



COMMENT IN RESPONSE TO PROPOSED RULE ON PAYDAY, VEHICLE-TITLE, AND CERTAIN HIGH-COST INSTALLMENT LOANS

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We appreciate the opportunity to respond to the Bureau of Consumer Financial Protection's (Bureau) proposed rule governing payday, vehicle-title, and certain high-cost installment loans.¹ The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group but is designed to assist the Bureau as it considers how best to regulate certain credit products.

On July 22, 2016, the Bureau published to the *Federal Register* a proposed rulemaking with request for comment regarding the regulation of "Payday, Vehicle Title, and Certain High-Cost Installment Loans."² The Mercatus Center at George Mason University submitted a comment in response to that notice.³ The suggestions made in that comment are still relevant and could help the Bureau as it assesses how best to regulate an important and frequently misunderstood credit market. For this reason, we are resubmitting the previous comment, which is attached.

If we can be of any further assistance, please do not hesitate to ask.

ATTACHMENT

"Comment on the CFPB's Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans" (Public Interest Comment)

¹ Payday, Vehicle Title, and Certain High-Cost Installment Loans, 84 Fed. Reg. 4252 (proposed February 14, 2019) (to be codified at 12 C.F.R. pt. 1041).

² Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. 47864 (July 22, 2016).

³ Thomas W. Miller Jr., Todd Zywicki, and Brian Knight, "Comment on the CFPB's Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, October 7, 2016).



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**PUBLIC
INTEREST
COMMENT**

COMMENT ON THE CFPB'S RULE ON PAYDAY, VEHICLE TITLE, AND CERTAIN HIGH-COST INSTALLMENT LOANS

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Proposed Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans

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The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.

We appreciate the opportunity to respond to the proposed rulemaking by the Bureau of Consumer Financial Protection (CFPB or Bureau) on payday, vehicle title, and certain high-cost installment loans. The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group but is designed to assist the Bureau as it considers whether—and, if so, how—to proceed with rulemaking regarding small-dollar lending. More generally, this comment seeks to assist the Bureau in embracing a regulatory approach that serves consumers by fostering competitive, innovative, accessible, and diverse credit markets.

I. INTRODUCTION

The proposed rule applies to loans with terms of up to 45 days and longer-term loans that (1) have an all-in annual percentage rate (APR) of more than 36 percent and (2) are secured by a vehicle title or are repayable through deductions from the borrower’s income or bank account.¹ Under the proposal, making such a loan would be an unfair and abusive act or practice unless the lender assessed the borrower’s ability to repay or the loan satisfied certain parameters. The proposed rule also would (1) restrict the ability of lenders to provide additional credit to borrowers with outstanding loans and (2) impose requirements on lenders who sought repayment from a borrower’s account. In some circumstances, lenders would be required to presume inability to repay. A lender who took advantage of an exemption to make certain long-term loans without assessing the borrower’s ability to repay would be required to refund all borrowers’ origination fees in any year in which the annual default rate on loans made by that lender under the exemption was higher than 5 percent. The proposed rule also would place restrictions on lenders’ withdrawal rights. Moreover, lenders would have to provide information about covered loans to registered information systems.

The Bureau notes that the proposal is intended to cover loans “typically used by consumers who are living paycheck to paycheck, have little to no access to other credit products, and seek funds to meet recurring or one-time expenses.”² As a foundational matter, the Bureau should consider whether the proposed rule would help or hurt these consumers. Consumers who have limited credit options already bear the cost of state-level consumer protection. They cannot afford an ineffective federal regulatory regime layered on top of existing state regulation.

Consumers who live paycheck to paycheck are remarkably talented at managing very difficult situations that would flummox people at higher income levels who have never had to deal with such hardship.³ We should not make this task any harder than it is now. Federal efforts, therefore, should focus on opening—rather than closing—the regulatory doors to competitors in the consumer credit space.

1. Bureau of Consumer Financial Protection (CFPB), “Payday, Vehicle Title, and Certain High-Cost Installment Loans,” 81 Fed. Reg. 47864–8218.

2. *Ibid.*, 47864.

3. See, for example, Thomas W. Miller Jr., “Differences in Consumer Credit Choices Made by Banked and Unbanked Mississippians,” *Journal of Law, Economics, and Policy* 11, no. 3 (2015): 367–412.

Small-dollar loans provide a lifeline for tens of millions of American families every year who rely on them to buy groceries, to put gas in the tank, or to pay the rent. The importance of these products to consumers and the economy has surged in the wake of the financial crisis and subsequent regulations, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009. Those regulations have resulted in a loss of access for many lower-income consumers to mainstream financial products, such as bank accounts and credit cards. Confronted with a dwindling array of options, consumers have increasingly turned to various small-dollar loans to make ends meet. The CFPB should not further restrict choices for those who already face limited choices.

This public interest comment identifies matters the Bureau should investigate as it considers whether the proposed rule will harm consumers. The Bureau should look at whether the proposed rule will limit access to, or raise the prices of, existing products. It should also consider whether the rule will prevent the emergence of innovative new products that could markedly improve these consumers' lives. Specifically, this comment urges the CFPB to conduct additional research to better understand the following:

- What will consumers who use products covered by the proposal use if the supply of these products is constrained by the rule?
- How will consumers use the different consumer credit products covered by the proposal?
- Will mandating underwriting to prevent rollovers and defaults harm consumers?
- Is the APR an appropriate metric for short-term products, and how will interest rate caps—direct or indirect—affect consumers who have limited credit choices?
- How will interest rate caps affect consumers' ability to understand their own risk profile?
- How will the proposal interact with existing law developed by states and private organizations through a century of balancing competing considerations in the short-term consumer lending space?

The comment considers each of these issues in turn.

