Committee Name:
Senate Committee – Privacy, Electronic Commerce and Financial Institutions (SC–PECFI)

Appointments

01hr_SC–PECFI_Appoint_pt00

Clearinghouse Rules

01hr_SC–PECFI_CRule_01–

Committee Hearings

01hr_SC–PECFI_CH_pt00

Committee Reports

01hr_SC–PECFI_CR_pt00

Executive Sessions

01hr_SC–PECFI_ES_pt00

Hearing Records

01hr_ab0000

01hr_sb0084a_pt02a

Misc.

01hr_SC–PECFI__Misc__pt01

Record of Committee Proceedings

01hr_SC–PECFI_RCP_pt00

PAYDAY ADVANCE IN AMERICA

In May 2001, the Credit Research Center at the McDonough School of Business at Georgetown University released the first-ever, comprehensive economic analysis of consumer demand for and use of payday advance services. Until the release of this study, only anecdotal evidence has been used to discuss the payday advance consumer. The Georgetown study presents the first impartial observation of payday advance in America.

"**Payday Advance in America: An Analysis of Customer Demand**," is an exhaustive study assessing the characteristics of the payday advance customer, attitudes toward credit and payday advances, consumer experience with payday advance credit, and the availability of alternatives to payday advance credit. The study was conducted among a nationally representative sample of customers of payday advance companies belonging to the Community Financial Services Association of America, the industry's national trade group. Highlights of the analysis include:

- **Customers overwhelmingly appreciate payday advance**. Ninety-two percent of payday advance customers believe payday advance is a useful service. "The overwhelmingly favorable response to this statement strongly suggests that payday advance companies serve a real economic need for their customers." Over 75% of customers were satisfied with their most recent payday advance transaction and only 12% were dissatisfied.
- **Customers do not want access to payday advance limited**. Two out of three consumers (69%) opposed limiting the number of payday advances you can obtain in a year and 62% did not want to limit the number of consecutive renewals.
- **Payday advance consumers take responsibility for their own financial situations**. More than three out of four customers (79%) believe overspending is the responsibility of the consumer, not the lender. The report argues, "These results suggest that the large majority of payday advance customers do not feel that they are victims of credit. They believe that consumers bear responsibility for their own spending."
- **Payday advance customers use the service responsibly.** Sixty-six percent of customers use payday advances to pay unexpected expenses or a temporary reduction in income. Thirty-four percent use payday advance for planned expenses or other discretionary uses.
- **Payday advance customers understand the cost of the service.** Ninety-six percent of customers were aware of and reported the finance charge and could compare it with similar fees, including late fees. Seventy-eight percent could recall that the payday advance fee had been disclosed to them as an annual percentage rate (APR), although most could not recall the rate. "A likely explanation," according to the report, "is that payday advance customers used finance charges rather than annual percentage rates in decision-making. Many costs that customers use payday advances to avoid are typically expressed as dollar amounts, not annual percentage rates."

- **Most customers use payday advance infrequently or moderately.** Sixty percent either did not renew payday advance at all in the last year or renewed only 1-2 or 3-4 times. ("Renewals" include both rollovers and new advances taken out on the same day a prior advance was paid in full.) About 78% of customers use the service less than 14 times a year. Four out of five have outstanding advances for less than half of the year. While a small percentage of customers had payday advances outstanding for a long time, the report suggests that these consumers may have had few alternatives and that payday advance gives them control over their finances that they otherwise would not have.

- **Most customers fit the expected economic profile of consumers in early life-cycle stages**. Most customers are middle-income, middle-educated young families who may not have met their earning potential or accumulated many liquid assets. More than half report income between $25,000 and $50,000. Nearly 94% have a high school diploma or better, with 55.5% having some college or a college degree. Only one in ten payday advance customers is 55 or older while seniors represent three out of ten of all adults in America.

For more information on the Georgetown Study, you can access the full report at http://www.msb.georgetown.edu/prog/crc or call the Senior Researcher Gregory Elliehausen at Georgetown University's Credit Research Center at (202) 625-1384.

###

Revised 06/02/01

Payday Advance Credit in America: An Analysis of Customer Demand

Monograph #35

April 2001

Gregory Elliehausen, Ph.D.

Edward C. Lawrence, Ph.D.

Credit Research Center

McDonough School of Business
Georgetown University
Washington, D.C.

Credit Research Center
McDonough School of Business
Georgetown University

PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND

Gregory Elliehausen, Ph.D.
Senior Research Scholar
Credit Research Center
McDonough School of Business
Georgetown University
Washington, DC

Edward C. Lawrence, Ph.D.
Professor of Finance
College of Business
University of Missouri-St. Louis
St. Louis, Missouri

April 2001

The Credit Research Center
McDonough School of Business
Georgetown University

About the Center:

The Credit Research Center was founded in 1974 by Robert W. Johnson, Professor of Finance at Purdue University's Krannert Graduate School of Management. The center's founding was an outgrowth of Dr. Johnson's services as presidential appointee to the National Commission on Consumer Finance in 1969. During its 3-year existence the Commission coordinated a massive research program to study the operation of consumer credit markets in the United States. Delivered to Congress in 1972, the Commission's multi-volume report established the value of academic research for guiding public policy towards markets for financial services. With a combination of foundation and corporate grants, Dr. Johnson established the Credit Research Center at Purdue to provide an ongoing means of directing academic research expertise toward practical problems in consumer and mortgage credit markets.

Over the past quarter-century the Center has gained a national reputation for its work in evaluating public policy toward credit markets. The Center's operations have been sustained by generous grants from both the public and private sectors. Over one hundred articles and monographs by distinguished scholars document its research product. The Center's senior research staff have frequently testified before Congress and state legislatures on such topics as Truth-in-Lending disclosures, the impact of interest rate ceilings on credit availability, equal credit opportunity regulations, personal bankruptcy, credit insurance, credit scoring, credit card usage, and the impact of privacy regulations. The value of these contributions to rational discourse stems from CRC's academic affiliation, rigorous external review of its research, and the years of research experience of its principal researchers and authors.

In July of 1997 the Center relocated its offices to Georgetown University in Washington, D.C. The Center is a non-profit unit of the McDonough School of Business where it continues its tradition of non-partisan research and education on economic issues relating to consumer credit and markets for retail financial services. For more information about the Center and its publications visit its website at www.msb.edu/prog/crc.

CRC GOVERNING BOARD
2000-2001

David A. Walker, Chairman
John A. Largay Scholar
Georgetown University

Michael E. Staten
Professor and Director,
Credit Research Center
Georgetown University

Steven Alexander
Executive Vice President
Fleet Bank

James R. Barth
Lowder Eminent Scholar in Finance
Auburn University

Joseph R. Crouse
Executive Vice President
MBNA America

William Dunkelberg
Professor of Economics
Temple University

Mark J. Flannery
Bank of America Eminent Scholar
in Finance
University of Florida

Cynthia J. Grunze
Senior Vice President
Discover Financial Services, Inc.

Katherine H. Harmon
Manager of Credit Marketing
J.C. Penney Co., Inc.

Thomas M. Holloway
Director, Risk Analysis
Freddie Mac

William C. Hunter
Senior Vice President
Federal Reserve Bank of Chicago

Vish Vishwanath
Vice President, Risk Management
Sears, Roebuck and Co.

Michelle White
Professor of Economics
University of Michigan

TABLE OF CONTENTS

PAGE

ACKNOWLEDGMENTS iii

EXECUTIVE SUMMARY iv

INTRODUCTION 1

CHAPTER 1 THE PAYDAY ADVANCE TRANSACTION
- Loan Size and Finance Charges 3
- The Underwriting Process 3
- Costs 4
- Regulatory Environment 5
  - *State Laws* 5
  - *Federal Laws* 7
  - *Self-Regulation* 8
- Consumer Protection Issues 9

CHAPTER 2 ANALYZING THE BENEFITS AND COSTS OF A PAYDAY ADVANCE TRANSACTION
- Analytical Model for Consumer Credit Use 11
- Analysis of the Payday Advance Transaction 12
- Evaluating Availability of Alternatives 16

CHAPTER 3 SURVEY OF PAYDAY ADVANCE CUSTOMERS
- Survey Objectives 18
- Target Population 19
- Methodology 20
  - *Sample Design and Selection* 20
  - *Interviewing* 20

CHAPTER 4 FRAMEWORK FOR ANALYSIS
- The Buyer-Behavior Model 23
  - *Problem Recognition* 23
  - *Internal Search* 24
  - *External Search and Alternative Evaluation* 24
  - *Purchase and Outcome Evaluation* 24
- Information Processing in the Buyer-Behavior Model 25

