Does Increasing Formal Credit Access Reduce Payday Borrowing?

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Why We Care

- Use of high-interest payday loans has generated substantial concern among policymakers.
  - Borrowers are more likely to be credit constrained and have poor access to traditional credit (Bhutta et al. 2015).
  - Regulators have urged banks to loan to riskier, subprime borrowers.
- However, will increasing formal credit access reduce payday borrowing?
  - Studies find borrowers turn to payday loans as a needed source of alternative financing (Morse, 2011; Zinman, 2010).
  - Studies also find borrowers use payday loans even with substantial credit card liquidity (Agarwal et al. 2009; Pagel and Olaffson, 2018)

What We Do

Empirical Challenge:

- Payday loans are not reported on standard credit reports.
- Credit profiles likely vary with unobservable characteristics.

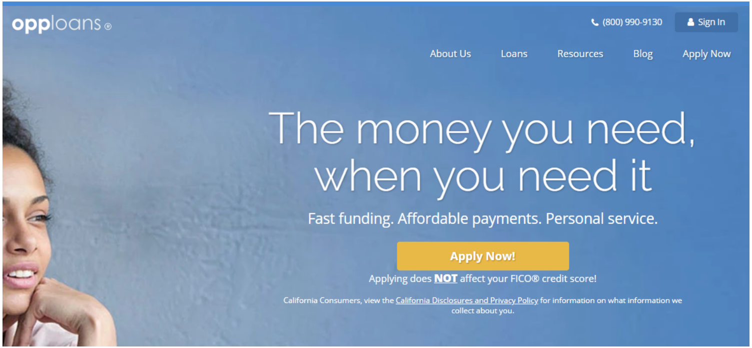
Our Approach:

- Link alternative credit panel with standard credit reports
- Exploit bankruptcy flag removals as unexpected positive ”shock” to mainstream credit access.
- Provide first direct evidence whether of improved credit access affects payday borrowing.

Outline

Background and Credit Panel

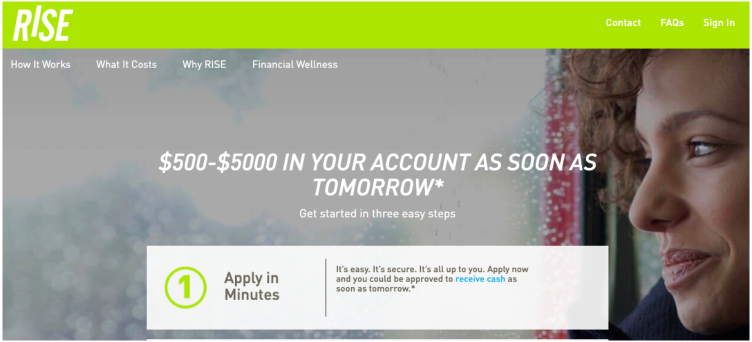
Payday Loans



- Uncollateralized short-term, single payment loans where repayment coincides with next payday (2 to 4 weeks), often auto-renewing.

- Loan amounts range $50 to $300, fees ranging from $10 to $20 per $100 borrowed

High-Risk Installment Loans



- Larger loan amounts ranging from $500 to $5000
- Used by some lenders to get around state payday regulations.

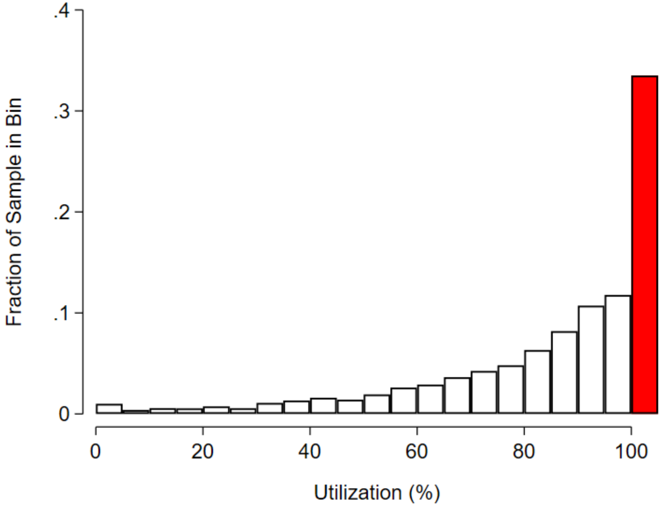
Linked Credit Panel

- Main credit bureaus do not track alternative credit options such as payday loans.
- *Clarity Services* is a credit reporting agency that specializes in providing underwriting for subprime loans.
  - Covers 70 percent of subprime borrowers in the U.S., but may not cover all subprime products used by each borrower.
  - 1 million random sample from 2013 to 2017
  - Link sample with standard credit bureau reports
  - Restrict sample to those with Chapter 7 flag removals (N=30,246)
- Fair Credit Reporting Act requires the removal of Chapter 7 bankruptcy flags from report after 10 years