II. TAKING AWAY LEGAL OPTIONS COULD HARM CURRENT SMALL-DOLLAR LOAN CUSTOMERS

Consumer credit products exist because they enable consumers to change a current pattern of cash inflows and outflows to a preferred pattern. Consumers weigh the benefits and costs of using credit and then make choices that are based on their preferences and expectations of future income and expenses.

The demand for small-dollar credit is often born of difficult circumstances. Such circumstances may be alien to prime borrowers with savings in the bank, a salaried occupation, and ready access to mortgages, credit cards, and car loans—a category in which many regulators, consumer advocates, and much of the general public happily find themselves. Many subprime borrowers, however, tend to be hourly workers who live paycheck to paycheck. Unlike prime borrowers, these subprime consumers are painfully familiar with income variability. Salaried employees get paid when they are sick and cannot come to work. Hourly employees do not get paid unless they work. Roofers do not work—and therefore do not get paid—when it rains. Restaurant servers do not get paid to take a child to the doctor. This income variability imperils consumers’ credit and gives rise to the need for short-term loan products.

Eliminating the difficult circumstances would be ideal, but in the meantime, a need exists and it must be met.⁴ If legal options are not available, consumers may experience great hardship or resort to illegal options and face more onerous enforcement mechanisms if they default, including the possibility of violence.

As it considers the proposal’s effects, the Bureau should seek to understand where consumers would go for credit if the proposal eliminates currently available small-dollar lending. Will consumers’ backup options only make them worse off? For example, if vehicle title loans are less readily available, consumers may instead sell their cars to get the needed cash—an extremely costly option for consumers. Other consumers might patronize lenders who operate wholly outside of the law—a dangerous place for consumers to be.

III. A VARIETY OF CONSUMER CREDIT PRODUCTS IS NECESSARY TO MEET CONSUMER NEEDS

Small-dollar lending products differ in size, length, terms, underwriting, repayment schedules and methods, cost, and use. Appreciating how the proposed rule will affect consumers requires a nuanced understanding of the nature of each product, of whether and how it is underwritten, and of the role each product plays in the lives of consumers—especially subprime borrowers. Consumers know that installment loans, vehicle title loans, and payday loans are not substitutes for one another; they know that different products serve different purposes for different borrowers. They understand that a borrower who is well served by one type of loan might not be well served by others.⁵ The Bureau must likewise seek to understand such differences before it devises a new payday lending rule.

Although the particularities of consumer demand for particular products vary, those who use small-dollar loans share several common characteristics. First, such consumers invariably have

4. See, for example, *Short-term, Small Dollar Lending: The CFPB’s Assault on Access to Credit and Trampling of State and Tribal Sovereignty Before the Subcommittee on Financial Institutions and Consumer Credit of the Financial Services Committee of the House of Representatives* (testimony of Robert Sherrill, owner, Imperial Cleaning Systems, Nashville, TN, February 11, 2016), <http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=400267>, at approximately 4:53: “We’re looking for something. We have nothing, and that’s why I chose to go to payday lending. . . . If you ain’t got it, then you got to go get it some type of way.”

5. Miller, *Consumer Credit Choices*, 378–79.

impaired credit and lack access to more preferred credit, such as credit cards. They turn to small-dollar credit either because they cannot obtain a credit card or because they are maxed out on their credit cards and would suffer penalties.⁶ Second, those who use small-dollar credit search extensively for credit before using a small-dollar loan. They show great awareness of the dollar cost of their options and awareness of the options that are available to them.⁷ Third, much of the time, small-dollar credit is used to meet pressing needs, such as rent, utilities, or medical bills. Finally, most small-dollar loan products are lifecycle products for households—consumers tend to make greater use of these products when they are younger and starting off in life and when they simultaneously have a high demand for credit and have access to a lower supply of credit.⁸ As consumers age, increase their annual income, and establish longer work and credit histories, they tend to increase their access of mainstream products such as credit cards and mortgages and reduce their reliance on small-dollar loans.⁹ Thus, some consumers use small-dollar loans throughout their lives, but this fact should not obscure the reality that many consumers use these products transitionally until they gain access to better options.

Pawnbroker, vehicle title pawn, vehicle title installment, lump sum payday, payday installment, and traditional installment loans are different loan products. They differ in important ways. The general characteristics of these types of loans are discussed next.

A. Pawnbroker Loans

In a pawn transaction, the consumer offers a tangible item to the pawnbroker, who pays cash to the consumer and takes possession of the item.¹⁰ The pawnbroker generally asks whether the consumer wants to sell or to pawn the item. If the consumer wishes to pawn the item, the parties negotiate the amount that the pawnbroker will loan on the item. If they reach an agreement, the consumer delivers possession of the item to the pawnbroker, and the pawnbroker gives the agreed-upon cash to the consumer and issues a pawn ticket that precisely details the terms of the transaction and cost of redemption.

6. “Consistent with the premise that pawnshop borrowers face tough liquidity constraints, we find that they are more likely to have bad credit scores and to have maxed out their outstanding lines of credit than the general population is.” Marieke Bos, Susan Payne Carter, and Paige Marta Skiba, “The Pawn Industry and Its Consumers: The United States and Europe,” (Vanderbilt Law and Economics Research Paper 12-26, Nashville, TN, 2012) 2, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2149575.

7. “We also find that the lion’s share of pawn credit borrowers do not apply for mainstream (cheaper) credit before taking a pawn loan. The decision not to apply, however, turns out to be rational—we find that 93 percent of their loan applications would have been rejected had they applied for credit at a mainstream financial institution.” Sumit Agarwal and Marieke Bos, “Rationality in the Consumer Credit Market: Choosing between Alternative and Mainstream Credit” (June 2014).

8. Thomas A. Durkin et al., *Consumer Credit and the American Economy* (Oxford, UK: Oxford University Press, 2014), chapter 8.

