Research Comment On: "Do Defaults on Payday Loans Matter?"

By Debbie Gruenstein Bocian and M William Sermons *March 2014*

In "Do Defaults on Payday Loans Matter?" author Robert Mann uses a difference-in-difference regression-based analysis to analyze "harm" in the payday lending market. He finds little difference in changes in credit scores between payday defaulters and non-defaulters and uses this as evidence that payday loans do not cause harm. However, this study suffers from significant conceptual and technical flaws.

1) Credit score is a poor metric for analyzing the harm caused by payday lending.

- Credit scores, such as the VantageScore used in this paper, are poor metrics for measuring financial health for the payday population. Credit scores are designed to be used by financial institutions to predict the likelihood of default and, while they may be useful metrics of access credit, payday borrowers typically have stretched their credit to the limits—therefore, they have scores that are strongly skewed toward the lowest ranges of the credit score spectrum.[i] According to Mann, his sample of payday borrowers has an average score of 578 (compared to the overall VantageScore average of 736) and a standard deviation of 48. It is, therefore, unclear that measuring movement within this very low range credit scores gives any insight into the financial wellbeing of these borrowers.
- Payday lenders do not report to credit bureaus so there is no direct link between the performance of payday loans and credit scores. However, using credit score as the outcome variable leads to potential reverse causation because changes in borrowers' scores may impact other credit options which, in turn, may impact their ability to pay off payday loans. Such reverse causation may lead to unreliable coefficients and significance estimates.

2) Mann's hypothesis and model are incoherent.

- More importantly, Mann is testing an incoherent hypothesis. Any harm to credit scores would be caused, not by default, but by the financial drain resulting from paying the exorbitant fees charged by payday lenders. This harm would be incurred most acutely by the payday borrowers who pay multiple fees- these borrowers may or may not be the defaulters.
- Even if credit score is serving as a crude proxy for the financial distress caused by an inability to repay a payday loan, Mann's model is flawed because he assumes inability to repay always leads to default when, in fact, more often than not it leads to serial loan refinancing (i.e. "rollovers"). Mann justifies his model technique the following way:

> "Recent regulatory initiatives suggest an inclination to add an 'ability to pay' requirement to payday-loan underwriting standard that would be fundamentally inconsistent with the nature of the product. Because the

> premise of that regulation would be that borrowers suffer harm when they fail to repay such a loan, it is timely to examine the after-effects of such a default empirically."

However, because Mann's "difference-in-difference" analysis compares payday defaulters to all non-defaulters (including those who had to rollover their loans) both the treatment group and the control group include borrowers who were unable to pay off their loans.