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**SOCIAL AND INSTITUTIONAL FACTORS BEHIND PAYDAY LOANS IN ESTONIA**

Master's thesis

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I hereby declare that I am the sole author  
of this master's thesis and it has not been  
presented to any other university for examination.

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## Abstract

Focus of this master's thesis is to explore what has been the main force driving people to consume above their capabilities by using the services of payday loan providers and what have been the factors supporting this situation to happen in Estonia. Theoretical part of this work is constructed around Minsky's financial instability theory, Duesenberry's relative income theory, the phenomenon of *financialization* (money-manager capitalism) with elaboration on the institutional factors behind market processes, i.e. regulations. Eleven interviews were conducted with different governmental institutions, debt counselors and payday loan companies. During the interviews several new reasons were brought out explaining the current market situation and suggestions how to alleviate the consequences. Problems have evolved because of speculative borrowers are unable to meet payments due to unexpected changes in welfare and lack of social security. Interviews showed that majority of payday loans are used for daily life expenditures, while poor social system does not support most of our problematic borrowers. Hence, payday loans are taken as a last resort. Associating with or consuming the same level as social target groups is not a priority for payday loan users. Also, the possibility that financial institutions are possessing excessive power over local governments is not an issue in Estonia. For market economies to function well, appropriate interventions and institutional structures are necessary. Here, problems begin at the school level, where financial illiteracy is an issue. An objective for the government would be to raise people's awareness and offer better social security that could reduce the number of bad financial decisions people make.

**Keywords:** payday loan, consumer credit loan, demonstration effect, financial instability theory, Estonia

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## Introduction

Since the 1980's the Western hemisphere has undergone a new business cycle with better access to financial markets, but along that came inflation, widening income inequality and rising household indebtedness. Lowered credit standards and steady financial innovation has made borrowing more accessible to households, firms and financial investors. Asset price inflation has provided better collateral and widened the range of assets that could be collateralized (Palley 2007, 20). Similar situation could be observed in 2000s in Estonia, where cheap credit provided by foreign-owned commercial banks fueled housing and consumption boom that kept up high economic growth (see Juuse 2015). At the same time, one can observe the raise of non-bank predatory lenders that flooded the market with dire socio-economic consequences.

According to Estonian Finance Committee (Villmann 2014) there are around 50 000 people who are struggling to pay back their payday loans. There is no legal definition for a payday loan in Estonia, but it is known as a short term (up to one year), small scale (less than thousand euros) consumer credit loan with or without collateral and it takes less than 24 hours to issue it. Compared with commercial banks, payday loans have a higher annual percentage rate of charge (APRC) (Danilov *et al.* 2014, 2-4, 12). If considered that Estonia has a population of 1.31 million people (Statistikaamet 2016) then it makes every 26th person in trouble. No significant steps were taken until 2015 to change the situation although the Finance Committee suggested already earlier that necessary changes should not be postponed. This asserts one of the most liberal policies regarding payday loans in Europe that have been favorable for credit companies due to lack of appropriate legislation (Villmann 2014).

Among other aspects, the issue of an increased indebtedness of the household sector was caused by poor underwriting standards by financial institutions who gave out mortgage loans during the booming years without any in-depth analysis. Moreover, people became so desperate that they tried to cover mortgage debts with payday loans creating a vicious circle (Vitsut 2007). The

problem started to evolve already in 2007 when there was no governmental organization to regulate payday loans and this favored a quick expansion of the market. Nobody was dealing with the consequences. New possibilities of electronic payday loans started to spread, as innovative and extremely simple technical possibilities made it really easy to obtain credit (Sein 2013, 33). Aside from an unregulated market factor, payday loan companies took also advantage of people's insufficient knowledge. Thus, improving financial literacy and setting requirements for a payday loan were the first steps suggested by the Estonian Banking Association for improving the situation (Esmane probleem SMS-laenuturuga on statistika puudumine 2013). Due to low legal awareness and high annual percentage rate of charge, also the Estonian Supreme Court made a proposal in 2014 to the legislator to limit the high annual percentage rate of charge (cost), and supervise payday loan companies (Mägi 2014). As a result, the Ministry of Finance submitted an application to change the law regulating consumer loan creditors (Krediidiandjate- ja vahendajate seadus 2014). The biggest changes in the new law were that payday loan companies must apply for a permit, all of them have to follow a responsible lending policy, they cannot exceed upper price target for loans, arbitration cannot be used for quick decisions and they must follow the restrictions on advertising (Kivisikk 2015, 25-28).

When looking at the experience of other countries, in Sweden consumer loan creditors have had to apply for a permit from Financial Inspection already from 2013, the same principal is now used in Estonia. In Sweden special executive agency monitors consumer loans with the purpose of promoting ethical financial behavior and preventive debt counseling (Kiirlaenude alane regulatsioon välisriikides 2012, 2-3). In Finland the legislation was changed in 2010 by setting requirements for the payday loan creditors to register their company. In 2013 an additional law was enforced to prevent impulsive borrowing, limitations were set on when the money could be transferred to the bank account and there was an upper limit for extra cost of recovery. Regional governments restructure loans for the ones who are already deep in debt by issuing a new loan to pay off all the other high interest loans. These social loans have a low interest rate (Danilov *et al.* 2014, 41, 49). Compared to the mentioned Nordic countries and other segments of the financial market in Estonia, the problem with the payday loan business area is that there are not many studies made in this field in Estonia. Probably the best overview paper so far was issued by the Ministry of Economic Affairs and Communications (Danilov *et al.* 2014), covering legal aspects, demand for and background on payday loans.

That said, this thesis elaborates on the factors that have driven Estonian households increasingly into debt with deteriorating capabilities to service their obligations. Problems regarding payday loans in Estonia are getting really severe and there is public interest to get the issue solved.

The following research questions are explored in this thesis:

- What have been the main forces driving people to consume beyond one's means in Estonia?
- What have been the (institutional) factors supporting the creation of this situation?

