Basic Project No:1

Payday Loan Project

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Introduction

Payday lending is a novel commerce which has developed up in an unexpected rate over the past decade. The concept is a comprehensive elucidation for instant monetary requirements, which are instigated by unforeseen alterations in expenses and income. People could get a payday loan for various reasons such as emergencies including medical bills, auto repair, or household expenses like rent, food, and utility bills.

Understanding the payday lending is fundamental for policymakers, economists as well as citizens. For politicians, comprehending the concept of the market and the effects of regulation is necessary to create welfare that is purposed in improving the regulatory environment. Furthermore, the reality is that for many people, limited access to credit and emergencies can combine to make a payday loan the best option. The goal of policymakers should not be to limit individuals’ choices or patronize their decision making. Instead, they should ensure that the best options are available to their constituents and that the consumers are fully informed of those preferences.

The considerable progress in the claim for minor and temporary lends by credit is primarily affected by firms and providers policies. Credit market around the world is ever growing each time. In Denmark, the type of consumer loans has seen a quantum leap. It is due to great innovation how the consumer takes the loans by simply filling a form using mobile phones or via the Internet. Moreover, the loan does not need collaterals and do not entail the condition of purchase. It is because they are short term loans having a maximum maturity of three months.

Literature Review

Through the enlightenment, the European economy had been growing increasingly with its culmination being the industrial revolution. The progress included surging development in every sector of the economy. Moreover, the banking houses had been set up to provide credit to a wide range of economic sectors (Brook, 2014). In the mid-17th century, northern Europe adopted another generation of economics. The scholars who believed that usury had an essential role in achieving the economic goals, asserted that it should be allowed freely (Brook, 2014). Furthermore, the spread of direct electronic money transfer and deposit led to a slowdown in the growth of demand for cash services. Many check cashing directors became credit providers, but the payday loans were considered as a secondary activity for their first business, which was cashing checks for a fee (Stegman, 2007).

Modern societies over the years have become more lenient with cases of lending money with charging fees and interests. Besides, merchant bankers and Jewish creditors in Europe, hold the perception of charging an interest rate for loans as a necessity (Brook, 2014). Through the period, views of damages and costs that might harm the lender were prolonged. The creditor’s effort and time to raise the loan were used as an excuse for charging interest. It even became a trend for a lender to impose interest if he or she could see other profitable alternatives in using his money. By lending his own money, the creditor could be unable to make a profit in any other way. Therefore, as compensation for this loss, the interest was premised (Brook, 2014). Additionally, rollovers exist when the borrower is not able to repay the loan on time. In such instances, the individual recommences it for extra short term and pays extra charges (Stegman & Faris, 2003).

To evade situations where the debt seemed being pushed forward, certain providers request the borrower to acquire a “different lend” with a novel charge. The practice is referred to as “touch and go.” Moreover, the lenders pay off the old debts and instantly create a new loan with new amounts. Irrespective of the names for these repeated transactions, the new credits have the same results, whereby the interest for payments have short terms and continue to rise without reducing the basic (Janet Livingston v. Fast Cash USA Inc.). Furthermore, due to the great charges and small terms, pledgers find themselves in debt of huge costs compared to the original quantity they lent, especially when the charges are pushed forward through twelve months. The industry defends its great and high prices on the grounds, whereby the prices of customer loaning do not differ by the amount. For minor advances, it could be further overpriced per unit than huge customer lends (Stegman & Faris, 2003). On the other hand, others argue that the advances are among the very few available foundations in very temporary lend. It is because the payday loans providers do not intend to be a basis of extended duration of borrowed money and are defended against the annual percentage rate (APR). Based on the analysis, it is not a fair way to assess the industry’s charges.

