The Heritage Foundation

ISSUE BRIEF

No. 4479 | NOVEMBER 4, 2015

Dodd–Frank and the Consumer Financial Protection Bureau Put Squeeze on Private Payday Lenders

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The 2010 Dodd–Frank Act authorized the Consumer Financial Protection Bureau (CFPB) to impose new regulations on payday lenders and other short-term credit providers, and these rules will likely harm millions of consumers. The act compounded this regulatory burden by effectively creating a variety of taxpayer-subsidized alternatives to private lenders in this market. Supporters of Dodd–Frank argue that these changes are necessary because private short-term lenders tend to "trap" consumers in high-cost debt. This view is fundamentally flawed, and the federal government has no need to regulate short-term lenders, all of whom are currently regulated by state governments.

Payday Lenders Provide Valuable Services

Advocacy groups have campaigned against payday (and other short-term) lenders for years, claiming that these companies systematically "trap" people in high-cost debt.[1] Since Dodd–Frank passed in 2010, federal regulators are basing new regulations on this flawed premise. For instance, the director of the CFPB recently stated, "Too many short-term and longer-term loans are made based on a lender's ability to collect and not on a borrower's ability to repay."[2] However, if lenders build their business on collecting money from people who cannot make good on their debts, they will soon find themselves out of business.

Furthermore, the CFPB's own complaint database does not support the claim that there is a systematic problem in this industry. From July 2011 to August 2015, consumers lodged approximately 10,000 complaints against payday lenders.[3] Ignoring the fact that these are unverified complaints, the figure pales in comparison to the more than 12 million people *per year* using payday loan services. Certainly, some customers have legitimate complaints, but four years of raw complaint totals represent less than *one tenth of one percent* of the number of *annual* payday loan customers.[4]

Newly published survey results cast further doubt on the notion that payday lenders are systematically trapping consumers in debt. On the contrary, most customers knowingly choose to roll over their payday loan before becoming debt free, and they are even able to accurately predict when they will be debt free for one pay period.[5] While it may appear to some people that payday loan customers are making bad economic decisions, policymakers cannot make such judgments because the value in question is subjective. In other words, even though someone not connected to a payday loan may view the cost as "too high," the borrower is the only person capable of making that judgment.[6]

APR Does Not Apply to Payday Loans

One common criticism of the industry is that payday lenders gouge customers by charging a high annual percentage rate (APR)—sometimes

This paper, in its entirety, can be found at
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"upwards of 390%."[7] This criticism is misplaced, in part because it misuses the APR concept. Properly used, the APR represents the actual rate of interest someone pays over the course of a year due to compounding, the process whereby interest is added to unpaid principal.[8] However, in a typical case, payday loan customers do not borrow for a full year, and the interest charges do not compound.[9] Thus, there usually is no APR on a payday loan.

For example, if a customer borrows $100 for two weeks, for a fee of $15, then the only way to appropriately express this fee as a rate would be 15 percent ($15 divided by $100). When a payday loan customer rolls over a loan at payday, he has to pay a new $15 fee and is then responsible for repaying a total of $130; the fee could then be expressed as a rate of 30 percent, and so on. Thus, interest costs cannot "explode" exponentially as they can, for example, with a home mortgage, since there is no compounding.[10]

Should the customer in this example roll the loan over more than 6 times, he would pay more in interest than the original $100 loan. However, this does not mean that the customer has been harmed. Such a criticism is particularly puzzling when made by federal officials since government-housing policies have, for decades, been geared toward increasing long-term mortgages for low/moderate income households. These mortgages can be criticized on precisely the same grounds, and they impose much higher total interest costs than payday loans.

Overview of the CFPB's Proposed Rules

The CFPB's current proposal creates two classes of short-term loans: those with up to 45 days in duration and longer-term ones that mature in up

1. See, for example, Leslie Parrish and Uriah King, "Phantom Demand: Short-Term Due Date Generates Need for Repeat Payday Loans, Accounting for 76% of Total Volume," Center for Responsible Lending, July 9, 2009, http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf (accessed November 2, 2015).
2. Greenberg Traurig, "CFPB Outlines Payday Loan Rule," CFPB Observer, March 2015, p. 1, http://www.gtlaw.com/News-Events/Publications/Alerts/183460/CFPB-Outlines-Payday-Loan-Rule (accessed October 23, 2015).
3. Consumer Financial Protection Bureau, "Monthly Complaint Report," Vol. 3, September 2015, http://files.consumerfinance.gov/f/201509_cfpb_monthly-complaint-report-vol-3.pdf (accessed October 23, 2015).
4. According to the Pew Charitable Trusts, more than 12 million Americans borrow over $7 billion per year from these firms. Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why," July 19, 2012, http://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why (accessed October 23, 2015).
5. Ronald Mann, "Assessing the Optimism of Payday Loan Borrowers," 2013, 21 Sup. Ct. Econ. Rev., 105 (2013), http://www.columbia.edu/~mr2651/AssessingPayday.pdf (accessed October 23, 2015). For additional research, see Robert DeYoung, Ronald J. Mann, Donald P. Morgan, and Michael R. Strain, "Reframing the Debate about Payday Lending," Federal Reserve Bank of New York, October 19, 2015, http://libertystreeteconomics.newyorkfed.org/2015/10/reframing-the-debate-about-payday-lending.html#.Viqed1_D-II (accessed November 2, 2015), and Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans," Federal Reserve Bank of New York *Staff Reports* No. 309, February 2008, http://www.newyorkfed.org/research/staff_reports/sr309.pdf (accessed October 23, 2015).
6. One researcher notes that many payday loan customers value these services so much they even tip their tellers. See Lisa J. Servon, "The Real Reason the Poor Go Without Bank Accounts," *The Atlantic* Citylab, September 11, 2013, http://www.citylab.com/work/2013/09/why-poor-choose-go-without-bank-accounts/6783/ (accessed October 27, 2015).
7. Mandi Woodruff, "The Reign of Payday Lenders May Soon Be Over," Yahoo! Finance, August 13, 2014, http://finance.yahoo.com/news/the-reign-of-payday-lenders-may-soon-be-over-201715917.html# (accessed October 23, 2015).
8. Credit card companies, for example, provide their customers with a stated annual rate of interest, but the actual (effective) rate the customer pays depends on the frequency of compounding. Thus, the APR is meant to express an interest rate used to compound multiple times per year *as an annual rate*.
9. The overall average maturity is not clear, but the Pew Survey (Pew Charitable Trusts, "Payday Lending in America") estimates an average of five months of continuous borrowing. For an explanation of why this figure may be high, see Mann, "Assessing the Optimism of Payday Loan Borrowers," Note 30.
10. Regulations vary by state, but some states prohibit any kind of rollover. See "Florida Congressman Recommends State Laws to CFPB for Payday Loans," August 18, 2015, http://about100dayloans.com/florida-congressman-recommends-state-laws-to-cfpb-for-payday-loans/ (accessed October 27, 2015).

