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## Competition in a consumer loan market: Payday loans and overdraft credit<sup>☆</sup>



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### ABSTRACT

Using variation in payday lending restrictions over time and across states, we study competition in the market for small, short-term consumer loans. We find that banks and credit unions reduce overdraft credit limits and prices when payday credit, a possible substitute, is prohibited. These findings suggest that depositories respond to payday loan bans by taking less risk, bouncing checks that they would have otherwise covered. The decline in overdraft prices is surprising when viewed in isolation, but sensible given that depositories incur lower credit losses as they limit overdraft coverage. We find some evidence that credit unions' overdraft activities are more profitable when payday loans are prohibited, consistent with decreased competition. In addition to characterizing the impact of prohibiting payday lending, a common state policy change in recent years, our findings illuminate competition in the small-dollar loan market by highlighting the importance of non-price adjustments to credit offers.

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## 1. Introduction

This paper studies competition between two very different looking financial intermediaries offering similar credit services. On the one side are mainstream banks and credit unions that supply overdraft credit whenever they cover checks or other transactions that would have overdrawn depositors' accounts. Depository institutions earned an estimated \$23 billion in overdraft lending revenues in 2007.<sup>1</sup> On the other side are payday lenders who advance cash against customers' personal checks for two to four weeks, providing the check-writer with \$50–\$1000 of credit in the interim. An estimated 19 million households paid between \$8 billion and \$9 billion of interest charges on payday loans in 2007 (Stephens, 2008, 2011).<sup>2</sup>

Both types of credit are controversial, and as a result are increasingly regulated. Payday lenders have long been maligned for high prices, while depositories have come under fire more recently for the high cost of overdraft credit. Fifteen states now prohibit payday loans via usury limits or outright bans. In 2009 both houses of Congress considered legislation limiting the price and frequency of overdraft charges (H.R. 3904 and S. 1799), and in July 2010 the Federal Reserve issued new rules requiring customers to opt-into overdraft coverage of ATM and debit transactions.

Much of the literature on payday lending studies the effect of credit access on household financial distress. Our focus is different; we ask firstly whether payday lending influences the pricing and provision of short-term credit at depositories. While it has been casually observed that overdraft credit providers compete with payday lenders (Bair, 2005; Stegman, 2007) and two thirds of borrowers report "avoiding bounced checks" as a benefit of payday credit (Cirillo, 2004), we know of no evidence that payday credit availability directly affects overdraft credit terms. Beyond establishing that competition exists, we ask secondly how is it manifest? Do depositories capitalize on enhanced market power by raising overdraft prices when payday loans are no longer available? Do they extend less overdraft credit when no longer pushed by a competitor? Answering these questions is important not only for evaluating policies that affect payday and overdraft credit availability, but also for understanding the nature of competition in the market for short-term consumer loans.

Research on competition in consumer credit markets highlights the uniqueness of credit relative to other products and services, and emphasizes that competition may not reduce the price of credit. For example, problems of adverse selection (Stiglitz and Weiss, 1981; Ausubel, 1991, 1999; Brito and Hartley, 1995) and moral hazard (Karlan and Zinman, 2009) may prevent lenders from competing on price, and instead induce them to compete on non-price dimensions of loan contracts, such as loan size, maturity or collateral requirements (Edelberg, 2004; Einav et al., 2012). Drawing on these insights, our analysis examines the effects of payday lending on the price of overdraft credit as well as the most important non-price characteristic, the credit limit.

We use data from a national survey of banks and credit unions to measure the effects of payday lending on overdraft prices and credit limits. In order to avoid estimation problems created by the endogenous location decisions of payday lenders, we estimate the effects through two different identification schemes. The first, following Morgan et al. (2012), compares how overdraft terms change as states switch from allowing to prohibiting payday credit, or vice versa. The second, following Melzer (2011), examines geographic variation in payday lending competition: focusing on states that prohibit payday credit, we compare overdraft terms at institutions located near a state that allows payday credit with overdraft terms at institutions located further away. The rationale behind this comparison is that depositors who have proximate access to payday lenders have an alternative to overdraft credit that depositors banking further away lack. The identifying assumption for the first scheme is that legal changes within states are independent of overdraft terms. The

<sup>1</sup> Similar to Parrish (2009), we estimate the amount of overdraft lending revenues by multiplying total deposit account fees at banks and credit unions in 2007 (\$45.6 billion) by estimates of the proportion of fees attributable to overdrafts and bounced checks (74%, FDIC, 2008) and the proportion of overdraft and bounced check fees due to paid overdrafts (69%, Parrish, 2009).

<sup>2</sup> Overdraft and payday credit accounted for approximately 65% and 22%, respectively, of all interest and fee revenue on short-term loans in the U.S., according to the authors' calculations and data reported in a 2010 market study by Core Innovation Capital and Center for Financial Services Innovation (2011). Pawn lending, car title lending and tax refund anticipation lending are small by comparison, with market shares of 7%, 4% and 2%, respectively.

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