People are unsure if payday loans provide useful services for many customers or not. Defenders for the production claim that payday givers offer a custom of temporary spare liquidity cover to individuals who are desperate. For example, if an individual has a higher likelihood to face situations many times over the year, then the service is significant and useful. The provision might enable individuals to meet emergency and unexpected circumstances for the reason that money deficits triggered by thoughtless planning. On the other hand, in numerous circumstances, when the subsequent wage era arises, they find it difficult to decide. The persons may spend their accessible money amount to recompense the debt (Caskey, 2001). If the individuals pay the debt, the number of available incomes which are dedicated for discretionary expenditures reduce. Moreover, the people are more probable to have less money again earlier to their subsequent salary era and are compelled to visit the payday investor to acquire a new loan. Alternatively, the individuals can reimburse the charged interest and fees to extend the period of the debt pending the following wage era. When such a tactic is taken, people may face the same situation and choices in the next pay period. In this way, an instant crisis advance turns into a medium-term debt over a sequence of it being pushed forward or is considered a sequence of intermittent temporary debt.

Problem formulation

From the analysis of conducted reports and surveys, it is evident that there is a growing number of loans and its amounts. Additionally, the quantity of the borrowers, the total interests, and fees through few years have increased. It is fundamental to research the phenomenon. Moreover, the purpose of the study is to describe and highlight the aspects related to the relationship between the providers of the type of loans and the consumers' response.

Research questions

RQ 1: How can economic situations and consumer behavior affect the volume of payday loans in Denmark?

RQ 2: How can government policies affect the supply side of this type of loans?

RQ 3: How can the individual behavior impact on the payday loans?

Research design

For the research design, quantitative data will fit to investigate the research questions. Moreover, it provides the paper with linear caution for more understanding of the relationship between increases the consumption of payday loans and providers policies. The study will provide a framework of the research paper about payday loans in Denmark from 2010 to 2014. Additionally, it will answer the research question through the logical process and structure. Also, it will elaborate on the link of the variables in the research question, methodology, and findings. According to the research question, there will be an examination of the volume of payday loans, which will be the dependent variable. On the other hand, the independent variables will be studying the effects of consumer and provider behavior in the market. Besides, the structure of the research paper is deductive, whereby it will begin with reviewing economic and social theories, and based on these concepts, and the hypothesis will be formulated. For the article, the rationale is the financial situation, and the psychological motivations of individuals will drive people to apply for more payday loans.

The best method which could serve the descriptive purpose of any phenomena is surveyed. The Competition and Consumer Authority has conducted an extensive and comprehensive review for provider and consumer at the same time. The secondary data will be applied in the project. Moreover, the secondary data differs from primary data as it is more time efficient. The reasons for adopting the source is because the volume of data been conducted in this survey is significant, and it will be impossible for any person and single group to carry out. Another factor is because the individuals that performed the exercise have sufficient experience to conduct such an extensive survey. Therefore, the material will provide the research paper with high quality and valid information.

Theories

The quantitative theory of money

The concept in respect of monetary policy is the foundation theory of the project. It provides a detailed explanation of how the economic situations could affect the providers as well as the consumers when there is an upsurge in credit. The capacity theory of cash assumes that variation in price level relates to the difference in the money supply.

Moreover, it adopts that presently it is a fixed related correlation between the alterations in the cash fund and expense extent. The formulation of the concept is founded on a balance set by American economist Irving Fisher (Konkurrence, 2015; Ball, 2012).

$$M \times V = P \times T$$

M: CASH SUPPLY

V: RATE OF CURRENCY

P: AVERAGE PRICE

T: THE CAPACITY OF TRANSACTION THROUGH THE ECONOMY

In other words, it assumes the increases in money quantity will lead to higher prices and vice versa. It is because the more the money becomes circulated into the economy, the more the spending by consumers. Moreover, it will result in an examination of the functions of money. Cash for economists serves three purposes. The medium of exchange depicts that money is acceptable in purchase goods and services. Therefore, for this reason, people hold money to pay their daily bills, and the number of cash people desires to stay as cash and checking accounts is called the money demand. The next function, which is the unit of account, means salaries, bills, and the level of wealth are measured in money. In a barter economy, there are higher transactions cost as both have functions (medium of exchange and unit of account) as any deal required in a double coincidence to find a trading partner and make a good deal (Konkurrence, 2015; Ball, 2012).

