NATIONAL CENTER FOR POLICY ANALYSIS

Proposed Payday Lending Rule Will Hurt Lower-Income Consumers

Issue Brief No. 201 by Kathryn A. Reed December 2016

The Consumer Financial Protection Bureau is a federal agency created by the Dodd-Frank Wall Street Reform and Consumer Protection Act *to protect consumers from "unfair, deceptive, or abusive practices" by financial institutions.*[1] *On June 2, 2016, the CFPB proposed federal regulations for the short-term loan industry.*

Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
202.830.0177
governmentrelations@ncpa.org

These nonbank financial services have been utilized by an estimated 5.5 percent of the population in the past 5 years, or 12 million Americans annually, to help cover unexpected expenses.[2] The payday loan industry, valued at $46 billion, employs over 50,000 Americans.[3]

The proposed rule includes penalty-fee prevention provisions; 30-day waiting periods between loans; loan renewal limits; and the collection and reporting of information on ability-to-repay to a centralized database. Critics say it would decrease access to credit and the supply of loanable funds for low-income individuals and those with bad credit histories. They also claim it will encourage consolidation of the payday industry, further increasing the cost of borrowing. The rule would reduce the volume of payday loans by 84 percent, according to the Community Financial Services Association.[4] Indeed, the CFPB says that reducing the volume of loans and number of lenders — that is, market consolidation — is one of the goals of the regulation.

Regulation of the so-called payday loan industry was a state responsibility prior to the Dodd-Frank Act, and states adopted a variety of laws ranging from outright bans to permissive rules. While the proposed federal regulations would provide uniformity, are they in the best interest of the consumer? After public comment, the CFPB expects to issue the final rule in 2017.

Misconceptions About Payday Lending

The following addresses some frequently asked questions concerning the payday lending industry.

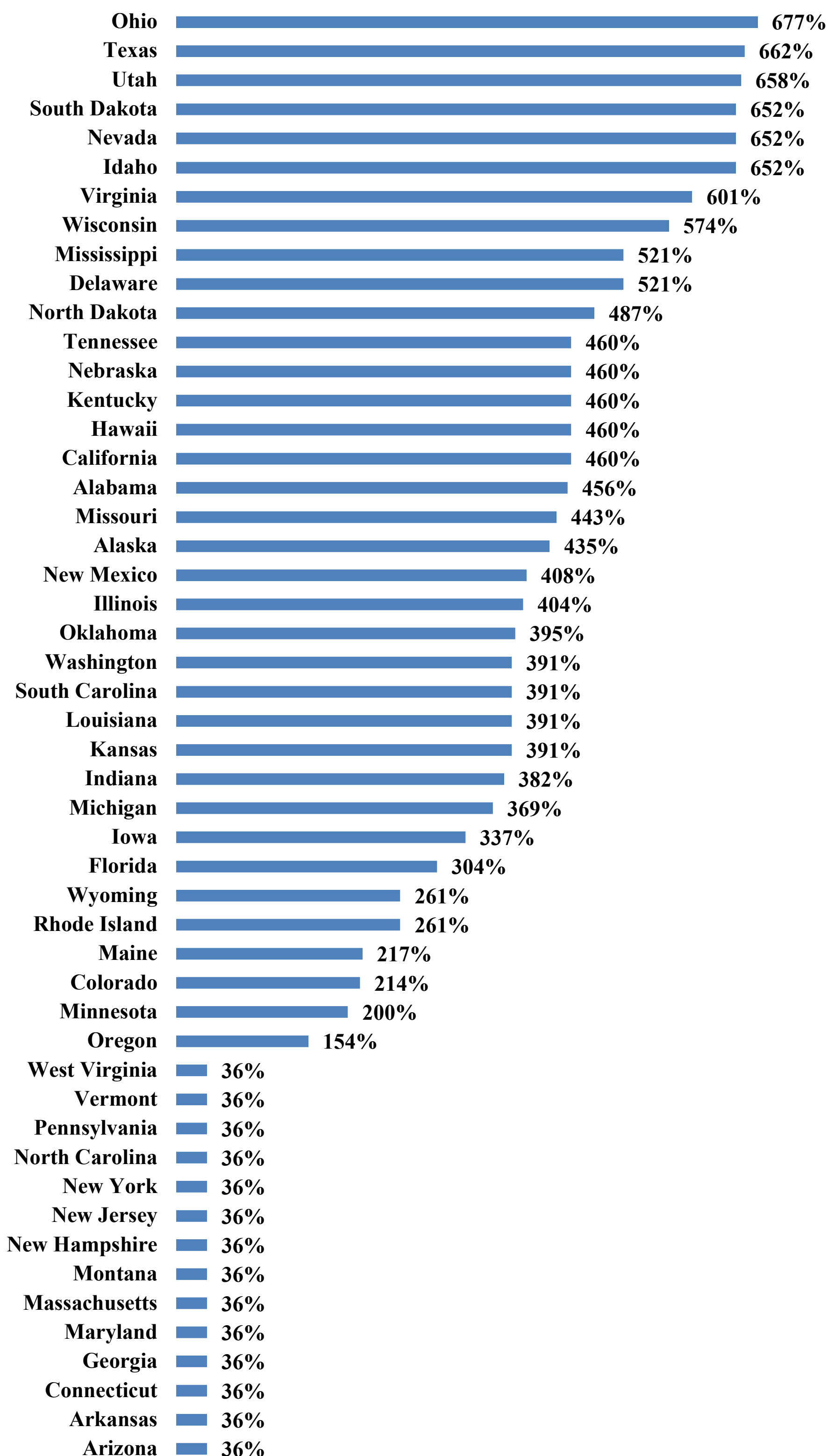
What Is Payday Lending? A payday loan or cash advance is a short-term, small-dollar, high-risk, high-cost loan. In order to obtain a payday loan, a borrower goes to a payday store, presents proof of income, such as payroll deposit advice, writes a postdated check to the lender for the principal plus fees and leaves the store with cash.