Related Literature

- Bankruptcy flags have been used to study impact of credit access on labor and mainstream credit market outcomes.
  - Musto (2004), Gross et al. (2018) find both short and long run effects on credit access and use.
  - Dobbie et al. (2020) find zero to negligible effects on employment and earnings.
- It is unclear what the impact of flag removal will be on payday borrowing.
  - Payday loans mitigate credit constraints (Morse, 2011; Bhutta et al. 2014, Elliehausen and Lawrence, 2001).
  - Payday borrowers still take out loans even with substantial credit card liquidity. (Agarwal et al., 2009, Olaffson and Pagel, 2017).

Payday Borrowers are Credit Constrained



Empirical Framework

- Estimate parametric specification:

$$Y_i = \beta_i + \alpha t_{pre} + \gamma_y + \gamma_c + \sum_{\tau=0}^{20} \delta_\tau I(r_{it} = \tau) + \epsilon_i \qquad (1)$$

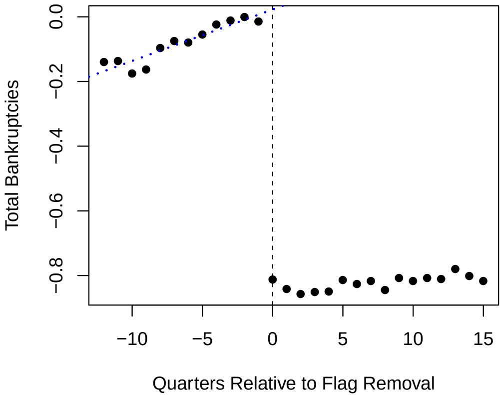
  - where r_{it} indicates quarter since bankruptcy flag removal
  - pre-removal linear trend (α_t)
  - year FE (γ_y), cohort FE (γ_c)
  - other specifications: time FE, individual FE, pre+post linear trends

- Compares outcomes of borrowers who have flag removed with those who have not

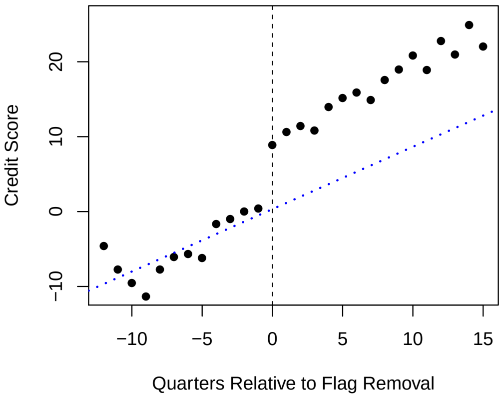
- Assumes shock is unanticipated and pre-removal trend would continue.

