Are Payday Lending Markets Competitive?

Despite their claims, credit unions seem unable to offer competitive payday loans.

BY VICTOR STANGO

The rapid and widespread growth of the payday loan market has sparked considerable controversy, in part regarding the "high" prices charged on payday loans. Are such accusations warranted? Payday lenders argue that their loans do not yield excess profits once one accounts for the full economic costs of the business. Banks and credit unions, however, argue that prevailing fees more than cover costs; credit unions in particular argue that they can effectively serve the same borrowers at lower prices.

This article presents several new pieces of evidence addressing the question. Can credit unions provide functionally identical payday loans at a lower price, or offer a different product with a price/characteristic mix that payday borrowers prefer? Considering both prices and non-price characteristics is critical, because even lower-priced credit union payday loans cannot compete with standard payday loans if they have qualitative characteristics that potential borrowers find extremely unattractive, or if they screen potential borrowers out of the market through tighter credit approval requirements.

The most direct evidence is the most telling in this case: very few credit unions currently offer payday loans. Fewer than 6 percent of credit unions offered payday loans as of 2009, and credit unions probably comprise less than 2 percent of the national payday loan market. This "market test" shows that credit unions find entering the payday loan market unattractive. With few regulatory obstacles to offering payday loans, it seems that credit unions cannot com-

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pete with a substantively similar product at lower prices.

Those few credit unions that do offer a payday advance product often have total fee and interest charges that are quite close to (or even higher than) standard payday loan fees. Credit union payday loans also have tighter credit requirements, which generate much lower default rates by rationing riskier borrowers out of the market. The upshot is that risk-adjusted prices on credit union payday loans might be no lower than those on standard payday loans.

A final point—one that is too often ignored in policy discussions—is that borrowers find the non-price characteristics of standard payday loans superior to the non-price features of credit union payday loans. Credit unions have locations and business hours that consumers find less convenient than those of commercial payday lenders. Application times are longer at credit unions. And default on a credit union payday loan may harm one's credit score, while default on a standard payday loan does not harm one's credit score. Current payday loan customers view these restrictions negatively, expressing a preference for a less restrictive but higher-priced payday loan over a more restrictive and lower-priced payday loan. Borrowers also dislike the lack of privacy conferred because credit union payday loans do not "keep my payday borrowing separate from my other banking."

In short, the claim that other financial institutions can serve the market at lower prices does not seem justified. At lower rates and fees, credit unions are either deterred outright from offering payday loans or are only willing to offer a type of loan that potential borrowers find unappealing.

ILLUSTRATION BY MORGAN BALLARD

Payday Lending: A Primer

A payday loan is a short-term advance against a future paycheck. A payday lender generally advances a customer $100–$500 per loan. In return, the borrower leaves a postdated check with the lender for the loan principal plus fees, and the lender deposits the check after two weeks. The loan fee, which one can view as an interest charge, is typically about $15 per $100 advanced.

Payday advances are uncollateralized, like credit cards and unlike home and auto loans. Approval requirements are minimal; a recent bank account statement, a pay stub, and photo identification are often enough for approval. In most cases, the only cause for denial is recent default on a payday loan. Because payday lenders generally track prior payday advance defaults using databases independent from the major credit bureaus, approval decisions and prior defaults do not affect borrowers' credit reports. For borrowers, the looser credit standards are attractive. The downside for lenders is more frequent default because the loans are uncollateralized and payday lenders lend money to riskier borrowers.

Payday lenders compete on location and convenience as well as price. The scale of a payday outlet can be quite small and startup costs are minimal compared to those of a bank. Payday lenders quickly saturate attractive markets. They can locate nearly anywhere and have longer business hours than banks. Borrowers seem to have little trouble understanding payday lenders' prices because the price structure is much simpler than that for most other loans.

Demand for payday lending is substantial and has become widespread in the United States during the last 20 years. There are currently more than 24,000 physical payday outlets; by comparison there are roughly 16,000 banks and credit unions in total (with roughly 90,000 branches). Many more lenders offer payday loans online. Estimates of market penetration vary, but industry reports suggest that 5–10 percent of the adult population in the United States has used a payday loan at least once.

Nor does borrowing appear confined to those who are "credit constrained." Recent research suggests that many payday borrowers take out loans even when they have lower-priced options such as credit cards. Payday borrowers are also aware that payday loan fees may be lower than those from overdrawing on a checking account or going over a credit card limit.