At the end of the loan period, the lender cashes the check. If the check bounces the borrower will incur a fee from their bank as well as more fees from the lender. If the borrower cannot pay the loan back before the period ends, he can go back to the store to refinance or roll over the loan. This refinancing is referred to as a debt trap by the CFPB and it claims that over half of payday loans are refinanced in this way.[5]

What Happens When States Ban Payday Lending? In May 2004, Georgia banned payday lending, and in December 2005 North Carolina did the same. After the ban, Georgians were more likely to file for Chapter 7 bankruptcy, implying payday lending is associated with fewer bankruptcies. Results in North Carolina were similar.[6] Economists Donald P. Morgan of the Federal Reserve Bank of New York and Michael R. Strain, director of Economic Policy Studies at the American Enterprise Institute, suggest people are worse off under a ban because the next best alternative to payday borrowing is bounced check and debit card protection sold by credit unions and banks.[7]

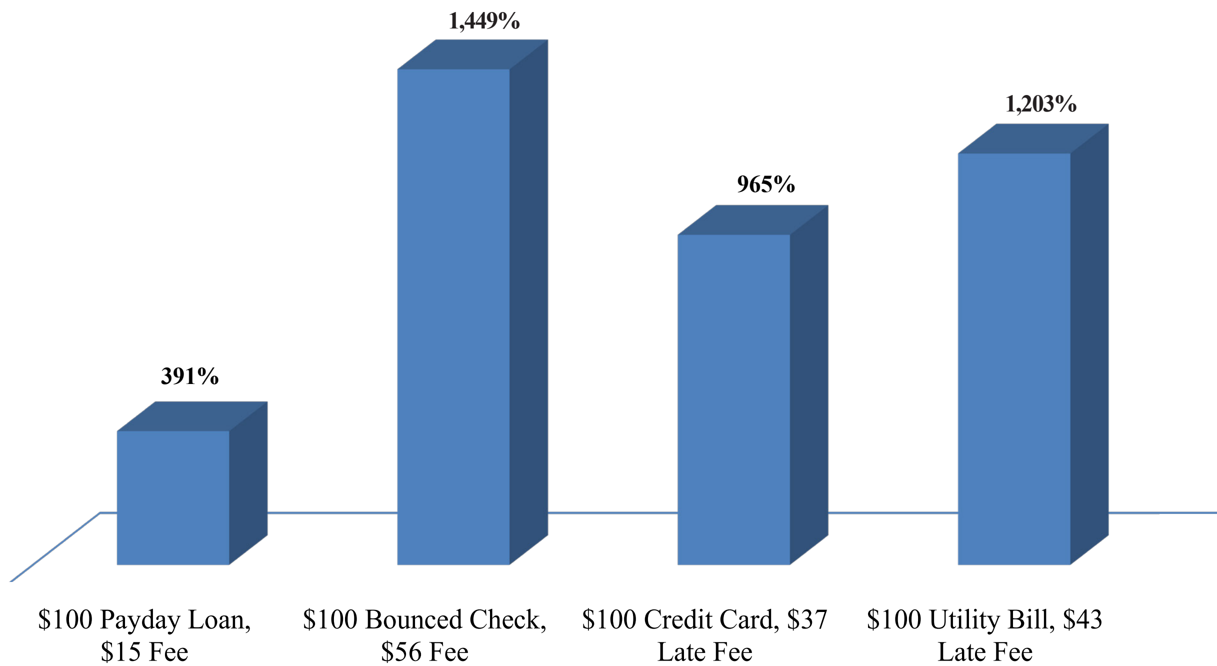
How Much Does a Payday Loan Cost? The cost of a payday loan varies from state to state. Figure I shows the average effective annualized percentage rate for a $300 two-week loan varies from a low of 36 percent in 14 states that control rates to a high of 677 percent in Ohio.