Determinants of the Extent of the Decision Process 26
Situational Factors 26
Product Characteristics 26
Consumer Characteristics 27
Environmental Factors 27

CHAPTER 5 SURVEY RESULTS
Characteristics of Payday Advance Customers 28
Family Income 28
Age, Marital Status, and Family Life-Cycle Stage 29
Income and Family Life-Cycle Stage 31
Education 32
Attitudes Toward Credit and Payday Advances 33
Attitudes toward Credit 33
Attitudes Toward Payday Advances 35
Perceptions of the Cost of Payday Advances 36
Consumer Experience With Payday Advance Credit 37
Frequency and Duration of Payday Advance Use 38
Use of Different Payday Advance Companies 39
Late Payments on Payday Advances 40
Availability of Alternatives to Payday Advance Credit 41
Availability and Use of Bank Card Credit 42
Debt-Payment Burdens of Payday Advance Customers 45
Credit Availability 45
Customers' Most Recent Payday Advance Transaction 47
The Most Recent Payday Advance 47
The New Payday Advance Decision 47

CHAPTER 6 SUMMARY AND CONCLUSIONS
Survey of Payday Advance Customers 54
Survey Findings 55
Characteristics of Payday Advance Customers 55
Attitudes Toward Credit and Payday Advance Credit 55
Consumer Experience With Payday Advance Credit 55
Availability of Alternatives to Payday Advance Credit 56
The Most Recent Payday Advance 56
APPENDIX A
Best Practices for the Payday Advance Industry 61

APPENDIX B
Questionnaire 62

BIOGRAPHIES OF AUTHORS

ACKNOWLEDGMENTS

Many people contributed to this study. Thomas A. Durkin, of the Board of Governors of the Federal Reserve System; James Lacko, of the Federal Trade Commission; and Michael E. Staten, of the Credit Research Center reviewed the questionnaire and provided detailed comments and suggestions. Members of the Credit Research Center's Advisory Council also provided many helpful suggestions. Board members of the Community Financial Services Association of America (CFSA) provided a thorough review of the factual material regarding the payday advance industry.

At Market Facts, Cecile M. Johnson directed the survey of payday advance customers. She was assisted by Lefki Anastasiou. Both provided helpful guidance in the development of the questions. Alan Roshwalb designed and selected the sample. We also thank the CFSA-member companies and their customers who participated in the survey.

Thomas A. Durkin; Robert W. Johnson, of Consumer Credit Intelligence, LLC; and Michael E. Staten reviewed the draft of this monograph. Their comments and suggestions greatly improved the content of the monograph. At the University of Missouri-St. Louis, Karen Wagster provided research assistance.

This project was supported, in part, by a grant from the Community Financial Services Association of America.

EXECUTIVE SUMMARY

This monograph investigates consumers' demand for payday advance credit. The data for the investigation are from a nationally representative sample of customers of payday advance companies belonging to the industry trade association, the Community Financial Services Association of America. Member companies operate about half of the approximately 10,000 offices offering payday advance credit. The survey was conducted from December 28, 2000 to January 9, 2001.

The payday advance industry emerged during the 1990s to cater to unfulfilled demand for very small, short-term consumer loans. Payday advance customers are primarily moderate-income consumers who are often in early stages of the family life cycle. They are more likely to use consumer credit and tend to have higher levels of consumer debt relative to income than the population as a whole. According to previous research, such consumers typically have high rates of return on investments in household goods. Because of the high return on household investment, they have strong demand for credit, which at the margin makes them insensitive to interest rates on loans. Thus, payday advance customers' use of such credit, which has very high annual percentage rates, is consistent with the predictions of economic theory and previous empirical research.

Payday advance customers are generally aware of the cost of such credit. Nearly all payday advance customers were aware of the dollar amount of the finance charge on their most recent new advance. But few were able to report accurate annual percentage rates despite recalling receipt of that information in Truth in Lending disclosures. A likely explanation is that payday advance customers used finance charges rather than annual percentage rates in decision-making. Many costs that customers use payday advances to avoid (e.g., fees for returned checks or late payments) are typically expressed as dollar amounts, not annual percentage rates. Since customers did not use annual percentage rates to make their decision, they did not retain the information in memory.

In other circumstances, payday advance customers may use annual percentage rates. Nearly all payday advance customers owe other types of consumer credit. They are concentrated in the middle levels of educational achievement. Other surveys have found these levels to be associated with relatively high awareness of annual percentage rates for consumer instalment credit. Moreover, payday advance customers who had bank cards were generally aware of the annual percentage rate on the bank card used most frequently.

Many customers recognize that payday advance credit is costly. Although many customers consider the cost of payday advances to be the same or less than fees for returned checks or late payments, a very large number thought payday advances were more expensive. And the small percentage of customers who were dissatisfied with their most recent new payday advance cited the high cost as the reason for their dissatisfaction.

Payday advance customers perceived limitations in credit availability and had fewer alternatives than the population as a whole. Nearly three-fourths of payday advance customers have been turned down by a creditor or not given as much credit as applied for in the last five years. Two-thirds of customers considered applying for credit but changed their mind because they thought they would be turned down. Payday advance customers were less likely than the adult population to have a bank or retail credit card. Of the 56.5% of customers having bank cards, over half refrained from using such cards in the last year because they would have exceeded their credit limit.

Most payday advance customers use advances infrequently or moderately. About half of customers had advances outstanding less than a total of three months during the year, and nearly four in five had advances outstanding less than half of the year. Generally, payday advances were used at different times over the year. Over half of customers' longest consecutive sequence of advances were less than a month. These findings suggest many payday advance customers use payday advances regularly for short periods of time. Attitudes expressed by customers disagreeing with the government limiting the number of times a consumer can obtain payday advances during the year are consistent with such use.

A small percentage of customers had payday advance credit outstanding for more than half of the year, however. These customers may have had few alternatives to payday advances. Nevertheless, the favorable attitudes toward payday advances and the high level of satisfaction with the most recent advance suggest that for many of these customers continued use of payday advance credit was a choice, not a burden from which they could not escape. Of the customers expressing dissatisfaction with their most recent advance, only a very small percentage of customers were dissatisfied because of the difficulty of getting out of debt.

In sum, most payday advance customers use such credit as a short-term source of financing. Nearly all are aware of the finance charge for payday advance credit. Payday advance customers use other types of consumer credit and are likely aware of annual percentage rates for such credit. However, they may have difficulty obtaining additional credit from traditional creditors, especially on an unsecured basis. Thus, payday advances give these consumers a little control over their financial situation that they otherwise would not have. This may explain customers' positive attitudes toward payday advance credit and high levels of satisfaction.

INTRODUCTION

Payday advances are very small, short-term consumer loans. In a payday advance transaction, the customer writes a check for the amount of the loan and finance charge. The creditor agrees to hold the check until the next payday, typically about two weeks, when the customer redeems the check with cash or the creditor deposits the check. Other names for this product are payday loans, cash advances, and deferred presentment services.

Consumer demand for very small, short-term consumer loans is not new. In the latter part of the nineteenth century, small loan companies lent small amounts using chattel mortgages or wage assignments.[1] These small loan companies typically charged annual interest rates ranging from 20-300%, well in excess of the legal interest rate of 6% per annum. Payments were scheduled for every payday. For a typical loan of $25, payments would be scheduled for 13 weeks. The customers of these companies were primarily government employees, low-level white collar workers, skilled-tradesmen and foremen. These companies served the credit needs of moderate-income workers, who struggled to keep up with their middle-class ambitions.[2]

The small loan business was illegal, of course. But the usury laws were sporadically enforced, and the business prospered because it served a real need. Eventually, the small loan industry became a target of Progressive reformers, who prosecuted the illegal small loan companies. However, the reformers realized that a need existed and recognized that it was impossible to make a profit on small loans with a 6% interest rate. Therefore, the reformers proposed higher rate ceilings for small loans in exchange for licensing and regulating of creditors extending such credit. Many small loan companies came to accept such proposals, and in 1917 a committee of reformers and small loan companies agreed on model legislation, the Uniform Small Loan Law. The subsequent passage of small loan legislation in many states enabled creditors to make small loans profitably and allowed emergence of the modern finance company industry.

The cost structure of the consumer finance industry is such that operating costs increase less than proportionately with loan size (Benston [1972]; Durkin and Elliehausen [1998]). In other words, companies producing larger loans have lower costs per dollar of credit than companies producing smaller loans. Thus, for a given interest rate, larger loans are more profitable than smaller loans. Perhaps because of increased competition unleashed by deregulation of financial service markets in the 1980s, many finance companies, which historically served the very small loan market, shifted their business to more profitable, large consumer loans. Banks offer revolving credit (bank cards and check credit) to satisfy small and short-term credit needs, but many consumers still have limited access to such credit despite the development of a subprime market for bank cards.

