



Small-Dollar Lending: Is There A Responsible Path Forward?

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August 2012

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Acknowledgements

The Center for Economic and Policy Research thanks the National Bankers Foundation for its generous support of our work on financial markets.

The author’s understanding of the issues discussed in this report was greatly increased by helpful comments from Dean Baker of the Center for Economic Policy Research, Jean Ann Fox of the Consumer Federation of America, Michael Grant of the National Bankers Foundation, Kevin Kimble of Cash America, and Ed Mierzwinski of the U.S. Public Interest Research Group. However, none of these individuals or organizations bear any responsibility for the information and conclusions in the report; these are the sole responsibility of the author.

Executive Summary

This report examines the problem of access to credit for low- and moderate- income households. It notes that this problem has two dimensions. On the one hand, there are millions of consumers without access to mainstream sources of consumer credit. On the other hand, many of these same consumers do obtain high-cost credit that ends up harming rather than helping them.

A person or household may be in a serious or even desperate situation when their financial resources are insufficient to cover necessary expenditures. But providing a loan in these circumstances will be beneficial only if the borrower is able to repay it at reasonable cost.

The small-dollar loan problem needs to be understood not simply as a need for increased access to consumer credit, but as a need for increased access to consumer credit that is affordable and welfare-enhancing.

Bank regulators and consumer advocates have adopted four criteria for identifying high-quality small-dollar loans:

- 1) an Annual Percentage Rate (APR) of no more than 36%,
- 2) a loan term of at least 90 days,
- 3) repayment in installments rather than in a single lump sum, and
- 4) an assessment by the lender of the borrower's ability to repay the loan.

There is broad agreement that the demand for such loans far outstrips their supply.

This report reviews currently available small-dollar loans to low- and moderate-income households, most importantly payday lending, to examine the extent to which they meet these criteria. For the most part, these options fail badly on all four measures. However, the report also identifies examples of high-quality small-dollar loan products that do meet the four criteria as well as ongoing initiatives to expand the supply of such loans.

Finally, this report reviews the argument for a newly introduced bill in the House of Representatives, the “Consumer Credit Access, Innovation, and Modernization Act” (H.R. 6139) to determine the extent to which it offers an effective way to increase the supply of affordable, high-quality small-dollar loans to consumers who lack access to credit cards or other mainstream credit options. It does not appear as though this bill would result in an increase in high-quality small-dollar loans. There is a substantial risk that it would increase the supply of high-cost credit that could leave borrowers worse off than if they had not obtained credit at all.

Introduction

This report was undertaken to examine the problem of access to credit for low- and moderate-income households, review the various lending options that currently exist for small-dollar loans to these individuals and families, and determine the extent to which proposed federal legislation offers an effective way to increase the supply of high-quality small-dollar loans.

Part I of this report reviews the two central dimensions of this problem. On the one hand, there are millions of consumers without access to mainstream sources of consumer credit. On the other hand, many of these consumers do obtain high-cost credit that ends up harming them rather than helping them. This section attempts to clarify that the underlying problem needs to be understood not simply as a need for increased access to consumer credit, but as a need for increased access to consumer credit that is affordable and welfare-enhancing.

It is also necessary to understand efforts to address the problem that are already underway. Thus, Part II explores promising current initiatives to expand the supply of affordable, welfare-enhancing small-dollar loans; to address the underlying problem in complementary ways; and to reduce the availability of harmful consumer credit.

Part III attempts to determine whether and to what extent proposed federal legislation – currently the “Consumer Credit Access, Innovation, and Modernization Act” (H.R. 6139) – offers an effective way to increase the supply of affordable, high-quality small-dollar loans to consumers without access to credit cards or other mainstream credit options. It identifies the main features of the proposed legislation; summarizes the arguments offered by its proponents; critically assesses those arguments; and analyzes the legislation’s likely impact on the supply of affordable and welfare-enhancing small-dollar loans to those currently without access to them. This assessment finds that H.R. 6139, if adopted, would significantly worsen the underlying problem rather than contribute to its solution.

The final section offers a brief summary of major findings and conclusions.

I. Dimensions of the Problem

The small-dollar loan problem today has two dimensions. First, there is a large unmet demand for helpful small loans. Second, the supply of harmful small loans is too great. What is needed is to expand the availability of the former type of credit while shrinking the supply of the latter.

There is no question that many millions of lower-income households need more money. Most generally, the broad extent of poverty and near-poverty in the U.S. is well documented. More narrowly, as we shall see below, the FDIC and others have documented in great detail the existence and characteristics of many millions of unbanked and underbanked households. However, the need for more money is not the same as the need for loans.

While loans do provide borrowers with money, they must – by definition – be repaid, generally with more money than was received. Thus, only people with the ability to repay the money that they borrow can be regarded as having a need for loans, rather than just a need for money. For most of those who need more money to maintain an adequate standard of living, the need is not for loans

but, rather, for some combination of more income (from employment or other sources) and increased provision of free or subsidized goods and services.

An analogy can be provided by the widespread existence of hunger among lower-income households. Because most of those who are hungry are in that position precisely because they lack the means to buy sufficient food, the problem of hunger cannot be solved simply by the provision of more conveniently-located grocery stores. Recognizing this, our nation's response to the hunger problem has consisted primarily of providing food for free through food pantries and facilities offering free meals, and of providing added purchasing power to consumers through food stamps. Adopting policies that increase the number of conveniently-located grocery stores could provide only a small part of the solution to the hunger problem.

The analogy may be extended in one important way. The problem of hunger – and, more generally, the problem of poor nutrition – has been exacerbated by the high-priced, nutrient-poor products that tend to be sold in the fast food outlets and grocery stores that locate in lower-income neighborhoods. Similarly, the problem of too little money has been exacerbated by the high-cost credit products that are readily available in many lower-income neighborhoods. Just as the wrong kind of food can be harmful rather than helpful to people's physical well-being, the wrong kind of credit can be harmful to their financial well-being.

Accordingly, the problem addressed by this report is the need for expanding the supply of small-dollar loans that will help rather than harm the lower-income borrowers who receive them. Such loans will be referred to by a number of terms used interchangeably in this report: *high-quality loans*, *welfare-enhancing loans*, *affordable loans*, or *responsible loans*.

In contrast, expanding the supply of harmful loans will exacerbate rather than ameliorate the problem addressed by this report. A person or household may be in a serious or even desperate situation when its financial resources are insufficient to cover necessary expenditures. But providing a loan in these circumstances will be beneficial only if the borrower will be able to repay it at reasonable cost. Otherwise, providing a loan will only make the situation even worse, in the same way that providing a struggling swimmer with a “cement life raft”¹ would increase rather than decrease his or her chances of drowning. In the words of the National Consumer Law Center: “harmful forms of credit *should* be restricted...if high-rate borrowing is not sustainable for the borrower in the long term, it is better for the borrower to address the underlying problems early rather than later...*If a loan cannot be made responsibly, then it should not be made at all.*”²

Defining High-Quality Small-Dollar Loans

The idea that some loans are too expensive or exploitative to be allowed is not a recent invention of welfare state liberalism. Indeed, for literally thousands of years societies have adopted rules aimed at prohibiting loans judged to be too harmful or exploitative to be permitted, generally because of excessively high interest rates, or usury. An accessible short summary of the history of prohibitions on usury from the Babylonian Empire through the eighteenth century, with special attention to relevant biblical passages, is provided by Graves and Peterson.³

1 Warren and Tyagi (2003), chap. 6

2 Saunders *et al.* (2010), p. 8; emphasis in original

3 (2008), pp. 648-655

In response to widespread exploitative small-dollar lending around the turn of the twentieth century,⁴ the Russell Sage Foundation championed a model “Uniform Small Loan Law” that was adopted in 34 states between 1914 and 1943. These laws typically established maximum interest rates in the range of 36%.⁵ Most of these laws are still in force today, and the higher-cost lending that takes place is usually the result of specific legislation that provides an exemption for particular categories of loans, such as payday loans or auto-title loans.

This provides the historical background for the widespread adoption of 36% APR⁶ as an appropriate ceiling for responsible small-dollar loans. The Military Lending Act, which took effect in 2007, established 36% as the maximum allowable APR for loans to active duty military personnel or members of their families.⁷ A 36% ceiling was also adopted by the FDIC in the standards for its model small-dollar loan program and by the National Consumer Law Center in the criteria it used to identify “genuine alternatives” to payday loans.^{8,9}

Other essential features for high-quality loans include a repayment period of at least ninety days, repayment in a number of installments rather than in a single lump sum on the due date, and an assessment by the lender of the applicant’s ability to repay the loan. All three of these additional features are also adopted by both the FDIC and the NCLC.

These should not be regarded as rigid or final criteria. Reasonable people could disagree about what ceiling should be imposed on the APR,¹⁰ on how long a loan period is minimally necessary to provide a real opportunity to obtain the funds necessary to comfortably repay the loan, on the structure and timing of installment payments, and on underwriting criteria to be used in determining ability to repay. Nevertheless, these four criteria for identifying welfare-enhancing small-dollar loans provide a useful general framework. This framework will be used below to describe how far payday and other widely-available ultra-high-cost loans are from high-quality loans and will be used again, later in the report, to consider the scope of current and emerging high-quality small-dollar loan products.