Figure I
Average Annualized Percentage Rate for a $300, 2-week loan



Source: Center for Responsible Lending.

Figure II
Effective Annualized Interest Rate on Payday Loan Alternatives



Source: Community Financial Services Association, "Myth vs. Reality."

Figure II compares payday loans to available alternatives expressed in terms of the annualized effective interest rate (APR) over a two-week period. It shows that effective interest rates on payday loans are actually lower than some of the alternatives for emergency cash. Thus, for example, an individual would be better off taking out a payday loan to cover the balance on their debit card and avoiding an overdraft fee. In the event of a payday ban, people could turn to alternatives, such as pawning items, car-title loans, rent-to-own programs for select products or even borrowing from family members. However, payday borrowers have usually exhausted these other methods.

Who Gets a Payday Loan? A Fordham University study led by Aaron Huckstep observed that "[t]hese borrowers have been described in some articles simply as 'poor people,'" though a Georgetown University study "indicates that most payday loan borrowers are middle-class, have access to other forms of credit, have steady jobs, and use payday loans exactly as intended — for short-term emergency cash flow problems."[8] The Pew Charitable Trust found that the typical borrower is above the federal poverty line, has a household income of $30,000 per year, and their "average credit score is consistently below 550."[9]

Is Payday Lending Profitable? Multiple studies have shown that "default rates [on payday loans] substantially exceed the customary credit losses at mainstream financial institutions."[10] A Fordham University study on the demographic breakdown of payday borrowers challenged the negative perception of payday lending ventures and concluded that the industry's "proffered justifications for high service fees, and by extension high APRs, may be justified by both high store expenses and high loan losses."[11] The study also found that payday lenders' profit margins were "less than half that of their mainstream lending counterparts."[12]

Furthermore, based upon study of a Texas population, a Community Financial Services Association report found that "allowing for taxes and

return on invested capital produced a breakeven annual percentage rate of over 100 percent."[13] This study cannot be extrapolated to the nation at large because Texas has such a low cost of living relative to other states, but it demonstrates why payday lenders have gone out of business under 36 percent state APR caps: A payday lender must charge at least 100 percent APR to cover costs. Additionally, a report in the Cato Institute's journal *Regulation* makes the point that "because payday loans are uncollateralized, it is almost impossible to recover the loan principal on a bad loan. This can dramatically increase break-even loan fees."[14]

The Content of the Proposed Rule

The proposed rule has some good elements, such as requiring the lender to notify someone before debiting their bank account. It also has some questionable provisions — such as ability-to-pay measures that act like a tax on the industry and a centralized database in which all payday loan applicants' personal information will be stored.

"The proposed rule will reduce the volume of car title loans by 48 percent to 78 percent."

Penalty Fee Prevention. The penalty-fee prevention provision requires the lender to notify the borrower by email three days before attempting to debit their account. The penalty-fee is incurred if there are insufficient funds to honor the check. After two unsuccessful attempts to debit the account, the lender must obtain written permission from the borrower for a third attempt. The CFPB says that banks "closed 36 percent of accounts with a failed debit attempt from an online lender."[15]

Ability-to-Repay. ATR is "the ability to repay the loan, while continuing to meet other major financial obligations and basic living expenses, without needing to reborrow."[16] Under the proposed rule, the lender must obtain information about the loan applicant's income, major financial obligations, payments due on other debt, child support and other legal obligations, and assumptions about basic living expenses.[17] The regulatory burden of obtaining such information is an effective tax on the industry that will increase the cost of borrowing and reduce the availability of credit.