---

[1] For discussion of the development of consumer credit markets in the nineteenth and early twentieth centuries, see Calder [1999] or Michelman [1966].

[2] Pawnbrokers were another source of small, short-term loans. In contrast to the small loan companies, pawnbrokers catered to a lower income, working-class clientele (Calder [1999]). The difference in customer profiles suggests that pawnbrokers and small loan companies may have served different market segments.

The payday advance industry emerged during the 1990s to serve a void created by the withdrawal of traditional lenders from the very small loan market. Payday advance credit is different from the small loans offered by finance companies. Payday advances are single payment loans rather than instalment loans, and the underwriting process for payday advances does not involve a credit investigation. Therefore, the costs and risks of the two types of credit are not the same. However, it is likely the factors influencing the demand for these products are similar. This monograph investigates the demand for payday advance credit using new data from a representative survey of customers of payday advance companies belonging to the industry's national trade association, the Community Financial Services Association of America. The strong demand for very small, short-term consumer loans is evident from the growth in the payday advance industry. The number of payday advance offices grew from virtually zero offices in 1990 to over 10,000 offices in 1999 (Stephens Inc. [1999]).

CHAPTER 1

THE PAYDAY ADVANCE TRANSACTION

A payday advance is a small, short-term, single-payment consumer loan.[3] In a payday advance transaction, the customer writes a personal check for the sum of the loan amount (amount financed) and finance charge. The payday advance company agrees in writing to defer presentment of the check until the customer's next payday, which is often 10 to 30 days later. At the next payday, the customer may redeem the check by paying the loan amount and the finance charge, or the payday advance company may cash the check. In some states, the customer may extend the payday advance by paying only the finance charge and writing a new check.

Payday advance companies may provide only payday advances, or they may provide payday advances and other services such as check cashing. For this study, payday advance company refers to any company that provides payday advances, regardless of whether the company provides only payday advances or other services as well.

Loan Size and Finance Charges

Payday advances typically range from $100 to $500, although some states permit payday advances up to $1,000. Finance charges are typically between $15 and $20 per $100 of the loan amount. The calculation of the cost of a payday advance is straightforward. Consider, for example, a customer borrowing $200 for 14 days, where the finance charge is assessed at a rate of $15 per $100 borrowed. The finance charge is $\$200 \times (\$15 \div \$100) = \$30$. The annual percentage rate for this transaction is 390.00%, which is the periodic rate 15.00% multiplied by 26, the number of 14-day periods in a year.

The Underwriting Process

Many of the costs of consumer lending do not vary by size of loan (see discussion of costs in the next section), making small loans relatively more costly per dollar than large consumer loans. For this reason, payday advance companies have sought to make the underwriting process as streamlined as possible. The underwriting process consists primarily of verifying the applicant's income and the existence of a bank account. Payday advance companies typically request that applicants provide the last bank statement, the last pay stub, identification (e.g., social security number and driving license), and sometimes proof of residence. Companies generally limit the maximum amount of the advance to a specified percentage of the customer's take-home pay. Unlike traditional lenders, payday advance companies do not obtain a credit bureau report. However, some companies do subscribe to a risk assessment service that provides information on current payday advance use by the applicant.

---

[3] State laws governing payday advances vary as to whether the transaction is considered a loan and whether the fee charged is interest. Regardless of treatment under state law, all payday advances are treated as loans for the purposes of this study.

Taking a postdated check helps reduce the costs of collection. If the consumer fails to redeem the check, the payday advance company has a relatively low-cost method of collection. The company can deposit the check to obtain payment of the loan amount and finance charge. Depositing the check does not ensure payment, of course, since the customer may not have sufficient funds in his account. But not having sufficient funds in the account subjects the customer to overdraft fees, which makes failure to repay the payday advance costly to the customer. Thus, the postdated check provides an incentive to repay the payday advance, thereby reducing the probability of default and the expected value of collection costs.[4]

Costs

This study is primarily concerned with a consumer's payday advance decision, not the cost of payday advance credit. Nevertheless, because of the relatively high annual percentage rate, some discussion of the relationship between costs and annual percentage rates is useful for understanding the payday advance transaction. At this time, data on the cost of extending payday advance credit are very limited. However, all creditors perform the same basic activities, and empirical studies of costs of other types of consumer lending provide evidence on the cost of small, short-term loans.

The costs of consumer lending can be classified into several categories: operating costs, taxes, and return on invested capital. Operating costs are the largest category. They arise from the basic functions that all creditors must perform to extend credit. Operating costs include the salaries and office expenses for loan acquisition, processing, and collection of payments, plus expenses for bad debts.

By far the greatest part of operating costs is expenses for loan acquisition, processing of payments, and collection of past due accounts. Loan acquisition costs include the cost of taking an application, evaluating the application, preparing the loan document, and disbursing the funds. Processing costs include receiving and recording loan payments, monitoring accounts to ensure prompt payment, and contacting customers who are past due to arrange for collection of late payments. Lending involves all of these costs, regardless of the size of the loan. This characteristic implies that a substantial part of the cost of lending is fixed. Because of this fixed cost, the breakeven annual percentage rates for consumer lending are inversely related to the size and term to maturity of the loan. Empirical analyses for the National Commission on Consumer Finance [1972] indicate that the breakeven annual percentage rate on a larger loan is less than the breakeven annual percentage rate on a smaller loan. An intuitive explanation for this finding is that the fixed cost is spread over a greater loan size. Likewise, analyses indicate the breakeven annual percentage rate for a longer term to maturity is less than that for a shorter term to maturity. An intuitive explanation for this second finding is that the fixed cost of acquisition is spread over time with a greater number of payments.

These empirical results are based on data from different types of creditors many years ago. However, the activities that creditors must perform are largely the same now as they were

[4] Theoretical analyses by Jaffee and Russell [1976], Barro [1976] and Benjamin [1978] demonstrate that making default costly for the borrower reduces the probability of default.

then, and all types of creditors must perform them. Although information processing systems automate many of these activities, the labor inputs are still substantial. Application information must be entered into the computer. The computer may prepare the loan document, but employees must explain the document to the customer and disburse the funds. Employees must receive payments and record them into the accounting system. They must extract information identifying past due accounts, contact customers, and arrange for collection of late payments. All of these activities entail substantial fixed costs.

For very small loans, one study for the National Commission on Consumer Finance indicates that breakeven rates are quite high. This study examined costs of the "small" small loan industry in Texas (Durkin [1975]). These small loan companies were specially licensed to make instalment loans of $100 or less (about $450 or less in 2001 dollars). The minimum annual percentage rate to recover operating costs for an average loan was about 80%. This rate did not include taxes or return on invested capital. Allowing for taxes and return on invested capital produced a breakeven annual percentage rate of over 100%.

The findings of the various studies for the National Commission on Consumer Finance cannot be used to infer breakeven annual percentage rates for payday advances. Payday advance credit is extended for much shorter terms to maturity and may entail different credit risk than the various types of instalment credit in these studies. Nevertheless, these studies suggest payday advance credit will have high costs relative to loan size because of the small loan sizes and very short terms to maturity.

Regulatory Environment

Payday advance credit is regulated by state and federal laws. In addition, many payday advance companies voluntarily submit to self-regulation, adhering to a set of industry standards promulgated by an industry trade association, the Community Financial Services Association of America.

State Laws

Recent state legislation has made the rapid growth in the payday advance industry possible. At the present time, 33 states and the District of Columbia allow payday advance companies to operate within their borders.[5] Of the states allowing payday advance companies, 24 have legislation or regulations explicitly authorizing payday advances. Typically, the state payday advance laws exempt payday advances from usury or interest rate ceilings in exchange for establishing maximum fees and rollover limits. The state payday advance laws also require licensing and periodic examinations to ensure that the licensees are abiding by all applicable federal and state laws.

The other 17 states effectively prohibit payday lending through strict interest rate ceilings, which make very small loan sizes unprofitable. For example, Alabama, Alaska, Rhode

[5] For discussion of state laws and regulations, see Chen, Goodwin, Jaworski and Tolle [2000] or Community Financial Services Association [2000].

Island and Virginia all place a 36% annual interest rate ceiling on small loans. A creditor in these states may charge a maximum of $2.77 on a $200 cash advance for two weeks. This amount is considerably lower than the $30-$45 that payday advance companies charge for this same product in states that allow payday advances. Since payday advance companies do not operate in states with restrictive interest rate ceilings, it is likely that the 36% annual percentage rate is lower than the payday advance industry's breakeven annual percentage rate for payday advance credit.