Economical behavior

Behavioral economics, as a theory, argues the standard of economic analysis. The concept refines and adopts the three essential principles of the financial, which are equilibrium, optimization, and empiricism. Experts believe through the principle of optimization that persons would attempt to pick the paramount alternative. Moreover, through balance, they would take the best alternative while they are interacting with each other. Besides, the results will be tested with data through empiricism (Laibson & John, 2015). There are six principles of this theory:

STANDARD 1: Though individuals would attempt to elect the greatest choice, but sometimes they cannot thrive. It is speculated that they create mistakes while they are trying to take the optimal choice. The main factor which plays an essential role in training and experience.

STANDARD 2: Individuals care partly roughly in what way their statuses equate to situation points. For instance, it might be the quantity of cash that the one is anticipated to be paid in the next period. Moreover, the individuals compare the rewards with losses and take the decision.

STANDARD 3: Individuals could have will power difficulties. Besides, there is a breach among the one's objectives and his or her engagements. People could plan to work hard, stop smoking, or save money for retirement, but they do not do so.

STANDARD 4: Even if people probably care about our material rewarding, they also precaution about the plans, payoffs, and actions of persons, even who are separated from the families. The point aids individuals as well as policymakers to understand in an in-depth context the social preferences.

STANDARD 5: Market exchange could affect the psychological factors of individuals. Moreover, psychological factors are likely to affect the market. For example, in the U.S, when housing crisis emerged, the global finance suffered from a deep and prolonged depression. Majority of largest banks in the world were unsuccessful. It could illustrate how behavioral economic impacts on the market.

STANDARD 6: In concept, preventing individual’s varieties might moderately safeguard them from impulsiveness and developmental preferences, but in exercise, there is varied effect. At almost, it is unpopular.

The field has grown into an essential constituent of the contemporary economy. The experts have adopted the basic codes of present finances, such as equilibrium and optimization, and tried to refine and develop these thoughts to create them empirically precise. Moreover, behavioral economists show how persons attempt to elect the paramount preference. Despite the individuals making the best efforts, they still perform mistakes (Laibson & John, 2015).

Methods and Methodology

Data presented on the supply side is collected by six providers who are active in the market currently. They are Microcredit Ltd, Trust Buddy AB, Mobillån Denmark ApS, 4Finance Aps, and Folkia AS Norway Branch Sweden. The organizations market themselves through a website such as vivus.dk. For Ferratum Denmark Aps, it advertises itself through quick machine.com and ferratum.dk. Moreover, the six providers are expected to fill out questionnaires, whereby they describe their practices in many areas, such as practices of credit. Once the form is completed with financial information such as total earnings from fees and interests, whole loans, and the number of defaults. It is possible to have an idea about the market's evolvement in recent years.

The information about the demand side in the market is essential, particularly the considerations the consumers take when they get their payday loans. The Competition and Consumer Authority has conducted 6,521 online responses to a survey of 20-59 years old. The assessment was done in August 2014 through MEGA- consumer panel on behalf of the Competition and Consumer Authority. Additionally, the organization acknowledged the difficulties in carrying out the consumer survey, because the individuals have complications in understanding the financial terms such as the APR concept and using this term in practice.

Data Observation

The data collected shows that Danish payday loans have seen significant growth in recent years. In 2010 the consumer borrowed around 37 million Danish krone, whereas in 2013 the total lent 302 million krone. It means that there is an eightfold increase compared to 2010. The growth of payday loans has continued to earn around 436 million in 2014. Interest rate and fees were estimated about 9.5 million Kr. in 2010 and surged to approximately 140 million Kr. in 2014. The number of borrowers increased more than sevenfold, from 7,240 in 2010 to 53,741 in 2013 and 136,000 in 2014. Moreover, in the same period, the number of loans increased from 20,384 to 118,496, showing an increase of almost 80 percent every year. About 5% of the total population tried to get fewer credits. All ages use these loans, but it is popular among younger generations, from 20 to 29 years old. They form 43% of total borrower payday loans. They are more prevalent in the middle-income group than the higher and lower income group.