Are Payday Loans Usurious?

If one treats the standard $15 per $100 loan fee as an interest charge, the annual percentage rate (APR) on a typical payday loan is 391 percent. It is the APR that critics generally label as "too high," both because it exceeds the levels on most other consumer loans and because it exceeds the usury ceiling in most states. Critics argue that high prices justify legislation capping payday loan APRs at lower levels; such legislation has passed in some states.

"Too high" can only be measured relative to a benchmark, of course, and for most economists and policymakers the right benchmark is "breaking even," or earning zero profit in economic terms. That benchmark also helps to frame the debate as articulated by banks and credit unions. To argue that APRs charged by payday lenders are too high is to argue either that payday lenders are charging prices that are above their own break-even levels or that credit unions could break even at significantly lower rates and fees.

The existing academic research identifies some key issues in the analysis of whether payday lenders charge break-even prices. Like all lenders, a payday lender must cover the full set of costs (explicit and implicit) associated with its loans. But for payday lenders the makeup of those costs is quite different from that for costs on auto or credit card loans. For a payday lender, fixed costs—rent, utilities, and the portion of labor costs that is independent of loan volume—are substantial compared to revenue. For larger loans, fixed costs are covered by much greater revenue (loan revenue per mortgage far exceeds loan revenue per payday loan, for example).

Payday loan costs also include per-loan processing costs: labor and any costs associated with credit scoring. Again, on a payday loan, these costs are more substantial in relative terms than for home and auto loans because payday loan dollar amounts are so small.

Another difference between payday loans and other loans is that payday loans have higher default rates. Because payday loans are uncollateralized, it is almost impossible to recover the loan principal on a bad loan. This can dramatically increase break-even loan fees. Suppose a payday lender faces fixed and marginal costs of $25 per loan, a figure supported by Mark Flannery and Katherine Samolyk's 2005 study of payday lenders' cost structure. With no risk of default, the break-even per-loan charge is $25. But if 5 percent of customers default and the average loan is $300, the break-even per-loan charge rises to $40.

It is worth noting that in contrast to large-principal loans (such as mortgages) on which the cost of funds comprises nearly all of the per-loan costs, payday loans have a small cost of funds relative to other costs. So, using the APR as a measure of the "markup" on a payday loan is misguided; the APR is really only a good metric of the loan markup when financing costs are the most important component of costs to the lender.

Beyond the evidence directly comparing payday lenders' costs, a smaller body of work reviewed by Jonathan Zinman shows that the imposition of rate and fee caps forces payday lenders out of business. That is what one would expect if the caps lie below break-even price levels for payday lenders. Nor do payday lenders appear to earn "excess returns" in the stock market, according to a 2009 paper by Paige Skiba and Jeremy Tobacman.

The evidence of break-even pricing is also consistent with industry structure in general, which makes persistent economic profitability unlikely. Payday lending has many characteristics associated with perfectly competitive markets, including small scale and free entry. Nonetheless, many remain skeptical of such an argument.

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How Many Credit Unions Offer Payday Loan Products?

For a brief period in 2009, the National Credit Union Administration (NCUA) required credit unions to report whether they offered payday loans. Those data are publicly available and cover the entire population of federally insured credit unions in the United States at the time. The data describe, for each credit union, whether it offers payday loans as well as other detailed information about its location, size, and characteristics.

The data show that as of March 2009, of the 7,749 credit unions covered in the data, roughly 6 percent (479) offered payday loans; by June, slightly more (503) credit unions reported offering payday loans. Unfortunately, these data do not include payday loan volume at these lenders.

A back-of-the-envelope calculation is instructive, however. If each of those 479 credit unions matches the loan volume of the typical payday lender, then credit unions represent roughly 2 percent of the national payday lending market. The figure will be smaller if one includes online payday lending. It will also be smaller in states that allow payday lending, because payday lenders are concentrated there.

While the situation may change over time, the available NCUA evidence suggests two things about entry by credit unions into the payday lending market. First, relatively few credit unions find it worthwhile to enter the market. Second, entry by credit unions to date is small compared to the size of the market now served by payday lenders.

Why don't more credit unions offer payday loans? | The fact that so few credit unions offer a payday advance product raises a simple question: What is the practical obstacle to offering payday advances at lower prices? To answer that question, a survey was conducted in May 2009 to ask credit union representatives about the downsides of offering payday loans. The surveyor (a graduate student research assistant) contacted 46 credit unions via phone calls, starting from a list of 250 credit unions randomly selected from the NCUA data file of 7,749. All respondents were credit union employees, and many were loan officers or branch managers.