State laws also regulate nonprice terms of payday advance transactions in several ways. Some laws limit the number of times an advance may be rolled over or refinanced. Eighteen states (e.g., Colorado, Florida and Kansas) do not permit a payday advance customer to retire an existing advance with the proceeds of a new advance.[6] Five states (e.g., Idaho and Illinois) permit a current advance to be rolled over no more than three times.

Many payday advance laws limit the size of payday advances. Size limits frequently range between $300-$500 per advance. Some states directly limit the size of the advance. Others limit the size of the check, which includes the amount of the advance plus the finance charge. Montana has a variation on size limits that restricts advances to the lesser of $300 or 25% of the customer's net monthly income. Nevada limits the amount of the advance to one-third of the customer's net monthly income. Many states also limit the aggregate amount of advances to a customer at a company, which is generally the same as the size of the maximum advance. The intent of these restrictions on nonprice terms is to force consumers to use payday advances for short-term needs and to keep the consumers from falling too far into debt.

State laws generally prohibit payday advance companies from threatening defaulting clients with criminal prosecution or civil damage penalties to intimidate or force repayment. Nevada specifically prohibits lenders from harassing defaulting debtors by posting an NSF check in a public area or publishing a list of consumers who have given bad checks. Some state provisions may allow criminal prosecution in cases of fraud, however. Hawaii, for example, allows the criminal process to be used in cases where the consumer either stops payment on the check or closes the bank checking account before the advance has been repaid.

The state laws explicitly authorizing payday advance lending provide for oversight of the industry. The laws impose certain statutory requirements on licensees (e.g., that licensees are bonded and satisfy minimal net worth criteria). The laws usually also require licensees to provide periodic written reports and submit to on-site examinations by regulators. Such requirements help protect consumers from unscrupulous or financially weak lenders. They also help enforce compliance with state and federal laws. Regulation of this type has been effective in driving out companies that are unwilling to satisfy regulatory standards. When Tennessee passed its Deferred Presentment Services Act in October 1997, for example, many existing

---

[6] However, a consumer can obtain a new advance from a different company to repay an existing advance. Such action is possible because there is no database listing customers of all payday advance companies. Even if a database existed, it would be difficult to prevent a customer from taking out an advance at one company and immediately repaying an advance at another company.

payday advance companies ceased doing business in Tennessee rather than comply with the new restrictions (Tennessee Department of Financial Institutions [1998]).

To enforce their regulations, most states have criminal or supervisory penalties that can be used against payday advance companies. Some states authorize private enforcement. Seven states allow consumers to file a private cause of action to obtain relief against a payday advance company (Community Financial Services Association [2000]).

Federal Laws

Payday advances are consumer loans and, therefore, are subject to the federal Truth in Lending Act (15 U.S.C. §1601 *et seq.*), which is implemented by the Federal Reserve Board's Regulation Z. Truth in Lending requires a detailed set of disclosures of the price and other terms of consumer credit transactions. The key price disclosures are the annual percentage rate and the finance charge. The annual percentage rate is the periodic interest rate applied to outstanding balances multiplied by the number of periods in a year. The finance charge is the total dollar amount of all interest payments. Other disclosures for payday advance transactions include the amount of the loan (amount financed), the total of payments (for payday advances, the check amount), and the schedule of payments. The Federal Trade Commission has jurisdiction for Truth in Lending for payday advance companies.

The Fair Debt Collection Practices Act (15 U.S.C.§1692 *et seq.*) establishes debt-collection standards for third-party collectors. The act prohibits harassment, false statements, and certain practices in collecting debts. Third-party collectors are collection professionals and firms who assist creditors in collecting past-due accounts. The small advance size makes use of third-party collectors uneconomical. Therefore, very few payday advance companies, if any, use third-party collectors. Payday advance companies normally collect their own past due accounts. However, the industry trade association, the Community Financial Services Association of America, includes limitations of the Fair Debt Collection Practices Act as a guideline for member companies' own collection efforts.

The National Bank Act may have important consequences for the structure of the payday advance industry. The courts have consistently held that the National Bank Act (12 U.S.C. §§ 85-86) allows federally insured banks to charge the higher of (1) the interest rate allowed in the state in which the bank is domiciled or (2) 1% above the discount rate on 90-day commercial paper in the Federal Reserve district in which the bank is located.[7] In effect, the act preempts state interest rate ceilings of the borrower's home state. Nationally chartered banks are able to export the interest rate they charge in their home state to customers in other states.[8]

[7] *Marquette v. First of Omaha Serv. Corp.*, 439 U.S. 299 [1978]; *Smiley v. Citibank (South Dakota), N.A.*, 135 L. Ed. 2d 25, 116 S. Ct. 1730 [1996].

[8] Similarly, the Depository Institutions and Deregulation and Monetary Control Act of 1980 (12 U.S.C. § 1831d(a), §1463(g), § 1785(g), and § 1735f-7a) allows state-chartered banks and other financial institutions accepting federally insured deposits to export rates across state lines.

This aspect of the National Bank Act has induced many financial institutions to establish credit card banks in South Dakota and Delaware, which have no interest rate ceilings for revolving credit. The ability to export interest rates is not limited to revolving credit, for which business is conducted through the mail. Recent court cases suggest a company may enter into an agreement with a national bank in a high-rate ceiling state to provide payday advances through the company's stores located in other states.[9] The key requirement for such agreements is that the bank grant the advance, but the offices are owned by the company, not by the bank. Several companies currently have such agreements with national banks. Extension of payday advances by national banks limits the ability of states to regulate such credit using interest rate ceilings. It should be noted, however, that the nonprice restrictions imposed by states (discussed in the previous subsection) would still apply, regardless of whether the advance was granted by a bank or a payday advance company.

Self-Regulation

In 1999, several payday advance companies founded an industry trade association, the Community Financial Services Association of America. Currently, the association has over 60 member companies. These companies operate approximately 5,000 offices nationwide. This represents about half of the estimated 10,000 offices making similar short-term loans (Stephens Inc. [1999]).

The primary function of the Community Financial Services Association is to guide industry standards and to promote a favorable regulatory environment for payday advance lending. The crucial element of a favorable regulatory environment is that state price regulation (i.e., interest rate ceilings) does not make payday advance lending unprofitable. In return for nonprohibitive price regulation, the association supports a set of industry standards for payday advance lending, which it designates as "Best Practices." The "Best Practices" consist of the following standards:

- Disclosure of finance charge, annual percentage rate, and all terms of the payday advance transaction;
- Full compliance with applicable state and federal laws;
- A commitment to clear and truthful advertising;
- Consumer education promoting short-term use of payday advance services and informing customers of the availability of credit counseling services;
- Limitation of the number of rollovers to the lower of four or the state maximum, and prohibition where rollovers are not specifically allowed;
- Provision of the consumers right to rescind the transaction at no cost;
- Adherence to limitations on collection practices contained in the Fair Debt Collection Practices Act;
- Renunciation of the threat or use of criminal prosecution to collect on a returned check;
- Participation in self-policing of industry;

[9] *Cade v. H&R Block, Inc.*, 43 F 3d 869 (4th Cir., 1994); *Christiansen v. Beneficial Nat'l Bank*, 972 F. Supp. 146 (S.D. Ga., 1997); *Basile v. H&R Block, Inc.*, 897 F. Supp. 194 (E.D. Pa., 1995). These cases concern loans made through tax preparation offices.

- Support for state legislation that incorporates the association's standards; and
- When payday advances are extended through an agreement with a national bank, assurance that the national bank adheres to the association's standards.

The complete text of the Community Financial Services Association's "Best Practices" is reproduced in appendix A.

The "Best Practices" include numerous consumer protections. Some of the protections are also contained in state or federal laws. Many states do not have all of the protections of the "Best Practices," however, and the protections in the Fair Debt Collection Practices Act do not apply to payday advance companies collecting their own accounts. Thus, the association's standards constrain member firms' behavior.[10] The association promotes incorporating its standards into state laws. Colorado, for example, passed an improved payday advance law during the 2000 legislative session and was the first state to incorporate the "Best Practice" of providing the consumer a right to rescind the transaction at no cost by the close of the following business day. When incorporated in state law, the standards with their consumer protections and associated compliance costs are imposed on nonmember companies as well as member companies.