4 “...the pervasive problem of predatory lending...was ubiquitous across America’s major cities. Offering quick and easy loans...these lenders – or ‘loan sharks’ as they were popularly called – charged interest rates as high as 400 percent a year and roped low-income workers into cycles of debt that were difficult for many to escape” (Anderson, 2006, p. 3). For a detailed history of the origins and early history of “salary lending” in the late 19th century, and of attempts to regulate it in the early decades of the 20th century, see Mayer (2010), chaps. 1-2.

5 Anderson (2006), p. 4

6 Annual Percentage Rate (APR) is a measure of the cost of a loan that is defined in the Truth in Lending Act (TILA), which requires that it be disclosed to loan applicants. The APR includes the impact of most fees as well as of interest charges, and it expresses these costs at an annual rate, thereby providing a measure that facilitates comparison shopping for credit products.

7 Fox (2012), pp. 3-7

8 Miller (2010), p. 28 and Saunders *et al.* (2010), pp. 1 and 8-18

9 Most recently, the “Protecting Consumers from Unreasonable Credit Rates Act of 2012” (S. 3452), sponsored by Sen. Dick Durbin (D-IL), would extend a 36% APR cap to all consumer loans.

10 An alternative to capping the APR alone is to provide separate ceilings for fees and for the interest rate. This is the approach adopted by Massachusetts, which allows a maximum interest rate of 23% plus a maximum administrative fee of twenty dollars that can be charged to a given borrower only once in any twelve-month period (Plunkett and Hurtado, 2011, p. 73).

The Unmet Demand for High-Quality Small-Dollar Loans

There is wide agreement that the unmet need for affordable small-dollar loans is very large. Few would dispute the conclusion of researchers from the Center for Financial Services Innovations that “there is a shortage of high-quality small-dollar, short-term credit in the marketplace today.”¹¹

There appears to be no good, evidence-based quantitative estimate of size of the unmet need for credit by the households who fall in a particular layer of the population – neither so “high” a layer that they have access to mainstream credit sources, most commonly in the form of credit cards, nor so “low” that they lack the ability to repay even affordable small-dollar loans.

Even without such an estimate, however, it is reasonable to infer from the very large size of the current market for ultra-high-cost credit (as reviewed in the following section) that the unmet demand for high-quality small-dollar loans is very large. Presumably, all of those who currently obtain ultra-high-cost loans would, other things being equal, prefer to obtain much lower-cost affordable loans.¹²

Detailed information about the households who make use of ultra-high-cost credit products is available in the FDIC’s *National Survey of Unbanked and Underbanked Households*¹³, based on a Census Bureau survey of about 47,000 households. Unbanked households are defined as those with neither a checking nor a savings account; underbanked households are those who have such an account, but also use alternative financial providers for money orders or check cashing or use payday lenders, pawn shops, rent-to-own stores, or refund anticipation loans.

The FDIC reports that just over one-quarter (25.6%) of all U.S. households – that is, about 30 million households containing about 60 million adults – are either unbanked (about 30% of the total) or underbanked (the other 70%). The percentage of unbanked or underbanked households is considerably higher for blacks (54%), Latinos (43%) and Native Americans (45%). The FDIC estimates that over one-third of unbanked and underbanked households – that is, about 10.8 million households – use at least one of the alternative credit products mentioned in the preceding paragraph at least once per year. The survey found that four million unbanked and underbanked households obtained at least one payday loan per year.¹⁴

Whatever the exact size of total demand for high-quality small-dollar loans, there can be no doubt that it is very large, and also no doubt that the current supply of such loans falls far short of the demand. Some promising initiatives to increase the supply of high-quality small-dollar loans will be reviewed in Part II of this report.

11 Schneider and Noide (2010), p. 2

12 The phrase “other things being equal” is, of course a major qualification. Fees and interest rates are not the only aspects of a loan product that matter to consumers. Many of those who borrow from payday lenders, for example, cite their convenient locations, rapid loan processing, friendly treatment, and privacy as valued features.

13 (2009)

14 FDIC (2009), pp. 15, 29, and 40-41

The number in the final sentence is the author’s calculation from data provided in the FDIC report. (6.6% of 9 million unbanked plus 16.2% of 21 million underbanked is 4.0 million households.) A useful supplement to the FDIC’s report is a report by the Center for Financial Services Innovation on its own earlier survey of unbanked and underbanked households, with detailed information about their demographic composition, use of specific credit products, and attitudes and preferences about borrowing (Schneider and Koide, 2010).

Before concluding this discussion, it is important to note that while measures to increase loan supply are the major focus of this report, increasing supply is not the only way to reduce the amount of unmet demand for high-quality small-dollar loans. Unmet demand can also be reduced by decreasing the need for such loans. For example, increasing households' savings would allow temporarily increased spending needs be met without borrowing. Alternatively, improving households' credit histories and credit scores would enable them to qualify for credit cards or other sources of lower-cost mainstream credit.

The Too-Great Supply of Harmful Small-Dollar Loans

The high level of payday lending has been cited above as an indicator of the first major dimension of the small-dollar loan problem in the U.S. today – the fact that the supply of high-quality, affordable small-dollar loans is far less than the demand for such loans. We turn now to the second major dimension of the problem – the extent to which borrowers are receiving ultra-high-cost loans that are, in many cases, harmful rather than helpful. Although there are a variety of forms of ultra-high-cost small-dollar lending, payday lending is the best known of these and will be the focus of this discussion.¹⁵

Payday loans are made to borrowers who have a bank account and a regular documented source of income, such as a paycheck or a direct deposited Social Security benefit.¹⁶ The loan fee is expressed by lenders in terms of number of dollars per \$100 borrowed, with most fees in the \$15 - \$20 range (because the typical payday loan is for two weeks, or one twenty-sixth of a year, this translates to an annual percentage rate [APR] of 390% to 520%).¹⁷ For example, a borrower who receives a typical-size loan of \$350, and is charged the average rate of \$16.90 per \$100 (439% APR), would agree to repay \$409.15 on his or her next payday in two weeks, either by giving the borrower a post-dated check or pre-authorizing an electronic debit from his or her bank account.¹⁸

Since emerging in the early 1990s, modern payday lending has become big business. Stephens, Inc., the industry's main investment banker, estimated that there were 19,700 storefront offices at the end of 2010. About half of these were operated by fifteen national corporations, six of which are publicly traded.¹⁹ Although the number of storefronts is down from a peak of over 24,000 in the middle of the last decade, online payday lending has been growing. According to Stephens, Inc., the

15 Other types of ultra-high-cost lending include auto-title loans, pawn-shop loans, refund anticipation loans, and bank overdraft loans. The last of these, bank overdraft loans, is particularly large and important and will be briefly discussed at the end of this section.

16 Payday loans are usually described as requiring that the borrower be employed, but what matters to the lender is that there is a regular source of income that can be committed to repayment of the loan. A 2008 *Wall Street Journal* article reported on the prevalence of payday lending to those dependent on Social Security, disability, and other benefit payments (Schultz and Francis, 2008).

17 A table prepared in 2009 by the Center for Responsible Lending, with data on maximum dollar charge for each state in which a \$350 payday loan is allowed, reports that the weighted average of the fees allowed was 16.9% of that amount (Parrish and King, 2009, p. 29). This is quite consistent with the data presented by the interactive map on one industry association's website, which enabled the author of this report to calculate that the median cap for a \$100 loan in the states where payday lending is allowed is 16.6% (an APR of 434%). (Map is at: <http://cfsaa.com/our-resources/customer-resources/know-your-fee.aspx#>)

18 Payday loans take many forms and can vary substantially from the typical payday loan described here. In particular, payday loans sometimes have their single payment due well over one month from the date the loan is originated. This issue will be addressed at greater length in Part III, below.

19 The Stephens, Inc. estimate is cited by Bianchi (2012, p. 9) who also lists the six publicly-traded corporations: Advance America, Cash America, Dollar Financial, EZ Corp, First Cash Financial, and QC Holdings.

industry will make \$44 billion of payday loans in 2012.²⁰ Even with a generous estimate of \$440 as the average loan size, this would mean that a total of 100 hundred million payday loans will be made this year.²¹ Survey research sponsored by the Pew Charitable Trusts indicates that twelve million Americans received a payday loan in 2010.²² The industry collects more than \$7 billion in fees from its borrowers annually.²³

In addition, banks have begun to make payday loans themselves. Although these bank-originated payday loans are given different names (such as “direct-deposit advances”), they share the core payday loan features of short term to maturity, preauthorized repayment (in this case from the borrower’s next direct deposit) in a single sum, and triple-digit APRs.²⁴ (The statistics on payday lending given in this report exclude bank payday lending.)

Historically, small dollar-lending has been regulated at the state level. Most states have general usury laws and/or small installment loan laws that set maximum permissible interest rates or APRs. Payday lending usually requires specific authorizing state legislation that provides an exception to the general laws. Ten states never authorized payday lending, while others have withdrawn previous authorizations or adopted new prohibitions. Currently, seventeen states plus the District of Columbia effectively prohibit payday lending. These include eight states in the Northeast (all of the six New England states except Rhode Island, plus Pennsylvania, New York, and New Jersey), plus Maryland, North Carolina, Georgia, West Virginia, Ohio, Arkansas, Montana, Arizona, and Oregon.²⁵

Since July 2011, however, payday lending has also been subject to regulation by the newly established Consumer Financial Protection Bureau (CFPB), the result of a specific mandate in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The significance and implications of this new federal regulation, and its potential for reducing the harmfulness of payday lending, will be examined in Part II of this report.²⁶

20 Estimate cited by Center for Responsible Lending, *et al.* (2012, p. 1).

The reports of Stephens, Inc. are available only to subscribers and so are not cited here directly.