Very few credit unions were responsive, but among those who did supply answers the most common reason for not wanting to offer a payday loan product was that such loans are "too risky." Some of the respondents reported that assessment came as a result of direct experience, e.g., "We used to offer payday loans but stopped because delinquencies were too high." The remaining respondents split their reasons between "insufficient demand" and "interest rates are too high." The latter response is, in essence, a risk-based explanation; the rates required to break even were either unattractive to customers or above a rate that the credit union was willing to set.

While the sample here is small and it is probably best to treat the responses as anecdotal, they are consistent with a view that most credit unions do not offer payday loans because, at below-market fees and rates, it is too difficult to offset default risk. In some sense, this evidence provides a market test of whether credit unions can be competitive providers of short-term credit, and right now that test suggests a negative answer. Another possibility is that credit unions (and commercial banks) stay out of payday lending because they earn greater marginal returns on checking overdrafts. Overdraft revenue is now the single greatest component of non-interest income for banks.

What Are the Terms of the Credit Union Payday Product?

Beyond the evidence regarding entry, we can also learn about the competitiveness of the market by examining prices at those credit unions that do offer payday loans. Do those credit unions substantially undercut prevailing payday loan rates? If so, we have evidence that prevailing payday loan rates might in fact be "too high."

Data are limited, but via online sources (Google searches), the phone survey mentioned in the previous section, and a credit union industry report published by the National Credit Union Foundation, we can learn terms at roughly half of the credit unions that offered payday loans as of 2009–2010.

Two pieces of background information are necessary. First, federal credit unions face a regulatory prohibition against charging more than an 18 percent APR, which equals $1.50 per $100 of loan principal per month. Most credit unions comply with that requirement. Some state credit unions charge APRs of up to 36 percent. To offset lower loan APRs, credit unions do two things: they impose per-loan processing fees or annual loan program fees, and/or they impose restrictions on loan terms and access. The former raise prices, while the latter are intended to reduce default risk.

Second, many credit unions offer payday loans through alliances offering a standardized product and pooling default risk. The two largest alliances are Better Choice and StretchPay, located in Pennsylvania and Ohio. Better Choice has roughly 80 credit union members, while StretchPay has over 100, meaning that together these two alliances make up roughly 40 percent of the national total of credit unions that offer payday loans. So, the terms set by those alliances are very informative because they have been adopted by many credit unions. One other point worth noting is that the Better Choice program receives subsidies from the Pennsylvania state treasury. Its prices are therefore subsidized rather than market prices.

Both Better Choice and StretchPay charge an APR of 18 percent. Both also charge fees: StretchPay charges an annual fee of $35 for loan amounts of $250 and $70 for loan amounts of $500, while Better Choice charges a per-loan application fee of $25 for loan amounts up to $500. Better Choice has a 90-day repayment period, while StretchPay has a 30-day repayment period.

Table 1 shows terms of Better Choice and StretchPay loans, and shows terms at some other credit unions. Terms of other credit unions' payday loans vary somewhat, but are generally similar in structure: nearly all combine an 18 percent APR with fees. Some credit union payday loans forgo charging an APR altogether and simply charge per-$100 fees. One of the more well known of such programs is the GoodMoney program, which has a fee of $9.90 per $100 borrowed and a two-week loan term.

TABLE 1

Terms of Credit Union Payday Loan Alternatives

	Fee	APR	Maximum Term	"Savings" held back	Other restrictions
Better Choice	$35–$70 per year	18%	90 days	5%	A, E
StretchPay	$25 per loan	18%	30 days	10%	A, B, C
ADVANCPay	$60–$70 per loan	none	2 weeks	none	D
GoodMoney	$9.90 per $100	none	2 weeks	none	B
Rivermark	$15 per loan	25%	30 days	none	A, B
Veridian	$20 per loan	21%	180 days	50%	C, D
1st Financial FCU	$50 per loan	10%	30 days	none	A, B, C
Four Corners	$20	18%	120 days	none	B, D

Sources: http://www.ohiocreditunions.org/StretchPay/CUInfo.htm, http://www.pacreditunions.com/betterchoice.html, http://www.realsolutions.coop/assets/2009/3/24/REAL_Solutions_Payday_Loan_Toolkit_v032309.pdf.