Consumer Protection Issues

The relatively high finance charge and annual percentage rate for the payday advance credit has attracted the attention of consumerists, politicians, and regulators and has led to several concerns. The first concern is that the price of payday advance credit is too high. A second concern is that consumers may not be fully aware of the price of payday advance credit. Awareness of the price is important because this information is necessary to make an economically rational decision. As discussed earlier in this chapter, Truth in Lending requires disclosure of the finance charge and annual percentage rate. Disclosure alone does not ensure consumers are aware of the information, however. A third concern is that the high price of payday advance credit imposes a financial burden on customers making it difficult for them to pay-off the debt. As a result, they continually renew payday advances, making such credit a long-term debt. Many state laws and the trade association's "Best Practices" address renewals on a company basis. They do not prevent customers from taking out an advance at one company to repay an advance at another company. Related to the concern over renewals is a belief that payday advance customers would be better-off using less expensive, long-term credit. Finally, the price of payday advances also reflects the high risk of these transactions. These customers have a high probability of repayment problems, which subject them to the collection process. Again, many state laws and the trade association's "Best Practices" have provisions regarding collection practices.

---

[10] That the "Best Practices" constrain member companies' behavior is suggested by the response of two payday advance companies to the most recent revision to the standards. Two large payday advance companies pulled out of the association rather than assure that the national bank through which it was offering payday advances adhere to all of the restrictions in customers' home states. See Payday Lenders' Group Revises Guidelines, *American Banker* [July 19, 2000].

This monograph is not intended to address the concern that the price of payday advance credit is too high. As mentioned, many states have limited the price of payday advance credit by law. If the limit is lower than the cost of production, the availability of credit will be restricted. Numerous empirical studies have demonstrated this result (see Staten and Johnson [1995]). Restricting availability of payday advance credit in this way would not ensure that consumers get credit from another source or at a lower price, however. Most economists would recommend allowing market competition to determine the price of payday advance credit. Economic theory demonstrates that competitive markets tend to produce the lowest price consistent with the cost of production.

This monograph examines the latter three concerns. The survey of payday advance customers conducted for this study provides evidence on (1) payday advance customers' awareness of finance charges and annual percentage rates; (2) the frequency of renewals, duration of payday advance sequences, and availability of alternative sources of credit; and (3) customers' experiences with past due payday advances. The survey evidence allows an assessment of the extent to which problems arise in the latter three areas.

CHAPTER 2

ANALYZING THE BENEFITS AND COSTS OF A PAYDAY ADVANCE TRANSACTION

The payday advance transaction clearly is a consumer credit transaction. As such, standard economic models are applicable for analysis of payday advance use. The short term to maturity, the use of a postdated check, or the relatively high finance charge do not fundamentally change the method of analysis.

Analytical Model for Consumer Credit Use

Juster and Shay [1964] developed the basic theoretical economic model of consumer credit use. Consumer credit is typically used to finance the purchase of household durable goods, which provide a return in the form of a stream of services over a period of time. The economic value of the stream of services, Juster and Shay argued, can be measured in terms of the cost of purchasing those services in the market. For example, the value of the services of a washing machine could be measured by the cost of obtaining the services in a laundromat, or the services of an automobile could be measured by the cost of using public transport. Even the services of durables such as a television or video recorder can be valued in such a way. The value of services of a television, for example, could be measured by the cost of going to the cinema, a concert, or other entertainment activities that would be undertaken if television were not available. Empirical research suggests that even with conservative assumptions about usage, the rates of return on household durables can be quite high (Poapst and Walters [1964]; Dunkelberg and Stephenson [1975]).

Viewing the purchase of a durable as an investment, the consumer compares the purchase price of the durable with the present value of the services it provides. To determine the appropriate discount rate for computing the present value of the stream of services, Juster and Shay turned to the consumption/investment choice model developed by Fisher [1930] and extended by Hirschleifer [1958]. The model determines the most highly valued inter-temporal pattern of consumption that an individual can achieve given his income stream and investment opportunities and market rates for borrowing and lending. At the optimum point, the rate of return on investment is equated with the appropriate discount rate. This discount rate can be the borrowing rate, the rate of time preference, or the lending rate. The model shows the conditions under which borrowing at high rates may be optimal. These conditions are characterized by relatively high-return investment opportunities, low current income, and preferences for current consumption.

Juster and Shay used this framework to analyze consumer credit markets. Normally, consumer credit is repaid out of future income. Most consumers do not have sufficient liquid assets to repay debts. To reduce default risk, creditors typically require borrowers to build equity in the durable being financed. The equity requirement reduces default risk by making default more costly to the borrower. This requirement may also affect the cost of financing the durable because building equity forces the borrower to forgo current consumption. Borrowers not wishing to forgo current consumption can sometimes obtain additional credit by using unsecured personal credit, but this credit is riskier and therefore more costly than other forms of credit. For

many consumers, additional unsecured personal credit is available only from specialized high-risk creditors at a substantially higher cost.

Juster and Shay referred to borrowers who were constrained by creditors' equity requirements as "rationed" and borrowers who were not constrained as "unrationed." They hypothesized that rationed borrowers would be in early family life-cycle stages, in which rates of return on household investments would be high. These borrowers would also have relatively low or moderate income, which would make sacrifices in current consumption to satisfy equity requirements costly. Rationed borrowers would have relatively low levels of savings, making use of liquid assets to pay for household investment costly to them. According to the theoretical model, rationed borrowers' demand for credit would be unresponsive to increases in annual percentage rates because returns on household investment are high, and the alternatives to credit are more costly. Unrationed borrowers, in contrast, typically would be in later family life-cycle stages or have relatively high incomes. These borrowers would have relatively few high-return household investment opportunities and would have discretionary income to pay for household durables[11]. Their age and income allow unrationed borrowers to have relatively high levels of savings. Thus, using liquid assets to purchase durables would not be especially costly to unrationed borrowers. The model predicts that unrationed borrowers' demand for credit would be sensitive to annual percentage rates.[12]

Consumer credit markets have changed considerably since Juster and Shay's study. Advances in information and technology have improved creditors' ability to assess risk. Equity requirements have been relaxed, as terms to maturity have lengthened for most closed-end instalment credit. Another consequence of these advances is the growth in availability of unsecured credit through bank credit cards. Today many borrowers use bank cards in much the same way as Juster and Shay described earlier borrowers using unsecured personal loans (see Bizer and DeMarzo [1992]; Brito and Hartley [1995]). A subprime credit card market has developed specifically to serve such borrowers. Still, many consumers do not have bank credit cards, and market innovations have developed to provide credit to rationed borrowers. The emergence of the modern payday advance industry is one such development.

Analysis of the Payday Advance Transaction

A decision to use a payday advance should be evaluated like any other credit transaction. The investment outlay is the expenditure financed by the payday advance. The income from the investment is the expense saved by making the investment. The interest rate for the payday advance is the discount rate for computing the net present value calculation. Use of a payday advance is advantageous if the net present value of the transaction is positive.

[11] For example, the return a consumer places on purchasing his only television set would likely be higher than for purchasing a big-screen television or the household's third set.

[12] Empirical evidence from experimental data generally supported the predictions of the theoretical model. See Juster and Shay [1964].

Consider, for example, a consumer who needs $100 immediately to pay a $50 utility bill and a $50 minimum payment on a credit card. Assume he cannot cut $100 of other expenses between now and the time of his next paycheck. Making late payments might cost $35 in total, a $5 late fee to the utility company and a $30 late fee to the credit card company. Costs not considered in this example include the record of late payments in the consumer's credit history or the inconvenience caused by having one's electric or water shut-off by the utility for nonpayment. With a payday advance fee of $15 per $100 advanced, the finance charge is $15. The periodic rate is 15.00%, which corresponds to a 390.00% annual percentage rate for a two-week advance.

Table 2-1 summarizes the cash flows associated with this example. The consumer receives a $100 payday advance and immediately pays the bills (the -$100 investment outlay on day 0. The consumer redeems the payday advance check for $115 (the amount advanced plus the finance charge) on day 14. The payday advance saves $35 in late fees and payment of the $100 bill payments that would have been made on day 14 in the absence of an advance.

2-1 Cash flows for avoiding late payments
(Dollars)

	Day 0	Day 14
Investment	–100.00	135.00
Loan (payday advance)	100.00	– 115.00

The net present value (*NPV*) for taking out a payday advance to avoid late payments is calculated using the investment cash flows as follows:

$$NPV = I + \frac{S}{1+d} = -\$100 + \frac{\$135}{1.1500} = \$17.39$$

where I is the investment outlay (the expenditure financed by the payday advance), S is the income from the next pay check including savings in expenses, and d is the periodic discount rate. The cost of the payday advance is accounted for by the discount rate. Inclusion of the $15 interest payment would result in double counting. The $17.39 net present value indicates that using a cash advance to make timely payments would be less costly than making late payments.[13]

Consider another example involving the repair of an automobile. The consumer needs $200 to repair an automobile but does not have the cash to pay for the repair. He could delay the repair two weeks until the next payday and use public transportation, or he could obtain a payday advance and have the repair done immediately. To simplify the computations, it is assumed the consumer would use the automobile only for commuting between his home and work for two weeks, beginning on a Wednesday. He borrows the payday advance on a Tuesday evening after work and will pay it back with a fee exactly two weeks later. Further assume the consumer does not use the automobile on the weekends. The net cost of taking public transportation to work is

[13] Note that $17.39 is the present value of the $20.00 net cash flow or savings in table 2.1.