The thesis is divided into two sections. The first part presents the theoretical propositions that could explain the emergence of payday loan providers and demand for such financial products, but also the implications for socio-economic stability. In particular it is shown how within the *financialization* processes (also, Minsky's notion on *money manager capitalism*) financial corporations expand without restrictions. The author relies on the principles of Duesenberry's relative income theory and Minsky's financial instability hypothesis for elaborating on the essence and different aspects of borrowing in an institutionally constrained or unconstrained environment. Second part of the paper collects and presents the insights gained from interviews with eleven persons, followed by the chapter that includes a discussion on and interpretation of empirical findings in relation to the theoretical positions and finally, conclusions are drawn.

# 1. THEORETICAL FRAMEWORK

## 1.1 Financial instability theory

In the perfect world bankers – creditors in general – should only give out loans to people who do not need the money, otherwise they should lend against good collateral. By having good collateral the loans are more secured and credit risk is reduced to a minimum (Kregel 1998, 2). George Soros (1987, 81 cited in Kregel 1998, 2) has brought out that decisions made on financial markets are based on future value expectations. By lending out money expectations might change and the real value of collateral as well, because with time the value also changes. There is a connection between the value of collateral and the value of the loan it secures, a company that manages to serve the loan may strengthen the company and the bank. The ones that fail to serve their commitments may have to tighten their business activities and reduce the value of collateral promised as a pledge for the loan (*ibid.*, 2). Such changing creditor-debtor relations have been well depicted by Minsky's (1991, 4) classification of financing profiles, where he distinguishes between three positions: hedge, speculative and Ponzi. A sustainable way of borrowing would be hedge financing when the borrower has a large enough cash flow to cover both principal and interest that are due for debts (Minsky 1991, 14). Hedge financing assumes that the asset balance sheet produces the expected cash flows that exceed the financing costs and operating expenses. Also, there is an added margin of safety for any unforeseen unexpected changes in cash flows. (Kregel 1998, 3). Speculative financing position implies occasional debt extensions on the borrower side to meet its payment commitments, even though the net present value of an investment is positive by the end of the loan for full repayment, while in Ponzi scheme a safety margin almost does not exist and the probability of shortfalls is high – debtors need to borrow additional capital to service previous commitments in a pyramid-like scheme (Minsky 1991, 14). When a Ponzi financed companies (or households) do not have enough cash flow, they start to reduce cash outflows, delay payments to suppliers, cut back expenditures and try to make cash by selling inventories. If that is not sufficient to meet payments they are forced to sell other assets to generate necessary funds. In these cases companies



might seek for temporary financing to keep operating, but short-term money markets lend with higher rates (Kregel 1998, 3-4). If all projects are Ponzi ones with negative net present values then the debt-deflation problem can be resolved with a debt moratorium followed by a debt workout for avoiding a full-scale debt crisis. Alternatively, reducing financing costs by lowering interest rates could improve the cash flow situation for indebted entities (*ibid.*, 12).

Increasing use of wide range of credit products, including payday loans, and hence growing debt level of private entities reveals the essence of Minsky's (1991) financial instability hypothesis, whereby the economy moves from robust and tranquil financial relations to fragile ones, i.e. from hedge to speculative and eventually Ponzi one. Minsky stated that financial instability is an inevitable outcome of a stable endogenous process toward fragility. Problems evolve in an environment that underprices risks in a highly leveraged system. Markets generate incentives for riskier players with higher returns from investments and punish those who refused to participate (Wray 2011, 16). In this regard, it is not surprising that household debt levels have risen, which have been supported by the easy availability of payday loans – the field that has historically been the target of the banking sector through personal lending. Moreover, obtaining information about greater number of potential borrowers has become easier for the financial sector with developments in the new information technology and advances in risk management techniques. Previously, financial institutions preferred serving middle- and upper-income households because of stable incomes. Now aggressive marketing and advertising strategies are channeled to a wider population (Karacimen 2013, 11-12). By filtering good borrowers from the bad ones, financial institutions can give out risky loans with high interest rates and with improved risk assessment it should make borrowing more accessible to everyone (Cynamon and Fazzari 2008, 14-15). In a way, households are encouraged towards an asset-based welfare system, where taking risks can accumulate wealth. In addition, loose monetary policy has enabled large number of low and middle-income households to take mortgage loans through which some finance their spending needs. In some cases, governments have even favored financial institutions to offer payday loans to low and middle-income households to stimulate the economy (Karacimen 2013, 16, 20-21).

## 1.2 The process of *financialization*

Throughout time the extent to which indebtedness can rise before a crisis occurs has changed and each period has its unique elements. Efficacy of intervention and institutional structures can

influence transformation from recession to a depression cycle. According to Joseph Schumpeter new financial institutions and practices have an impact on the overall stability of the economy, often each period of rapid financial change and of financial fragility has unique characteristics. (Minsky 1991, 18).

In a modern era since 1980s, changing financial relations with increasing debt levels and proliferation of diverse financial products could be described with the notion of *financialization*. This phenomenon captured the evolution of shifting the center of economic influence from product markets to financial markets, from non-financial corporations to financial institutions and from business elites to financial elites (Zalewski and Whalen 2010, 760). In the US context, Minsky (Wray 2011, 6-9) described the evolving relationship between industry and finance through time as money managerial capitalism, a process that has been slowly transforming for nearly fifty years. The financial structure began with a conservative low debt level and over time many leading corporations gained market power and generated sufficient cash flows to make themselves more independent from shareholder demands. Eventually this led to a more unequal distribution of wealth and income throughout the society than in earlier decades and a trend toward financing through markets rather than intermediaries resulted in a *managed-money capitalism*.