Waiting Periods. This is the CFPB's major effort to stop the debt trap, mandating 30-day waiting periods between loans. If a borrower wants to roll over a loan within 30 days of paying off a previous loan they would have to demonstrate ability to pay the new loan. They can do this for three loans within 30 days of each other. Yet, even if they can demonstrate the ability to pay back a fourth loan within 30 days of the third loan, they would be prohibited from taking it out.

Centralized Database. The proposed rule creates a centralized database under CFPB control, in which all the information collected on ability-to-repay will be stored. The creation of this database would set a dangerous precedent for federal control and monitoring of markets as well as personal data collection. The personal data contained in the database would be vulnerable to unauthorized access or hacking, as all systems are, and will likely be used to justify further regulations. The Bureau already maintains a Consumer Complaint Database that has experienced a multitude of technical errors.[18]

Car Title Loans. The proposed rule also states that "a lender would not be permitted to take vehicle security [sic] in connection with these loans."[19] Long-term installment car title loans would still be legal, but "lenders making only vehicle title loans would only be able to make such loans to borrowers who the lender is able to determine have the ability to repay the loan."[20] The CFPB estimates that the waiting periods and the ability-to-repay approach will reduce the volume of car title loans by 48 percent to 78 percent.[21] The Bureau justifies these restrictive regulations by asserting that 20 percent of people who take out a single-payment car title loan default and end up losing ownership of their vehicle, while for nonsingle payment or installment loans only 11

percent lose ownership of their vehicle.[22]

Effects of the Proposed Rule

Despite criticisms that payday lending hurts the borrower, research shows that discouraging payday lending causes market consolidation and reduces the supply of loanable funds. Additionally, highly restrictive payday lending laws have been unable to achieve their stated aim of lowering the default rate.

There have been a few notable legislative reccomendations from members of Congress, such as allowing states to opt out of the proposed rule, replacing the single director of the CFPB with a five-member board, subjecting the CFPB to the appropriations process, and an amendment to the Fiscal Year 2017 House Financial Services and General Government Appropriations bill that would slow the finalization of the payday lending rule if it takes effect.

The Payday Lending Market. The CFPB claims that payday and car title loans are too expensive — so expensive that they are predatory. The market for short-term credit is still rapidly expanding, but the CFPB's regulation will likely lead to a very concentrated market for payday loans, just as it did when states began enacting APR caps in 2007. Some of the largest payday lenders have "heralded the bureau's approach" because the ruling will reduce the ability of smaller lenders to compete.[23]

"Three large banks were already preparing to offer a 5 percent payment option."

Unsurprisingly, the pending rule has demonstrably discouraged firms from entering the market. The Pew Charitable Trusts has spearheaded what it calls "the 5 percent payment option," which was included in the 2015 draft of the payday lending rule. This is not a 5 percent interest on the principal; 5 percent refers to the maximum percentage of someone's paycheck a lender could request as compensation for a loan. According to Pew, "Before the CFPB announced the draft rule, at least three large banks were already preparing to use the 5 percent payment option to make small loans at prices far lower than those charged by payday lenders."[24] They planned to undercut the other lenders, but now the plan is stalled because of the proposed rule.

Market consolidation is the expected outcome when government intervention reduces the profitability of an industry. Only those firms with economies of scale are able to continue operating. A study by Sumit Agarwal at the National University of Singapore on the impact of antipredatory mortgage legislation (HB4050) in Chicago found that "the number of active lenders declined disproportionately in the target geographic area."[25] The total amount of loan applications decreased 51 percent and the total amount of loan originations decreased 61 percent.[26] This decrease in the supply of loanable funds caused upward pressure on interest rates (that is, the cost of borrowing). Even with this decrease in so-called predatory loans, the 27 percent default rate fell by a statistically negligible amount.