21 Researchers at the Center for Responsible Lending reported estimates of the industry’s size in 2009 that are somewhat smaller, but still indicative of a very large industry: \$27.2 billion for total loan volume, \$350 for average loan size, and 77.8 million for the number of loans (Parrish and King, 2009, pp. 11-12). The smaller size of these estimates may result from their being based on data that omits most online lending.

22 Bourke *et al.* (2012), p. 8

23 Cordray, Richard. 2012. Prepared Remarks to Consumer Financial Protection Bureau. *Payday Loan Field Hearing*, January 19. Available at: <http://www.consumerfinance.gov/speeches/remarks-by-richard-cordray-at-the-payday-loan-field-hearing-in-birmingham-al/>; accessed August 15, 2012.

Note that this is consistent with the previously cited estimates for total loan volume of \$44 billion and an average fee of 16.9% of the amount borrowed ($\$44B * 0.169 = \$7.4B$).

24 Borne *et al.* (2011) provide a recent account of the nature and extent of bank payday lending.

25 Parrish and King (2009, p. 30) provide a table showing, as of 2009, the rate cap and most recent legislative or regulatory activity in each of the states where payday lending is effectively prohibited. (Montana’s prohibition is the result of a 2010 referendum.) Bourke *et al.* (2012, pp. 19-31) classify only fourteen states (and DC) as having “restrictive” regulation of payday lending; they classify Ohio as “permissive” because payday lending has continued despite passage of state legislation and a ballot initiative designed to end it, and they classify Maine and Oregon – along with 6 other states – as having “hybrid” regulation. On the other hand, the Consumer Federation of America classifies Colorado as having effectively prohibited payday lending; as of August 2010, the minimum loan term for payday loans in that state is six months, and almost all of what that state calls “payday loans” are now installment loans rather than single-payment loans.

26 The Military Lending Act, adopted in 2006 and discussed below, is an earlier instance of federal regulation of payday lending, but its scope was limited to loans to active duty military personnel and their dependents. The CFPB has not

High-cost payday loans do much more harm than good. The following paragraphs present a summary of the evidence supporting this conclusion, but no attempt is made to survey the very large – and rapidly growing – literature about payday lending.²⁷ Nor is any attempt made to summarize and analyze the arguments offered on behalf of the payday lending industry; although these may have surface plausibility, none of them can withstand careful scrutiny in light of the existing evidence.²⁸

The key argument against payday lending is that borrowers become caught in a “debt trap” when their inability to repay an initial payday loan creates the need to take out another.²⁹ The very high cost of the repeated loans results in the extraction of huge sums from households who are the least able to afford it. Furthermore, the collateral damage suffered by the nearly half of payday borrowers who ultimately default on their loans adds substantially to the harm from the loan fees themselves.³⁰

Payday loans would be much less harmful if they were, as the industry maintains, an alternative source of funds that was used relatively rarely by people faced with one-time (or infrequent) emergencies, such as the repair of a car essential to their employment. However, recent research by the Pew Charitable Trusts found that even considering only each borrower’s initial storefront payday loan, more than four times more loans were used for recurring expenses than for unexpected or emergency expenses (69% vs. 16%).³¹

yet proposed any new regulations for payday lenders, but the public hearing that it held in Birmingham, Alabama on January 19, 2012 and the hundreds of comments that it received in response to its call for comments on the issues raised at that hearing are a valuable source of information about the industry (www.consumerfinance.gov).

27 The best single introduction to that literature is Robert Mayer’s monograph, *Quick Cash: The History of the Loan Shark* (2010), an illuminating history of high-cost payday-based lending in the U.S., and of attempts to regulate this lending, since its emergence in the late 19th century, along with a thoughtful and even-handed examination of the public policy issues raised by payday lending. The book includes 29 pages of notes and a 14 page bibliography.

28 The case for the beneficial nature of payday lending is presented on the website of the Consumer Financial Services Association (CFSA), which represents mainly storefront payday lenders (www.cfsaa.com). See also the website of the industry-created Coalition for Financial Choice (www.coalitionforfinancialchoice.org); although this website appears not to have been updated in the last few years, the essence of the arguments for and against payday lending have changed very little over time. Much less such material is presented on the websites of two other industry associations – the Financial Service Centers of America (FiSCA), which represents mainly storefronts that offer check-cashing and other services in addition to payday loans (www.fisca.org), and the Online Lenders Alliance (OLA) (www.onlinelendersalliance.org).

29 Many of the industry’s most prominent critics have summarized their arguments, and provided many citations to the literature, in a “Comment” submitted this April to the Consumer Financial Protection Bureau by the Center for Responsible Lending (CRL), the Consumer Federation of America (CFA), the National Consumer Law Center (NCLC), and thirteen other groups (Center for Responsible Lending, *et al.*, 2012). Much additional material critical of payday lending is available at the CRL website (www.responsiblelending.org) and at a website maintained by the CFA (www.paydayloaninfo.org). For a very useful survey of the industry and of the concerns raised by its critics, see Stegman (2007).

30 While most critics of payday lending share this report’s concern for the practical harm that payday lending does to borrowers, others focus on the moral issues raised by the ultra-high interest rates or APRs. Opposition to usury has long been part of the Jewish, Christian, and Islamic traditions, and faith-based organizations and religious leaders have played prominent roles in campaigns against payday lending, high-lighting the moral dimension of charging triple-digit interest rates. Graves and Peterson, whose survey of the history of usury prohibitions in religious thinking was cited earlier, conclude that survey by noting that “if the biblical injunction against usury... is to have any meaning at all in today’s society, then making payday loans to impoverished borrowers at a three hundred percent interest rate must surely be a sin” (2008, p. 655).

31 Bourke *et al.* (2012), pp. 14-15

In fact, the great majority of payday loans are accounted for by those who receive multiple loans. Researchers at the Pew Charitable Trusts found that the average payday borrower receives eight loans per year, lasting an average of 18 days each. The same researchers calculated that the typical recipient of an initial loan of the average size of \$375 ends up paying a total of \$520 in fees during the following twelve months – substantially more than the amount borrowed.³²

Similarly, the Center for Responsible Lending found that just 2% of payday loans were made to borrowers who received only one loan during the year and that 76% of payday loans were repeat loans made to borrowers within two weeks of the repayment of an earlier loan.³³ A later study by the same pair of researchers tracked all payday borrowers in Oklahoma for two years from the date of their initial loan. They found that these borrowers were in debt to payday lenders for an average of 372 days – that is, for over half of time during the two-year period. While the average initial loan was for \$279, the average indebtedness over the entire period was \$466.^{34, 35}

Payday lending by banks has also been found to result in borrowers being trapped in a cycle of extensive repeat borrowing, with the average borrower paying an APR of 365% and being in debt for 175 days per year – that is, for 48% of the time.³⁶

This “debt trap” phenomenon does not happen by accident, but results from the very nature of the payday loan product and the payday loan business. The loans are so costly that only those who have pressing needs for immediate cash, but lack the ability to use credit cards or other sources of mainstream credit, are likely to borrow from payday lenders. It is entirely predictable that these borrowers, in such circumstances, will be unable to obtain the funds needed to repay the entire amount received, plus the fee, in a single payment just two weeks later. The short-term, single-payment nature of the loan – made on the basis of the borrower’s post-dated check or authorized ACH withdrawal, rather than any underwriting based on ability to repay out of future income – virtually guarantees that many borrowers will have to take out another payday loan to repay the first, paying another fee just as great as the initial one.

From the lender’s point of view, repeat borrowers are the easiest way to generate loan volume and fee income, and so incentives are strong to encourage customers to roll over their loans rather than to repay them. Indeed, a report by the Pew Charitable Trusts, citing Stephens, Inc. (investment banker to the payday industry) and researchers from the Federal Reserve Bank of Kansas City, finds that the storefront “payday loan business model depends upon heavy usage – often, renewals by borrowers who are unable to repay upon their next payday – for its profitability.”³⁷

32 Ibid., p. 9

33 Parrish and King (2009), pp.11-12

34 King and Parrish (2011), p. 3

35 An extreme case of a payday borrower unable to extricate himself from the debt trap was reported by the PBS program “Need to Know” on May 18, 2012. Through loans from multiple lenders, Eliot Clark’s total payday debt reached \$2,500 and his total payments, over more than three years, totaled \$30,500 (Available at: <http://www.pbs.org/wnet/need-to-know/video/need-to-know-may-18-2012-financial-inclusion/13840/>). The plausibility of this amount may be confirmed by a rough calculation: a loan of \$2,500 at 400% APR that was outstanding for three years would generate total interest of $\$2,500 * 4 * 3 = \$30,000$.

36 Bourne, *et al.* (2011), p. 6

37 Bourke *et al.* (2012), p. 7

The conclusion that, on balance, payday loans result in substantially more harm than help to those who receive them seems fully justified by the available arguments and evidence. Similar conclusions for other widely available types of ultra-high-cost loans such as overdraft loans and auto-title loans are also warranted. For purposes of the rest of this report, these conclusions are accepted in the belief that any objective and impartial reviewer of the evidence and arguments would agree in finding them justified.