9. “The typical payday loan customer has lower or moderate income, is in an early family life-cycle stage and has children, has little liquid assets, and uses other types of credit.” Gregory Elliehausen, “An Analysis of Consumers’ Use of Payday Loans” (Financial Services Research Program Monograph 41, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, DC, and George Washington University School of Business, Washington, DC, 2009), vi.

10. See National Pawnbrokers Association, “Pawn Shops Today,” accessed October 6, 2016, <https://www.pawnshopstoday.com/how-it-works/>.

In a pawn transaction, the consumer does not need to show any proof of income or credit history. The pawnbroker does not report the customer's performance on the transaction to a credit reporting agency.¹¹ A pawn transaction is not a loan in the traditional sense because the consumer has no obligation to repay the sum obtained in the pawn transaction. The pawnbroker has no recourse if the customer abandons the pawned item. A pawn transaction, therefore, is essentially a sale with a renewable, month-to-month repurchase agreement.

In the typical pawn transaction, to redeem the pawned item, the consumer must pay various charges for interest, storage, and other fees, in addition to the sum originally advanced by the pawnbroker. The maximum allowable fees vary according to state law.

Pawn loans tend to be rather small (less than \$100) because they are limited in size by the value of the pawned item.¹² Also, they are used frequently by unbanked consumers who cannot access a payday loan without a bank account.

B. Vehicle Title Pawn Loans

A vehicle title pawn loan is similar to a pawn loan, but with an important difference: in a pawn transaction, the consumer gives possession of the item to the pawnbroker; under the terms of a title pawn loan, the borrower retains possession of the pledged collateral. As in a pawn loan, if the borrower defaults on a title pawn loan, ownership of the collateral (the vehicle) is transferred to the lender, and the lender can repossess the vehicle and begin the process to sell it. Like pawn loans, title pawn loans are nonrecourse; if the vehicle is sold for an amount that is less than the amount owed, the borrower does not have to make up the difference.¹³ If, however, the vehicle is sold for more than the outstanding amount owed, the borrower might participate in the excess sale proceeds. This participation is a matter of state law.

Vehicle title pawn loans are frequently used by unbanked consumers who cannot gain access to payday loans because they do not have a bank account. Such consumers may need to borrow more money than they can gain with a pawnbroker loan. Research also indicates that some independent small businesses use their vehicles as a source of operating capital and that many of these consumers are actually small businesses (such as a handyman or landscaper).¹⁴

11. "Pawn lenders require no credit checks, no deposit accounts, and no employment history." Joshua D. Shackman and Glen Tenney, "The Effects of Government Regulations on the Supply of Pawn Loans: Evidence from 51 Jurisdictions in the U.S.," *Journal of Financial Services Research* 30 (2006): 71.

12. Caskey finds the average payday loan is between \$50 and \$70. John P. Caskey, *Fringe Banking: Check-Cashing Outlets, Pawn Shops and the Poor* (New York: Russell Sage Foundation, 1994), 36; Paige Marta Skiba and Jeremy Tobacman, "Measuring the Individual-Level Effects of Access to Credit: Evidence from Payday Loans" (Working Paper 1069, Proceedings from Federal Reserve Bank of Chicago, July 3, 2007); Robert W. Johnson and Dixie P. Johnson, "Pawnbroking in the U.S.: A Profile of Customers" (Monograph 34, Credit Research Center, Georgetown University School of Business, Washington, DC, 1998), 16.

13. "Most title loans, like pawnbroker loans, are nonrecourse, which means that even borrowers who default can be confident that the consequences of default will be predicable and limited." Todd J. Zywicki, "Consumer Use and Government Regulation of Title Pledge Lending," *Loyola Consumer Law Review* 22, no. 4 (2010): 437.

14. *Ibid.*, 448-49.

C. Vehicle Title Installment Loans

Vehicle title installment loans are *not* the same as financing for the purchase of a new or used vehicle. Sales financing occurs at much lower interest rates, covers a bigger percentage of the value of the vehicle, and extends for a longer time. In addition, the lenders underwrite the sales financing contract by gathering income and expense data on the applicant and reviewing credit reports. Failure to perform on a sales finance contract results in a lower credit score. Making the payments in a timely fashion, however, helps maintain a healthy consumer credit score. A vehicle title installment loan, by contrast, is generally for a short time (4–12 months), carries a relatively high monthly interest rate, is not underwritten (the vehicle title alone secures the loan), and does not influence credit scores.

Moreover, vehicle title installment loans are *not* the same as vehicle title pawn loans. A vehicle title pawn loan is a lump sum loan that is paid off in full with interest, extended for another loan period with an interest payment, or simply abandoned by the borrower. By contrast, a vehicle title installment loan is, as the name suggests, an amortizing installment loan with monthly payments made over the loan period. Borrowers do not have the legal right to abandon a vehicle title installment loan. The borrower is obligated to make the payments.

There is no typical state law for vehicle title installment loans. As is common in many small-dollar loan laws, the allowable interest rate varies by loan size. For example, in Virginia¹⁵ the allowable rate is 22 percent per month on the portion of the principal that does not exceed \$700, 18 percent per month on the portion of the principal from \$700 to \$1,400, and 15 percent per month on the portion of the principal exceeding \$1,400. In Virginia, there is no maximum loan amount that can be borrowed, but the loan amount cannot exceed 50 percent of the fair market value of the vehicle. The allowable maturity date of the loan ranges from 120 days to 12 months. Prepayment penalties are not permissible; to the contrary, Virginia mandates language on the loan contract to encourage faster repayment. In Virginia, such loans cannot be extended, renewed, or refinanced.