Both *money-manager capitalism* and *financialization* served a purpose to elevate the significance of financial sector relative to real sector, to increase the income inequality and transfer income from the real sector to the financial sector (Zalewski and Whalen 2010, 761). *Financialization* was driven by the need of managers to show quick results on investments to the owners and therefore enjoying the fruits of the game. Instead of becoming an innovation driven long-term company in a complex and uncertain world, *financialization* supported more short-term goals in a cosmetic and virtual world of finance (Deutchmann 2011, 359). According to Epstein (2005, 3), *financialization* means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies. *Financialization* process has been supported by the wage stagnation as well as widening income and wealth inequality – factors that are attributable to financial sector developments and at the same time, decreased the constraints on financial services. For the households it has meant greater possibilities for borrowing (Palley 2007, 3). The process of *financialization* targets short-term returns through financial trading and speculation, but does not serve the needs of a sustainably growing economy by providing patient financial capital (Vasudevan 2008, 27). It is not a failure

of a capitalist system or lack of business ethics, but a model of capitalism and a natural process of knowing how to explore opportunities (Rodrigues 2012, 4).

### 1.3 Conspicuous consumption and demonstration effect - Duesenberry's relative income argument

While there is a macroeconomic and evolutionary reasoning in the Minsky's analysis and the *financialization* concept, the ideas of conspicuous consumption (see Veblen 1899) and demonstration effect (see Duesenberry 1949) capture the behavioral aspects on the demand side that explain the debt-financed consumption. The argument goes that in need to continuously improve our living standards compared with our neighbors, the easing of liquidity constraints have increasingly lured households to use credit and grow indebtedness to finance consumption in excess of current income. The burden to service their debt, however, pushes them to work harder and for longer hours, thereby contributing to the persistence of low wages and labor costs (Barba and Pivetti 2008, 126-127). With the influences of Western (and not only) consumption patterns, knowledge is extended and limits pushed further to consume more, which Duesenberry (1949) called the "demonstration effect". Being in contact with new consumption possibilities widens the imagination and desires; demonstration leads to imitation that eventually it could lead to reduced savings (see Nurkse [1953] 2009, 140-143). This effect is considered interdependent with the preference groups that encourage individuals to compete for the consumption behavior to maintain or increase their social status and prestige. Status is evaluated on the basis of visible consumption and the future expenditure is decided on the living standards of target groups with higher status (Mason 2000, 555). Such sociological constructs built around either the "demonstration effect" or conspicuous consumption help us understand the consumer behavior by showing the importance of social norms according to which individuals shape their consumption patterns. Individuals' identity is based on social relations between different groups of consumers and where they want to belong. The social groups mostly related to helps us choose the way to consume. At the same time, it needs to be acknowledged that consumption patterns are not just exogenously given, but develop over time by events and social interactions. Social reference groups' consumption patterns introduce new products and provide knowledge how to appreciate them. Households compare their consumption standards with the reference group because they care about their ranking in the consumption hierarchy (Cynamon and Fazzari 2008, 5-6). This, in turn, helps to explain why currently households use financial markets more extensively to finance their expenditure.

Duesenberry's relative income theory claims that “keeping up with the Joneses” is one of the motivations for consumption. The desire for an individual to be like his target group increases his consumption, but when a person has reached his/her regular consumption norm, it is difficult to reduce it in the conditions of decreasing (real) income. This is due to the fact that the distribution of consumption is more equal than distribution of income<sup>1</sup>, and thereby households with lower incomes spend proportionally more than households with higher income (Palley 2008, 6, 12). Thus, low and middle income households react to changes in income distribution for trying to maintain their relative standards of consumption compared with households with higher incomes as long as possible. Social ranking of living standards is pushing households to put an effort to preserve not only their absolute but also their relative standards of consumption and maintain the acquired position (Barba and Pivetti 2008, 120).

Same kind of social belonging was analyzed by Veblen (1899) in his conspicuous consumption theory already developed in the 19<sup>th</sup> century among high-class citizens. Consuming valuable goods was a sign of belonging to the reputable leisure class and demonstrating possession of wealth, drive to outrun others pushes their normal consumptions to a new higher standard. Already then covering real needs was outperformed by external wealth. In Veblen's view it is waste of time when consumption pattern is driven by demonstrative assets and social standards instead of actual need. (Veblen 1899, 39-42).

In the US, the experience of the last 25 years has shown how households are struggling to maintain their living standards when their incomes decrease. They tend to borrow more and save less to make up the difference in family budget. In this regard, Duesenberry's assumptions point out that consumption does not depend only on the current income but also current income relative to past income. Therefore, when incomes decrease, people reduce savings or even dissave, e.g. by using payday loans to protect their living standards (Barba and Pivetti 2008, 124-125). In these circumstances, problems occur, when most borrowers are speculative or Ponzi type and do not have enough collateral (see Kregel 1998, 12).

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<sup>1</sup> According to Piketty (2014, 430-431) this inequality will rise in the twenty first century, wealthier individuals might get average return on capital as much as 6-7 percent compared to the less wealthy who might have to do with 2 or 3 percent in investments. The wealthier have an advantage by having better access to financial and other advisors. Taking risks usually does not entail that severe consequences for the wealthier strata of a society, if they have substantial reserves compared with the ones that own nothing. It amplifies the process of catching up becoming more difficult for the ones in the bottom, because the inequality increases through time.

## 1.4 Institutional environment

Economic processes are embedded in the institutional structure of the political economy of a country and affected by its particular set-up. Most important factors influencing overall economic situation are government regulations and different public policies. Temporary stability can be achieved, but market players learn from changes and adjust their behavior to fulfill their targets. In an unconstrained world individualistic decision making could lead to instability. Thus, having appropriate institutions and interventions could lead to tolerable outcomes (Ferri and Minsky 1991, 20, 22).