Congress reached this same conclusion, at least for loans to military personnel, in 2006. In response to strong advocacy by Department of Defense officials concerned about the impact on the performance of military personnel, especially those deployed overseas, of payday loan indebtedness of themselves or their families at home, Congress passed, and the President signed, the Military Lending Act. This law effectively prohibited payday lending and other forms of ultra-high-cost lending to active duty military personnel and their immediate family members by imposing a 36% APR ceiling on small-dollar loans.³⁸

Since then, state law-makers and citizens have been coming to this same conclusion as well. While the number of states explicitly authorizing payday lending increased from 23 (plus DC) in 2000 to 38 (plus DC) in 2005³⁹, it has since dropped to 33. Oregon and the District of Columbia enacted rate caps in 2007, and New Hampshire did so in 2008. In three other states where there were referendums on payday lending in recent years, citizens voted overwhelmingly to prohibit payday lending. In 2008, 64% of voters in Ohio approved a measure to impose a maximum APR of 28%. Later the same year, 60% of voters in Arizona defeated an industry-sponsored measure that would have allowed payday lending to continue operations in that state. And in 2010, a Montana proposal to cap APRs at 36% was approved by 72% of the voters. A similar ballot initiative is expected to be voted on in Missouri this November.⁴⁰

As noted above, the payday loan industry's responses to the arguments and evidence of its critics, and its claims that payday lenders provide a helpful service to their borrowers, are unconvincing, and are not reviewed in this report. Nevertheless, one of the arguments frequently advanced by the industry's supporters makes an important point – that some of the alternatives to payday loans, including overdrafting bank accounts and writing checks not backed by sufficient funds, have even higher APRs than do payday loans. Although bank regulators do not officially classify overdraft loans as loans, that is exactly what they are – the bank advances funds on behalf of its customer and requires repayment of the amount advanced and a fee (plus in some cases, interest charges). The FDIC has calculated that typical overdraft loans involve APRs of more than 1,000%, and a recent Consumer Federation of America survey of the nation's fourteen largest banks found that the median APR for a two-week \$100 overdraft loan was 1,352%.⁴¹

38 Fox (2012)

39 Stegman (2007), p. 177

40 Other states have tightened their payday lending regulations. Most recently, in June 2012, Delaware's governor signed a law limiting borrowers to five payday loans in any twelve month period and creating a database to track all payday loans made in the state. Colorado's newly restrictive regulations, effective in mid-2010, were noted in an earlier footnote.

41 The primary practical consequence of overdraft loans not being officially regarded as loans is that the Truth in Lending Act's requirement for disclosing the APR does not apply. However, the FDIC, assuming a \$27 overdraft fee (the median in its survey), calculated typical APRs for overdraft loans ranging from 1,067% (for a \$66 check overdraft repaid in two weeks) to 3,520% for a \$20 debit card overdraft repaid in two weeks) (FDIC, 2008, p. v). The Consumer Federation of America survey found APRs ranging from 884% to 2,779% (CFA, 2012, pp. 4-5).

The proper response to over-priced and abusive overdraft loans is appropriate regulation to eliminate their abusive features and reduce their prevalence, not to use their existence as a reason to allow harmful payday lending to continue or expand. Nevertheless, the industry's argument here does call attention to the widespread availability of this other form of harmful small-dollar credit, which generated almost \$24 billion in fees for banks in 2008.⁴²

II. Current Initiatives

The small-dollar loan problem has received widespread attention for many years, and there are a number of promising current initiatives designed to respond to it. This part of the report offers a brief survey of these initiatives in order to provide additional background for Part III's consideration of proposed federal legislation.

Expanding the Availability of High-Quality Small-Dollar Loans

There are many examples of high-quality small-dollar loan products and programs that meet all of the criteria identified above. The National Consumer Law Center has provided a useful survey of examples of alternatives to payday loans that do, and of others that do not, meet a set of similar criteria for "genuine payday loan alternatives."⁴³ The FDIC has offered a summary of the small-dollar loan pilot program that it operated from 2007-2009 that required participating banks to meet all four of the criteria adopted in this report.⁴⁴ Two other recent surveys of affordable small-dollar loan products have been provided by the Center for Financial Services Innovation⁴⁵ and the U.S. Government Accountability Office (GAO).^{46, 47}

A review of these surveys leads to mixed conclusions. On the one hand, the overall scale of the alternatives is quite small compared to the scale of the payday lending industry's current operations. The GAO emphasizes that the alternatives are "limited in scope."⁴⁸ For example, the 31 banks participating in the FDIC small-dollar loan pilot program made just 34,000 loans for a total amount of just \$40 million over a two-year period⁴⁹ and there have been no reports that the pilot program resulted in the widespread adoption of similar small-dollar lending programs by other banks. Further, the surveys emphasize the challenges posed by the need to keep program costs and credit losses low enough to make affordable loan programs profitable for the lenders.

On the other hand, a review of these surveys and of other materials on efforts to expand high-quality small-dollar lending provides four reasons for concluding that the initiatives currently underway have the potential to bring about a very substantial expansion of such loans: impressive

42 For an excellent summary of the impacts of overdraft loans on consumers, together with a set of proposals for reform, see Center for Responsible Lending, *et al.* (June 2012). The \$24 billion figure is from p. 4.

43 Saunders *et al.* (2010)

44 Miller *et al.* (2009)

45 Schneider and Koide (2010), pp. 9-21

46 (2011), pp. 23-37

47 For earlier discussions of successful examples of alternatives to payday loans, see Bair's case studies (2005, pp. 21-27 and Appendix) and Havener and Smith's summary of a conference at the Federal Reserve Bank of Philadelphia (2007, pp. 13-17).

48 (2011), p. 23

49 Miller *et al.* (2010), p. 28

examples of successful programs; an insight into why many banks refrain from offering potentially profitable programs; the growing use of new technology and new insights from behavioral economics in program design; and the expanding network of non-profit organizations working together on this problem. The following paragraphs will review these four reasons in turn.

First, the surveys cite numerous specific programs that demonstrate the feasibility of high-quality small-dollar loan programs that are not only affordable and welfare-enhancing for borrowers but also economically sustainable for lenders. This point can be illustrated by noting four particularly interesting programs.

- Progreso Financiero makes loans primarily to lower-income Latino immigrants without credit histories, using proprietary software to screen applicants. It operates from rented spaces in grocery stores and pharmacies and now has 80 sites in California and Texas. Its typical loan of \$1,000 is repaid in two \$60 payments per month for ten months, resulting in an APR of about 36%. In seven years of operation it has made over 300,000 loans.⁵⁰
- A number of innovative programs involve partnerships between lenders and employers that enable workers to obtain advances against their earnings that are repaid by payroll deduction. By piggy-backing on already existing employer human resources databases and payroll systems, these programs minimize administrative costs.⁵¹
- The Salary Advance Loan program at the North Carolina State Employee Credit Union (SECU), a very large depository with other one million members and over \$12 billion in assets, “shows that large institutions can market more affordable payday loan products to high-risk customers at interest rates that are a small fraction of prevailing payday loan rates.”⁵² The loans, for up to \$500, have an APR of 12% and are repaid by the borrower’s next direct deposit. Repeat use is heavy, but a borrower who took a loan in the middle of each month and repaid it two weeks later would incur an annual cost of just \$30 (as opposed to over \$1,000 for someone with the same borrowing pattern who used payday loans with the typical charge of \$16.90 per \$100 borrowed). Between 2001 and 2007, SECU made over one million of these loans, experienced a charge-off rate of 0.25%, and earned a profit on this loan program.⁵³
- A number of major banks offer overdraft lines of credit that can also be used to transfer funds directly to a deposit account. Citibank’s Checking Plus program currently charges an interest rate of 18.25%, plus a fee of \$10 each time funds are transferred from the line of credit to the deposit account. The minimum monthly payment is one-sixtieth of the outstanding balance. Key Bank’s adoption last year of a very similar program was highlighted in an *American Banker* article;⁵⁴ the KeyBasic program has an interest rate of 19.99% plus a \$25 annual fee and a \$10 fee for each transfer, and is reported to be profitable for the bank.

50 Progreso Financiero is included in the surveys by the Saunders *et al.* (2010, p. 30) and Havener and Smith (2007, p. 14). For more up-to-date journalistic accounts, see Reckard (2010 and 2012).

51 Two of the employer-based programs, FlexWage and Workers Choice USA, were highlighted in Congressional testimony last fall (Manturuk, 2011, p. 5). Others are noted in the survey by Schneider and Koide (2010 pp. 14-15).

52 Stegman (2007), p. 183

53 SECU’s Salary Advance Loan program is discussed by Stegman (2007, pp. 183-185), Havener and Smith (2007, pp. 13-17), and Bair (2005, p. 21). Current information on the loans is available at SECU’s website: www.ncsecu.org/PersonalLoans/SalaryAdvance.html.

54 Horwitz (2012)

These and similar programs show that large banks can offer relatively low-cost loans that allow borrowers to repay over an extended time period.⁵⁵

Second, a 2005 report by Sheila Bair (then a professor at the University of Massachusetts Amherst, later Chairman of the FDIC) that investigated the feasibility of banks and credit unions offering low cost alternatives to payday loans reached two important conclusions. Bair found that banks and credit unions do indeed have the capability to profitably offer low-cost small-dollar loans, but also found that “the proliferation of fee-based bounce protection programs represents a significant impediment” to their offering these products. In other words, depositories reaping high fees from overdraft loans have a strong financial incentive not “to cannibalize this income by offering their customers lower-cost small dollar credit options.”⁵⁶

Michael Stegman also finds that banks’ “bottom lines are better served by levying bounced check and overdraft fees on the payday loan customer base than they would be by undercutting payday lenders with lower cost, short-term unsecured loan products....they have little incentive to compete in the market for lower-priced payday loans.”⁵⁷ These findings suggest that any successes in reducing the current high levels of ultra-high-cost overdraft loans (noted at the end of Part I, above) will also have the effect of increasing the willingness of banks and credit unions to increase the supply of high-quality small-dollar loans.