Notes: Other restrictions include: (A) membership length requirement, (B) minimum income/employment tenure requirement, (C) internal credit check, (D) direct deposit, and (E) external credit check. An "E" indicates use of an external credit check different from that used by payday lenders (e.g., GoodMoney uses Teletrack, so it does not receive an "E").

On the high end is the ADVANCPay program operated by One Nevada Credit Union (formerly Nevada Federal Credit Union), which charges a flat fee of $70 per loan, with loan amounts up to $700. Because these data are not comprehensive, it is possible that other credit unions charge rates and fees that are either higher or lower than those in the sample shown here. But the data are representative of the range and variety of rates and fees nationally.

Comparing these terms to those of the standard payday loan is not straightforward. Total charges for a credit union payday loan will vary based on how quickly the loan is repaid. When a credit union imposes an annual fee rather than a per-loan fee, average charges per loan will fall as the number of loans taken rises. Finally, some credit unions require a "savings deposit" from the loan principal. StretchPay requires a 10 percent deposit, while Better Choice requires 5 percent. Lenders only grant borrowers access to those deposits after loan repayment, effectively reducing the loan amount by either 5 percent or 10 percent; for example, a $500 StretchPay loan actually leaves the borrower with $450 in short-term cash. The proximate effect of such savings deposits is to increase effective interest rates on credit union payday loans. For example, Veridian Credit Union holds back a full 50 percent of the loan amount, but charges interest on the entire amount; that effectively doubles the APR paid by the borrower.

In order to compare loan terms in light of these details, Table 2 chooses representative loan amounts and repayment periods, calculating the total cost of borrowing across different products. The table shows total borrowing costs for a small ($180) and large ($450) loan with two terms: two weeks and one month. For those loans with two-week terms, the latter scenario represents one "rollover" of each loan.

The table reveals that the standard payday loan compares favorably to some programs and unfavorably to others. There are no columns in which the standard payday loan is more costly in total than any credit union alternative. That stems in large part from the very high fee on the ADVANCPay loan. But for loans with smaller amounts and shorter terms, the standard payday loan beats most of the programs in terms of total borrowing cost. In particular, for the $180 loan over a two-week horizon, the standard payday loan beats three of the other programs, essentially matches one other, and is more costly than two others. Note, however, that StretchPay is by far the most common benchmark for other credit unions, and for that term the standard payday loan costs almost exactly as much as a StretchPay loan.

The patterns in Table 2 suggest one general conclusion and some specific conclusions. The general conclusion is that credit union payday loans are generally less costly than standard payday loans, but often not by much—and that sometimes they are more costly. The specific conclusions pertain to how different types of borrowers would view the alternatives. All else equal, a borrower needing a small sum for a short period of time may find the standard payday loan to be quite competitive in terms of total borrowing costs. Borrowers who need money for longer periods of time, and who would therefore roll over a series of loans, should find credit union payday loans with longer terms attractive. Among those loans, ones with annual fees rather than per-loan fees should be the best choice. Loans with annual fees rather than per-loan fees appear to be rare, however. Borrowers wishing to borrow significant sums should find attractive the credit union payday loans with per-loan fees that do not increase at higher loan amounts.

Both the tilt toward longer terms and the tilt toward higher loan amounts suggest that credit union payday loans should appeal more strongly to those borrowers in greater financial distress, who would both borrow more and roll over their loans. Borrowers in better financial shape may not be so strongly drawn to the credit union product. That raises a question: Is it reasonable to expect credit unions to compete for the more-stressed borrowers currently served by payday lenders? One might expect that credit unions inherently would attract borrowers who are more financially stable than average. Credit unions generally have lower loan default rates than commercial banks, suggesting that their customer base is less risky. Such a mismatch between products and borrowers might make it harder for credit unions to make inroads in this market. That mismatch is, of course, a function of the interest rate caps faced by credit unions because credit unions must recoup the forgone interest revenue via application fees or annual fees. If consumers find the fee structure permitted by the NCUA unattractive or complex, then it would be fair to view the NCUA interest rate ceiling as an entry deterrent for credit unions.