Aside from direct financial regulation and supervision, several other institutional prerequisites such as countercyclical monetary and fiscal policies, robust financial governance etc. could be considered as necessary for financial stability and sustainability accompanied by economic progress (see Minsky and Whalen 1996). One could add also the social safety nets and educational factors that affect the financial behavior of economic agents. For instance, the main focus of corporations and labor unions has been to reduce insecurity and to offer stable social welfare for the workers, while *laissez faire* is not a functioning system in a continuously evolving market as having it now (Minsky and Whalen 1996, 4-9). Especially, in a rapidly developing financial system, where decisions are based on the maximization of returns on investments, insecurity and uncertainty are increased. Hence, the government's role in securing workers' social welfare is of great importance that has grown in the last decades because of industries with flexible production possibilities (*ibid.*, 13). At the same time, OECD (2005) has brought out that one of the reasons for households making bad financial decisions is financial education or lack of it. More complex and hard to understand financial products and services make it difficult for consumers to understand what they are getting themselves into. Constant need to keep up with consumer demands in an unequal society makes financial education more important. Eventually, financially educated consumers lead to the development of better new products and services by increasing innovation and competition between providers (Santos 2014, 4-5, 11, 18).

It needs to be noted that the economic and financial system are prone to malfunctioning, if policy makers do not adjust their interventions according to developments on the markets (Ferri and Minsky 1991, 22). Constantly reassessing regulations and procedures will help us to avoid becoming obsolete and prevents the reoccurrence of the previous mistakes. It is important to

understand the background information before regulatory proposals are made and afterwards evaluate the impact on current conditions (Kregel 2014, 3-4).

## 2. ESTONIAN PAYDAY LOAN MARKET: BACKGROUND INFORMATION

Between 2010 and 2012 the loan balance of Estonian households increased approximately 30% a year, which was a very quick pace, given that the average loan issued was up to 300 euros and the total amount of issued loans rose from 70 million euros in 2010 to 118 million euros in 2012. And, out of all consumer loans, 25% are payday loans. Moreover, in the Estonian payday loan market 30 companies give out 90% of the overall loans, while six companies account for around 50% of the total volume. Even more significant fact is that every third loan is not paid back on time, implying that approximately 35 000 persons have problems paying back payday loans. (Danilov *et al.* 2014, 3, 7-8).

The author chose this topic, because not much focus has been set on the social aspects of payday loans, although several studies and analyses have been undertaken by research and government institutions (see e.g. Kivisikk 2015, Raamat 2015, Kolk 2014, Danilov *et al.* 2014). With this thesis the author tries to explain, why consumers are borrowing and what the root causes are. Many other research papers, however, have focused on the legal aspects and possible outcomes in the future with the intention to describe potential consequences. Interviewing a wider range of related parties hopefully helps to understand, what has caused a market situation, where payday loans have become a problematic issue and what should have been done earlier to prevent this. Although no consumers were interviewed, this thesis tries to give an explanation based on collected information from different stakeholders as to why payday loans are an issue in Estonia and does restraining them solve the problem of over-indebtedness.

### 2.1 Methodology

Current research was conducted by using qualitative research method. For the empirical part overall eleven structured interviews (see Appendix 1 on stakeholders and persons) were conducted

between November 2015 and April 2016. The interviewees were asked 25 questions (see Appendix 2) that were divided into two categories:

- consumer behavior and market conditions;
- institutional factors, including regulation and supervision.

Some of the questions were addressed to state institutions and some to service providers, not all interview questions could be answered in some cases. Answers received from the interviewees represent their personal standpoint and are based on their experiences. Interviews were recorded with their permission and lasted approximately one hour per person. Several new research points came out of the interviews that could be used to develop this topic further.

## 2.2 Empirical findings

### 2.2.1 Consumer behavior and market conditions

The public interest is to limit payday loans without considering the background information as to why people are using this service. Payday loans emerged with the last boom in 2006, when the consumer society was in desperate need of quick cash that was acquired via payday loans. While banks were focused on above average customers, poor quality customers were left on the market and this gap was filled with payday loans. We have to be aware that these customers need loans the same way as others do, but their possibilities are limited. Thus, this gap in the market had to be filled, as came out from the interviews, since many borrowers do not have any other alternative.

According to Minsky's financial instability theory ([1986] 2008; Wray 2011), loans should be given out against good collateral to minimize the risk. However, when issuing loans to non-solvent customers that will probably have a problem with repayment, payday loan companies are facing moral hazards (see Bertola *et al.* 2006, 13). Namely, in case of payday loans, high rate of APRC shows that companies issuing the loans have already calculated risk margin into the loans. Even though both interviewed payday loan companies have claimed that the target is to offer payday loans to customers with good credit background as all competitors do (Interviewee J, K), then market competition has pushed loan percentages and credit standards down, which forces all companies to follow the suit. Hence, lenders are increasingly targeting speculative or Ponzi customers, while hedge borrowers are using solutions provided by banks. Even worse, by



interviewing debt counselors it came out that there has been a big problem issuing loans to the retired, the unemployed or to people with problematic background since payday loan companies are intentionally interpreting the law in their favor to give out as many loans as possible. These problems were brought by most of the interviewed people (Interviewee A, B, C, E, F, I, J, K), who noted that payday loans are targeted for people, who cannot afford loans provided by everyday commercial banks. It is then not surprising that the gap left behind by the banks was quickly filled by payday companies, who were willing to take the risk. However, due to the high number of speculative and Ponzi customers, the problem has been tried to be solved by changing the legislation and overseeing credit companies. One of the biggest changes for consumer loan companies is a systematic background check for new and existing customers, although it existed also earlier, but the way it was done varied from company to company. Now, having a regulated system for all concerned parties helps the Financial Supervision Authority to oversee the market processed. Yet, it has not been recognized that at the same time the new law makes borrowing more expensive and could mean some loans will not be available any more. This, in turn, will leave a gap in the market that will probably be filled soon.

