

Payday Loan Usage, State Law, and Financial Capability

(ACCI 2015 Meeting Oral Session Proposal)

Objective

Payday loans are a high cost loan used mainly by low income consumers. Consumers write a check for a small sum, dated for their next payday, and receive cash, minus the fee (e.g., \$115 check that includes a \$15 fee for a \$100 loan). Consumers using payday and other high cost loans may have a lower level of financial literacy and need government protection assistance (Lusardi & Scheresberg, 2013). Payday loan usage may hurt consumer financial well-being and need attention by government consumer protection agencies (Campbell, Campbell, Jackson, Madrian, & Tufano, 2011). The recently created Consumer Financial Protection Bureau has responsibilities to protect consumers from unfair practices of high-cost loan providers (Kirsch, Mayer, & Silber, 2014). The purpose of this study was to examine effects of payday loan usage and state payday loan laws on consumer financial capability. It was conducted because one of the indicators of financial capability, as defined by the FINRA Investor Education Foundation's National Financial Capability Study (FINRAIEF, 2013), is avoidance of high cost non-bank borrowing methods such as payday loans. Compared to prior research, this study used a more comprehensive measure of financial capability and a unique state law status variable to examine effects of payday loan usage and state payday law status on consumer financial capability.

The objectives of this study were:

- 1) To examine if there are differences in financial capability between consumers who use payday loans and those who do not.
- 2) To examine if there are differences in financial capability between consumers who live in a state with a payday loan law and those who live in a state without such a law.
- 3) To examine if there are interaction effects of payday loan usage and state law status on financial capability.

Significance

Payday loans, also known as check loans and cash advances, are short-term loans, generally \$500 or less, at high interest rates. For example, a \$15 fee for a \$100 payday loan carries a 390% APR if the loan is rolled over from one two-week period to the next ($26 \times \$15$). According to a 2014 CFPB report (CFPB Data Point, 2014), four of five payday loans are rolled over or renewed, putting borrowers even deeper in debt, and three of five loans are made to borrowers whose fee expenses eventually exceed the initial amount borrowed. The ability to avoid excessive borrowing costs is an indicator of financial capability. In 2012, 12% of American consumers reported using payday loans (FINRAIEF, 2013). Yet, 32 states permit payday lenders to operate (CFA, n.d.). This begs the question of whether residents of the other 18 states and the District of Columbia with payday lending laws are more financially capable. This study explores the association of state payday lending laws with five measures of financial capability. The findings have implications for consumer policy makers who enact payday lending laws and consumer educators who help disadvantaged consumers achieve financial well-being.

Method

Data

Data used in this study were from the 2012 National Financial Capability Study (NFCS). In consultation with the U.S. Department of the Treasury and the President's Advisory Council on

Financial Literacy, the FINRA Investor Education Foundation commissioned the 2012 NFCS that included 25,509 American adults (roughly 500 per state, plus the District of Columbia) and 1,000 military service members through online surveys (FINRAIEF, 2013).

Variables

Financial capability. Five variables were used to measure financial capability: 1) objective financial literacy, 2) subjective financial literacy, 3) desirable financial behavior, 4) perceived financial capability and 5) financial capability index (calculated by summing Z scores of objective financial literacy, subjective financial literacy, desirable financial behavior, and perceived financial capability), which were used in previous research (Xiao, Chen, & Chen, 2014; Xiao & O'Neill, 2014). *Payday loan usage* was a binary variable, in which the user was coded as 1, otherwise 0.

State payday loan law was a binary variable also. If a respondent lived in a state with any law restricting payday loans, it was coded as 1, otherwise 0. Based on information provided by Consumer Federation of America, 18 states plus Washington, DC have a payday loan law (CFA, n.d.). Variable specifications can found in Table 1.

Data Analyses

A series of two-way ANOVA tests were conducted to answer research questions. Based on the main effect results of two-way ANOVA, selected following simple main effect tests were also conducted. The unweighted sample was used in data analyses.