Impact on Traditional Credit Access and Use

Impact on Total Bankruptcies and Credit Scores

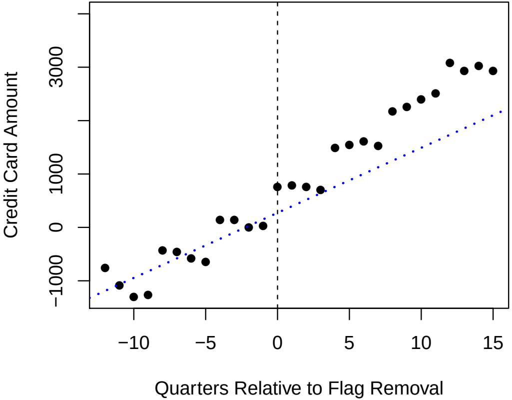


$yr_1 = -0.9^{***}$, $yr_4 = -1.0^{***}$ $\overline{bank}_{pre} = 1.1$

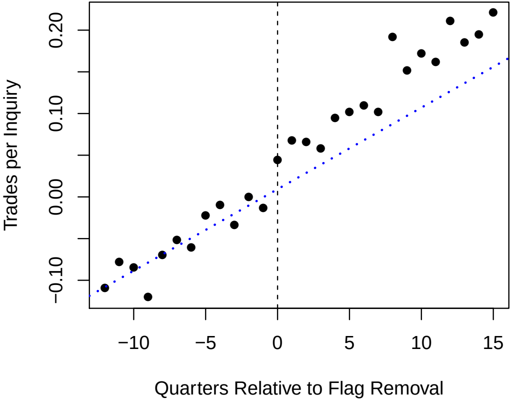


$yr_1 = 7.1^{***}$, $yr_4 = 5.9^{***}$ $\overline{score}_{pre} = 531$

Impact on Credit Limits and Approvals



$yr_1 = 63^{**}$, $yr_4 = 491^{***}$, $\overline{limit}_{pre} = 1977$



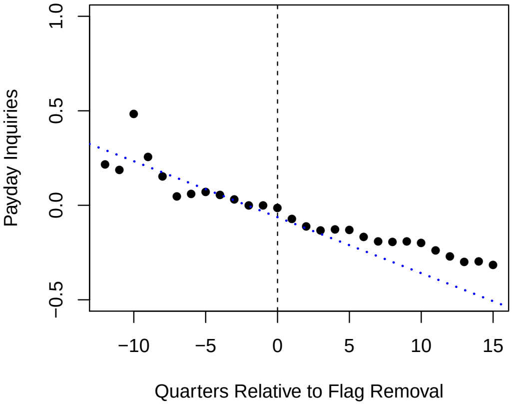
$yr_1 = .03^{***}$, $yr_4 = .05^{**}$, $\overline{approvals}_{pre} = 0.4$

Impact on Traditional Credit Use

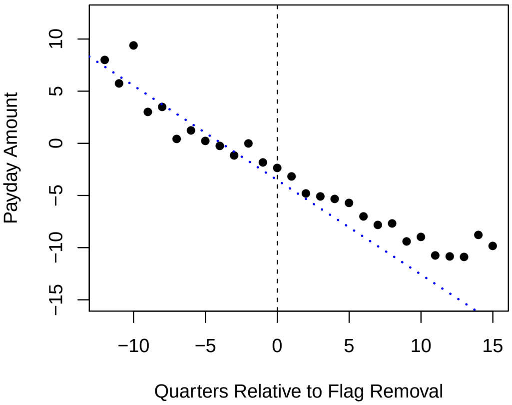
	Year 1 Effect	Year 2 Effect	Year 3 Effect	Year 4 Effect
Credit Inquiries	0.00967***	0.00966*	0.0102	0.0140
	(0.00358)	(0.00510)	(0.00689)	(0.00886)
Credit Card Balance	49.71***	152.4***	258.9***	340.4***
	(18.81)	(32.51)	(47.45)	(64.17)
Utilization	0.194	-0.287	-0.888	-2.129***
	(0.268)	(0.408)	(0.557)	(0.718)
Auto Loans (#)	0.0734***	0.175***	0.226***	0.242***
	(0.00634)	(0.0108)	(0.0162)	(0.0218)
Collections	-299.1***	-503.1***	-728.8***	-817.5***
	(33.17)	(54.68)	(77.05)	(101.8)