Consumer character

The proportion of consumers who take up consumer loans is highest in the group with less education, and it is the lowest among consumers with higher education. Unemployed consumers or individuals who are outside the labor market; for example, people who retire for sickness benefits are 11,5% of total consumers. The majority of small consumer loans have been used to buy clothing, electronics, and furniture. Besides, only 7% of the total consumers spent money on services like food and bills. Around 65% of borrowers answered that they do not know how to estimate the real cost of their loans. According to notes from bankers, it is evident that 61% of women and 31% of men are not familiar with APR, where 73% of younger consumers (from 18 to 25 years old) have little knowledge about it.

Consumer behavior

About 18% of total borrowers believe they have had a personal economy, while only 5% of consumers who never tried to get consumer loans to share the same idea. Another interesting point is that 17% of borrowers who recorded consumer loans have revealed they were unable to pay their bills on time, while only 5% who have never tried to register small loans were unable. Around 4% of consumers who have taken up consumer loans, regretted to raise this type of loans.

Marketing Regulation

In recent years the government and commercial organizations focus more on strengthening the public understanding of financial concepts and financial issues of the business. The panel carries out activities and projects to build consumer knowledge and interests of economic problems in general (Konkurrence, 2015). It will be translated into academic programs, to enable school pupils and students to be introduced and comfortable with the concepts which are necessary to understand. The ideas are fundamental when a considerable number of crucial decisions need to be taken later in the future. Primary school also must provide students with some insight into the terms of economy, but nowadays some results indicate increases in the public understanding of financial and economic matters.

In connection with the consumer credit marketing and the signing of the agreement, consumers should be informed by law on information about the loan costs (Konkurrence, 2015). All these procedures are set to increase transparency in the market and try to organize the information about loan costs in a way which makes the market for the consumer more transparent. For example, they represent a new concept, explaining the loan costs in a more understood way than, the concepts of APR and borrowing rate, which is essential and mandatory information. Another instance is that it could be about highlighting into total refund amount term. There are regulations in every period through the quick loan procedure (Konkurrence, 2015).

Marketing of quick loans, before the agreement, leads to the conclusion of the contract, through the long term. Through the marketing of fast loans, the operation should always comply with the marketing laws. Before the agreement, the providers should asses the customer creditworthiness through the contract and meet the disclosure requirements of a consumer contract, and that of the credit treaty. The conclusion of the agreement reveals that the providers must also provide information concerning the contract itself by credit contracts and finally through the long term.

Credit agreement: It aims to protect the consumers in respect of contracts of credit. It involves the actual loan, and also credit purchases.

Marketing act: It regulates in several operators behavior on the market. By the law, the operators should not incomplete or misleading information in marketing. Also, it regulates the information advertising of credit agreements.

Additionally, it is an offense to mislead customers as to their obligation and rights. For example, if a loan agreement to set conditions that are contrary to consumers' essential rights under the law. When a provider advertises for a payday loan, the advertisement should indicate the number size on the costs and an interest rate, then all of the following information given in the form of a representative example stand clearly and in a prominent way in advertising. For instance, the appropriating level stable, or a adjustable amount, or mutually with information on costs, the entire quantity of acclaim, the every twelve months proportion rate is calculated by the acclaim pact, the maturity, and the complete sum unsettled by the user and installments.

Before the conclusion of a loan agreement, the supplier is obligated to provide the consumer with information (Konkurrence, 2015). The data must ensure that the customer has sufficient information which enables him or her to equate diverse deals from other providers, to regard his resolution. Moreover, the valuation of the user's wealth cannot be done to assess the loan provider's risk of loss, but rather to determine the consumer given his financial situation. For example, current revenues, refinancing, or realization of assets will be able to pay the predictable repayment of the credit. The purpose of the rating is to protect customers from obtaining loans if the consumer's private economy is too unstable for the user to pay the installments on loan.