Almost all of interviewees agreed that the ease of getting a loan has increased the market in the absence of national regulations (Interviewee A, B, C, D, E, F, G, H, I, K). Thus, in relation to the competitive situation on the payday loans market, competition between loan service providers existed before and still exists after the law was changed in 2015. It is not unusual for one payday loan company to file a complaint against another. These kind of situations occurred also during negotiations, when the new law was discussed and all sides were included in the debate (Interviewee D, F). It shows that there are companies in the market, who are interested in offering good quality loans, but higher margins attract competitors, who are willing to bend the rules to gain a better position on the market. The same kind of competition existed at the beginning, when first consumer loans came to the market – they were innovative and technology driven by trying to find new ways of making borrowing money easier. It can be seen that commercial banks have followed suit and adopted the same principles. Hence, differences between commercial banks and payday loan companies are decreasing and eventually it forces one side to differentiate to gain market position. Payday loan market is attractive and holds a lot of potential, which is why many bigger companies are owned by international corporations. On the other hand, payday loan companies have put a concerted effort to solve the problematic loans, as all three debt counselors admitted that communication between different companies is easier and all sides are interested in solving the problem. Having five different companies behind one table to find a solution is not

that strange any more. Payday loan companies were involved in roundtables arranged by the government, when new legislation was made and many companies brought up suggestions on how to improve the law and terminate future bottlenecks (Interviewee A, B, C, E, G, I, J, K). Also, suggestions were made in several interviews that consumer loan companies should ask for background information as to why the customer is applying for a loan. By doing prudent underwriting, they would be able to suggest, what the best solution is for the customer. This is what banks are doing in their daily work and it helps to improve loan quality. Eventually this could lead to a systematic approach where spontaneous loans are minimized (Interviewee A, B, C, D, E, F, I). Issuing loans is part of their business for companies and having good quality loans assures them a sustainable growth.

On the demand side, typical payday loan users have changed in recent years. While there used to be more men in their early twenties, then now the balance has changed, as men and women are borrowing equally and their age has increased to 25 to 35. They also usually have at least secondary education and are family people but it is not unusual to have a borrower with a university degree (Interviewee B, C, D, E, J, K). More important is to look at the purposes for which payday loans are used. It came out that most of the loans issued are used to pay off mortgages, cover unexpected repairs, buy food or commodities and pay medical bills. Loan counselors brought out seasonality in consumer loans, as more people are applying for loans in autumn when children are going to school. Also, buying winter tires or doing Christmas shopping is evident every year, as this group of borrowers is highly targeted by payday loan companies and there are special loans to promote their borrowing (Interviewee A, B, C, D, E, I).

On the other hand, consuming according to social norms is not so much applicable in Estonia, despite heavy influences from neighboring countries. Still, it cannot be neglected that a desire to improve the living standards compared to West European levels has increased the level of indebtedness, whereas expectations of increased income and ease of getting credit has helped to make this happen (Kukk 2012, 29, 31). Also, an interesting statement was given: "...people coming from rural areas and moving to bigger cities like Tallinn are taking over some consumer habits." (Interviewee I) It does not necessarily mean they will end up with problematic loans, but there is a tendency to adapt to society's standards. This needs more attention by public authorities, as most of loan consulting is done in bigger cities and other places do not get enough support. The problem lies in the potential drop in (real) incomes that imply severe financial constraints,

provided that people are used to consume at the same level from month to month. Moreover, most of the households do not have safety buffers in case somebody loses a job or a bigger investment has to be made (Interviewee A, B, C, D, E, I, J, K). Although the pressure from society is high to consume more of better products, feedback from loan counselors was that only a minority of borrowers uses consumer loans for luxury products like expensive mobile phones (Interviewee B, C, E). This situation is reflected in the research findings that have pointed to insignificant savings and their unpopularity among younger and over 50 year old people, as younger people are short-sighted and do not plan ahead, whereas older people are affected by their past negative experiences and prefer not to save so that in cases of emergency they hope to rely on descendants (Nestor *et al.* 2013, 28, 34).

One of the biggest challenges with the consumers is that in some cases households deny having a problem for a long time and this leads to an accumulation of problems. In addition, easily taken credit is usually used for excessive consumption and some borrowers even admit they have no intentions of paying back the loan. During 2009 and 2010 there were more such incidents; currently these kinds of customers are more of an exception. It is not possible to say, if this is the result of better public awareness or more effective background checks done by loan companies (Interviewee B, C, D, E, J, K). Still, it is a challenge to change consumer habits and fears, as having a loan is anonymous and allows to have several loans before problems escalate. Several cases were identified, where family members have payday loans from over five or more companies for many years and paying back the loans is already beyond their capabilities, but they are ashamed of admitting it in front of their families (Interviewee B, C, E, I, J, K). Over 60% of payday loan debtors have taken out more than one loan (Raamat 2015, 8). This issue comes up, when the borrowers are suggested to file for a private bankruptcy. In many cases borrowers are not dealing with the issues soon enough, as was attested by most of the interviewed people. It is very important for payday loan companies to deal with the problems before they are too severe by offering restructuring and other possibilities to solve the situation. Instead it came out that most borrowers are having another payday loan from another company to refinance the previous loan or to handle debt payments, implying a typical Minskyan Ponzi financing. Snowball effect is very common and characteristic to the Estonian market (Interviewee B, C, D, E, H, I). On a positive side, there have been improvements in payday loans, as users are more conscientious and willing to cooperate when problems occur (Interviewee B, C, D, E, J, K).

To conclude, consumer habits and lack of financial safety buffers has pushed people to choose an easier way for financing their needs. Also consumers that are now struggling to pay back their loans are mostly people who could not get any financing from bigger banks. For them it was the only option at that time to have a high margin payday loan, because it was not that regulated and the whole process was much easier. Compared with standard loans from the bank, payday loans are more anonymous, which has allowed for spontaneous decisions to be made (Interviewee B, C, D, E, F, H, I, K).