The law in Virginia attempts to give the consumer time to resume making payments before the vehicle is repossessed. For example, the lender must give the borrower at least 10 days' advance notice that it intends to repossess the vehicle.¹⁶ This notice must alert the borrower that an option to avoid repossession exists if the borrower pays the stated principal and interest due. If a vehicle is repossessed, the lender must give the borrower at least 15 days' advance notice before the sale of the vehicle.¹⁷ If the vehicle is sold, the borrower is entitled to any surplus above the amount owed on the loan plus any reasonable costs of repossession and sale.¹⁸

15. See Code of Virginia § 6.2-2200 et seq.

16. *Ibid.*, § 6.2-2217, A (i), <http://law.lis.virginia.gov/vacode/title6.2/chapter22/section6.2-2217/>.

17. *Ibid.*, § 6.2-2217, B.

18. *Ibid.*, § 6.2-2217, C.

D. Lump Sum Payday Loans

The most common payday loan is a short-term, lump sum loan. Most of these loans are for a term of 30 days or less. Payday loans are also known as *cash advance loans*, *delayed deposit loans*, and *deferred presentment loans*. In a traditional payday loan, a borrower writes a check to a lender in exchange for a short-term cash loan. The lender agrees not to cash the check until a date specified in the loan agreement.¹⁹

To obtain a payday loan, borrowers must generally have an active checking account, provide proof of income to the lender, show valid identification, and be at least age 18.²⁰ Generally, payday lenders do not require a traditional credit report and do not report to credit rating agencies. Typically, there is little underwriting for these products. Because lenders do not intensively underwrite such loans, payday loans are an important source of credit to borrowers who have poor credit histories, who have an immediate need for cash, or who have a financial history that does not lend itself to building credit.²¹ On the one hand, payday loans tend to be used by deep subprime borrowers, with an average credit score of approximately 520.²² On the other hand, most payday loan borrowers are middle class or lower-middle class (not poor) and have bank accounts, because a bank account is a requirement for a payday loan.

E. Payday Installment Loans

Payday installment loans are relatively new loan products that display characteristics of both traditional installment loans and traditional lump sum payday loans. The term of these loans runs from 4 to 12 months. States generally regulate the finance charges lenders may charge monthly. These loans amortize fully by using equal installment payments, just as traditional installment loans do. Accordingly, at the end of the loan term, the loan is fully repaid. Unlike a traditional installment loan, however, there is typically little underwriting and little reliance on or reporting to credit reporting agencies. In these aspects, a payday installment lender operates in a manner similar to a lump sum payday lender.

F. Traditional Installment Loans

In the early 1900s, a battle raged against illegal loan sharks, and an alternate new loan source emerged through the collaboration of consumer advocates and lenders who wanted to offer small-dollar loans. The Universal Small Loan Law (USLL) of 1916 emerged from these collaborative efforts, despite lobbying by illegal loan sharks and those who favored low ceilings on interest rates. By the 1960s, almost all states had adopted some version of this model law.²³

19. Elliehausen, "An Analysis of Consumers' Use of Payday Loans," 1.

20. *Ibid.*, 2.

21. Note that failing to build a credit history is not indicative of being a poor credit risk per se. Failing to use debt, renting or owning a home outright (so there is no mortgage payment), and having other benign characteristics can lead to a borrower lacking the track record to be easily underwritten.

22. Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, "Payday Loan Choices and Consequences," *Journal of Money, Credit and Banking* 47, no. 2-3 (2015): 223-60, 233.

23. Durkin et al., *Consumer Credit and the American Economy*, 491.

The striking feature of this model law—which covered loans “up to \$300” (in today’s dollars, about \$7,137)—was that it allowed for interest rates higher than were allowed under existing usury laws.²⁴ When collaborating on the USLL, the parties agreed that legal installment lenders must be able to earn a reasonable profit, which was initially set at 3.0 percent to 3.5 percent per month (between 36 percent and 42 percent APR).²⁵ The maximum interest rate would be reexamined periodically to sustain the industry.

Traditional installment lenders underwrite the loans. Using credit history and other financial information, they determine the likelihood of the borrower paying back the loan. People who are not likely to repay the loan are denied credit.

The small-dollar installment loan industry is 100 years old, and the states regulate these installment lenders. The typical installment loan customer is distinguished from payday loan customers by being subprime in credit score but not deep subprime. Deep subprime borrowers (credit score of about 520) typically cannot be approved for an installment loan and must rely on payday loans.

IV. MANDATING UNDERWRITING TO PREVENT DEFAULTS AND ROLLOVERS HARMS CONSUMERS

The Bureau’s proposal is motivated in part by a concern about the harm consumers can suffer as a result of rollovers and defaults.²⁶ The Bureau’s proposed solution is to effectively mandate underwriting to ensure borrowers’ ability to repay. Specifically, the Bureau proposes to treat lending without underwriting as an abusive act or practice.²⁷ This approach ignores the important reality that it sometimes is mutually beneficial for borrowers and lenders to forgo an extensive and expensive underwriting process. Borrowers may prefer to avoid the time and cost burden of underwriting, particularly if they have a poor or scant credit history and know the process will not yield a lower interest rate or other favorable terms. Although underwriting typically lowers default risk, it is costly and time-consuming for lenders. Very small loans cannot be made with extensive underwriting; it is simply too costly for the lender and borrower. Rules intended to protect defaulters might simply end up harming nondefaulting, low-income borrowers by raising their borrowing costs.

24. Bruce Carruthers, Timothy Guianne, and Yoonseok Lee, “Bringing Honest Capital to Poor Borrowers: The Passage of the U.S. Uniform Small Loan Law, 1907–1930,” *Journal of Interdisciplinary History* 42, no. 3 (2012): 393–418.

25. “The 3.5 percent figure was at first a bald political compromise, struck by Ham in 1916 as part of a deal to convince the [American Association of Personal Finance Companies] to agree to a bill that would forbid all additional fees.” *Ibid.*, 403.