Legislative Response. There have been a few notable legislative responses to the CFPB's proposed rule. Congressman Scott Tipton (R-Colo.) has come out firmly against the proposed rule, stating "the Bureau has completely disregarded the efforts that a majority of states, including Colorado, have already made to protect families from predatory lending while preserving their access to short-term credit."[27] Colorado oversees payday lending but does not ban it outright. The industry operates profitably there. "Tipton's bill [H.B. 5552] would allow any state or a federally recognized Indian tribe to request a wavier for exemption from the CFPB's final regulation."[28]

Rep. Tipton is also a strong supporter of House Financial Services Committee Chairman Jeb Hensarling's CHOICE Act.[29] The CHOICE Act would replace the director of the CFPB with a bipartisan, five-member commission subject to the appropriations process.[30] The Bureau currently sets its own budget with funds provided by the Federal Reserve. The CHOICE Act would also "repeal [the CFPB's] authority to ban bank products or services it deems abusive," preventing the proposed rule from taking effect.[31] In addition, an amendment to

the Fiscal Year 2017 House Financial Services and General Government Appropriations bill would delay enforcement "until the CFPB completes a report, with public comment, on the impact of the rule on populations with limited access to credit, and until it identifies existing credit products available to replace the current sources of short-term, small-dollar credit."[32] Each of these efforts are a step in the right direction.

Conclusion

The classical economist and utilitarian philosopher who convinced Adam Smith, who was originally for interest rate caps, of the economic benefit of usury, Jeremy Bentham (1748-1832), is rolling over in his grave at the threat of this proposed rule. Bentham argued against putting a ceiling on the interest rate, stating "why a policy, which [were it] applied to exchanges in general, would be generally deemed absurd and mischievous, should be deemed necessary in the instance of this particular kind of exchange, mankind are as yet to learn."[33] People would be outraged by government intervention in any normal goods market if it would cause a shortage of that good. Why is it any different in this market?

How can "the legislator, who knows nothing, nor can know anything at all about the matter" justify barring a man from obtaining a loan the lender is willing and able to give?[34] How indeed is he to justify sacrificing a market to the false god of consumer protection?

This proposed rule will be unable to achieve its aim of decreasing the default rate and decreasing the cost of short-term credit. Instead, it will increase the cost of such credit by encouraging market consolidation and decreasing the availability of short-term loans. This rule will set a dangerous precedent for federal intervention in the transactions of individuals and for federal storage of individuals' financial data.

Kathryn A. Reed is a Koch Internship Program alumnus and a Financial Policy Associate with the National Center for Policy Analysis.

Notes

1. Dodd-Frank Act, Title X, Subtitle C, Sec. 1036; PL 111-203, July 21, 2010.
2. Nick Bourke, Alex Horowitz and Tara Roche, "Who Borrows, Where They Borrow, and Why," Pew Charitable Trusts, July 2012.
3. Community Financial Services Association, "About the Payday Advance Industry."
4. New Orleans City Business, "Federal regulators propose restrictions on payday lenders," LexisNexis Academic, June 2, 2016.
5. "Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps," June 2, 2016.
6. Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare After Payday Credit Bans," Federal Reserve Board of New York Staff Report Number 309, February 1, 2008, page 3.
7. Ibid., page 4.
8. Aaron Huckstep. "Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?" *Fordham Journal of Corporate & Financial Law*, Volume 12, Issue 1, 2007, page 3; and Gregory Elliehausen and Edward C. Lawrence, "Payday Advance Credit in America: An Analysis of Customer Demand," Credit Research Center, Georgetown University, Monograph No. 35, 2001.
9. Sultana Ali, "Understanding the CFPB Proposal for Payday and Other Small Loans" 2016, Pew Charitable Trusts. page 13; and Neil Bhutta, Paige Marta Skiba and Jeremy Tobacman, "Payday Loan Choices and Consequences," *Journal of Money, Credit, and Banking*, Volume 47, Numbers 2-3, 2015, pages 223-259.
10. Mark J. Flannery and Katherine Samolyk, "Payday Lending: Do the Costs Justify the Price?" FDIC Center for Financial Research, Working Paper Number 2005/09, June 2005.
11. Aaron Huckstep. "Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?" *Fordham Journal of Corporate & Financial Law*, Volume 12, Issue 1, 2007, page 214.
12. Ibid., page 214.

