other studies.

"This behaviour is seemingly puzzling as payday loans carry very high interest rates corresponding to annualised percentage rates of several hundred per cent, compared to ten to thirty per cent on credit cards," Li and Sun wrote.

The so-called Payday Loan Puzzle is that people do not exhaust their credit card limits to protect their credit scores, since payday lenders do not report to credit bureaus. As a consequence, households trade off the long-term reputational benefit of maintaining one's credit score versus the short-term cost of borrowing on more expensive payday loans.

Households differ in patience, the authors explain. Impatient households are riskier borrowers for banks compared to patient ones, due to their propensity to consume rather soon than later. However, banks cannot observe the patience of households and instead use credit scores to assess the riskiness of their borrowers. If a household is hit by a low income shock, it can borrow using payday loans to smooth consumption while avoiding a credit score downgrade.

Banks' limited information leads to a cross-subsidisation in the lending market as impatient households, who are more likely to use payday loans, are subsidised by patient households, according to Li and Sun.

To shed more light on the current political debate on regulation in this sector, the authors investigated welfare implications of limiting access to payday loans through amount caps or an outright ban of such loans.

If access to payday loans is more constrained, impatient households lose while patient ones gain. Impatient households are more likely to borrow larger loan sums and are thus more affected by the quantity cap.

In addition, imposing a cap reduces informational asymmetry in the bank market and hence lowers the cross-subsidisation of impatient by patient households.

By contrast, a full ban reduces welfare of both household types. The reason for the welfare loss is the reduction in available insurance, Li and Sun said.

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Both impatient and patient households use payday loans to smooth earnings shocks without harming their credit scores. “With a full ban, the insurance loss outweighs the gains from reduced cross-subsidisation for patient households,” they noted.

The authors also discuss the repercussions of an increase of default costs. Increasing bankruptcy default costs leads to welfare gains, whereas increasing only payday default costs leads to welfare losses for both households.

Increased bankruptcy default costs allow households to get bank loans at lower interest rates, due to a lower default rate. In contrast, increased payday default costs make it harder for households to default without damaging their credit scores, which explains the welfare loss in this case, according to the paper.

“Banning payday loans or increasing their default costs result in aggregate welfare losses,” the authors conclude.

The presented discussion paper is a publication without peer review of the Collaborative Research Center (CRC) Transregio 224 EPoS. Access the full discussion paper here. Find the list of all discussion papers of the CRC here.

Authors
Tsung-Hsien Li, Ph.D. candidate in economics at the University of Mannheim
Jan Sun, member of the Collaborative Research Center Transregio 224 EPoS and Ph.D. candidate in economics at the University of Mannheim

The Collaborative Research Center (CRC) Transregio 224 EPoS
Established in 2018, the Collaborative Research Center Transregio 224 EPoS, a cooperation of the universities Bonn and Mannheim, is a long-term research institution funded by the German Research Foundation (Deutsche Forschungsgemeinschaft, DFG). EPoS addresses three key societal challenges: how to promote equality of opportunity; how to regulate markets in light of the internationalization and digitalization of economic activity; and how to safeguard the stability of the financial system.

Contact
For further information and interview requests, please contact the author of the study:
Jan Sun
Department of Economics
Mannheim University
Phone: +49 621-181-1905
Email: jsun@mail.uni-mannheim.de