26. See, for example, CFPB, “Payday, Vehicle Title,” 47919, which states, “the Bureau is concerned that lending practices in the markets for storefront and online payday lending, single-payment vehicle title, and other short-term loans are causing harm to many consumers who use these products, including extended sequences of reborrowing, delinquency and defaults, and certain collateral harms from making unaffordable payments.”

27. *Ibid.*, 47865–66. (Note that “the proposed rule would identify it as an abusive and unfair practice for a lender to make a covered short-term loan without reasonably determining that the consumer will have the ability to repay the loan.”)

Small-dollar lenders know that a certain percentage of their borrowers will default, but because underwriting is too costly relative to the size of the loan, they do not incur the costs to find out which borrowers are likely to default. As a result, to cover the risk of default in the entire pool of borrowers, the lender must charge each borrower the same amount to cover the collective default risk.

The structure of the loan product plays a key role in determining whether, or how, the lender will underwrite the loan. For a short-term loan with a single balloon payment, such as a two-week payday loan, the question is simple: Will the borrower have funds available to repay the loan in two weeks? For a secured loan, the question is whether the net proceeds of liquidating the collateral will be sufficient to repay the loan in the event of default. For a loan with periodic payments over a longer term, the lender must assess whether the borrower will have a reasonably stable income and expense flow over the term of the loan.

Moreover, even if lenders do underwrite, there will be defaults and rollovers. Risk is inherent in any loan. Indeed, if we learned anything from the financial crisis, it is that even traditional 30-year fixed-rate mortgages can be risky when housing prices fall and unemployment rises. In some instances, defaults or rollovers might be attributable to the borrower's inability to repay—a fact of which the borrower was aware when he or she took out the loan and of which a lender could have discovered through robust underwriting. In other cases, the inability to repay on time might not have been foreseen by the consumer, let alone the lender, at the time a loan was initiated. For example, the borrower might lose a job unexpectedly or incur an unanticipated expense after taking out a loan. Alternatively, a consumer, who is able to repay, might have other reasons for making a rational choice to roll over or default on a loan. Moreover, the Bureau fails to account for the unique difficulties of conducting ability-to-repay analyses for various types of credit products. Payday lenders, for example, will have difficulty assessing the ability of customers with extreme and unpredictable income volatility to repay. Therefore, such lenders may exclude those who might benefit most from access to short-term loans. Even the borrower may not be able to predict with great accuracy his or her ability to repay.

More important, many consumers default strategically on loans, especially small-dollar loans: they could repay their loan or redeem their pawned item, but choose not to. For example, one commonly stated reason that payday loan customers find payday loans attractive (despite their high cost) is that payday lenders do not report defaults to credit bureaus.²⁸ The Bureau's proposed rule ignores this reality, however, and implicitly assumes that the only reason that borrowers default is that they *cannot* pay, not because they *will not* pay. "Better underwriting" will not mitigate losses from those who strategically default on a loan that they could pay but choose not to.

This reality also points out a potential for an unintended consequence of the Bureau's fixation on ability to repay and default risk that could have serious adverse consequences for borrowers.

28. Victor Stango, "Are Payday Lending Markets Competitive?," *Regulation* 35, no. 3 (2012): 26–33; Victor Stango, "Some New Evidence on Competition in Payday Lending Markets," *Contemporary Economic Policy* 30, no. 2 (2012): 149–61.

It has been long understood that the default rate on any loan to a business or to consumers will reflect in part the aggressiveness of the remedies that borrowers choose to exercise on default. Tying the ability to make a small-dollar loan to default rates or other mechanical tests may have the unintended consequence of leading lenders to be more aggressive in collecting delinquent loans, a result that may not improve consumer welfare over the long run.

The Bureau contends that it is only “proposing to require that lenders make a reasonable assessment of consumers’ ability to repay certain loans above the 36 percent demarcation, in light of evidence of consumer harms in the market for loans with this characteristic.”²⁹ But the Bureau’s definition of *reasonable assessment* requires the lender to verify the loan applicant’s income and housing costs, “forecast a reasonable amount of basic living expenses for the consumer,” and project the “consumer’s net income, debt obligations, and housing costs.”³⁰ These requirements will likely be cost prohibitive for many small-dollar loans.

V. THE PROPOSAL’S EMPHASIS ON INTEREST RATE IS MISPLACED

The Bureau’s proposal focuses on the total cost of credit on an annual percentage basis. Consumers earn, spend, and owe dollars, not percentages. What is relevant to the consumer’s welfare is dollar cost. The total cost of a loan is driven by several components: the interest rate charged, the amount of principle loaned, and the length of the loan. The Bureau, by focusing so much attention on an abstract annual percentage rate, may inadvertently harm the consumers it seeks to protect. While proposing the total cost of credit, the Bureau expresses concern that “lenders might otherwise shift their fee structures”³¹ to avoid being covered by the rule if the Bureau used the criteria found in Regulation Z.³² The Bureau should be mindful of the risk that lenders will, by necessity, shift the nature of their products to larger and longer loans that are not well suited to certain borrowers’ needs.

A loan with a lower annual percentage cost of credit can be more expensive than a higher annual percentage cost loan if the borrower has to borrow more to qualify for the low rate or is in debt longer. For example, a 30-year mortgage with a 4 percent APR will require interest payments equal to about 72 percent of the principal over the life of the loan. Conversely, on a two-week payday loan with a fee of \$20 for every \$100 borrowed (an APR of 520 percent) that is paid back in two weeks, the borrower pays interest equal to 20 percent of the principle. Does this contrast mean that people should finance homes using payday loans? No. A payday loan’s very short term would not work for the average home buyer. The comparison, however, does illustrate two important points. First, annual percentage rates are not the only factor to consider when assessing the cost of a loan. Second, the amount borrowed and the length of the loan also affect whether the loan is a good fit for the borrower’s needs. A \$5,000 traditional installment loan might have a lower annual total cost of credit percentage rate than a \$500

29. CFPB, “Payday, Vehicle Title,” 47912.

30. *Ibid.*, 47865.