Results

Table 2 presents mean scores of the five financial capability variables by state law and by payday loan usage status. Table 3 presents the statistics of two-way ANOVA. Based on Table 2 and 3, for main effects of payday loan usage, consumers who used payday loans scored lower in all five financial capability variables compared to those who did not use payday loans, suggesting payday loan users are less capable as measured by the five financial capability variables. For main effects of state laws, among five financial capability variables, only subjective financial literacy and desirable financial behavior scored better among consumers who live in a state with a payday loan law than those living in a state without such a law, but there were no differences in the other three financial capability variables. The interaction effects between payday loan usage and state law were found in only three financial capability variables, subjective financial literacy, desirable financial behavior and financial capability index. Thus, additional simple main effect tests were conducted.

Table 4 and 5, combined, present findings of simple main effect tests. For the subjective literacy variable, among payday loan users, consumers living in a payday loan state scored better than those in a state without the law, but no such state law effect was found among payday loan non users. On the other hand, among consumers living in a state without a payday loan law, payday loan users scored lower than non users, but the effect was not shown among consumers in a state with such a law. For the financial behavior variable, three out of four possible simple main effects were significant except for the state law effect among payday loan non users. For the financial capability index, the two simple main effects of payday loan usage were significant but the two simple main effects of state law were insignificant, suggesting that payday loan users had lower scores controlling for the state law status, but consumers living in a state with a law showed no differences in financial capability from those in a state without a law after controlling for payday loan usage status.

Conclusions/Relevance

The findings of this study show that, to identify those who need to improve consumer financial capability, payday loan status is more important than state law status. For policy makers and regulators to help consumers improve financial well-being, they need to provide special assistance to payday loan users. Consumer financial educators may also provide information for consumers who use payday loans to help them find better borrowing sources.

The findings also suggest that state payday lending laws have some effects on consumer financial capability through its main effects or simple main effects. Consumers in a state with a payday loan law scored higher in both subjective financial literacy and desirable financial behavior. This finding can encourage consumer advocates to lobby for more states to create laws restricting the unfair practices of payday loan providers. Consumer educators need to provide consumers information about payday loans, state law status, and strategies to better manage cash flow and debts. It is important to note that online payday loans are available to any U.S. resident, regardless of state law status, and have been found to employ even more abusive practices than storefront payday lenders (Fraud and Abuse, 2014).

References

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Table 1
Variable Specifications

Variable name	Variable label	Attribute
	<i>Financial capability</i>	
Sum(m6x, m7x, m8x, m9x, m10x)	Objective financial literacy	0-5, the sum of correct numbers for financial literacy questions. The original financial literacy variables (m6-m10) were recoded to binary variables in which 1=correct answer, 0=otherwise and then the new variables were summed to form the score.
M4	Subjective financial literacy	1-very low, 7-very high
See note	Desirable financial behavior	The sum of desirable financial behaviors
M1_1	Perceived financial capability	1-strongly disagree, 7-strongly agree
	Financial capability index	A sum of Z scores of objective financial literacy, subjective financial literacy, desirable financial behavior, and perceived financial capability variables.
	<i>Payday loan usage</i>	
G25_2_payday	Used payday loan at least once	1=yes, 0=no
	<i>State law</i>	
paydaylaw	State has any law restricting payday loan	1=yes, 0=no. A new variable created by using the zip variable in NFCS and state payday loan information (CFA, n.d.).

Note: 20 desirable financial behaviors are spending within income, saving for children's college education, saving for emergency, checking credit reports, checking credit scores, using advice on financial services (debt counseling, investment, mortgage, insurance, and taxes), contributing to 401k plans, comparison shopping for credit card, calculating retirement needs, making mortgage payment on time, and desirable credit card behaviors (making full payment, not keeping balance, not making minimum payment, not paying late fees, not being over the limit, and not using cash advance) . All of these variables are binary variables that are appropriately recoded from corresponding variables from the original data set using following variable names: j3_no_overspend, j6_child_coll, j5_emerg, j11_credit_rep, j12_credit_score, k1_advice_debt, k2_advice_invest, k3_advice_mort, k4_advice_ins, k5_advice_tax, c5_contri_401k, f10_cc_shop, j8j9_cal_retire, e15_mort_ontime, f2_1_cc_fullpay, f2_2_cc_no_balance, f2_3_cc_no_minipay, f2_4_cc_no_latefee, f2_5_cc_no_overlimit, and f2_6_cc_no_cash.