### 2.2.2 Institutional factors – regulation and supervision, education, and social safety nets

Debate around where to draw the line with regulations has brought the topic more to the public discussions. Payday loan companies are putting more focus on analyzing and minimizing the risks, because the new law has given consumers more legal rights and more responsibilities to credit companies. It also means higher costs for issuing a loan and eventually this reflects on the loan market. All of the people interviewed, however, mentioned that having a positive credit register would ease many problems, but it needs to be agreed with all financial institutions working in Estonia. This is not in the interest of bigger banks because they already have a remarkable customer base with background information and sharing this would give away their competitive advantage (Interviewee A, B, C, D, E, F, G, H, I, J, K). By ruling out asymmetrical information between competitors, it would allow the market to function smoothly, while setting same standards and regulations for all market players minimizes the risk of bad credit decisions (Kivisikk 2015, 30). Of course, government intervention is not the panacea in all cases since it cannot prevent consumers from borrowing and making bad financial decisions. What would help is enabling consumers to have better education and preparation how to manage a budget. Although some schools are now having supportive courses in finance, problems occur with consumers above school age and they do not receive enough assistance. This argument is also supported by research saying that the most problematic age is between 25 and 35 (Raamat 2015, 33). This is the group of people who are left without support and need special attention (Interviewee E). Preventive measures should be aimed more on younger generations, because they are most vulnerable groups to get trapped in poverty (Milanovic 1995, 52-53).

Research done by PISA in 2012 among 15-year old students showed that only one third of working people are planning their money matters up to one month and 7% is planning for one year. These

numbers could be explained with the result that 78% of students have not got any financial education in schools (Riitsalu 2014, 4, 6). By all interviewed people financial illiteracy seems to be the biggest problem, by not understanding the content of the contract consumers are signing legally binding documents that in the future could cost them a lot of money. Both of the two payday loan companies that were interviewed are putting a lot of energy into explaining the customers what commitments are involved within the contract and what are the obligations on both sides. This is really important to explain, a problem is that even though you go through the contract with the customer they still lack knowledge to understand the content. Now there are advertisements supported by national funds that try to support borrowers, advising them how to react when you are in debt. This issue is even bigger than it seems at first; problems arise already at early ages because all this education should have been done in school. By not having a working social program in schools, consumers do not know how to manage a budget in everyday life. Most interviewees suggested that having a social program in schools would help, teaching children how to plan their budget and most importantly, how to save money can help them in future (Interviewee A, B, C, D, E, F, I, J, K). Financial illiteracy is clearly evidenced in cases where borrowers are demanding their rights in court and not understanding the background information, not understanding that by signing a contract they have taken certain obligations upon themselves. All the loans issued before the law was changed in March 2016 are handled with the old legislation (Interviewee B, C, D, E, F, I). It means that in future years we will still see a lot of problematic borrowers. Having financial literacy enables consumers to understand financial concepts and risks in order to make effective decisions and to improve financial well-being (OECD 2014, 32).

With regard to social safety nets, inequality and poverty are risks that people are facing within the current social expenditures by the government, as the Estonian social system is built upon having two incomes per household (Eesti Inimarengu Aruanne 2011, 74). Estonia has a low expenditure with 19% of GDP on social protection compared with EU average of 27% (Aidukaite 2013, 91,93). A typical Estonian family expects state support in guaranteeing social security and average incomes, as only 9% have admitted that every family should manage without state intervention (Aidukaite and Ainsaar 2009, 10). Studies have indicated that the current welfare system is built on protecting against old social risks, such as disability, old age and sickness, whereas nowadays the specter of problems to be dealt with is somewhat different, including single parenthood, youth poverty and contemporary welfare policies. Given the living standard being about half the EU average, there are not many prospects for it to increase unless social welfare policies are changed (Toots and Bachmann 2010, 33, 40). Problem is not only in Estonia but all three Baltic States that

have been facing high inequalities and coping with low social expenditures and involvement due to focusing on traditional resource intensive and unskilled-labor industries after the communist era (Adascalitei 2012, 62).

Concerning the regulatory measures adopted for payday loan providers, the government has made gradual changes to improve the market situation. The first attempt was in 2009 when they set a limit for the APRC. Since it did not give the desired result a new, lower target was set in 2015. Setting restrictions for the debt collection costs and misleading advertising were the next steps to relieve the situation (Kivisikk 2015, 25-29). Biggest challenge for having a sustainable situation on payday loan market is for the Financial Supervision Authority - all financial companies are now operating under their supervision. For Financial Supervision Authority this is definitely a challenge: from operating with less than 10 banks a year ago they now have to manage over 70 different companies. It works in their favor that they have the most experience in this field and for some payday loan companies it means they have to start monitoring their own activities more, making sure they operate according to the law. The new law requires that all payday loan companies are registered, they have to apply for a permit and without that they can not offer financial services (Interviewee G). This measure is thought to have the biggest influence on improving the market situation. Losing their permit will stop their business and probably bankrupt the company.

Discussions if earlier changes in the law like obligation to apply for a permit could have alleviated the problematic situations are unclear (Interviewee J). Changing this law alone probably would not have helped. The responsible lending principle was applied for all the companies under Financial Supervision Authority. These two changes allow FSA more efficient supervision and - within certain limits – they now supervise all payday loan companies. State intervention is necessary when the market is no longer self-regulating and there is a need to protect consumer interests (Kivisikk 2015, 28-29). When the market is being regulated and supervised, payday loans can be a competitive and necessary product on the financial markets. One payday loan company pointed out during the interview that a negative side of new regulations is that the process is made more expensive due to additional responsibilities and it will make smaller loans irrational (Interviewee K).

Although there are debates on why wasn't the law changed earlier to prevent aggravation is still unanswered, Minsky's theory on *financialization* implies that big corporations will wield influence on behalf of their own interest. In Estonia 50% of the payday loan market is held by 6 companies, 90% of the market by 30 companies (Danilov 2015). Persons interviewed (Interviewee B, C, D, F, G, H, J, K) did not think this was the case in Estonia, the biggest local financial institutions are banks and it would have been in their interest to change the law a long time ago. Companies operating in payday loan market do not reach the same turnovers as local banks do, they are not comparable. Reason why changing the law was delayed could have been the learning process, hoping that previous changes would give a better effect and entrepreneurship would not have to be limited. Eventually it was understood that drastic measures have to be made to effect a positive change.

