Short-Term, Small-Dollar Lending: Policy Issues and Implications

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Summary

Short-term, small-dollar loans are consumer loans with relatively low initial principal amounts (often less than $1,000) with relatively short repayment periods (generally for a small number of weeks or months). Short-term, small-dollar loan products are frequently used to cover cash-flow shortages that may occur due to unexpected expenses or periods of inadequate income. Small-dollar loans can be offered in various forms and by various types of lenders. Banks and credit unions (depositories) can make small-dollar loans through financial products such as credit cards, credit card cash advances, and checking account overdraft protection programs. Small-dollar loans can also be provided by nonbank lenders (alternative financial service [AFS] providers), such as payday lenders and automobile title lenders.

The extent that borrower financial situations would be made worse from the use of expensive credit or from limited access to credit is widely debated. Consumer groups often raise concerns regarding the affordability of small-dollar loans. Borrowers pay rates and fees for small-dollar loans that may be considered expensive. Borrowers may also fall into *debt traps*, situations where borrowers repeatedly roll over existing loans into new loans and subsequently incur more charges rather than completely paying off the loans. Although the vulnerabilities associated with debt traps are more frequently discussed in the context of nonbank products such as payday loans, borrowers may still find it difficult to repay outstanding balances and face additional charges on loans such as credit cards that are provided by depositories. Conversely, the lending industry often raises concerns regarding the reduced availability of small-dollar credit. Regulations aimed at reducing costs for borrowers may result in higher costs for lenders, possibly limiting or reducing credit availability for financially distressed individuals.

This report provides an overview of the small-dollar consumer lending markets and related policy issues. Descriptions of basic short-term, small-dollar cash advance products are presented. Current federal and state regulatory approaches to consumer protection in small-dollar lending markets are also explained, including a summary of a proposal by the Consumer Financial Protection Bureau (CFPB) to implement federal requirements that would act as a floor for state regulations. The CFPB estimates that its proposal would result in a material decline in small-dollar loans offered by AFS providers. The CFPB proposal has been subject to debate. H.R. 10, the Financial CHOICE Act of 2017, which was passed by the House of Representatives on June 8, 2017, would prevent the CFPB from exercising any rulemaking, enforcement, or any other authority with respect to payday loans, vehicle title loans, or other similar loans. After discussing the policy implications of the CFPB proposal, this report examines general pricing dynamics in the small-dollar credit market. The degree of market competitiveness, which may be revealed by analyzing market price dynamics, may provide insights concerning affordability and availability options for users of certain small-dollar loan products.

The small-dollar lending market exhibits both competitive and noncompetitive market pricing dynamics. Some industry financial data metrics are arguably consistent with competitive market pricing. Factors such as regulatory barriers and differences in product features, however, limit the ability of banks and credit unions to compete with AFS providers in the small-dollar market. Borrowers may prefer some loan product features offered by nonbanks, including how the products are delivered, in comparison to products offered by traditional financial institutions. Given the existence of both competitive and noncompetitive market dynamics, determining whether the prices borrowers pay for small-dollar loan products are "too high" is challenging. The **Appendix** discusses how to conduct meaningful price comparisons using the annual percentage rate (APR) as well as some general information about loan pricing.

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Introduction

Short-term, small-dollar loans are consumer loans with relatively low initial principal amounts (often less than $1,000) with short repayment periods (generally for a small number of weeks or months).[1] Short-term, small-dollar loan products are frequently used to cover cash flow shortages that may occur due to unexpected expenses or periods of inadequate income. Small-dollar loans can be offered in various forms and by various types of lenders. Federally insured depository institutions (i.e., banks and credit unions) can make small-dollar loans via financial products such as credit cards, credit card cash advances, and checking account overdraft protection programs. Nonbank lenders, such as alternative financial service (AFS) providers (e.g., payday lenders, automobile title lenders), also provide small-dollar loans.[2]

Affordability is a concern surrounding small-dollar lending. The costs associated with small-dollar loans appear to be higher in comparison with longer-term, larger-dollar loans. Furthermore, borrowers may fall into *debt traps*. A debt trap occurs when borrowers who may be unable to repay their loans reborrow (roll over) into new loans, incurring additional charges, rather than make progress toward paying off their initial loans.[3] When individuals repeatedly reborrow similar loan amounts and incur fees that steadily accumulate, the rising indebtedness may entrap them into worse financial situations. Debt traps are frequently discussed in the context of nonbank products such as payday loans; but they may occur when a consumer makes only the minimum payment (rather than paying off the entire balance at the end of each statement period) on a credit card, which is an example of a loan product provided by depositories.