to six months.[11] For both categories, the CFPB has proposed two options, where lenders can choose between a *prevention* or *protection* framework. For the shorter-term loans, the prevention option requires lenders to apply the ability-to-repay standard.[12] This standard generally requires lenders to "make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms."[13]

If the borrower then defaults, he has the right to sue the lender for misjudging his ability to repay the loan. This option also creates a *rebuttable presumption* of an inability to repay either a second or third short-term loan within 60 days of the original loan. In other words, a lender cannot make another loan to the consumer within a 60-day period unless the lender can "prove" the borrower can repay. If the lender *can* rebut the presumption, it can provide no more than three consecutive loans without a 60-day cooling off period.[14] Combined, these two new provisions would severely shrink payday lenders' profitability and ultimately shrink consumers' access to capital.

Alternatively, a lender can choose the *protection* option, a framework that includes several *screening* and *structural* requirements. Using this option, the lender must first (among other requirements) verify the consumers' income and borrowing history, as well as verify that extending a loan will not result in the customer being in debt "for more than 90 days in the aggregate during a rolling 12-month period."[15] This option would impose a major change on the industry—currently, most payday lenders only require proof of employment and a bank account.

Once all screening requirements are met, the lender can provide only a loan that meets certain structural criteria, such as a maximum amount of $500 and a duration of no more than 45 days. The current plan would also require lenders to structure loans to "taper off the consumer from indebtedness."[16] Longer-term loans face a similar set of new restrictions and, in some cases, have their interest rates and fees capped.

Title XII of Dodd–Frank Compounds Problems

Dodd–Frank places additional burdens on the industry because it creates several subsidized alternatives to privately provided short-term loans. Section 1204, for example, establishes federal grant programs to help FDIC-insured banks provide more "small-dollar value loans."[17] Section 1205 authorizes similar grants for a wider range of entities, including nonprofit organizations as well as state and local governments.[18] Finally, Section 1206 establishes grant programs for taxpayer-funded groups known as community development financial institutions (CDFIs) to provide loans of up to $2,500.[19] Thus, the federal government is now subsidizing the competitors of the private lenders upon whom they are imposing high regulatory costs.

11. The Regulatory Flexibility Act of 1980 (5 U.S. Code §§ 601 et seq.) requires the CFPB to convene and chair a Small Business Review Panel unless they certify a particular proposed rule will not have a major impact on a large number of small businesses. The CFPB published an outline of their rule proposal as part of this process. See Consumer Financial Protection Bureau, "Outline of Proposals Under Consideration and Alternatives Considered," March 26, 2015, http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf (accessed November 2, 2015).
12. For a good summary of both the short-term and longer-term proposals, see Greenberg Traurig, "CFPB Outlines Payday Loan Rule."
13. Diane Katz, "Dodd–Frank Mortgage Rules Unleash Predatory Regulators," Heritage Foundation *Backgrounder* No. 2866, December 16, 2013, http://www.heritage.org/research/reports/2013/12/doddfrank-mortgage-rules-unleash-predatory-regulators.
14. Consumer Financial Protection Bureau, "Outline of Proposals Under Consideration and Alternatives Considered," p. 7.
15. Ibid., p. 17.
16. Ibid. Currently, the typical industry practice is to verify employment with two recent paystubs and to secure the loan with a post-dated personal check. See Donald P. Morgan, "Defining and Detecting Predatory Lending," Federal Reserve Bank of New York *Staff Report* No. 273, January 2007, https://ideas.repec.org/p/fip/fednsr/273.html (accessed October 20, 2015).
17. 12 U.S. Code § 5623.
18. 12 U.S. Code § 5624.
19. See 12 U.S. Code § 4719.

Conclusion

The Dodd–Frank Act authorized the CFPB to impose federal regulations on the short-term lending industry, and the agency is developing rules that will harm private firms and their customers. Furthermore, the federal government is now subsidizing these private lenders' competitors. Combined, these changes will make it very difficult to for private business owners to serve their customers.

This new framework is based on the false claim that private lenders systematically prey on customers who cannot repay their debts. The evidence does not support such a claim, and the new approach is likely to prevent millions of people from gaining access to the beneficial credit products they currently use. The best way to ensure customers have access to low-cost credit is to foster private competition. The federal policies in Dodd–Frank take the opposite approach, and they are on the brink of shutting down many of the private firms that provide short-term loans.

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