Third, technological innovations and new insights from behavioral economics promise to enable the development of lower-cost, more consumer friendly, and better designed small-dollar loan products. Use of rapidly-evolving online and mobile-phone technology to reduce the need for face-to-face interactions can contribute to reducing the costs of loan origination and servicing. Increasing the convenience and speed with which high-quality, affordable small-dollar loans can be obtained will undercut one of the major current advantages offered by payday and other high-cost lenders. Behavioral economists, led by Jonathan Zinman of Dartmouth, have offered – and in some cases rigorously tested with randomized trials – ideas to improve the design of lending products and programs by taking into account biases and habits that shape economic decisions differently from what would be predicted by traditional economic models that assume rational, maximizing behavior.⁵⁸

Fourth, there is an active network of impressive organizations working to promote the development of high-quality small-dollar loans and other innovative products for households outside the mainstream financial system. Doing more here than listing these organizations is beyond the scope of this report, but detailed information is available at the indicated websites.

The Center for Financial Services Innovation (www.cfsinnovation.com) plays a central role in this network, including by organizing a large annual “Underbanked Financial Services Forum.” The work

55 Citibank’s Checking Plus program is described by Bair (2005, p. 27); current information is available at: <https://online.citibank.com/US/JRS/pands/detail.do?ID=CheckingPlus>. The survey by Saunders *et al.* includes this Citibank program as well as similar overdraft lines of credit from Capital One and U.S. Bank (2010, p. 30).

56 (2005), pp. 3-4 and 8-13

57 (2007), pp. 181 and 185

58 A PowerPoint presentation in which Zinman (2011) summarizes many of his ideas is available on his website (www.dartmouth.edu/~jzinman/), which also has links to many other items of interest. Also, Melissa Koide (2011, pp. 3-4) has provided a succinct survey of recent innovations designed to “create a viable and sustainable small-dollar loan product for the underserved market.”

of the U.S. Household Finance Initiative of Innovations for Poverty Action (www.poverty-action.org/ushouseholdfinance) is also particularly notable. The Pew Charitable Trust's Safe Small-Dollar Loans Research Project (<http://www.pewstates.org/projects/safe-small-dollar-loans-research-project-328781>) is still researching unsafe loans as a preliminary step to working on safe, high-quality alternatives.

Related federal government efforts include the FDIC's Alliance for Economic Inclusion (www.fdic.gov/consumers/community/AEI/) and work by several components of the recently established Consumer Financial Protection Bureau (CFPB), including the offices for Research, for Installment and Liquidity Lending Markets, and for Financial Empowerment (www.consumerfinance.gov). In addition, Section 1205 of the Dodd-Frank Act ("Low-Cost Alternatives to Small Dollar Loans") charges the Treasury Department to promote and fund multiyear demonstration programs in this area.

Some Important Complements

As noted earlier, expanding the supply of high-quality small-dollar loans is only one way of reducing the unmet demand for such loans by households that do not have access to mainstream financial products such as credit cards. A complementary approach is to decrease the need for such loans. At the most general level, this would be best accomplished by reducing involuntary unemployment and part-time employment, and by expanding the benefits that our social safety net provides to those in need. However, more targeted and specific measures can also make a contribution. These include measures to improve budgeting and decision-making skills to bring expenditures into line with incomes; measures to increase savings and build assets that can be drawn upon when needed to meet unanticipated expenditures; and measures to build credit records and credit scores that will allow access to mainstream credit products.

Multiple efforts are being pursued in each of these three areas, including many by the just-mentioned organizations that are involved in initiatives to increase the supply of high-quality small-dollar loans. For example, many of the lower-cost small-dollar products reviewed earlier in this section incorporate savings components (whereby part of the initial loan proceeds are put into a savings account and/or part of each loan payment is added to a savings account) and others include reporting loan payments to credit reporting agencies in order to help build a positive credit history.

Indeed, there is far too much happening in these areas to summarize accurately and briefly. The purpose of this section is simply to emphasize that providing more high-quality small-dollar loans is not the only way to reduce the unmet demand for such credit products.

A New Regulatory Regime

Just as the second major aspect of the small-dollar loan problem is the too-great supply of harmful small-dollar loans, the second major aspect of solving this problem is reducing harmful lending – either by reducing the number of harmful loans made or by reducing how harmful the individual loans are. In this regard, the importance of the recent creation of the Consumer Financial Protection Bureau (CFPB) can hardly be overstated. This new agency has great potential to reduce the extent to which consumers are harmed by high-cost small-dollar loans.

The CFPB was established, as of July 21, 2011, by Title X of the Dodd-Frank Act.⁵⁹ The CFPB, the first and only federal agency whose primary mission is consumer financial protection, was given authority over almost all consumer financial products and services. This authority includes writing the regulations that implement consumer financial laws (“rule-writing”) as well as direct supervisory and enforcement authority over banks with assets of \$10 billion or more and over some types of nondepositories. In the area of small-dollar lending, the CFPB was explicitly given supervisory and enforcement authority over all payday lenders but only over “larger participants” in other small-dollar lending markets. These other markets, and the criteria for identifying the “larger participants” in each of them, have not yet been defined by the CFPB; possible markets include installment lending, auto-title lending, and pawn lending.⁶⁰

For the first time, all types of small-dollar lenders (banks, credit unions and nondepositories) are subject to meaningful federal supervision for compliance with federal laws and regulations. Payday lenders and other state-chartered small-dollar lenders are now subject to both federal and state supervision and enforcement, with the Dodd-Frank Act providing that new CFPB regulations will not replace state regulations that offer stronger protections for consumers. The CFPB has committed itself to work cooperatively with state regulators and Attorneys General, and state officials have broad authority to enforce federal laws as implemented by CFPB regulations. It is notable that the new federal regulatory regime represented by the CFPB is being implemented during a period of increasingly restrictive state laws and regulations limiting the operations of payday lenders, as described near the end of Part I, above.

Although the CFPB is expressly prohibited from imposing any usury limits that cap interest rates or APRs, it has broad authority to issue regulations implementing almost all federal consumer protection laws as well as the power to identify and take action against any lender acts or practices that it determines to be “unfair, deceptive, or abusive.” In its “Examination Procedures: Short-Term, Small-Dollar Lending” (at all types of lenders), the CFPB indicates its intention to examine carefully all stages of the lending cycle – from marketing, through loan origination and repayment, to debt collection for loans that are not repaid on time. It also indicates its intention to give particular attention to repeat borrowing, or what it calls “sustained use” of payday loans.

Of the four offices in the CFPB’s Division of Research, Markets, and Regulations that are devoted to major market areas, one covers “Installment and Liquidity Lending Markets” (the others cover Cards Markets; Mortgage Markets; and Credit Information, Collections, and Deposits Markets). Other parts of the CFPB are also involved in gaining a full understanding of the actual operation of small-dollar lending markets and in developing appropriate policies, including rules and regulations, to fulfill the CFPB’s general mandate of making consumer credit markets “fair, transparent, and competitive.”⁶¹

59 The full text of the Dodd-Frank Act (“The Wall Street Reform and Consumer Protection Act of 2010”) is available at: <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>. Title X, which has its own title of “The Consumer Financial Protection Act of 2010,” is on pp. 580-738 of this PDF document.

60 The relevant portion of the Dodd-Frank Act is Sec. 1024 (“Supervision of Nondepository Covered Persons”). The CFPB explained its general approach to defining “larger participants” in a July 7, 2011 blog post by Peggy Twohig (<http://www.consumerfinance.gov/blog/2011/07/page/2/>). Its first final rule actually defining the “larger participants” in a specific market was issued in July (Bureau of Consumer Financial Protection. 2012. “Defining Larger Participants of the Consumer Reporting Market.” *Federal Register*, Vol. 77, No. 140, July 20, pp. 42874-42900).

61 The CFPB’s organization chart is available in the “About Us” section of www.consumerfinance.gov.

III. Proposed Legislation

We are now in a position to determine whether and to what extent the proposed “Consumer Credit Access, Innovation, and Modernization Act” (H.R. 6139) offers an effective way to increase the supply of affordable high-quality small-dollar loans to consumers without access to credit cards or other mainstream credit options.⁶²

In keeping with the purpose of this report, discussion and analysis of the proposed legislation will be limited to its potential impact on small-dollar lending. It should be noted, however, that the new federally-chartered companies made possible by the legislation would also have the power to provide a variety of other consumer financial products and services and to make loans of up to \$25,000 to small businesses. Although no individual products or services are itemized in H.R. 6139, the following were explicitly listed in the predecessor bill, H.R. 1909: check-cashing, reloadable stored value cards, wire transfers, money orders, bill payment, and tax preparation.

Key Provisions

The proposed legislation would authorize a new type of financial institution – called National Consumer Credit Corporations (NCCCs) – whose primary business would be required to be serving underserved consumers. These new companies would be chartered and regulated – subject to existing federal consumer laws and regulations – by the Office of the Comptroller of the Currency (OCC), the primary regulator of federally-chartered banks.⁶³ The companies would be able to operate nationwide, and would be exempt from state laws and regulations.