$4.56 per day, which includes bus and subway fares of $3.50 each way; a savings of $3.72 in costs each way for fuel, maintenance, and depreciation of his automobile, and a $2.50 opportunity cost for an additional 15 minutes commuting time each way.[14] Table 2-2 summarizes the daily costs for the consumer of public transportation versus driving a personal car.

2-2 Daily costs

Daily cost of public transportation	
Bus and subway fare (2 × $3.50)	$7.00
Less: Savings of fuel, maintenance, and depreciation on automobile (2 × 12 miles × $0.31 per mile)	$7.44
Plus: Opportunity cost for additional commuting time (2 × 0.25 hours × $10 per hour)	$5.00
Equals: Net savings from driving car	**$4.56**

As in the first example, assume a payday advance charge of $15 per $100 advanced. The finance charge for a $200 advance is $30. In this example, the periodic discount rate *d* is a daily rate of 1.07% (390.00% ÷ 365). The net present value is the total of the discounted cash flows in table 2-3.[15] The net present value of the transaction is $14.55, which indicates that using a cash advance to repair the automobile now would be less costly than waiting until the next payday.[16]

---

[14] Public transport fares are based on the cost of commuting from a Washington, DC suburb to the District during rush hour. The $3.50 fare is for a bus and transfer to the subway. The distance between the consumer's residence and work is 12 miles. Automobile expenses are based on the federal government reimbursement rate of $0.31 per mile for travel by private automobile. Parking is assumed to be provided by the employer. The wage rate for computing opportunity cost is $10 per hour. One could think of the opportunity cost as the constraint of working 30 minutes less each day due to the longer bus ride.

[15] The equation for computing the net present value is

$$NPV = I + \sum_{t=1}^{14} \frac{S_t}{(1+d)^t}$$

[16] The conclusion would not change if the finance charge were much greater. For example, if the borrower paid a $20 fee per $100 (a 520% annual percentage rate), the net present value is still positive at $5.38.

2-3 Cash flows for $200 automobile repair
(Dollars)

	Day	Net cash flows	Discounted cash flows
0	Tuesday	- 200.00	-200.00
1	Wednesday	4.56	4.51
2	Thursday	4.56	4.46
3	Friday	4.56	4.42
4	Saturday	0	0
5	Sunday	0	0
6	Monday	4.56	4.28
7	Tuesday	4.56	4.23
8	Wednesday	4.56	4.19
9	Thursday	4.56	4.14
10	Friday	4.56	4.10
11	Saturday	0	0
12	Sunday	0	0
13	Monday	4.56	3.97
14	Tuesday	204.56	176.24
Total		**45.60**	**14.55**

Other assumptions might lead to different decisions. If the cost of repairing the automobile were $400 instead of $200, the net present value of obtaining a payday advance to finance the repair would be -$13.14. Since this result is negative, use of a payday advance would be detrimental. Under these assumptions, financing the automobile repair using a payday advance would be more expensive than using public transport to commute to work until the consumer receives funds from his next check to pay for the repair.

These examples are hypothetical, of course. Benefits and costs will differ from case to case. Other examples clearly are conceivable. It is difficult to generalize when numerous transaction-specific calculations are possible. Nevertheless, concluding that there are cases in which consumers' savings could exceed the cost of a payday advance seems entirely reasonable.[17]

Calculations such as those discussed above are sufficient to make decisions if the consumer has no alternative but to delay expenditures until the next payday. In some cases, however, consumers may have alternative sources for short-term borrowing.

[17] These examples do not include non-pecuniary benefits, such as avoiding the risk of writing a bad check, maintaining a record of timely payments, or enjoying the comfort of commuting in one's own automobile. Non-pecuniary benefits may have value to the consumer. In principle, this value could be included in a net present value calculation.

Evaluating Availability of Alternatives

Consumers with alternative sources for short-term borrowing should evaluate these sources in the same way that they evaluate the payday advance transaction–comparing the investment outlay with the present value of savings, using the cost of source for the discount rate in the present value calculation. In evaluating alternative sources for financing, one needs to consider a few characteristics of consumers' financial behavior that may cause the nominal and subjective costs of alternatives to diverge. These characteristics involve the precautionary motive for saving and the use of financial contracts to enforce budgetary discipline.

First, subjective yields on liquid asset holdings tend to be high because precautionary motives for saving are strong. Many consumers use liquid assets grudgingly even when events occur that impair their earning potential or require large expenditures. Their reluctance to use liquid assets stems from a belief that the worse the current situation, the greater is the need to maintain reserves for future emergencies (Katona [1975]).[18] As a consequence, subjective yields on liquid assets are often substantially greater than nominal yields. This characteristic of consumers' financial behavior may explain consumers' simultaneous holding of consumer debt and relatively large amounts of liquid assets. The weighted average annual percentage rate on the outstanding consumer credit is greater than the nominal yield but less than the subjective yield on the liquid assets. Since consumers who have personal loans from finance companies or credit card debt also hold liquid assets, the subjective yield on liquid assets is likely to be quite high for some consumers.

Second, consumers may use consumer credit rather than draw against their liquid assets because they believe that they do not have the discipline to replenish the depleted assets.[19] The credit contract forces the borrower to budget his money, saving via the debt repayment rather than fritter future income on the numerous goods and services that are available in the market. This practice is costly, but there is considerable evidence that many consumers are willing to pay to be protected against their own bad habits (Juster and Shay [1964]; Katona [1975]). Consumers have also used other types of contractual arrangements–for example, whole life insurance, lay-away plans, and Christmas club accounts–to force themselves to budget their money. It seems likely some consumers use payday advance credit to perform a similar mandatory budgeting service.

Third, considerations that affect consumers' use of liquid assets may influence their use of credit cards. Unused credit limits on credit cards are an asset against which some consumers

[18] Consumers' response to accelerating inflation provides an example of the strength of consumers' precautionary motive for saving. With the recognition of the accelerating inflation, consumers added to their liquid assets, even though the yields available to them on savings were less than the rate of inflation. In making their decisions the uncertainty associated with inflationary economy outweighed the loss in value of their assets. See Katona [1973].

[19] Closed-end credit imposes greater discipline than open-end credit because closed-end credit provides a fixed schedule for repayment and does not allow further extensions of debt. As noted below, some consumers are reluctant to use open-end credit because they believe they do not have the discipline to repay the debt.

may be reluctant to borrow.[20] Recent evidence suggests that consumers maintain target levels of unused credit limits (Gross and Souleles [2000]; Bird and Hagstrom [2000]). One interpretation for this behavior is that consumers hold some precautionary assets in the form of unused credit limits. The subjective cost of borrowing beyond the target levels would be greater than the nominal interest rate. In addition, some consumers may be reluctant to increase credit card debt because they fear that they will not have the discipline to make payments on the additional debt (Katona [1975]). Using payday advances as a contractual obligation to enforce budgetary discipline may be costly, but perhaps less costly than the exposure of increased vulnerability to higher debt levels over the long run.

[20] Most consumers recognize the value of a credit card for an emergency. Anyone having experienced a car breakdown or a medical emergency on a trip knows it can be extremely difficult to acquire the needed service without one.

CHAPTER 3

SURVEY OF PAYDAY ADVANCE CUSTOMERS

Information on consumer's use of payday advance credit has been limited mainly to anecdotes and individual companies' marketing studies. Broadly, representative data have been largely unavailable. PricewaterhouseCoopers [2001] surveyed payday advance companies to obtain primarily transactional data but also limited information on customers' demographic characteristics. The data on customer demographics were very limited because few items are collected on a consistent basis across companies.

Many questions about payday advance customers cannot be answered with data from company records. The number of times in a year a consumer uses payday advances from all companies, the availability of alternatives for short-term borrowing, or his understanding of payday advance terms, for example, can only be obtained from consumer surveys. Such information is crucial for understanding consumers' decisions to use payday advances. Understanding consumers' decisions is important for payday advance companies in designing products to meet the needs of their customers and for public policy makers in choosing appropriate regulatory policies.