Impact on Subprime Borrowing

Impact on Payday Loan Applications and Amounts

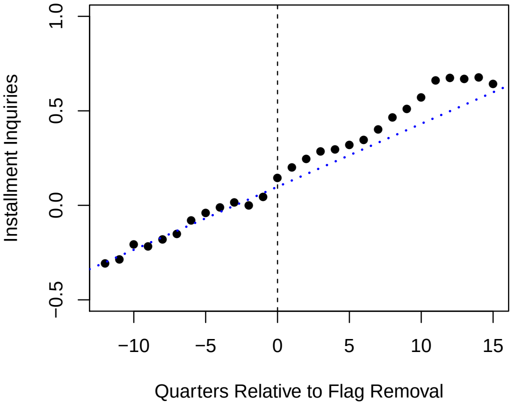


$yr_1 = .02^{***}$, $yr_4 = .14^{***}$, $\overline{paydayapp}_{pre} = 0.5$

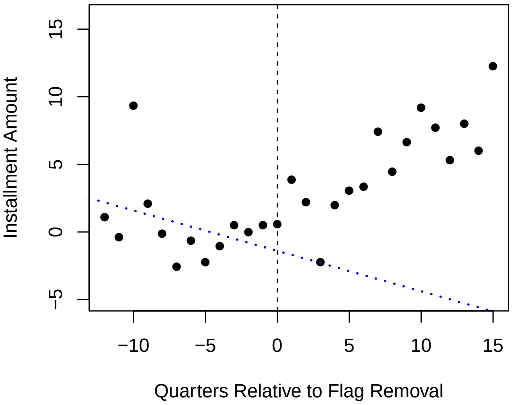


$yr_1 = 0.4$, $yr_4 = 3.5^{*}$, $\overline{paydayamt}_{pre} = 28.6$

Impacts on Installment Loan Applications and Amounts



$yr_1 = .07^{***}$, $yr_4 = .12^{***}$, $\overline{installapp}_{pre} = 0.2$



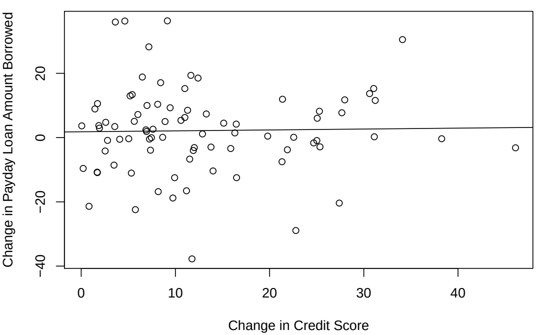
$yr_1 = 1.2$, $yr_4 = 7.9^{***}$, $\overline{installamt}_{pre} = 22.3$

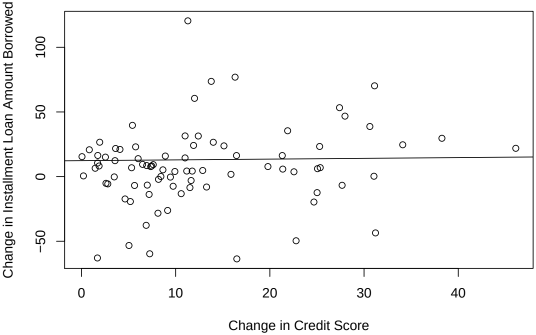
Summary: Subprime Borrowing Does Not Reduce

- We find that a flag removal does not reduce payday loan borrowing, and in fact increases use of some subprime credit products.
    - Our confidence intervals allow us to rule out even very small reductions in payday borrowing.
    - The result is robust to many specifications, alternative sample definitions, and different subgroups.
    - This is true for many alternative formulations of the dependent variable (e.g. any payday or number of loans).
    - This is true also for the number of payday loans, the likelihood of taking out any payday loan, and on the distribution of different loan sizes.

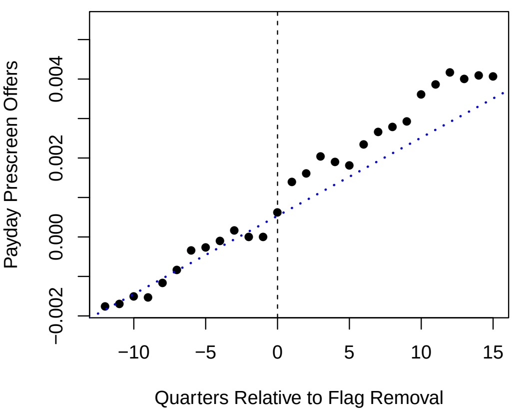
Why Do Subprime Borrowers Not Substitute Towards Traditional Credit?

Credit Score Increase is Just Not Enough

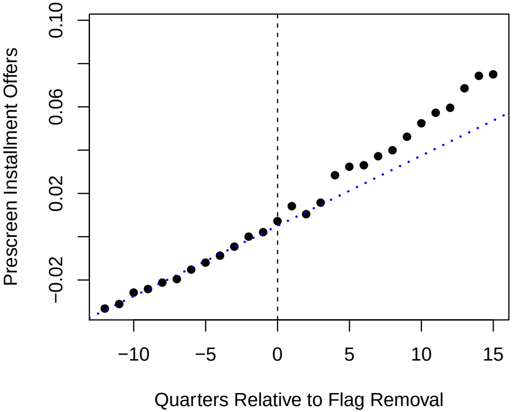




Borrowers Experience Increase in Subprime Marketing



$yr_1 = 0.0^{***}$, $yr_4 = 0.0^{***}$



$yr_1 = 0.0$, $yr_4 = .02^{***}$

Payday Loans Fulfill Alternative Needs Not Met By Credit Cards

- Payday and installment loans provide immediate cash.
  - Distinction between cash and credit card liquidity may be more important for payday borrowers. Rent, child support, informal loans cannot be paid back with credit cards.
- Payday loans do not impact your credit profile.
  - We do observe significant reductions in collections that do impact credit scores post flag-removal.
- Borrowers use payday loans as regular income supplements.
  - Payday loan borrowers (64%) use loans to cover regular expenses such as utilities, groceries, rent, credit card and medical debt (Nuñez et al. 2016).

Conclusion

Takeaways

- We find a positive shock in mainstream credit access does *not* reduce payday borrowing and *increases* borrowing of high-risk installment loans.
- Payday loans and credit cards are not perfect substitutes; any financial solution must address the needs driving payday loan borrowing.
- Surveys suggest reliance on payday loans resides in a chronic inability to cover basic needs.
- Policies aimed at reducing payday loan borrowing may not be successful without simultaneously strengthening social safety nets.