An NCCC would be required to submit an application for any consumer financial product that it wished to offer. This application, even if not explicitly approved by the OCC, would be deemed approved unless the OCC determined within 45 business days that it would significantly harm the interests of underserved consumers. There would be only a few specific restrictions on consumer loan products, including that the loan term be at least 31 days, that there be no prepayment penalty, and the dollar amount of an unsecured loan be no more than \$5,000.

Neither the OCC nor any other regulator would be allowed to impose any limit on interest rates or fees for any loan. The Truth in Lending Act would be amended so that neither NCCCs nor any other lenders would be required to disclose the APR for loans of one year or less; instead, they would disclose the total cost of the loan as a dollar amount and as a percentage of the loan principal.

62 H.R. 6139 was introduced by Rep. Blaine Luetkemeyer (R-MO), on July 17, 2012. All citations to H.R. 6139 are to the page and line numbers in the PDF version available at: <http://www.gpo.gov/fdsys/pkg/BILLS-112hr6139ih/pdf/BILLS-112hr6139ih.pdf>. This bill effectively supersedes H.R. 1909, the “FFSCC Charter Act of 2011,” introduced by Rep. Joe Baca (D-CA) in May 2011. H.R. 1909 was itself a successor to a bill introduced by Rep. Baca in the previous Congress in July 2010: “The FFSCC Act of 2010” (H.R. 5942). Full-text versions of all three bills, together with lists of their co-sponsors and legislative histories, are available at www.thomas.gov.

63 Since it came into existence on July 21, 2011, the Consumer Financial Protection Bureau (CFPB) has had authority for writing and revising the rules and regulations that implement the relevant federal consumer financial laws, and H.R. 6139 explicitly confirms that the NCCCs will be subject to all of these laws (p. 24, lines 11-17). However, supervision and enforcement for the NCCCs would be the responsibility of the OCC.

NCCCs could be owned by, affiliate with, and enter into joint ventures and business partnerships with depository institutions, state-chartered consumer lenders, and others.⁶⁴ They could share business space (e.g., operate out of the same storefront) with any affiliate or joint venture or third-party business, regardless of which entity owns or leases the property.

While the proposed legislation includes numerous other elements, these are its key features and provide a sufficient basis for evaluating its prospects for contributing to a solution of the small-dollar loan problem.

Proponents' Case⁶⁵

Proponents of the proposed legislation maintain that it would result in a great increase in the availability of affordable small-dollar loans for currently underserved consumers. Their arguments strongly suggest that the loans that would be provided by the new federally-chartered lenders would be significantly different from, and better than, the payday loans that dominate today's marketplace. For example, the stated "Purpose and Intent" of H.R. 6139 is to "provide underserved consumers greater access to innovative, affordable, commercially viable, and better suited financial products or services."⁶⁶ At the July 24 Congressional hearing on the bill, Mary Jackson of Cash America testified that passage of the bill would provide consumers with "new, innovative financial products," and Rep. Luetkemeyer emphasized that "this is not a payday lending bill," citing the prohibition on loan terms of less than 31 days.

It should be noted, however, that many of those who support the bill – in Congress, in the financial industry, and in the world of experts – also support payday lending as providing a needed and helpful service to consumers, and their arguments in support of H.R. 6139 sometimes overlap with arguments in support of payday lending. Furthermore, as shall be argued below, the enactment of H.R. 6139 would permit the expansion of payday-like lending to states where it is currently prohibited.

Nevertheless, accepting the claims of its proponents at face value, and in conformity with the primary purpose of this report, the analysis in this section and the next will be focused on whether and to what extent passage of H.R. 6139 would expand the availability of high-quality, affordable small-dollar loans.

64 NCCCs could not be owned or controlled, directly or indirectly, by another business unless the "primary business activity" of that other business is providing financial products and services to consumers (p. 9, line 20 - p. 10, line 14). The only apparent reason for this restriction is that it would reduce competition by excluding financial companies with non-financial parents. (Prominent examples of such financial companies include those owned by General Electric, Ford, Chrysler, General Motors, Sears, and Westinghouse. Wal-Mart is a prominent example of a non-financial company that could be interested owning an NCCC).

65 To my knowledge, there is no detailed, public document that makes a systematic, well-documented case for the proposed legislation. The case that is summarized here is based primarily on Section 2 of H.R. 6139 ("Findings, Purposes, and Intent," pp. 1-7); testimony at the July 24, 2012 Congressional Hearing on H.R. 6139 by witnesses Mary Jackson, John Berlau, and Michael Flores; and an unattributed, undated four-page document ("White Paper: Making the Case for a Non-bank Charter") included in a binder of materials related to H.R. 1909 that was provided to CEPR by Cash America in April 2012. The Congressional Hearing, held by the U.S. House Financial Services Committee's Subcommittee on Financial Institutions and Consumer Credit, was titled, "Examining Consumer Credit Access Concerns, New Products and Federal Regulations." Written testimony of the seven witnesses and a webcast of the entire hearing are available now, and the transcript will be posted later, at: <http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=303376>.

66 p. 6, lines 18-22

The essence of the argument offered by proponents is that neither banks nor existing consumer finance companies are able to provide affordable small-dollar loans in substantial volume, but that the proposed NCCCs would be able to do so. Their case has three logical components.

First, proponents claim that banks are unable to offer the loans because their business models and cultures are geared toward serving consumers with higher incomes and better credit ratings; banks are, they claim, both unfamiliar with and uninterested in serving currently underserved households. Furthermore, even if they wanted to serve this market, their regulators would prevent them from doing so because such loans involve too much risk and therefore would impose a threat to a bank's safety and soundness.

Second, the proponents argue that existing consumer finance companies, chartered and regulated by the states, are unable to offer the needed loans because of the complicated, confusing, and restrictive system of state regulations. Each state has its own laws and regulations, so that proposing a new product requires a different application in each state, and any resulting approvals will impose different rules in different states. H.R. 6139 invokes the specter of “duplicative and conflicting State laws that in many cases limit product innovation and choice and raise the cost of consumer credit.”⁶⁷

Third, the proponents contend that the proposed federally-chartered companies would be able to offer a high volume of high-quality loans. These companies would, by the terms of their charters, be devoted primarily to serving the underserved households that banks tend to ignore. Because they would not be depositories, their regulator would not need to worry about protecting the deposit insurance fund from the consequences of their potential failure. They would be free of the restrictive maze of state-level laws and regulations, yet they would be regulated by a responsible federal overseer who would ensure that borrowers are protected from potential harm. And, finally, their ability to offer uniform products nationwide would allow them to take advantage of cost-reducing economies of scale so that borrowers could receive less expensive loans.

Why the Proponents' Case Is Unpersuasive

None of the three major components of the proponents' stated case for the proposed legislation is able to withstand informed critical scrutiny. This section examines each component in turn. The analysis here makes use of the distinction, discussed in detail in Part I, between small-dollar loans that are helpful (high-quality, welfare-enhancing) and those that are harmful to the consumers that receive them and takes it as already established that ultra-high-cost loans such as payday loans are harmful rather than helpful.

First, the proponents' case is incorrect about the extent to which banks and credit unions (hereafter referred to collectively as “banks” for simplicity) lack the interest, capability, and regulatory permission to make high-quality small-dollar loans. As shown in Part II, above, numerous banks and credit unions have a demonstrated track record of offering high-quality small-dollar loans, with the encouragement of their regulators. There is no reason to believe that banks are unwilling or unable to respond to profitable business opportunities. The limited volume of high-quality small-dollar loans offered by these banks reflects primarily the inherent difficulties of providing such loans at an APR of less than 36%, rather than any disadvantages of banks relative to non-bank lenders.

67 p. 6, lines 7-10

Although the volume of high-quality small-dollar loans offered by banks may be modest, none of the loans offered by payday lenders meet the criteria for high-quality small-dollar loans that were identified in Part I.

It is difficult to see any basis for believing that federally-chartered banks would be at a disadvantage compared to the proposed NCCCs. At the end of 2011, there were 1,931 federally-chartered banks and savings institutions in the U.S., with a very wide range of sizes, business models, and interests.⁶⁸ All of these are already regulated by the OCC and already have the right to offer their products nationwide, to ignore state-level laws and regulations, and to take advantage of whatever cost savings result from large-scale, multi-state operations. The greater volume of small-dollar lending by existing nondepository lenders reflects their greater willingness to make high-cost loans, not a documented ability to offer these loans at lower costs. As noted in Part I, a number of national banks have recently begun to offer payday loan products, without public objection from the OCC, indicating that they do indeed have the ability and the interest to offer *harmful* small-dollar loans; their charges for these loans are substantially lower than the charges by payday lenders.

Second, the proponents' argument that a complex set of state regulations has prevented the introduction of small-dollar loan products that are new, innovative, and better suited to the needs of underserved consumers is unpersuasive in the absence of examples of specific loan products that state-chartered lenders have unsuccessfully proposed to states for approval. It seems likely that at least a large percentage of the 33 states where payday lending is permitted would be willing to approve proposed small-dollar loan products that were substantially less expensive and less harmful for consumers.

If the industry actually has a number of potential small-dollar loan products that are substantially "better" than currently-allowed small-dollar loans, then it seems reasonable to believe that model legislation that would allow these products to be offered could be promoted with success in many states. This might proceed in stages; successful experience with the new products in a few states could persuade other states to follow suit. If the proposed loan products were genuinely high-quality small-dollar loans, they might even be approved in states which currently prohibit payday lending.

