

FDIC on Payday Lending: Do the Costs Justify the Price?

The FDIC's Center for Financial Research released "*Payday Lending: Do the Costs Justify the Price?*" The report finds a strong consumer demand for short-term, small-denomination loans and deduces that payday lenders do not yield extraordinary profits due to their high operating costs. The authors, Mark Flannery and Katherine Samolyk, conclude that the race and demographics of a store location have little effect on store profitability and find that the industry's profitability does not depend on the presence of repeat borrowers.

Noted in the report:

Payday loans fill a consumer need for small-denomination, short-term credit

"Still, to those who would simply outlaw payday loans, we ask, "Where will the people who use the product as intended go to fulfill their financial needs?"

"Customer demand for this product appears to be very strong, and the industry has grown dramatically over the past decade."

"The past decade has seen a significant growth in the provision of alternative financial services (AFS)... Payday advance lending is perhaps the most notorious example of a nonbank credit product: small short-term loans intended to carry a borrower through a temporary cash deficiency."

APRs associated with payday loans are reasonable considering the nature of the loans and high fixed operating costs

"As we have shown, an important reason for high advance fees is that the loans are short term and nonamortizing."

"We find that fixed operating costs and high loan loss rates justify a large part of the high APR charged on payday advance loans."

"Most of the origination cost comes from the fixed costs of having a store location open for many hours per week."

Payday loans do not yield extraordinary profits

"These operating costs are not that out of line with the size of advance fees, a finding that suggests payday loans may not necessarily yield extraordinary profits."

"We also find that new stores generate negative or low profits for a few years before becoming fully profitable."

"The reader must keep in mind that the profitability numbers implied when one looks only at store operating costs quite substantially overstate true store profitability."

Renewals and frequent borrowers do not account for higher profitability

"... We find no evidence that loan rollovers and repeat borrowers affect store profits beyond their proportional contribution to total loan volume. In other words, the industry's profitability does not depend on the presence of repeat ("trapped"?) borrowers per se."

"... We do not find that loan renewals or loans from frequent borrowers are more profitable than other loans per se, although they certainly contribute to a store's loan volume."

“But somewhat surprisingly, high-frequency borrowers do not uniformly increase a store's profitability. Measured as a ratio to average outstanding loans or on a per loan basis, we do not find a significant relationship between a store's proportion of high frequency borrowers and its profitability.”

“The industry's profitability is very sensitive to the volume of advances outstanding at any time, but not specifically to the proportion of those advances that are rollovers.”

Neighborhood race and income demographics have little effect on store profitability

“...When store and portfolio characteristics and borrower use are controlled for, neighborhood race and income demographics seem to have little effect of profitability, although they do slightly influence default losses.”

“Finally, controlling for loan volume, we also do not find that economic and demographic conditions in the neighborhoods where stores are located have much of an effect on profitability, although they do slightly influence default losses.”

“Neighborhood demographics and local economic conditions play almost no systematic role in explaining store operating income ratios for our study sample of stores.”

“The neighborhood demographic and local economic variables provide some interesting effects, but perhaps less than one would expect. The poverty rate in the zip code where a store is located is positively related to losses. Controlling for store and portfolio characteristics, the only significant effect of the minority population variables indicates lower losses in neighborhoods with more Hispanic residents.”

“In terms of relative income, the average store (in all age groups) is located in a zip code that has median income somewhat below (94–98% of) the median income of its broader MSA (or non-MSA region). This is in the range generally considered ‘middle income.’”

Payday loans are comparable to alternative mainstream services if reported as APR

“These APRs substantially exceed the rates associated with mainstream consumer credit products, although some mainstream services (e.g., overdraft protection fees or credit card late payment fees) might translate into similar APRs if providers were required to report such information.”

Payday lenders compete on location, service and price

“...Firms appear to be competing in terms of the convenience of store locations and the provision of customer service.”

“In the payday loan industry, however, geographic convenience seems to be quite important. Price may not be the only—or even the most important—aspect of payday advances, therefore, and the industry will be competing on the basis of geographic locations.”

“Our regressions also indicate that store profitability is very sensitive to the fees charged on advances, but at the same time we observe a relatively tight range of fees charged, concentrated at or slightly below the maximum fee permitted by the state in which the payday loan company is operated.”

Payday loan customers consider the alternatives

“Importantly, a critical dimension of the customer's decision that is less understood is the cost of the alternatives to using the payday advance product and the extent to which the use of alternatives—such as overdraft protection—result in the repeat use, high effective interest rates, or other pernicious effects.”