It is possible that credit unions might eventually construct even more innovative business models that do compete effectively. North Carolina State Employees' Credit Union (NCSECU), for example, has a salary advance program with no fees, a one-month term, and a 12 percent APR. NCSECU retains 5 percent of each loan in a savings account that grows with each loan, and access to the funds is restricted; withdrawing funds bars the customer from obtaining another advance in the subsequent six months. Both the cumulative "savings" and restricted access effectively secure the loan for high-volume borrowers. For example, a customer who has borrowed for six consecutive months stands to lose 30 percent of the loan principal from defaulting, and

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a customer who has borrowed for 12 consecutive months stands to lose 60 percent; in neither instance is the customer permitted to withdraw funds from "savings" without forgoing the opportunity to get another salary advance for six months. There is little doubt that NCSECU's program has been successful, although its competitiveness against a standard payday loan cannot be measured because North Carolina currently prohibits payday lending.

As a final observation, the relatively high level of payday loan rates and fees charged by credit unions has proven somewhat controversial. In July 2009, the National Consumer Law Center issued a sharp critique of some credit unions for offering "false payday loan 'alternatives'" that cost nearly as much as standard payday loans. The letter notes that some credit unions, "which by law have an 18 percent usury cap, add fees to manipulate the APRs." In some of their examples, the effective APR on a credit union's payday loan exceeds 400 percent (that is merely a restatement of the results in Table 2, although I prefer to compare borrowing costs rather than APRs). In the same month, the NCUA issued detailed guidelines for credit unions considering offering payday loans, with the intent of alerting credit unions to the "risks, compliance issues, and responsibilities associated with operating a payday lending program."

TABLE 2

A Comparison of Borrowing Costs on Standard Payday Loans and Credit Union Alternatives

	$180 LOAN		$450 LOAN	
	Two weeks	One month	Two weeks	One month
Standard payday loan	$ 27.00	$ 54.00	$ 67.50	$ 135.00
Better Choice	$ 36.41	$ 37.84	$ 73.54	$ 77.09
StretchPay	$ 26.50	$ 28.00	$ 27.50	$ 30.00
ADVANCPay	$ 70.00	$ 140.00	$ 70.00	$ 140.00
GoodMoney	$ 17.82	$ 35.64	$ 44.55	$ 89.10
Rivermark	$ 16.87	$ 18.75	$ 19.69	$ 24.38
Veridian	$ 23.15	$ 26.30	$ 27.88	$ 35.75
Four Corners	$ 21.35	$ 22.70	$ 23.88	$ 26.75

Notes: Total costs include any annual or application fee and interest charges, from Table 1. Calculations assume a loan amount of $450 for all loans except StretchPay, Better Choice, and Veridian—the programs with forced saving deducted from cash proceeds. StretchPay loans are for $200/$500 before the 10% savings deposit, leaving the borrower with $180/$450 in short-term credit. Better Choice loans are for $189/$472.50 before the 5% deposit, leaving the borrower with $180/$450 in short-term credit. Veridian loans are for $360/$900 before the 50% savings deposit. ADVANCPay uses the nondirect deposit rate to provide comparability to the standard payday loan.

The discussion highlights the difficulty that credit unions face in developing a payday loan product that breaks even at prices below those charged on a standard payday loan. It also suggests that political economy may provide a partial explanation for credit unions' unwillingness to enter the market: if supervisory/regulatory authorities and consumer groups frown on payday lending, credit unions might fear that entering the market might simply spur tighter regulation or a loss of reputational capital.

Qualitative Differences between Payday Lenders and Credit Unions

Apart from the terms of loans, there are substantive differences between payday advance products offered by payday lenders and credit unions. Some differences are restrictions imposed by credit unions on approval and repayment. Credit unions generally impose stricter standards for loan approval. Most credit unions require that the borrower be a member of the credit union for 60–90 days before taking a payday loan. Most credit unions deny applications from customers with late payments on other loans or who have filed for bankruptcy. Some use credit bureau information to screen out bad risks. Some require that borrowers have direct deposit of their paycheck. Many only lend to borrowers above a minimum income threshold.

These restrictions have a natural economic connection to prices. It is well known that in credit markets, firms that set lower prices (typically interest rates) compensate by rationing credit—shutting riskier borrowers out of the market. By restricting access only to long-term customers with no other delinquent accounts, the credit union uses different, and arguably better, information about creditworthiness than a commercial payday lender would have about a walk-in borrower. Using credit bureau information represents a greater investment in learning about risk compared to that made by a standard payday lender. The membership restriction, minimum income requirement, and direct deposit requirement change the set of customers who are eligible for loans, generally screening out the more distressed borrowers and keeping the less distressed borrowers.

