Consumers Prefer Payday Loans to Cover Small-Dollar Expenses

A Federal Reserve Bank of New York staff report, *"Price-Increasing Competition: The Curious Case of Overdraft versus Deferred Deposit Credit"* finds that deferred deposit credit, payday loans, and overdraft protection (ODP) compete directly for market share in the short-term credit market, an $80 billion dollar market. The report by Brian T. Melzer and Donald P. Morgan concludes that payday advances are a cheaper alternative to cover small-denominations and "when deferred deposit credit [payday loan] priced per dollar borrowed is available, depositors prone to small overdrafts switch to that option." To make up for lost revenue from overdraft fees, banks charge more for overdrafts in areas where payday loans are available.

Full study available at http://www.newyorkfed.org/research/staff_reports/sr391.html

The report showed that:

- **Payday loans and bank overdraft protection products are direct competitors**

"On the one side are mainstream banks and credit unions that supply overdraft credit whenever they cover check, ATM, or debit card transactions that would have overdrawn depositors' account otherwise. On the other side are much smaller deferred deposit (payday) lenders who hold customers' personal checks for about two weeks (until payday), providing the check-writer with $50 to $500 of cash-credit in the interim."

"The key points to take away are that overdraft and deferred deposit credit are partial substitutes."

"Consistent with the notion that deposit and deferred deposit services are related, deferred deposit providers tend to locate in well-banked neighborhoods."

- **Payday loan fees are based on loan amounts, overdraft protection fees remain the same, regardless of loan amount**

"Although priced differently, overdraft and deferred deposit credit are partial substitutes. Perhaps to avoid regulatory scrutiny, mainstream intermediaries charged a fixed fee per overdraft regardless of the size of overdraft. The median price in 2006 was $27 per overdraft (FDIC 2008). By contrast, deferred deposit credit is priced per unit with a typical fee of $15 per $100. Although payday lenders are often maligned for their high prices, deferred deposit is cheaper than overdraft credit for sufficiently small overdrafts."

"Perhaps to avoid regulation as credit, including usury limits and interest rate disclosures, the great majority of DI [depository institutions] charge a flat fee per overdraft that is invariant to the amount or term of overdraft (White 2007). Ninety-eight percent of OD providers charge a flat fee per overdraft, regardless of the size or length of the loan (FDIC 2008)."

- **Payday loan fees are cheaper than overdraft protection fees for small-denominations**

"Although payday lenders are often maligned for their high prices, deferred deposit is cheaper than overdraft credit for sufficiently small overdrafts."

"Depending on the amount of the overdraft, overdraft credit can be more expensive than deferred deposit credit. The median NSF (insufficient funds) fee charged by depository institutions per overdraft was $27 in 2007 (FDIC 2008, p.III, bullet 5). At that fee, the implicit annual percentage interest (APR) on a hypothetical, two week overdraft of $60 is about 1,173 percent, more than the typical APR for deferred deposit credit. The implicit APR on overdraft credit increases, all else equal, as the size or term (maturity) decreases."

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- **Where payday loans are available, demand for overdraft protection is reduced**

"That finding, which we confirm and extend here, suggests access to deferred deposit credit reduces demand for overdraft credit, at least by some account holders."

"Small dollar overdrafters disadvantaged by the buffet (flat fee) pricing of overdraft credit switch to deferred deposit lenders (when available), saddling banks and other depositories with proportionately more higher cost, possibly riskier large-dollar overdrafts. Depository institutions raise prices and manage the extra risk by reducing the supply of free accounts without direct deposit."

"Flat fee pricing is also central to our thesis. That pricing obviously discriminates against more frequent, small-dollar overdrafters, so entry by firms practicing marginal cost pricing is to be expected. Our thesis is that entering deferred deposit may skim off small-dollar overdrafts, saddling depositories with proportionately more of the other type."

- **Educating consumers on fees is welfare increasing**

"…Gabaix and Laibson (2006) use overdraft protection as the leading example of a 'shrouded attribute,' an expensive, overpriced feature of a good or service that is hidden from consumers. Debiasing, that is, educating consumers by unshrouding hidden attributes is welfare increasing."

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