American Financial Services Association

SHOULD STATES IMPOSE 36% RATE CAP LAWS?

1. Are APR-based rate caps in general a good idea?
No. APR is not a helpful indicator of cost, quality, or affordability. It was intended only to help compare loans of equal size and duration, where one might have higher interest and the other higher fees. APRs are chiefly a function of the size and length of a loan: the bigger the loan, the smaller its APR. Capping APRs means cutting off access to all small loans, regardless of safety or affordability.

2. What is the relationship between cost and rate?
There is an inverse relationship between cost and rate: the lowest rate loans have the highest cost and vice versa. Thus rate caps also cut off access to the cheapest, lowest cost loans and they hurt the people they were supposedly intended to help.

3. Aren't payday loans dangerous and don't they have high APRs?
Yes, but they are not dangerous because of their APRs. The problem with payday loans is their structure: the lenders do not test the ability to repay and the loans are repayable in one lump sum, typically two weeks after the loan has been made. These factors cause many borrowers to become trapped in a cycle of debt. Otherwise they would be low cost loans.

4. What do economists say about rate caps?
Economists tend to disapprove of all such price controls, pointing out that without access to the banned products, consumers will be forced to choose products they like less and that carry a higher cost, and fewer safeguards.

5. What does the Federal Government think of rate caps?
All attempts to pass rate caps early in the first Obama Administration were soundly defeated, and in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress made sure the new Consumer Financial Protection Bureau (CFPB) could not make the mistake of imposing rate caps either.

6. What does the Bible say about rate caps?
Nothing. It does not discuss rates except when, in the parable of the buried talents, Jesus has the Lord ask why the bad servant did not at least invest his money with the bankers and make some return. St. Thomas Aquinas wanted to ban usury, which he defined as making ANY charge for the **use** of something you later receive back. What we would call rental payments. He mistakenly believed that money was sterile, whereas economists now realize it has value to its owner or renter.

7. Didn't the ancient Babylonians have rate caps?
Yes, but they were not time sensitive and thus not like APRs. Under their laws a typical payday loan would be legal, but a 5% APR 30 year mortgage would be illegal, as it would have a much higher TIP rate (Total interest paid as a percentage of principal).

8. If you don't use APR, how can you tell a good loan from a dangerous one?
Lots of things matter more than rate: for instance, cost and risk. What happens if you default? The key is STRUCTURE, especially having equal installments of principal and interest. CFPB Director Richard Cordray talked about loans made based on the borrower's ability to repay, not based on the lender's ability to collect. That's a good definition of the difference between a potentially predatory loan and a safe one.

9. What would be the impact of a 36% "all in" or "hard" cap in a specific state?
It would dry up the supply of almost all loans under $5,000, producing what Director Cordray calls a "credit desert."

10. Would the demand for loans shrink with the supply?
No. Unlike the use of credit cards for impulse buying over the internet, getting an installment loan is an intrusive process and their use is highly intentional. People apply for these loans because they need them, and they are given them because they can afford them.

11. Haven't many other states passed 36% rate caps? What happened there?
Very few, if any, states have passed an 36% "all in" cap. Some allow the sale of ancillary products like credit insurance others make exceptions for payday (Ohio) or title loans (Arizona). Because you can't legislate away the need for the loans, states that have passed restrictive rate laws tend to see a rise in bankruptcy filings and a flight into other less safe and more expensive loan products, like bank overdraft or internet payday loans. It also raises the price of consumer durables like TV sets, because the seller cannot finance the sale at a rate which reflects actual cost.

12. Why don't banks make these loans? Their costs are much lower.
Bank retail costs are not lower, just the cost of money. In 2010, the FDIC ran a pilot program under which they asked banks to try to make subprime consumer loans at 36%. Not a single bank reported that they could do so profitably. This message was recently repeated to the CFPB by bank and credit union representatives.

13. Where did this 36% number come from?
The number originates in the work of consumer advocate Arthur Ham a hundred years ago. He was looking to raise rates so that middle class Americans would have access to safe, state regulated loans, just like wealthy Americans. He found by trial and error that he could attract investors to make loans at 3.5% per month (42%) for loans up to $100, and at 2.5% per month on loans above $100. The average of 3.5 and 2.5 is 3%, or 36% per annum. $100 in 1915 is equivalent to about $2,500 today and 42% is not a bad interest rate for a $2,500 loan. It just doesn't work for a small loan of, say, $500 today. It should also be pointed out that Ham was not talking about APRs, which had not been invented. You could supplement his interest rate with fees and with the sale of ancillary products like insurance. It was certainly not an "all in" rate. He would have rejected that by the same trial and error method, since it would not have helped lower income Americans obtain and secure access to safe, state regulated installment loans.

14. Opinion polls show that many people support a 36% rate cap. So do many cities and counties. Shouldn't we pay attention to this?

No. Because the people polled are not experts in the cost and breakeven pricing of small loans. They might also, if asked, support a cap of $1 on the price of a steak at a restaurant. Unfortunately, we all know that it costs more than that for the restaurants to buy and cook the steak and to pay the building costs and the wages of the cooks and servers. We can all see that a $1 cap would not result in cheap steak but in no steak. It is the same with a rate cap. Pollsters generally omit to mention that the choice is between loans at over 36% and no loans at all. If they did, no doubt people would vote differently. Put politely, the pollsters are being disingenuous.

15. What would be the worst case scenario for consumers?

There is no doubt that the current situation is not ideal, even if the CFPB is planning measures that are expected to eradicate the problem loans in the near future. By far the worst case would be if 36% rate caps are imposed. It would lead to a credit desert, in which thousands of people would be unable to meet their real credit needs. The United Nations defines poverty as the lack of certain essential goods and services, including credit. Very simply, cutting off access to credit by imposing rate caps directly increases poverty.

16. Isn't it true that storefront lenders are bad, because they target the poor?

First, you should want loans to be made from storefronts: storefronts are open to the public and state licensed and regulated. In other words, they are safe. If loans are not made from storefronts, they must be made out of back alleys or over the Internet, in either case with fewer safeguards and higher prices. Second, we should want lenders to target the poor, that is, to design and sell products for the poor. What we don't need is more lenders to walk away from this market, as Citibank just did, when it announced the sale of OneMain Financial, saying it was going to concentrate its resources on corporations and wealthy individuals.

17. How do you explain the horror stories we hear about storefront lending? Surely this means such loans are bad for people.

There are certainly anecdotes about badly designed products, all of which are expected to be eliminated in the next year by the CFPB. However, there are clearly far more satisfied customers than unhappy ones, especially with regard to the traditional installment loan product. In Texas, the Consumer Credit Commissioner just reported that her office has received about one complaint per 10,000 borrowers of traditional installment loans over the last year, making no comment as to whether the complaints were in any way justified. It's hard to think of an industry with a similar record of customer satisfaction.

Nevertheless, anecdotal information is never as meaningful as scientific, long-term, longitudinal studies. Only one of these has been performed on the installment industry, by Professor Karlan of Yale and Zinman of Dartmouth, and it revealed that the random sample of turn-downs who received loans were more likely later on to be happy and employed and to be able to put food on their tables, and less likely to be in poverty, than those who did not.