These differences should produce lower default rates on credit union payday loans. Prospera Credit Union uses the GoodMoney program (which is quite similar to a standard payday loan), has no direct deposit or membership requirements, and only slightly more stringent approval standards; its loan loss rate is 4.6 percent. Wright-Patt requires 60-day minimum membership and a minimum monthly income of $1,300, but does not require direct deposit; its loan loss rate is 1.7 percent. Veridian Credit Union uses the same credit scoring database used by standard payday lenders, but requires direct deposit; its loss rate is 1.8 percent. Four Corners Credit Union requires direct deposit; its loss rate is 0.3 percent. By comparison, the net loss rate for payday lenders is around 4 percent.

Lower default on credit union payday loans means that a simple comparison of terms or borrowing costs cannot answer the "Are standard payday rates too high?" question. Standard payday loan rates are set to cover default risk on standard payday loans. Credit union payday loan rates must also cover default risk, but that risk is lower. Consequently, default-adjusted rates and fees at credit unions may be quite comparable to (or even more expensive than) those on standard payday loans.

Credit loans and payday lenders differ in other ways that seem subtler but may matter just as much to consumers. One difference is in application and approval times, which are generally shorter at payday lenders. Store hours at credit unions are limited relative to those at payday lenders, and are sometimes shorter than normal banking hours.

Consumer Preferences for Payday vs. Credit Union Products

To assess how important the non-price differences are, an independent survey research firm was commissioned to ask 40 current payday borrowers a series of questions about standard and credit union payday loans. The survey was conducted in a relatively high-volume location in Sacramento, Calif., on a high-volume day (Friday). Customers were selected at random and given a voucher for $25 (redeemable at the lender) in exchange for participating in the survey.

The main body of the survey began by positing a credit union payday loan with terms slightly better than those offered by the Better Choice program:

> In the next several questions, suppose that your bank or credit union offered a payday advance program that charged an 18 percent annual interest rate on each loan and a $35 annual fee (paid regardless of the number of loans).

The survey followed up by asking a series of questions comparing that loan to a standard payday loan. Each question also asked the borrower to value one other feature of the credit union product. For example, the question focusing on direct deposit asked:

> If the product had the fees/rates above but *required that the loan be repaid immediately when your paycheck was direct deposited*, and was otherwise just like a standard payday advance, would you use that product to meet short term needs for cash, or would you still prefer to use a payday lender?

The survey asked seven such questions, each varying the characteristics of the credit union product. The characteristics were:

- Direct deposit requirement
- Loans only available during normal banking hours
- Default negatively affects credit score
- 5 percent "savings deposit"
- 30-minute application and loan approval period
- No loan rollovers
- 60-day minimum membership requirement

The characteristics are simply the set of qualitative differences between standard payday loans and those offered by credit unions.

On the spectrum of prices charged by credit unions, the Better Choice product is quite attractive, meaning that any bias is probably in the direction of the credit union–like payday loan. And because it proceeds characteristic-by-characteristic, the survey also only asks borrowers to offset lower prices with one non-price benefit rather than the full set (which is presumably worth more than any one benefit). An advantage of the approach is that it elicits information about which non-price characteristics are valued most highly by borrowers.

Table 3 summarizes the survey results. For every characteristic but one, three-quarters (30/40) or more borrowers preferred a standard payday loan to a credit union payday loan. In some cases, the preference was nearly unanimous.

The survey results suggest a ranking of characteristics. The least attractive characteristics were limitations on rollovers and short operating hours. Next were longer application and approval times and reporting of default to credit bureaus. Minimum membership requirements and savings deposits were also viewed as deterrents to taking out a payday loan. The least unattractive option was payroll direct deposit. Given the small sample, the standard errors on these estimates are fairly large, but a majority of borrowers preferred the higher-priced but less restrictive choice.

The survey also asked two other questions intended to elicit information about the less tangible differences perceived by borrowers across the products. One question asked a direct question about preferred lenders for identical products:

> Suppose that your bank or credit union offered a short-term loan product that was *identical* to a standard payday loan. Would you use that product to meet short term needs for cash, or would you still prefer to use a payday lender?