31. *Ibid.*, 47906.

32. 12 C.F.R. § 1026 (2015).

payday loan, but that would not necessarily make it less expensive, and the borrower who needs only \$500 likely would prefer the smaller loan.

The Bureau—settling on a number that has a siren-like quality in the small-dollar regulatory space—“believes that a total cost of credit exceeding 36 percent per annum provides a useful line of demarcation.”³³ The evidence from today’s markets, however, does not support the focus placed on 36 percent. In fact, the market has definitively shown that this rate is not competitive for many types of loans.

The 36 percent annual interest rate does have historical origins, tracing to the reforms proposed under the USLL of 1916. As noted earlier, the USLL was the product of a collaboration between would-be lenders and progressive social reformers in response to the growing demand for small consumer loans. These groups recognized that to create a sustainable market-based alternative to the loan shark, the needs of both lenders and borrowers had to be satisfied.³⁴ Through a series of rigorous studies, the reformers determined that the costs and risks of small-dollar installment lending at that time merited a monthly interest rate of 2.5 percent on amounts more than \$100, and 3.5 percent for loans up to \$100.³⁵ These recommended annualized proposed rates—30 percent and 42 percent, respectively—were six times higher than the existing rate caps. Although the USLL was the product of rigorous study, it is now 100 years old. Its insight about the need to create a consumer credit market where legitimate lenders can operate remains valid. Its recommended interest rate level has become outdated.

A look at the analysis that led the drafters of the USLL to set rates at 42 percent for loans up to \$100 dollars (approximately \$2,200 in 2016 dollars) and 30 percent for loans more than \$100 shows why these rates likely are not appropriate in today’s market. If the loan length is held constant, the break-even APR for lenders falls as the loan size grows. In setting a higher legal rate for smaller loans, the reformers who created the USLL recognized that the smaller the loan amount, the higher the interest rate must be to make the loan profitable for the lender and thereby available to the borrower.

Today, the break-even point for a typical traditional installment lender offering a 12-month, 36 percent APR loan lies somewhere between a loan amount of \$2,600 and \$3,300.³⁶ A lender can profitably loan amounts above the threshold but will not make loans for amounts below

33. CFPB, “Payday, Vehicle Title,” 47864. See also at 47912 (explaining that “the Bureau is proposing to require that lenders make a reasonable assessment of consumers’ ability to repay certain loans above the 36 percent demarcation, in light of evidence of consumer harms in the market for loans with this characteristic”).

34. For detailed descriptions of the Progressive era, the Russell Sage Foundation, and credit reform, see Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit* (Princeton, NJ: Princeton University Press, 1999) and Elisabeth Anderson, “Experts, Ideas, and Policy Change: the Russell Sage Foundation and Small Loan Reform, 1909–1941,” *Theory and Society* 37, no. 3 (2008): 271–310.

35. F. B. Hubachek, “The Development of Regulatory Small Loan Laws,” *Law and Contemporary Problems* 8, no. 1 (1941): 144n14.

36. Thomas A. Durkin, Gregory Elliehausen, and Min Hwang, “Rate Ceilings and the Distribution of Small Dollar Loans from Consumer Finance Companies: Results of a New Survey of Small Dollar Cash Lenders” (working paper, December 2, 2014), 6, <http://ssrn.com/abstract=2533143>. One of the authors of this letter, by using a representative profit and loss statement from a branch office of a traditional installment lender, finds that the break-even loan size for an APR of 36 percent is \$3,300.

the threshold. Consumers who prefer a smaller, shorter-term, higher-rate loan to minimize their interest expense will find themselves trapped in a loan desert. These borrowers face poor options: (1) borrow more than they want to borrow for a longer term; (2) use alternative sources of credit, such as pawn loans, which may not suit their needs well; (3) seek illegal credit without the protections of law; or (4) leave themselves vulnerable to the risk of adverse financial circumstances that they sought to avoid by using credit.

The Bureau is not technically proposing an official interest rate cap. Doing so would be outside its authority. Nevertheless, the Bureau's proposed use of 36 percent annual total cost of credit as a threshold where regulatory burdens increase will likely have a similar effect. As an explicit cap would do, the increase in regulatory costs once the 36 percent threshold is crossed will distort the shape of loans and lead to larger loans with longer terms that are more expensive than the loans they replace. In fact, there is evidence this distortion is happening already. Lenders are changing the type of product they offer to avoid regulatory burdens and regulatory scrutiny, even if those products happen to be a worse fit for borrowers.³⁷

The Bureau should also consider that the country has been going through a period of unusually low interest rates that is unlikely to persist. When interest rates return to more traditional levels, the cost of capital for lenders will increase. The fixed costs faced by lenders are passed on to borrowers.³⁸ Using data from installment lenders, one of the authors of this comment estimates that a 1.00 percent increase in the costs of funds would increase the break-even APR for a \$1,000 12-month installment loan by approximately 0.63 percent.³⁹ Using an arbitrary rate will increase costs and restrict credit even under the current circumstances. As interest rates and the cost of capital increase, the restrictions will become even more onerous. Given the cost of amending rules, the Bureau will unlikely be able to respond sufficiently and quickly to market changes to mitigate this risk. As such, the Bureau should refrain from imposing an arbitrary rate to trigger additional regulatory burden.