Outcome of postponing the law changes is dealing with consequences according to the government agencies and a debt counselor. Even now when the law is changed it will take several years before the market changes and to see the positive effect because most of the problematic loans were issued before 2015. Some government agencies admitted that the policy against payday loan companies was too liberal, no serious steps were taken to change the situation (Interviewee B, C, E, F, G, I). By actively seeking new ways how to improve social security requires participants having access to skill acquisition and social services at all times, enabling them to adjust with the new conditions (Ferrerea *et al.* 2000, 132).

### 3. Discussion

Estonia's liberal policies have attracted foreign investments, but also brought out too much emphasis on external image of the country, while neglecting critical social issues. If former communist society was supportive on their citizens and guaranteed social security, then nowadays people need to adapt to the new situation, where their success is defined by to the ability to acquire knowledge-based skills and work capabilities. It is possible to determine that these people who are unable to adapt will face difficulties without government support (Cerami 2008, 1097, 1099). Here, the problem lies in the current social system or lack of it, i.e. not having safety buffers or social guarantees means that all costs must be covered by the individual. The government has been more of an observer and the welfare of population and maintaining living standards has been the responsibility of individuals rather than the state (Eesti Inimarengu Aruanne 2011, 71). This has resulted in increase in income inequalities and poverty rates, as citizens are relying more on the family and market support (Aidukaite 2004, 42). Thus, the current welfare system is out of date and built to protect old social risks, whereas nowadays people are facing other risks that government has not dealt with yet on a larger scale. Some payday loan companies are also offering reasonable consumer loans specifically focused on social issues, but this area needs more support from the government side, not only legislative but rather financial support.

Interviews showed that only a small number of borrowers are using payday loans with the purpose of not to paying it back. It was common during the last economic boom in late 2000s, where market players were testing the boundaries, how far it was possible to go without any consequences. Nowadays the majority of loans are speculative according to Minsky's classification, where borrowers are hoping to pay back the loans on time. Problems arise when something unexpected happens and no financial reserves are held. According to the Praxis study (2013, 28, 34), Estonian people do not have savings – one third of people would not last over one month, when their regular incomes halt. Problematic groups are younger people, who have no tradition or beliefs in savings.



A short-sighted way of life and big hopes to succeed in the future is their strategy. The next risk group is people over 50 years. Their negative experiences in the past do not inspire them to save, as monetary reforms and state regime changes have caused them to lose their savings (Nestor *et al.* 2013, 28, 34). Same findings were identified with the interviews, where people said that most problematic age group is 25-35. The problem is deeper than just borrowing, because most payday loans are taken to buy consumer goods and pay rental bills. In this regard, previous findings allow the author to overturn the explanatory power of Duesenberry's demonstration effect in Estonia that people are driven by social standards (see e.g. Mason 2000, 555). Although there are consumers who are influenced by social standards, they did not fit into this thesis' target group. Demonstration effect could be only seen in cases, where people from rural areas moved to the city and increased their consumption due to new and wider possibilities. To some extent, such marginal demonstration effects are surprising given the openness to Western consumer society that has not significantly influenced debt-financed consumption in Estonia. People are using consumer loans for daily expenses, which ideally should be covered by salaries or pensions. To alleviate the issue of debtors, the government's focus should be on rather offering social security for dealing with the causes of problems than dealing with changing the law on consumer loans as a symptom of underlying socio-economic problems. Focus on legislation will simply make the loans more expensive for the end users. Thus, dealing with the consequences does not solve the root causes; it only relieves it in some categories.

The emergence of payday loan providers and extensive use of such financial products by consumers for a variety of reasons can be considered as one of the manifestations of the *financialization* process in Estonia. In addition, to some extent, the elements of *money-manager capitalism* could be observed on the Estonian financial market, but more on the traditional commercial banking side. The need for managers to show quick results has created a situation, where payday loan companies were competing without considering consequences and this eventually led to new legislation. For regulations to remain effective, they must be reassessed frequently and adopted to the financial structure. It is a never-ending struggle, where at one point the changes are functioning and then need to be modified according to the market situation (Kregel 2014, 8). Interviewed people agreed that Estonian financial institutions do not have enough power to influence legislation, but this is an outcome of their actions and a market response. The law was changed many years after the problems began, because of a long learning process and attempts to use softer methods did not give expected results.

For market economies to function well, appropriate interventions and institutional structures are necessary (Ferri and Minsky 1991, 24). Since the first payday loans in the middle of 2000s until now in 2016 it has been unclear who is responsible for companies issuing these loans. Some areas were under National Consumer Protection, some under the Ministry of Economic Affairs and Communication and some under the Financial Supervision Authority. In a rapidly evolving financial system people feel insecure and are hoping for government intervention in social welfare issues (Minsky and Whalen 1996, 4-9). It came up in several interviews that the Consumer Protection Board, the Ministry of Social Affairs and the Social Work Center were waiting for the government to take more vigorous steps in order to alleviate the market situation, but focusing on consequences is the biggest problem with our system. Problems evolve already in schools where financial illiteracy is a big issue. According to the heads of schools, the amount of teachers that have got the training on finance is too low, one tenth of students have teachers with necessary financial education training in the last six months (PISA 2012, 6). It is naive to expect people to make better quality financial decisions, when they have not got basic training at the school level. The situation will not take a turn for the better in upcoming years unless the government improves the social security system, especially when the social protection expenditures are among the lowest in the EU (Aidukaite 2013, 93).

Although Estonian students placed third on the PISA test with financial literacy among 18 countries, our government needs to put more focus on this topic (PISA 2012, 10, 22). All interviewed people brought out that financial illiteracy is one of the biggest problems and the reason why payday loan problem has evolved. Signing contracts without understanding consequences and taking financial risks could be avoided, if people were more knowledgeable. Both interviewed payday loan companies have put more emphasis on explaining the content of the contracts, as having a good quality portfolio allows them to have a profitable and sustainable business.