The lack of comprehensive information about consumers' decisions to use payday advances motivated the survey of payday advance borrowers conducted for this study. This chapter discusses the objectives, target population, and the methodology of the survey.

Survey Objectives

Over and over, policy discussions of the payday advance industry have raised several fundamental issues about consumers' use of payday advances that could not adequately be addressed with existing data. The issues ultimately involve consumers' decision-making processes. The issues include

- What circumstances lead consumers to take out payday advances?
- Are payday advance customers aware of the cost and terms of the product?
- What alternatives do payday advance customers have for obtaining short-term credit?
- To what extent do payday advance customers shop among different sources for short-term credit? Why do they choose payday advances over other sources of credit?
- Do payday advance customers use payday advances for relatively short periods of time, or do they have payday advances outstanding over a large part of the year?
- To what extent are consumers satisfied with their experiences with payday advance credit?
- When problems do occur, what are the reasons for problems, and how are they resolved?

These issues underlie the development of the questionnaire. Where possible, questions were borrowed from other financial surveys (the Federal Reserve Board's Survey of Consumer Finances and the Survey Research Center's Survey of Consumer Attitudes) to facilitate comparison of payday advance customers with the general population. The questionnaire is provided in appendix B.

Target Population

The target population for the survey is recent customers of companies belonging to the industry trade association, the Community Financial Services Association of America (CFSA). As mentioned in chapter 1, the association has over 60 member companies operating approximately 5,000 offices, which is about half of the 10,000 estimated offices providing similar short-term loans nationwide. A sample based on this target population is representative only of customers of CFSA-member companies. It is not necessarily representative of all payday advance customers. Nevertheless, this target population was chosen because options for sampling from the population of all payday advance customers were prohibitively expensive or had other significant disadvantages.

One option for selecting a nationally representative sample would be to draw a random sample of households with telephones and screen household members for use of payday advances. The advantage of this option is that the sample would be representative of all payday advance customers, not just customers of CFSA-member firms. The disadvantage of this option is that it would be very expensive because of the low frequency of payday advance use in the general population.[21]

A second option for selecting a nationally representative sample would be to draw a random or systematic sample of customers from the files of all payday advance companies. This option would substantially reduce the number of consumers who must be sampled in order to obtain a target sample size. In principle, this option would be representative of all payday advance customers. However, there are practical difficulties. No comprehensive list of payday advance companies exists. Constructing a list from files maintained by state licensing agencies would be time consuming and probably incomplete, since states do not license payday advance companies uniformly. Moreover, even if an adequate list could be constructed, companies may not be willing to participate. Significant refusal of companies to participate would undermine the overall representativeness of the sample, which is the principle advantage of this option.

Selecting a sample of customers of CFSA-member companies has several advantages. A list of member companies exists, and the association was willing to make considerable effort to encourage member companies to cooperate. Thus, coverage of the target population was likely to be good. While not necessarily representative of the population of all payday advance customers, this target population comprises the majority of payday advance customers. It is possible that customers of CFSA-member companies may have different experiences than customers of nonmember companies. For example, because the association's "Best Practices" may set higher standards of conduct for members, customers of member companies may have fewer problems and express greater satisfaction than customers of nonmember companies. Still, findings from the CFSA-member company sample are useful because they reflect experiences and knowledge of customers of companies adhering to a specific set of standards. And to the

[21] Results of a proprietary marketing study conducted for a major payday advance company suggest less than 10%, perhaps much less, of screened households have ever used payday advances.

extent that state laws coincide with the association's "Best Practices," the findings of this survey may be more broadly representative than the CFSA-member base.[22]

Methodology

The survey was designed as a 15-minute telephone survey of approximately 500 payday advance customers of CFSA-member companies. The sample design, sample selection, and interviewing was performed by Market Facts, a national market research firm.

Sample Design and Selection

The sample was drawn from CFSA-member companies. A two-stage proportionate sample design was used to ensure appropriate representation by large, mid-sized, and small companies. Size was determined by number of retail offices operated by each company. The original 19 companies were selected with a probability proportionate to the number of offices. Each selected company then submitted a listing of all its offices. The appropriate number of offices, proportionate with the company's size, was randomly selected from within each organization. These selected offices, 78 in total, then submitted a list with names, addresses, and phone numbers of all individuals who had taken out a payday advance during the past six months. Seventy customers from each office were randomly selected for participation in the survey, yielding an initial sample size of 5,460.

To manage the sample and reduce response bias, ten equal replicates of 546 customer listings were formed. Each replicate served as a microcosm of the universe. Each included seven randomly selected customers from the 78 offices. As interviewing progressed, the replicates would be gradually released. Up to two attempts per day and at least nine attempts in total were planned for each phone number. The goal was to maximize the number of attempts on one replicate before proceeding to the next replicate.

Prior to interviewing, a search program identified duplicate phone numbers within and across replicates, uncovering 96 in total. In some cases, two or more adults from the same household had applied for a payday advance. In other cases, one individual had applied for an advance at two different companies. For duplicate phone numbers, one listing was eliminated, leaving a final sample of 5,364 eligible customers.

Interviewing

The survey was conducted between December 28, 2000 and January 9, 2001. Of the 5,430 sampled customers, 1,274 customers (23.8%) could not be contacted because the telephone number was not valid (table 3-1). A total of 1,894 customers (35.3% of sampled customers) were not available during the interview period, mostly because the customer was not at home when called during the 12-day period over which interviews were conducted. Interviewing during the holiday season and the very short interview period contributed to the large number of

[22] Some of the association's standards are requirements of state payday advance laws. See discussion of the regulatory environment for payday advance credit in chapter 1.

customers not available. Interviews were attempted for 2,196 (40.9%) of the 5,364 sampled customers.

3-1 Survey Response
(Number of sampled customers)

Number not valid	
Disconnected number	1,113
Business or wrong number	161
Subtotal	**1,274**
Not available for interviewing during interview period	
Not at home	1,451
Appointment scheduled	130
Communication difficulty	122
No answer, busy, answering machine, fax, modem	191
Subtotal	**1,894**
Interview attempted	
Completed interview	427
Payday advance not acknowledged	726
Quit interview	185
Refused interview	858
Subtotal	**2,196**
Total	**5,364**

Of customers with whom interviews were attempted, 427 (19.9%) completed interviews. Once interviewing began, some customers quit interviews. Most respondents quitting interviews quit in the first few questions asking about use of specific types of credit in the last year. By far the largest group of customers quitting early (726, or 33.1% of those with whom interviews were attempted) did so by not acknowledging they had used payday advances in the last year. It is likely that these customers were unwilling to answer financial questions and answered "no" to avoid further questions of this nature.[23] Finally, 858 customers (39.1% of those with whom interviews were attempted) refused to be interviewed. The number of refusals likely is higher than it ordinarily would be because of the short interview period. Had time permitted, refusals

[23] A subsample of those refusing to acknowledge use of payday advance credit was asked about use of selected types of credit, income, and demographic characteristics. The percentage of these consumers acknowledging use of mortgage credit was about the same as that for respondents, but percentages acknowledging use of other types of credit or reporting income were considerably less than those for respondents. Refusals to questions about demographic characteristics were negligible, however, and distributions of these customers' demographic characteristics were quite similar to those of respondents.

would have been recontacted by interviewers specialized in converting refusals. It is likely some would have responded in the end.

For customers who completed interviews, the quality of responses was very good. These customers provided answers for virtually all factual questions.[24] Reported values were generally reasonable, and missing values were inconsequential to the analyses.

[24] "Don't know" responses were considered acceptable for questions about attitudes and awareness of the price of payday advance credit.

CHAPTER 4

FRAMEWORK FOR ANALYSIS

The standard economic analysis of consumer behavior focuses on the outcome of decisions. This analysis uses a utility optimization model together with data on product choices, prices, consumer income, and perhaps consumers' demographic characteristics to estimate the responsiveness of decisions to differences in prices and income. Such analyses have been highly successful in predicting outcomes, but they often provide little insight on the decision process.

To understand the consumer decision processes, many researchers have used buyer-behavior models, which are based on research in marketing and psychology (Engel, Blackwell, and Miniard [1997]). The acquisition, understanding, and use of information play important roles in this process.[25] Thus, this framework is a useful supplement to the standard economic model for analysis of payday advance use since customers' awareness of costs, comprehension of the product, and consideration of alternatives are important concerns.

The Buyer-Behavior Model

The buyer-behavior model views the consumer's decision as a process occurring over several stages: problem recognition, internal and external search, alternative evaluation, purchase, and outcome evaluation. These stages are interrelated, with feedback occurring throughout the process. Developments occurring during each stage may cause the process to stop, move to the next stage, or proceed immediately to the purchase. Consideration of this process suggests several hypotheses about the ways in which consumers use payday advances.