Table 2 Financial Capability by Payday Loan Usage and State Law: Means

	Mean	p
<i>Objective financial literacy (0-5)</i>		
a) State law status		ns
State with a payday loan law	2.75	
State without a payday loan law	2.77	
b) Payday loan usage		***
Payday loan user	2.46	
Other	3.06	
<i>Subjective financial literacy (1-7)</i>		
a) State law status		*
State with a payday loan law	5.14	
State without a payday loan law	5.09	
b) Payday loan usage		***
Payday loan user	5.04	
Other	5.19	
<i>Perceived financial capability (1-7)</i>		
a) State law status		ns
State with a payday loan law	5.43	

State without a payday loan law	5.49	
b) Payday loan usage		***
Payday loan user	5.13	
Other	5.78	
<i>Desirable financial behavior (0-20)</i>		
a) State law status		***
State with a payday loan law	7.22	
State without a payday loan law	6.87	
b) Payday loan usage		***
Payday loan user	6.25	
Other	7.84	
<i>Financial capability index (-10.25-2.81)</i>		
a) State law status		ns
State with a payday loan law	-.49	
State without a payday loan law	-.56	
b) Payday loan usage		***
Payday loan user	-1.21	
Other	.16	

Note: * $p < .05$. ** $p < .01$. *** $p < .001$. ns = not significant. See Table 3 for detailed statistics of two-way ANOVA.

Table 3 Statistics of Two-way ANOVA

Source	df	F	p
<i>Objective financial literacy</i>			
State law	1	.680	.410
Payday loan usage	1	378.757	.000
State law * payday loan usage	1	.017	.895
Error	25505		
<i>Subjective financial literacy</i>			
State law	1	3.839	.050
Payday loan usage	1	27.711	.000
State law * payday loan usage	1	7.285	.007
Error	25505		
<i>Perceived financial capability</i>			
State law	1	3.080	.079
Payday loan usage	1	378.080	.000
State law * payday loan usage	1	1.219	.270
Error	25505		
<i>Desirable financial behavior</i>			
State law	1	14.399	.000
Payday loan usage	1	285.266	.000
State law * payday loan usage	1	17.085	.000
Error	25505		
<i>Financial capability index</i>			
State law	1	1.308	.253
Payday loan usage	1	522.823	.000
State law * payday loan usage	1	4.618	.032
Error	25505		

Table 4 Financial Capability by Payday Loan Usage and State Law Status: Simple Main Effects

	Payday loan use	Mean
<i>Subjective financial literacy</i>		
State with a payday loan law	Payday loan user	5.11
	Other	5.18
State without a payday loan law	Payday loan user	4.98
	Other	5.20
<i>Desirable financial behavior</i>		
State with a payday loan law	Payday loan user	6.62
	Other	7.83
State without a payday loan law	Payday loan user	5.87
	Other	7.86
<i>Financial capability index</i>		
State with a payday loan law	Payday loan user	-1.11
	Other	.13
State without a payday loan law	Payday loan user	-1.31
	Other	.090

Table 5 Statistics of Simple Main Effect Tests

Source	p
<i>Subjective financial literacy</i>	
State law status effect under following condition	
payday loan user	.014
payday loan non user	.255
Payday loan usage effect under following condition	
state have payday loan law	.123
state have no payday loan law	<.0001
<i>Desirable financial behavior</i>	
State law status effect under following condition	
payday loan user	<.0001
payday loan non user	.600
Payday loan usage effect under following condition	
state have payday loan law	<.0001
state have no payday loan law	<.0001
<i>Financial capability index</i>	
State law status effect under following condition	
payday loan user	.082
payday loan non user	.122
Payday loan usage effect under following condition	
state have payday loan law	<.0001
state have no payday loan law	<.0001