## Conclusion

The current thesis was aimed at finding what has been the reason people are consuming above their capabilities and what have been the driving forces supporting this situation. For answering the research questions, the analysis has been conducted on the basis of the theoretical positions of Hyman Minsky (financial instability theory), James Duesenberry (relative income theory), and the concept of *financialization* from the institutional perspective. In the empirical part, eleven interviews were conducted, including with different governmental institutions, debt counselors and payday loan companies.

Based on Minsky's financial instability theory that distinguishes between three different types of borrowers, hedge and speculative customers as safe bets can be priced with a lower margin by financial institutions. On the demand side, consumer decisions are made on future expectations on incomes. However, when unexpected changes in welfare are not covered with savings or government support, a speculative borrower is prone to go Ponzi – the highest risk pattern – and then it gets priced differently. This describes the situation in the Estonian market. Thus, the target is to avoid all loans to be Ponzi ones, as otherwise payday loan companies are not sustainable and the market could lead to a full-scale debt crisis. State intervention is necessary in early stages to regulate and redirect market players.

Demonstration effect is built around the argument of belonging to a social target group or trying to maintain a certain level of status by consuming more. In the Estonian case, it came out from interviews that the majority of payday loans are used for daily life expenditures, as the meager social safety nets do not support most of the problematic borrowers and as a last resort loans are taken. Often a snowballing effect is caused by trying to pay back previous loans with new ones, implying a typical *Ponzi* scheme. Because the target group of this thesis was not the users of payday loans, it is not possible to exclude that demonstration effect does not apply in Estonia. It

could be determined, if the focus of the research is shifted towards other groups, but needs to be researched separately.

Financial institutions do not possess excessive power to negotiate or pressure the government into making decisions. It is unfortunate that with critical topics it sometimes takes too long to find a solution. This was brought up in interviews that the government should react faster to crises and make bolder decisions before problems escalate. That said, more proactive rather than reactive stance of the government is required for dealing with the underlying problems behind the indebtedness due to using payday loans. Here, the critique could be directed towards the social welfare situation in Estonia, as in comparison to the rest of the EU, Estonia is lagging behind and current policies do not support social security. By having proper institutions and decision-making, it would be possible to increase social stability and overall economic situation. People admit that having savings is crucial but only few are doing it. Younger people are hoping to work their way up and that is part of their social security, they do not consider unemployment or health issues as relevant to them. Still, problems begin at the school level, where financial literacy has not been sufficiently targeted and here, preparing citizens to everyday life is a role of government institutions. Thus, an objective for the government would be to raise people's awareness and offer better social security that could be seen as the factors behind reducing the number of bad financial decisions.

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## Appendices

### Appendix 1: Interviewed people

All interviews were conducted by the author of the current thesis.

- A- Tea Danilov. Enterprise Estonia, entrepreneurship and export center director. 2<sup>nd</sup> of November 2015.
- B- Heete Simm. Tallinn Social Work Center, debt counselor. 16<sup>th</sup> of November 2015.
- C- Birgit Raamat. Tallinn Social Work Center, debt counselor. 19<sup>th</sup> of November 2015.
- D- Thea Palm. Consumer Disputes Committee, market supervision department manager. 15<sup>th</sup> of January 2016.
- E- Anne Rähn. Pärnu Social Work Center, debt counselor. 27<sup>th</sup> of January 2016.
- F- Kristiine Koll. Ministry of Justice, advisor in private law. 2<sup>nd</sup> of February 2016.
- G- Andre Nõmm. Financial Supervision, member of the board. 4<sup>th</sup> of February 2016.
- H- Art Andersson. Krediidiregister OÜ, manager of the company. 19<sup>th</sup> of February 2016.
- I- Regina Sergejeva. Ministry of Social Affairs, senior specialist. 19<sup>th</sup> of February 2016.
- J- Merle Laurimäe. Digital Estonia OÜ (Credit24), head of debt management department. 16<sup>th</sup> of March 2016.
- K- Helen Veski. Folkia AS (Monetti), managing director. 7<sup>th</sup> of April 2016.

### Appendix 2: Interview questions

1. What has favored payday loan lending in Estonia? How much could have influenced the absence of necessary regulations? Do you see any other factors?
2. How do you assess previous up to 2015 law on payday loans?
3. How much has the situation changed compared with 2008 and earlier years?

4. How many different interest groups were involved in discussions regarding the law changes?
5. For what reasons consumers take and use payday loans? How much could have influenced their decisions financial illiteracy?
6. Did the easiness of taking payday loans have any effect on the market?
7. In your opinion, could it be that power of financial institutions could have influenced issuing of payday loans?
8. Is it so that people tend to use payday loans to smoothen their fluctuations in incomes?
9. How much do you think we have to learn from our neighbor countries how to solve payday loan problems?
10. Currently is dealt with solving the consequences or prevention?
11. In your opinion, what is the main problem with payday loan customers?
12. How much cooperation are you doing with other institutions?
13. In your opinion, how many borrowers are taking loans with a plan not to pay back?
14. Can there be a snow-ball effect behind the increase of payday loans, where another loan is taken to payback previous ones?
15. How do you assess the role of social aspects in payday loans, are loans, are loans taken based on needs or social status?
16. In your opinion what has been the effect on payday loans having to resemble certain social status group?
17. In what regions in Estonia we have the most users for payday loans? Is there any pattern?
18. In your opinion, how many financial decisions are based on previous incomes?
19. How many payday loan users earning Estonian average salary?
20. In your opinion what is the profile of typical payday loan user?
21. What steps would help to improve problematic market situation? Why has not this been done earlier?
22. What could be the obstacles for these changes?
23. In what level there should be supervision on the service providers?
24. In what level Financial Supervision should involve more to prevent problems caused by payday loans?
25. What will be the main challenge for Financial Supervision to solve the problem?