In short, if the proponents of the proposed legislation are claiming that state laws and regulations prohibit the making of payday loans in many states, and impose conditions on these loans in many others, they are indisputably correct. But if they are claiming that the state-level regulation of consumer lending has prevented the approval of innovative, affordable, welfare-enhancing consumer loan products – that is, of what this report calls high-quality small-dollar loans – then their case fails in the absence of, at the very least, substantive descriptions of such products and, preferably, documentation of unsuccessful attempts to obtain their approval.⁶⁹

68 The number of federally-chartered banks is from the *FDIC Quarterly Banking Profile*, Fourth Quarter 2011, Table III-B. On the same date, there were also 5,426 state-chartered banks and savings institutions. In addition, there were 7,094 federally-insured credit unions (of these, 4,301 were federally-chartered and 2,793 were state-chartered) with 91.8 million members. (Data obtained from websites of the National Credit Union Administration and the National Association of State Credit Union Supervisors.)

69 With respect to changes that would simply lower the charges (fees, interest rates, APRs) for small-dollar loans, no legislative approval is necessary; existing laws and regulations establish maximum allowable charges and allow lenders to impose any charges that do not exceed these maximums. In fact, payday lenders nearly always charge the maximum amount allowed.

Third, the proponents' claim that the newly-chartered lenders would be able to offer high-quality loans in high volume is unpersuasive because the proposed legislation imposes very little information about, substantive standards for, or substantive restrictions on the nature of the loans that could be offered by the newly-chartered companies. H.R. 6139, as noted above, confirms that loans by NCCCs will have to comply with all existing federal consumer laws, and adds only the additional requirements that a loan must have a term of at least 31 days, impose no prepayment penalty, and be for no more than \$5,000. It also mandates that the lender have "a reasonable basis for believing that the consumer can repay the [loan],"⁷⁰ but this requirement would seem to be satisfied, in the case of a payday loan, by obtaining a post-dated check or its electronic equivalent from the borrower.

Within these broad guidelines, NCCCs can apply to offer any loan product and the proposed legislation strongly tilts toward approval of an application. Any disapproval of an application must be made within 45 days of the application, based on a determination that the product would "significantly harm the interests of underserved consumers"; if there is no such explicit disapproval by that deadline, the application would be "deemed approved."⁷¹ Furthermore, a mandated OCC annual report to Congress must include "a detailed explanation for each disapproval."⁷² The NCCCs would be able to set their fees, interest rates, and other charges at whatever level they choose, given that H.R. 6139 prohibits the OCC or any other regulator from limiting them.⁷³

Proponents of H.R. 6139 have emphasized that enactment of that bill would allow an expansion of installment lending, with the implicit implication that loans with equal monthly payments over an extended period would offer substantially lower APRs than single-payment payday loans. In fact, this is not necessarily the case. For example, the website of CashNetUSA (the online lending affiliate of Cash America) currently offers installment loans in four states. The examples provided on the website are four-month installment loans in New Mexico (\$850 loan, 431% APR) and in South Carolina (\$650 loan, 449% APR) and six-month installment loans in Missouri (\$1,500 loan, 298% APR) and in Wisconsin (\$1,000 loan, 289% APR).⁷⁴ H.R. 6139 would allow ultra-high-cost installment loans like these to be made in every state.

Thus, the proposed legislation provides no reason to believe that all, or even any, of the loan products that would be offered by the newly-chartered companies would be affordable, welfare-enhancing, high-quality loans. In particular, there is no reason to believe that such loans would necessarily meet even one of the four criteria for high-quality loans that were presented in Part I, above: an APR no higher than 36%, a loan term of at least 90 days, multiple payments rather than a single balloon payment, and determination of ability to repay from expected income. For example, a loan structured exactly like current payday loans, but with a term of 31 days rather than 14 days, would meet none of the four criteria (although its APR would be only 45% as high as current payday loans – e.g., 176% rather than 390%).⁷⁵

70 p. 19, lines 3-6

71 p. 21, lines 5-23

72 p. 30, lines 2-12

73 p. 24, lines 3-8

74 Details at: www.cashnetusa.com/fee-schedule.html (information current as of August 9, 2012).

75 This APR calculation assumes that the charge would remain at \$15 per \$100 borrowed. If the charge were doubled to \$30 per \$100 for the longer loan (remember that H.R. 6139 prohibits any cap on fees or rates), the APR would fall only to 353%.

The Actual Impact of the Proposed Legislation

In fact, the principal effect of H.R. 6139 would be to greatly reduce regulation of the large payday lending companies, thereby allowing a major increase of ultra-high-cost lending. H.R. 6139 would accomplish this in two major ways: by exempting NCCCs from state laws and regulations, and by assigning chartering and supervisory responsibilities at the federal level to the OCC rather than to the CFPB.^{76, 77}

The more important aspect of the two is the federal preemption of state laws and regulations, so that these would not apply to NCCCs (in the same way that they do not apply the national banks chartered by the OCC).⁷⁸ This would enable payday lenders (and other state-licensed high-cost lenders such as auto-title lenders) to expand their harmful lending into the states where it is effectively prohibited (17 states and the District of Columbia in the case of payday lending) and allow them to ignore restrictive regulations in others – subject to the new restriction that all loans have terms of at least 31 days.

It is important to recognize that the previously-cited statement of Rep. Blaine Luetkemeyer, H.R. 6139's chief sponsor, that because the proposed legislation would require loans to be for at least 31 days, it is therefore “not a payday lending bill” is not correct. Most importantly, nothing fundamental about a payday loan is changed if the term is for 31 days rather than for the more common 14 days. In terms of the law, the Dodd-Frank Act, which gives the CFPB supervisory authority over “payday lenders,” does not define that term. The CFPB’s “Examination Procedures” characterize rather than define payday loans, noting that “features vary” and that some “have terms for as long as six months.”⁷⁹ The Military Lending Act that prohibits payday loans to active duty members of the military applies to loans of up to 91 days. A survey of the state laws that authorize payday lending in 33 states indicated that five states do not specify a maximum loan term, one specifies a maximum term of 14 days, and four more specify terms of 30 days or less. The other 23 state laws authorizing payday lending allow loans of at least 31 days, with three of these states allowing loans of up to 45 days, and seven others allowing loans of 60 days or longer.⁸⁰

76 Another significant regulatory change included in H.R. 6139, the amendment to the Truth in Lending Act that would remove, for all lenders, the requirement to disclose the APR for loans of one year or less, has been noted above. The absence of this disclosure (which would be replaced by the required disclosure of the total cost of the loan as a dollar amount and as a percentage of the loan principal) would diminish the ability of consumers to comparison shop among loans of different terms, and would reduce the visibility of a feature of payday loans that has been a public relations disaster for the industry.

77 There may also be another significant deregulatory impact. According to the OCC, it is unclear whether or not H.R. 6139 would allow NCCCs to ignore the provisions of the Military Lending Act (discussed in Part I, above) that impose a 36% cap on the APRs of certain small-dollar loans to active duty members of the military and their families. (U.S. House, 2012, Testimony of Grovetta Gardineer, p.5)

78 This effort to escape from state regulation seems inconsistent with a statement that the Community Financial Services Association of America, one of the main industry associations of payday lenders, made in an April 23, 2012 letter to the CFPB: “In our view, payday lenders being appropriately licensed and regulated by the states where they operate is fundamental to establishing accountability for good business practices.” (available at www.regulations.gov/#!documentDetail;D=CFPB-2012-0009-0608)

79 (2012), p. 2

80 This survey is based on the information provided under “Legal Status of Payday Loans by State” at www.paydayloaninfo.org, a website maintained by the Consumer Federation of America. Loans of up to 45 days are allowed in IL, OK, and WA. Loans of up to 60 days are allowed in DE, KY, LA, and ND. UT allows loans of up to 70 days and WI allows loans of up to 90 days. In CO, the minimum loan length is six months.

The preemption of state laws and regulations is particularly significant when taken together with the Dodd-Frank Act's prohibition on the CFPB imposing any usury limit (Sec. 107(o)) and H.R. 6139's prohibition on the OCC imposing any limit on interest rates, fees, or other charges.⁸¹ Research by the Center for Responsible Lending and others has found that usury caps are by far the most effective measure in reducing harmful small-dollar lending.⁸²

This measure would also end the on-going, on-the-ground supervision, examination, and enforcement powers that state regulators currently exercise over the state-chartered companies that would be the applicants seeking to become NCCCs. Consumers would lose protections that have traditionally been provided by their states not only in regulating the kinds of small-dollar loan products that are allowed but also in overseeing the way that companies conduct their lending operations.⁸³

With the federally-chartered NCCCs free of state laws and regulations, it would no longer be the case that all providers of small-dollar loans within a single state would be subject to the same rules and the same supervision. The lenders who retained their state charters (most likely smaller local and regional lenders) would find themselves at a competitive disadvantage and could be expected to petition state lawmakers to allow them to operate on the same terms as the NCCCs. To the extent that they were successful, H.R. 6139 would result in the erosion of consumer protections for borrowers from state-chartered lenders as well as borrowers from NCCCs.

Although H.R. 6139 claims that the NCCCs, freed of restrictive state laws and regulations, would be subject instead to "strong uniform Federal lending regulations,"⁸⁴ the effect of the proposed legislation would be to significantly weaken federal legislation from what it is under current law. The quoted phrase suggests that new federal standards are being proposed in exchange for the NCCCs not being subject to state laws and regulations, but this is not the case. This proposed legislation imposes no federal regulations stronger than those that would apply in the absence of H.R. 6139, nor does it mandate the OCC to adopt any such regulations.