Before proceeding with its proposal, the Bureau should undertake extensive and rigorous analysis—just as the reformers did in the Progressive Era of the early 1900s.⁴⁰ The CFPB could even call for the formation of a new bipartisan national commission on consumer finance modeled

37. See Annamaria Andriotis, "A Payday-Loan Rival Gains Ground," *Wall Street Journal*, August 7, 2016; see also Aimee Picchi, *Moneywatch*, CBS News, August 11, 2016.

38. Durkin, Elliehausen, and Hwang, "Rate Ceilings and the Distributions of Small Dollar Loans," 3–6.

39. A casual reader might think that a 1 percent increase in the cost of funds would increase the break-even APR by 1 percent. The relationship between the cost of funds and break-even APR, however, is complex and highly nonlinear. An increase in APR directly increases revenue. Because loans with higher APRs amortize more slowly, receivables increase—which means equity, debt, interest expense, and bad debt expense all increase. The solution to the break-even APR when the cost of funds increases is, therefore, iterative in nature. See Thomas Miller Jr., "Estimating the Break-Even APR by Loan Amounts Made by Traditional Installment Lenders" (unpublished paper, Mississippi State University, Starkville, 2016).

40. The same reformers acknowledged the need for ongoing evaluation and study. For example, note 14 of the sixth draft of the USLL contained the following text: "The maximum rate of charge . . . is recommended as an initial rate in all states. . . . The rate is designed to attract aggressive competition by licensed lenders . . . in order to drive unlicensed lenders out of business. This rate should be reconsidered after a reasonable period of experience with it." See Hubachek, "The Development of Regulatory Small Loan Laws."

on the one Congress created in 1968.⁴¹ The findings of that commission are in stark contrast to the Bureau’s proposed rule. The commission found that, as a general rule “the essentials of how much credit, to whom, and at what price should be left to the free choice of consumers in the marketplace—provided that the marketplace is competitive.”⁴² The commission also found that state regulation “tended to restrain competition and unnecessarily segment the consumer credit market.”⁴³ The proposed rule threatens to increase the restraint of competition and market segmentation the commission wisely decried.

This is not to say that the commission’s findings should be treated as sacrosanct. There is much to learn about how the consumer finance markets have changed in the more than four decades since the National Commission on Consumer Finance published its findings. However, the Bureau should not discard those findings without performing at least as much study into the topic. A careful and detailed study of (1) why consumers use the credit products that they do and (2) the effects of competition and regulation on consumer choices would help regulators and legislators better understand the markets that they are currently regulating, as they collectively attempt to make consumers better off. A collaborative effort to understand the nature of the small-dollar credit market will help the Bureau to avoid instituting costly and distortive regulations that harm the consumers the CFPB is charged with protecting.

VI. REGULATORY CAPS INHIBIT THE ABILITY OF BORROWERS TO ASSESS THEIR RISK PROFILE AND MAKE INFORMED DECISIONS

Distorting annual rates, as the Bureau’s de facto 36 percent cap would do, threatens to harm consumers. Evidence shows that interest rate limits can serve as a focal point for pricing and potentially implicit collusion.⁴⁴ However, some clustering may be due to cross-subsidization of borrowers; borrowers who would be priced below the limit are overcharged to compensate for borrowers who would be priced above the limit. This cross-subsidization allows the lender to hedge the risk of the relatively riskier borrowers at the expense of the less risky borrowers. Although in a truly competitive market the less risky borrowers would be more able to find lenders willing to lend at appropriate market rates, the clustering effect of the cap decreases competition.

41. See Consumer Credit Protection Act, Pub. L. No. 90-321 (1968).

42. National Commission on Consumer Finance, *Consumer Credit in the United States: Report of the National Commission on Consumer Finance*, December 1972, 3.

43. *Ibid.*

44. Robert DeYoung and Ronnie J. Phillips, “Payday Loan Pricing” (Federal Reserve Bank of Kansas City Paper RWP 09-07, January 14, 2009). DeYoung and Phillips find that payday loans in Colorado are priced at the maximum interest rate limit and in a manner inconsistent with competitive pricing. See also Christopher R. Knittel and Victor Stango, “Price Ceilings as Focal Points for Tacit Collusion: Evidence from Credit Cards,” *American Economic Review* 93, no. 5 (2003): 1703. Knittel and Stango find that (1) intrastate credit cards tend to be priced at the state interest rate limit in a manner more consistent with tacit collusion than competition and (2) increased entry and competition from out-of-state competitors help lower prices. Note that these findings are not universally accepted. For example, research in progress by two of the authors of this letter has found the following: (1) about half the loans made by payday lenders in states with a \$500 maximum borrowing cap are made within \$100 of the amount cap; and (2) depending on how it is measured, 41 percent to 85 percent of the loans are made at the maximum fee cap.

Cross-subsidization is obviously harmful to the less risky borrowers paying more than market rates. It can also be harmful to the riskier borrowers who are deprived of information relating to the true potential cost and risk of the loan. The interest charged to a borrower is in part to compensate the lender for the risk that the borrower will default on the loan. Under normal conditions, riskier borrowers are charged more. The cost of the loan informs borrowers of the lender's appraisal of the risk of default. Lenders tend to be repeat players and are likely less subject to overoptimism about any given borrower's ability to repay than the borrower might be. The lender's objective appraisal thus provides borrowers with objective information about what kind of a credit risk they are. Borrowers always know more about their individual circumstances than does the lender, but the lender has the benefit of experience in lending to similarly situated borrowers.

If the lender is discouraged from charging the appropriate rate of interest, the lender may refuse to make a loan or may offset the mandated undercharging of risky borrowers with cross-subsidization from less risky borrowers. While cross-subsidization allows both sets of borrowers to access loans, it also deprive them of accurate information about the risk of default. Borrowers need this information to make an informed decision and to protect themselves. Not only is default costly for the lender; it is also costly to borrowers, who may suffer damage to their credit records, reduced access to credit in the future, and potential social stigma.