13. Gregory Elliehausen and Edward C. Lawrence, “Payday Advance Credit in America: An Analysis of Customer Demand,” page 5.
14. Victor Stango, “Are Payday Lending Markets Competitive?” Cato Institute, *Regulation*, Fall 2012.
15. “Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps,” June 2, 2016.
16. Center for Responsible Lending, “Initial Analysis of CFPB’s Proposed Rule to Address Payday & Car Title Loans,” June 6, 2016, page 3.
17. Ibid., pages 3-4.
18. Rachel Witkowski, “Errors Abound in CFPB’s Complaint Portal,” *American Banker,* November 17, 2015.
19. “Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps,” June 2, 2016, page 8.
20. Ibid., page 967.
21. “Supplemental findings on payday, payday installment, and vehicle title loans, and deposit advance products,” Consumer Financial Protection Bureau Report, June 2016, page 147.
22. “Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps,” June 2, 2016, page 2.
23. Nick Bourke, “Proposed Payday Lending Rule Would Leave Borrowers Vulnerable.” Pew Charitable Trusts, June 2, 2016.
24. Ibid.
25. Sumit Agarwal et al., “Predatory Lending and the Subprime Crisis.” *Journal of Financial Economics*, 2014, page 3.
26. Ibid., pages 20-21.
27. U.S. Official News, “Washington: Tipton Introduces Bill to Protect Colorado Families Access to Emergency Lending,” LexisNexis Academic, June 24, 2016.
28. Ibid.
29. Scott Tipton, “Financial CHOICE Act is Needed to Protect Our Families and Grow Our Economy,” press release, July 13, 2016.
30. Barbara S. Mishkin, “Congressman Hensarling’s Dodd-Frank replacement bill to include CFPB reforms,” CFPB Monitor, Ballard Spahr, June 8, 2016.
31. Jeb Hensarling, “Financial CHOICE Act Executive Summary.”
32. Fiscal Year 2017 House Financial Services and General Government Appropriations Bill.
33. Jeremy Bentham, “In Defense of Usury,” 1787a, 4th edition, (London: Payne and Foss, 1818), page 13.
34. Ibid., page 33.

Recent NCPA Financial Crisis Research Publications

C.K. Lee, “Causes, Recollections, and the Aftermath,” National Center for Policy Analysis, Backgrounder No. 185, October 6, 2016. http://www.ncpa.org/pdfs/bg185.pdf

Rep. Jeb Hensarling, “Principles of Financial Opportunity Reforms,” National Center for Policy Analysis, Issue Brief No. 193, June 3, 2016. http://www.ncpa.org/pdfs/ib193.pdf

Richard M. Ebeling, “The Federal Reserve and Sound Money,” National Center for Policy Analysis, Policy Report No. 188, February 4, 2016. http://www.ncpa.org/pdfs/ib188.pdf

Hector Colon, “The Role of Derivatives in the Financial Crisis,” National Center for Policy Analysis, Issue Brief No. 187, January 26, 2016. http://www.ncpa.org/pdfs/ib187.pdf

John Berlau, “Banks That Are “Too Big to Fail” Need Competition,” National Center for Policy Analysis, Policy Report No. 378, December 11, 2015. http://www.ncpa.org/pdfs/st378.pdf

Hector Colon, “Exporting U.S. Inflation,” National Center for Policy Analysis, Issue Brief No. 179, December 2, 2015. http://www.ncpa.org/pdfs/ib179.pdf

Peter J. Wallison, “Is the Dodd-Frank Act Responsible for the Economy’s Slow Recovery from the Financial Crisis and the Ensuing Recession?” National Center for Policy Analysis, Special Publication, November 20, 2015. http://www.ncpa.org/pdfs/sp_Paper%20on%20Dodd-Frank%20and%20the%20Slow%20Recovery.pdf

David Grantham, “Dodd-Frank in the Congo,” National Center for Policy Analysis, Issue Brief No. 176, November 10, 2015. http://www.ncpa.org/pdfs/ib176.pdf

David Ranson, “The Fed Is Holding Rates Down for All the Wrong Reasons,” National Center for Policy Analysis, Issue Brief No. 175, November 4, 2015. http://www.ncpa.org/pdfs/ib175.pdf

Chanan Steinhart, “The Mortgage Meltdown,” National Center for Policy Analysis, Backgrounder No. 179, September 29, 2015. http://www.ncpa.org/pdfs/bg179.pdf

Iain Murray, “How Dodd-Frank Harms Main Street,” National Center for Policy Analysis, Issue Brief No. 173. September 25, 2015. http://www.ncpa.org/pdfs/ib173.pdf

James Rickards, “How Central Bank Planning Ruins Markets,” National Center for Policy Analysis, Backgrounder No. 178, September 23, 2015. http://www.ncpa.org/pdfs/bg178.pdf

Richard M. Ebeling, “Markets, Not Janet Yellen, Should Set Interest Rates,” National Center for Policy Analysis, Issue Brief No. 169, August 18, 2015. http://www.ncpa.org/pdfs/ib169.pdf