Delimitation

There is minimal information about the consumers who raised payday loans. This lack of real knowledge is because the debate depended on attitudes from companies, individual reports, and some interest groups of consumers themselves. The survey has been carried out among 20-59-year-old consumers and complements the data collection from businesses; in other words, it described the demand side of the market. It is because firstly, the information from companies showed a high proportion of loans which had extended after maturity. Therefore, it will be uncertain if the consumer can distinguish between the term of final maturity and admission. The second point it will not be possible to conduct an extensive survey as the relevant consumers who are included is insufficient.

When the survey has been conducted, the difference in the definition of consumer loans and payday loans had been ignored. It is considered as a subset of customer credits, and the difference could be in the maturity period. The competition and the consumer authority overlapped the considerations that clients take account when they raise small loans regardless of the length of maturity, whether it is one month or 12 months.

Analysis

Market Analysis

It is certain that the need for quick and accessible loans is higher among consumers who are out of the labor market or have lower income. It is because they believe it will be difficult to get household resources over months or years. Nonetheless, for the same reason, we can argue that consumer loans could be problematic for the borrowers as the loans could aggravate their financial situations further. If the quick loans meet the basic needs of consumers who cannot afford the market prices, then they can reduce the economic shocks. However, the payday loans rate over months also shows that consumer used the money to meet his or her impulse needs where his or her considerations for other alternatives and the future impact on the person's economic situation could be limited. So we can conclude that consumer behavior is characterized by impulsiveness and optimism about his ability to repay his loan. Also, there is a lack of understanding of the costs of raising payday loans.

As the freedom in Denmark to contract agreement, this means the individual has self-responsibility to explore the market, compare other alternatives, and make his choice. On the other hand, the providers have the responsibility to make responsible lending to their customers; it means to assess the financial situation of their customers and expect who can repay the loan. In the case of the customers that are not able to repay the loan on time, and exceed the period, they have to pay extra expenses. Appeals Board for Finance established in January 2015 worked to protect the customers who are not aware of the market loans and issuing the credits and this committee. It also obligated the providers to inform the consumers how they make use of these loans. Half of the consumers ended their loans to be more expensive than they expected when they raised the loan, the survey finds that it is due to extensions and misunderstanding the APR concept.

Monetary policy

It is sure to argue that the financial system in Denmark has changed a lot after the big recession in 2009. In this aspect, there is a need to analyze the points and establish how this change in the monetary policy could drive banks to more lending. The banks are an essential part of the economy; the existence of the banks causes lower transaction cost. Furthermore, banks have the experience to deal with asymmetric information since they know how to lower risk associated with asymmetric information (Ball, 2012). They are financial intermediaries in the financial market; they receive funds from savers and pay interests and provide funds to those who need financing and charge them. The difference between the paid interest and charged interest is called Net Interest Margin, and the banks' earnings come from this margin. (Ball, 2012).

As an accounting identity:

Assets (loans, cash, bonds) = Liabilities + Capital (Net Worth).

The sources of the banks are Deposits (transaction, non-transaction, CD) and borrowing from other banks and central bank. The financial institutions use their resources for required reserve which is (Ball, 2012) determined by the central bank and for excess reserves which offer the liquidity that banks need in their daily deals, and provide the profit when the bank's managers use it to make loans and get interested for it. Therefore, the preference for liquidity or benefit is a real challenge for managers.

The Monetary Policy

The essential element when they manage the monetary policy is money supply. It is not only affected by the money that central bank injected into the economy (necessary money) but also increases more by the money multiplier, which increases by every credit happens to and from the bank (money multiplier). From this point, the money multiplier is affected a lot and in negatives way, if the savings of individuals and companies has increased (currency ratio). If the banks hold more excess reserves and not make loans (reserve ratio) (Ball, 2012).

M-1(MONEY SUPPLY) = B (BASIC MONEY)*M (MONEY MULTIPLIER).

In 2009, banks held a lot of excess reserve because of the low-interest rate (therefore they did not make loans), there was a lot of risk on their investments, and finally, they needed money in a short time. So the multiplier has decreased a lot and in hence the money supply. To react to the situation in the years from 2010 to 2014, the central bank adopted expanding policy and provided the banks with additional deeds which stimulated the economy and encouraged the institutions to make more loans to get profit.