This question elicited the borrower's preference for "soft" characteristics associated with each type of lender. It was followed by an attempt to understand what those soft characteristics might be:

> If you answered [that you] ... would still prefer to use a payday lender, can you explain why? Please check any reasons that apply.
>
> a. **Location**: my payday lender is closer to my home or work.
>
> b. **Hours**: Payday lenders let me obtain cash before or after normal bank business hours.
>
> c. **Speed**: Payday lenders are able to give me cash quickly, with-

TABLE 3

Consumer Preferences for Standard and Credit Union Payday Loans

By credit union payday loan characteristic

Characteristic	CONSUMERS PREFERRING: Bank/Credit union	Payday lender
Direct deposit requirement	33%	68%
Normal banking hours only	10%	90%
Default affects credit score	13%	88%
5% savings deposit	25%	75%
30-minute application time	18%	83%
No rollovers allowed	8%	93%
60-day membership requirement	25%	75%

Notes: Results from a survey of 40 current payday loan customers in Sacramento, Calif., in July 2009. Survey asked consumers to choose between a standard payday loan and a credit union loan with terms identical to those in the Better Choice program; the credit union loan also had the restriction listed in the "characteristic" column. With $n = 40$, the 90% confidence interval for any of the shares in the table extends +/– 16%.

out spending a lot of time in the store.

d. **Privacy**: I prefer to keep my payday borrowing separate from my other banking, for personal reasons.

A majority (55 percent) of current payday borrowers said they would prefer to borrow from payday lenders even if a bank or credit union offered an identical product. That indicates that for some customers, the qualitative benefits of payday lenders are substantial. Responses to the second question indicate that the most important "soft" features of payday lenders were hours (checked by 77 percent of respondents), privacy (73 percent), speed (64 percent), and location (59 percent).

Overall, the survey results paint a fairly clear picture. The characteristics of typical credit union payday loans make those loans quite unattractive to most payday borrowers. Most payday borrowers reject a product with even one of those restrictions, even if the credit union payday loan has fees and rates that are lower than those offered by payday lenders. (The terms of the loan in the survey were less expensive than even the subsidized terms of the payday lender Better Choice program.)

Some of the unattractive features are restrictions on approval or repayment, implying that borrowers place high value on the option to default should they be unable to repay the loan. The high value that borrowers place on softer features such as hours of operation and privacy are in some sense more damaging to the credit union business model because such characteristics are inherent in credit unions. Even if credit unions decide to mimic the standard payday product as closely as possible, they might be unable to match those features.

The survey results indicate that the characteristics of typical credit union payday loans make those loans quite unattractive to most payday loan borrowers. Most of those borrowers reject a product with even one of the restrictions imposed by credit unions.

Conclusion

The best available evidence supports a view that credit unions cannot viably serve as providers of short-term credit to the customers currently served by payday lenders. Most telling, very few credit unions choose to offer payday loans even though there are few legal or regulatory obstacles to doing so. That is a convincing market test: a standard payday loan out-competes the credit union version.

What is more, there is little to suggest that credit unions can offer a payday loan with competitive terms. Existing credit union payday loans often have total borrowing costs that are quite close to those on standard payday loans. And credit union payday loans have lower default risk; risk-adjusted prices on standard payday loans may be no higher than those on credit union payday loans.

Finally, current payday borrowers strongly value the non-price benefits offered by payday lenders. Some of those benefits—such as longer operating hours and privacy—are intrinsic to the payday lender business model and would be nearly impossible for banks or credit unions to replicate.

While this article uses credit unions as the competitive benchmark, there is little reason to believe that deposit banks could be more competitive than credit unions in competing against payday lenders. Banks generally charge higher loan rates across the range of products. Evidence from the Federal Deposit Insurance Corporation's Small Dollar Loan program for banks suggests that loan rates under the program were below break-even levels for some banks. These findings suggest that expecting firms—whether they are more stringently regulated payday lenders or other unregulated financial institutions such as banks and credit unions—to provide borrowers with lower-priced but otherwise similar short-term loan products is unrealistic.

Whether denying borrowers access to such products helps or hurts them is a separate question, of course. The evidence on that point is mixed, but it shows on balance that many borrowers are helped by access to short-term credit even at prices that some observers might consider "high." In light of that work, the evidence here suggests that regulating payday lending would simply drive lenders out of the market, and that we should not expect other financial institutions to fill the void, particularly at lower prices. That would leave borrowers who benefit from access to short-term credit with fewer options, making them worse off. Any discussion of public policy in short-term loan markets must consider that downside. R

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