The assignment of chartering, product approval, supervision, and enforcement powers over NCCCs to the OCC, rather than to the CFPB, is the key element of H.R. 6139's effort to weaken federal regulation of payday and other high-cost lenders. The recent establishment of the Consumer Financial Protection Bureau (CFPB) as an independent federal agency with a primary mission of protecting consumers, with broad rule-writing, supervisory, and enforcement powers, and with authority over the entire range of consumer financial products and their providers was described in Part II. Under current law, the CFPB is in the process of implementing "strong uniform federal lending regulations" for payday lending and is beginning to exercise its direct supervision and enforcement powers over payday lenders and other large consumer lenders. In this area and

81 p. 24, lines 3-8

82 King and Parrish (2007)

83 These supervisory activities, described in John Munn's testimony for the July 24 Congressional Hearing, are quite substantial. Now that the CFPB has federal supervisory authority over payday lenders and other state-chartered "larger participants" in consumer financial markets, these activities by state regulators will continue as a complement to, and in coordination with, the supervision by the CFPB. Munn notes that H.R. 6139 is "directly contrary to the goal of state-federal regulatory collaboration... [and will]... fundamentally undo the existing state-federal partnership." (U.S. House, 2012, Testimony of John Munn, p. 8.)

84 p. 5, line 1

elsewhere, the bureau's mandate is to provide consistent, uniform standards for consumer financial products and services, regardless of the entity that provides them.

If the goal of the proposed legislation were to facilitate the nationwide availability of uniform small-dollar loan products that would be substantially less costly than payday loans, that would be genuinely helpful to consumers, and that would be overseen by effective consumer protection for borrowers, then it would be natural to assign responsibility to the CFPB. H.R. 6139's designation of the OCC – an agency with no experience in regulating nonbank consumer lenders – would instead undermine the authority of the CFPB and weaken regulation of the newly-chartered entities relative to what it would be under current law.⁸⁵

This weakening would happen in three distinct ways. First, the mere fact of assigning regulatory authority to a different agency would undermine the general effort to move to a simple, clear, consistent regulatory structure by consolidating authority in a single agency. Dividing rule-writing authority between two agencies is bound to lead to confusion, inconsistencies, bureaucratic conflicts, and regulatory gaps. This is why the OCC official testifying at the July 24 Congressional Hearing said that agency was “concerned that H.R. 6139 could blur authorities and responsibilities for the OCC and CFPB and create additional confusion for consumers.”⁸⁶ Such problems create opportunities for lenders and their lawyers to find and exploit loopholes in the regulatory system.

A second way that federal regulation of NCCCs could be weakened by assigning regulatory authority to the OCC rather than the CFPB would be if the OCC proved to be a weaker regulator. Indeed, the OCC's regulation of consumer lending by banks during the last two decades earned it a widespread reputation for placing the interests of its banks above those of consumers. A major part of this reputation resulted from aggressively using its powers of “preemption” to exempt national banks from state laws and regulations while providing no serious federal-level oversight, regulation or enforcement in their place. More recently, as noted in Part I, the OCC has taken no public action to prevent some of the national banks that it regulates from offering bank payday loans or to restrict the nature of these loans. Although all regulators should apply existing consumer protection laws and regulations uniformly, it was reasonable to expect – on the basis of its recent history – that the OCC would be less rigorous than the CFPB in drafting and enforcing regulations on small-dollar lending.

However, this expectation may turn out to have been mistaken. At least since Thomas Curry assumed office as Comptroller in April of this year, the OCC appears to be taking its consumer protection responsibilities quite seriously. One indication of this is the testimony of the OCC's Grovetta Gardineer at the July 24 Congressional Hearing. This testimony was extremely critical of the proposed legislation and argued against supervisory responsibility over NCCCs being given to the OCC: “It is important that the types of products envisioned for NCCCs not be carved out of coverage of CFPB-administered lending standards.”⁸⁷

85 One particularly non-persuasive alternative justification was suggested at the July 24 Congressional Hearing: that the OCC is “the agency with chartering authority.” But just because one law (the National Bank Act) gives chartering authority for national banks to the OCC doesn't mean that a different law (such as H.R. 6139) couldn't give chartering authority for a different type of institution to a different federal agency.

86 U.S. House (2012), Testimony of Grovetta Gardineer, p.8.

87 Ibid., p. 2.

A third way in which H.R. 6139 would weaken federal legislation of NCCCs through assigning regulatory responsibility to the OCC is through particular provisions of the proposed legislation that would limit the ability of the OCC to regulate effectively, regardless of its intentions. Examples of such provisions include the severe restrictions on the process for approving or disapproving product applications from NCCCs (noted earlier); the provisions limiting the OCC's ability to regulate activities involving affiliates, joint ventures, and business partnerships;⁸⁸ and the provision that says that the enumerated consumer protection laws listed in Section 1002(12) of the Dodd-Frank Act apply to NCCCs but that does not mention the applicability of the CFPB's powers to regulate "unfair, deceptive, or abusive acts and practices" that were granted to it in Section 1031 of the same act. All of these provisions, and others, would enhance lenders' ability to increase harmful lending, while doing nothing to facilitate high-quality, affordable small-dollar lending.

The Bottom Line

Neither the arguments offered by its proponents nor the provisions of the proposed legislation itself offer any persuasive reason to expect that the lenders with the new federal-charters authorized by H.R. 6139 would make any high-quality, affordable, welfare-enhancing small-dollar loans at all.

However, there are very persuasive reasons to expect that, if H.R. 6139 were enacted, these lenders would greatly increase the volume of harmful, high-cost lending in the U.S. Payday-like loans, differing from current payday loans only in having a term of at least 31 days, would become legal in the 17 states where payday lending is now prohibited. None of the state laws and regulations that impose usury limits or other restrictions on small-dollar loans would apply to the newly-chartered lenders, and H.R. 6139 also prohibits any federal regulator from imposing any limit on interest rates, fees, or other charges. The assignment of supervisory authority over NCCCs to the OCC would undermine the ability of the CFPB to effectively protect consumers from harmful loans.

Conclusion

This report has argued that there is a genuine small-dollar loan problem in the U.S. today, which has two major dimensions. One dimension of the problem is a large unmet demand for high-quality, affordable small-dollar loans, which exists because of a large demand and a relatively small supply. The other dimension of the problem is a high level of ultra-high-cost loans that are harmful rather than helpful to those who receive them.

One approach to this problem, embodied in H.R. 6139, proposes to ameliorate this problem by creating a new class of federally-chartered consumer finance companies that would allegedly increase the supply of high-quality, affordable small-dollar loans. The analysis in this report indicates that this is a deeply flawed approach that would substantially increase the availability of harmful, ultra-high-

⁸⁸ For example, H.R. 6139 authorizes NCCCs to be owned by, or affiliated with, or enter into joint ventures and other business partnerships with various other entities, including "state-chartered or licensed nondepository creditors" (this category includes current payday lenders). It further states that neither the OCC nor any state "shall prohibit [an NCCC] from conducting its business operations and providing financial products...in office or retail locations it owns or leases or those owned or leased by an affiliated company, a joint venture, or a third-party business..." (p. 12, lines 7-14 and p. 23, lines 18-25). This would appear to enable a parent company to own both an NCCC and a state-chartered payday lending company and even to have them both operate out of the same storefront. The companies could then, in states where state laws and regulations were more lenient than those set by the OCC, continue to offer their traditional payday loans along with OCC-approved products.

cost loans, while offering no prospect of increasing the supply of affordable, high-quality small-dollar loans. The increase in harmful lending would result primarily because the proposed legislation would make the new federally-chartered lenders (NCCCs) exempt from state usury caps and other state-level regulation, thereby making ultra-high-cost lending possible in the 17 states where it is now prohibited and removing the constraints imposed by consumer protection laws, regulations, and oversight in every state.

At the same time, H.R. 6139 would significantly loosen the federal regulation of these high-cost lenders compared to what it would be under current law. This would result from the proposed legislation's assignment of exclusive supervisory and enforcement authority over the new lenders, along with some rule-writing and regulatory authority, to the Office of the Comptroller of the Currency (OCC) rather than to its natural location in the new Consumer Financial Protection Bureau (CFPB). It is worth noting that this would be counterproductive not only in terms of this report's specific concern with the small-dollar lending problem, but also in terms of the broad effort, institutionally embodied in the CFPB, to establish a uniform, effective system of consumer financial production for the entire range of consumer financial products and services.

This does not mean that nothing can be done about the small-dollar loan problem, and in fact serious initiatives on three fronts are making significant contributions to reducing it. First, the supply of high-quality, affordable small-dollar loans is being increased, not only by expanding the availability of currently available products but also by encouraging the continual introduction of well-designed new products. Second, other initiatives are working to reduce the demand for affordable small-dollar loans by increased savings and other forms of asset-building that reduce the need for borrowing and by building credit (e.g., improving credit scores) so that households are able to access credit cards and other affordable mainstream credit products. Third, the rule-writing and regulatory initiatives by the newly-established CFPB, in furtherance of its legislative mandate to provide – for the first time – uniform federal oversight over all small-dollar lending has great potential to reduce the harm caused by high-cost small-dollar lending by eliminating abusive features and practices at all stages of the loan cycle.

Policy-makers, responsible lenders, interested non-profit organizations and others should seek ways to support and enhance these three categories of efforts to deal constructively with the small-dollar lending problem. At the same time, they should reject measures such as H.R. 6139 that would only serve to make the problem worse.

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