VII. THE INTERACTION OF STATE, FEDERAL, AND PRIVATE LAWS MUST BE CONSIDERED

The Bureau proposes to add a layer of regulation to consumer lending that already is subject to extensive and longstanding regulation. States have been regulating consumer credit for a century. Recognizing that the demand for credit was here to stay, the drafters of the USLL—on which many state laws are based—sought to foster a system of legal lenders who could meet consumers' needs. They understood that consumers would be best served in a competitive, legal marketplace. A century later, the demand for small-dollar, nonbank credit has not dried up and may even have increased as regulation has made it more difficult for consumers to obtain credit from mainstream sources, such as banks.

A. State Law Has Long Governed Consumer Credit

The 100 years since the USLL was drafted provide a wealth of evidence about how different state regulatory approaches have worked. States have regulated consumer credit in a variety of ways and have modified their approaches over time. Given the active interest that state regulators play in developing effective, workable regulations in this area, the CFPB's involvement seems superfluous.

The Bureau argues that state law has been ineffective at “reducing reborrowing and other harms that confront consumers of short-term loans.”⁴⁵ The Bureau also acknowledges that states “have expressed concern that the identification of unfair and abusive acts or practices in this rulemaking may be construed to affect or limit provisions in State statutes or State case law,”⁴⁶ but it argues that such an outcome is not its intent.

Regardless of intent, the Bureau’s proposal would obstruct state efforts to craft regulatory approaches that appropriately protect consumers. The precise parameters imposed on lenders by the proposed rule will reduce the opportunity for state-level experimentation with different regulatory approaches, such as the disclosure regime of Texas cited by the Bureau in its supplemental findings.⁴⁷ The CFPB should be mindful that its rules are a sort of uncreative destruction—eliminating credit options without putting anything in their place. While innovations in credit provision may provide lower-cost access to credit for borrowers currently deprived of options, removing the options that exist now will not call those hoped-for new products into being. In fact, the restrictions proposed and the regulatory cost and uncertainty they will create may delay or prevent needed innovation as firms are dissuaded from risking entry into the market.

B. Private Law May Also Be an Effective Regulator of Consumer Credit

In addition to taking state law into account, the Bureau should consider whether private limits on lender behavior could reduce the need for formal federal regulation. Private regulation can be more effective and responsive to changing circumstances than government regulation. In deciding whether and how to proceed with its proposal, the Bureau should look at how private regulation is changing the landscape.

For example, the Bureau has expressed concern about the use of the Automated Clearing House (ACH) system by lenders and the risk of excessive fees generated by repeated attempts to obtain payment. This concern is largely based on research the Bureau performed on data obtained from banks involving transactions in 2011 and 2012.⁴⁸ In response, the Bureau announced that it might consider a lender’s seeking to withdraw funds after the second consecutive failed attempt to be an “unfair” practice.⁴⁹ Although the Bureau acknowledges recent changes to National Automated Clearinghouse Association (NACHA) rules designed to reduce the rate of returned payment requests, it considers that the rule change is likely insufficient to protect consumers.

45. CFPB, “Payday, Vehicle Title,” 47932–33 (“While these provisions may have been designed to target some of the same or similar potential harms identified above, these provisions do not appear to have had a significant impact on reducing reborrowing and other harms that confront consumers of short-term loans.”)

46. CFPB, “Payday, Vehicle Title,” 47904 at n. 415.

47. Bureau of Consumer Financial Protection, *Supplemental Findings on Payday, Payday Installment, and Vehicle Title Loans, and Deposit Advance Products*, June 2016, chapter 3.

48. Bureau of Consumer Financial Protection, *Online Payday Loan Payments*, April 2016.

49. CFPB, “Payday, Vehicle Title,” 48056–57.

Importantly, the NACHA rules change occurred after the Bureau’s research concluded, so the Bureau has not collected the data to assess the rule’s effectiveness. Rather than relying on research that has been overtaken by market developments to impose potentially significant costs on lenders, the Bureau should assess whether the new NACHA rules are having the intended effect. Doing so would allow the Bureau to observe current market reality and determine whether regulation is necessary. The Bureau acknowledges that ACH can be a “substantial convenience to both parties,”⁵⁰ so the Bureau should take care not to impose unnecessary costs on ACH users. The Bureau worries that “there is no guarantee that [NACHA rules] will exist in the same or an improved form in the future,”⁵¹ but if the rules change negatively or prove inadequate, the CFPB will be able to react at that point on the basis of current information. Acting on information that is known to be outdated does not serve consumers well.

VIII. CONCLUSION

The Bureau’s 1,300-page notice of proposed rulemaking covers a lot of ground. However, many questions still remain about the needs of the participants, the nature and operation of underlying credit markets, and the ways the rule would affect the consumers who currently rely on small-dollar loan products to meet their needs. In its frequent citation to its own beliefs unsupported by testable evidence, the Bureau itself acknowledges persistent research gaps.⁵² Rather than moving ahead with an intensely complicated rule that has the potential to harm an already struggling group of consumers, the Bureau should undertake additional research in this area to better understand these consumers and their needs. We have suggested some areas that would be fruitful for consideration, including how the rule will affect borrowers, how to best assess the cost and suitability of a loan, how the CFPB can avoid squelching innovation and competition, and the role that can and should be played by the states and private sector.

We would be happy to discuss these issues further with you.

50. *Ibid.*, 48049.

51. *Ibid.*, 48055.

52. The proposal contains approximately 779 “Bureau believes” statements compared to 27 instances of “the Bureau found” and 21 instances of “the Bureau’s research.” While this certainly does not mean that every statement of the Bureau is a leap of faith, the discrepancy highlights the gaps in information that exist and should be rectified before instituting a regulation that will have significant negative consequences for many borrowers.