Problem Recognition

The decision process begins with problem recognition. For example, a consumer foresees a shortfall of cash before he receives his next paycheck. He perceives the problem to be sufficiently serious to warrant further action and is not aware of any external constraints that preclude further action. The consumer might view the cash shortage as potentially costly in out-of-pocket expenses (such as fees or late payments or overdrawing a checking account) or delay in obtaining a product or service (such as delaying the repair of an automobile used to drive to work). An external constraint might be a belief by the consumer that he would be unable to arrange a loan soon enough to avoid the problem.

---

[25] For this reason, the buyer-behavior model has provided an especially useful framework for assessing regulatory policies in the consumer credit area, many of which address perceived information difficulties faced by consumers (for example, see Day and Brandt [1973], or more recently, Durkin and Elliehausen [2001]).

Internal Search

Once the consumer recognizes the problem and perceives no external constraints, he must then assess the alternatives for action. The assessment begins with a search of stored information and experience. Relying on past experiences, the consumer uses existing attitudes to identify and evaluate alternative solutions to the problem. One of three outcomes is likely. First, if the past experiences produced satisfactory results, the consumer may forgo external search and proceed to the purchase stage. In the cash shortage example, a consumer who previously used payday advances and was satisfied with the experience might decide to obtain another payday advance without further search. Second, if the internal search leads the consumer to believe the problem cannot be solved, the decision process may stop. For example, a consumer whose credit applications have previously been turned down may take no further action because he believes he cannot obtain credit. Third, if a consumer decides that he needs further information, he may search externally. For example, a consumer may recall having seen an advertisement by a cash advance company and decide to call or visit the company.

External Search and Alternative Evaluation

In this stage of the decision-making process, the consumer uses various sources of external information, such as the mass media (e.g., newspapers and magazines), personal sources (e.g., friends and relatives), and seller-dominated sources (e.g., advertisements and store visits). Before undertaking external search, the consumer may have little or no awareness of the characteristics of available brands or the advantages and limitations of the brands. The consumer may not even know appropriate criteria to use in evaluating alternatives.[26] External search will continue until the consumer believes he has enough information to make a purchase decision.

Consumers differ in their willingness to search. Personal characteristics, attitudes, and previous experience influence willingness to search. Some consumers are cautious and will search for additional information even when they already have considerable knowledge about alternatives. Other consumers may dislike shopping and will not search very much even if they risk paying too much or not obtaining the preferred set of product characteristics.

No matter how disposed a consumer is toward shopping, the willingness to search is limited. Search requires time and energy. At some point, the time and energy required for further search outweigh any expected gains from additional information. The consumer is then ready to make a purchase decision.

Purchase and Outcome Evaluation

The purchase decision involves choosing whether or not to acquire the good or service and choosing the variety (i.e., the specific set of characteristics) and supplier. The decision

---

[26] Evaluative criteria are the product characteristics that the consumer deems to be important in his choice of alternatives. Evaluative criteria are shaped by personality and by stored information and experience. Obviously, a consumer must have some knowledge of the class of alternatives before specifying those characteristics that are important in decision making.

process does not necessarily end with the purchase, however. Consumers may continue to process information to evaluate their decisions. An evaluation of the outcome is especially likely when the decision process has been extended. Satisfaction with the purchase decision serves to reinforce existing attitudes and the evaluative criteria upon which they are based. Obviously, satisfaction tends to encourage repeat purchases. Dissatisfaction can lead to revisions in attitudes and a reevaluation of evaluative criteria. In this case, the consumer learns from experience and avoids similar mistakes in the future.

Information Processing in the Buyer-Behavior Model

Information processing occurs through a psychological command center, which includes both memory and the basic facilities for thinking and directing behavior. The components of the command center necessary for understanding behavior are the information and experience stored in memory, the criteria by which alternative choices are evaluated, and attitudes toward alternatives. Each component is affected by personality. These variables interact to form a filter through which incoming information is processed. The filter plays a critical role in information processing. First, the filter greatly limits the amount of information that comes to the consumer's attention. The filter also may attenuate or distort information to be more consistent with the consumer's attitudes. Finally, the filter limits the amount of information that is retained in memory.

The operation of the filter has important consequences for the evaluation of payday advance use. The consumer must first become aware of the information. The creditor must provide easy access to information, but awareness also depends on the consumer's attitudes and evaluative criteria. A consumer may not become aware of some product characteristics if the characteristics are not important to him. He may focus only on the characteristics that are important to him, especially if the product has many characteristics. Most payday advance customers are likely to be aware of payday advance characteristics because it is a fairly simple product.

A consumer may be aware of information but not comprehend the information correctly. It is common for information to be attenuated and distorted to be consistent with the individual's own attitudes and experiences. For example, add-on interest rates rather than actuarial rates were commonly disclosed before Truth in Lending. In studies of consumer responses to Truth in Lending shortly after the law became effective, many borrowers recalling annual percentage rates appeared to understand the annual percentage rate as an add-on rate (e.g., Shay and Schober [1973]; Brandt, Day and Deutscher [1975]). This understanding probably reflected consumers' familiarly with add-on rates at that time.[27] Considering that payday advance costs are often expressed as a dollar amount per $100 borrowed and that cost comparisons are typically made using finance charges, it would not be surprising to find interest rates for payday advances to be understood as add-on rates, despite required disclosure of annual percentage rates.

[27] More recently, Durkin and Elliehausen [2001] reported that borrowers still do not understand the relationship between the annual percentage rate and finance charge. However, far fewer responses suggest that the borrowers understand the annual percentage rate as an add-on rate. One explanation for this decline is that consumers are no longer familiar with add-on rates because creditors no longer quote add-on rates.

Not all information that is processed is retained in memory. Memory is limited, so the amount of information finally stored will be less than the initial set. Consumers tend to retain the information that is consistent with their attitudes and experience. First-time customers of a product might collect more information than previous customers because they do not know what information is important. New customers will tend to retain the information that is consistent with their experiences. Inconsistent information is irrelevant and will tend to be forgotten. Thus, new borrowers sometimes appear to be better informed than more experienced borrowers.

Determinants of the Extent of the Decision Process

Empirical evidence on consumer behavior suggests several different types of factors that may affect the extent of the decision process. They are situational factors, product characteristics, consumer characteristics, and environmental factors. These types of factors suggest different hypotheses about the extent of the decision process for payday advances.

Situational Factors

Previous research has found several situations in which extended decision processes are likely. Among the situations are ones in which

- The consumer has little or no relevant experience because a consumer has never purchased the product.
- The consumer has no past experience because the product is new.
- Past experience is obsolete because the product is purchased infrequently.
- The purchase is considered discretionary rather than necessary.

These situational factors suggest a few hypotheses about payday advance customers. New payday advance customers may be more likely than long-time customers to consider other sources for short-term credit. Infrequent payday advance customers may be more likely than frequent payday advance customers to consider other sources. And customers using payday advances for planned expenses may be more likely to consider other sources than customers using payday advances for unexpected expenses.

Product Characteristics

There are several product characteristics that are associated with extended decision processes.

- Products that commit the consumer for a long period of time.
- Products that are high priced relative to the consumer's income.
- Products having substitutes with both desirable and undesirable characteristics relative to the product.

For most consumers, the term to maturity and the cost of payday advances probably would not motivate extended decision processes. The effect of consumers' evaluations of substitutes on the

decision process is unclear in many cases. Some payday advance customers, however, will have few alternatives making the possibility of an extended decision process unlikely.

Consumer Characteristics

Evidence indicates that many socio-economic characteristics of consumers are correlated with the extent of the decision process. Some of the characteristics probably reflect cognitive ability and the opportunity cost associated with search. Others may reflect experience or attitudes. Decision processes are more likely to be extended than limited when

- The consumer has a college education.
- The consumer has moderate rather than high or low income.
- The consumer is under 35 years old.
- The consumer enjoys shopping.
- The consumer perceives no urgent or immediate need for the product.

Profiles of payday advance customers in the existing literature indicate that payday advance customers tend to belong to the middle class (Community Financial Services Association [2000]). As such, their socio-economic characteristics would suggest they would not fall in especially extended or limited decision-process groups. However, considering the situations in which payday advances are used, payday advance customers are likely to perceive an immediate need for the product. This characteristic, which is associated with limited decision processes, is likely to dominate other customer characteristics.

Environmental Factors

Environmental factors include family and cultural influences. An extended decision process may be stimulated by differences between a consumer's attitudes and those of his family or one of his reference groups. Thus, consideration of personal characteristics may be justified, even if the characteristics' effects on the decision process cannot always be predicted.