The central bank has three tools to provide the banks with money. The central bank through (Ball, 2012). Open market operation purchases bonds from banks and pay them by cash or by crediting their reserves, and through both of these options, the money supply increase. Moreover, discount rate policy is the changes in the interest that the central bank makes on his loans to the institutions. In cases where the interest rate gets lower, the banks will borrow more from the central bank and will have a lot of funds to make the loans. Furthermore, reserve requirement policy refers to the changes in the percent of a deposit that institutions should set aside as a reserve rather than make loans. If the required reserve ratio increases, banks set aside more of the deposits coming in, and make fewer loans, and vice versa.

Money and credit

In this chapter, the paper would go much deeper to explain the relationship between money and credit, and how can they serve the financial system. Cash and credit are complements and substitutes at the same time. They are substitutes on the individual level; the consumer could use currency or credit to exchange any commodities. Where on the social scale, they will be complements to any fiscal policy, each one can provide a function in the exchange process; another one cannot fulfill (Mack Ott, 1982). As it has been mentioned in the quantity theory of money, there are three functions for the money:

1. The moderate of interchange.

2. Element of account.

3. Stock of worth.

Credit could serve the function of a medium of interchange more than money because it facilitates the transfer which involves time, such as services sale and exchange commodities with different dates, payment without credit would act as a medium of interchange for merchandises. This point illustrates the quality of products and services that consumer applies the payday loans for.

The acceptability of money makes credit agreement of exchange as a means to settle the deferred payments. A money payment would pay all credit contracts. This agreement on how we can pay the credit contracts makes credit more available for exchange mediation (Mack Ott, 1982). The decentralized use of credit entails that consumers must clear their debts on their own volition. Without this agreement on the ways of the settlement, credit clearing will require an expensive system. It can be concluded that the importance of marketing regulation of payday loans.

APR concept

An annual percentage rate (APR) could be defined as the yearly rate which charged for borrowing cash from the giver. It is conveyed as the twelve-monthly actual cost of the loan over its term. The percentage includes any costs or additional fees related to a transaction over the life of the loan (Caskey, 2001). The formula of the APR calculator is:

$$\mathrm{APR} = \left(\left(\frac{\frac{\mathrm{Fees}+\mathrm{Interest}}{\mathrm{Principal}}}{n} \right) \times 365 \right) \times 100$$

As the lending and credit agreements might vary in terms of transaction fees, interest-rate structure, late penalties, and another factor, the concept of APR provide the borrower with an actual percentage he can quickly compare to other rates set by other lenders. So from its definition and its formula, we can clarify the reasons make the consumers of our survey believe that he paid more than what he had expected. The first reason is the disclosed interest rate that he has been taking into account does not include any additional costs such as fees and extra payments, where the actual price includes all the expenses. Secondly, the APR value is inversely proportional to the period of the loan, so as the APR for one year will be less than APR for one month which is the maturity of our payday loans, so the consumers who have no idea about this calculation will misunderstand the actual payments. Finally, the probability of defaults is high according to our data so that the consumers will be charged with additional fees, and in hence the actual rates APR will be higher. The concept will explain economic behavior of the consumer, how he can make mistakes sometimes while he is trying to pick the finest practical preference which is the first principle, and also elaborate the second principle which is the persons care relatively around their statuses compared to references sections. If the consumer has taken the correct consideration into his account and was aware of the actual cost of his loan, he will not apply for the payday loans impulsively.

Conclusion

The paper has described the consumers' experience with payday loans and tried to highlight the aspects that could stand behind increasing in payday loans. The elements are related to psychologist reasons which control the demand side of payday loans market such as impulsive buying, inability to choose the best feasible option and misunderstanding of the actual cost of this type of loans. All these factors drive the demand side of this market to apply more and more for payday loans. On the other hand, the supply side, reveals how the governments will use these markets to perform its economic and monetary goals, it will inject money into the economy which will drive banks and financial companies to offer more loans to individuals to save their savings from recession. Moreover, it has been elaborated how credit can serve the same functions of money; thereby, it will complement the funds on the social level, and substitute it on the individual level.

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