Borrowers' financial decisionmaking behaviors arguably must be carefully observed before concluding that frequent usage of small-dollar loan products results in debt traps.[4] Determining how borrowers habitually get into cash flow (liquidity) shortages requires knowledge about their cash management practices and their perceptions of prudent spending and savings decisions. Policy initiatives to protect consumers from what may be considered expensive borrowing costs could result in less credit availability for financially distressed individuals, which may place them in worse financial situations (e.g., bankruptcy). The academic literature has not reached a consensus about whether access to expensive small-dollar loans contributes to or alleviates financial distress. Some academic research suggests that access to high-cost small-dollar loans improves well-being during temporary periods of financial distress but may reduce well-being if

[1] In addition, *near-small-dollar loans* are made for $2,500 or less. See Tammie Hoy, Jessie Romero, and Kimberly Zeuli, "Microenterprise and the Small-Dollar Loan Market," *Federal Reserve Bank of Richmond Economic Brief*, May 2012, at https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_brief/2012/pdf/eb_12-05.pdf.

[2] A nonbank can be defined as a firm offering financial products and services that does not have a bank, thrift, or credit union charter.

[3] Center for Economic and Policy Research, *Small-Dollar Lending: Is There A Responsible Path Forward?,* at http://www.cepr.net/documents/publications/small-dollar-lending-2012-08.pdf; and Leslie Parrish and Uriah King, *Phantom Demand: Short-Term Due Date Generates Need for Repeat Payday Loans*, Center for Responsible Lending, July 9, 2009, at http://www.responsiblelending.org/research-publication/phantom-demand-short-term-due-date-generates-need-repeat-payday-loans.

[4] See Gregory Elliehausen, *An Analysis of Consumers' Use of Payday Loans*, George Washington University School of Business, Financial Services Research Program, January 2009, at http://www.cfsaa.com/portals/0/RelatedContent/Attachments/GWUAnalysis_01-2009.pdf.

used for extended periods of time.[5] Whether access to relatively expensive small-dollar loans increases or decreases the likelihood of bankruptcy is still debated.[6]

Congress has taken some measures to address concerns related to small-dollar lending. For example, Congress passed the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act; P.L. 111-24) in light of concerns that cardholders may be paying excessive credit card rates and fees, especially in cases where they are unaware of assessed penalty fees and interest rate increases. Congress also passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203), which created the Consumer Financial Protection Bureau (CFPB). The CFPB was given the authority over both banking and nonbanking firms offering consumer financial products. The CFPB has subsequently implemented and proposed rules pertaining to small-dollar lending products. A recent proposed rule by the CFPB, which would implement federal requirements that would act as a floor for state regulations, would, among other things, require lenders to underwrite small-dollar loans to ensure borrower affordability unless the loan meets certain conditions. The CFPB estimates that its proposal would result in a material decline in small-dollar offerings by AFS lenders.[7] The CFPB proposal has been subject to debate. H.R. 10, the Financial CHOICE Act of 2017, which was passed by the House of Representatives on June 8, 2017, would prevent the CFPB from exercising any rulemaking, enforcement, or any other authority with respect to payday loans, vehicle title loans, or other similar loans.

This report provides an overview of the small-dollar consumer lending markets and related policy issues. It provides various small-dollar loan product descriptions, product usage information, and market metrics. The report also discusses current federal and state regulatory approaches to consumer protection in lending markets, followed by a summary of the recent CFPB proposal and policy implications. It then examines pricing dynamics in the small-dollar lending market. The degree of market competitiveness, which may be revealed by analyzing market price dynamics, may provide insights pertaining to affordability concerns as well as available options for users of certain small-dollar loan products.

Using various industry profitability indicators, some research finds evidence of competition in the small-dollar (payday) lending industry. Other factors, however, would indicate that pricing is not necessarily competitive. For example, banks and credit unions face restrictions on permissible activities, which limit their ability to compete with nonbank small-dollar (e.g., payday) lenders. In addition, borrowers may prefer certain product features or delivery methods, meaning that they may be willing to pay a premium for some loan products relative to others. Given that small-dollar markets contain both competitive and noncompetitive price dynamics, determining whether borrowers pay "too much" for small-dollar loan products is challenging. These issues are discussed in more detail in the report. The **Appendix** describes how to calculate the annual percentage rate (APR) and provides information about general loan pricing.

[5] See Christine L. Dobridge, *For Better and for Worse? Effects of Access to High-Cost Consumer Credit*, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2016-056, July 2016, at http://dx.doi.org/10.17016/FEDS.2016.056.

[6] For example, see Richard Hynes, "Payday Lending, Bankruptcy, and Insolvency," *Washington and Lee Law Review*, vol. 69, no. 2 (March 1, 2012); Donald P. Morgan and Michael R. Strain, *Payday Holiday: How Households Fare After Payday Credit Bans*, Federal Reserve Bank of New York, Staff Report No. 307, February 2008, at http://www.calcfa.com/docs/PaydayHolidayHowHouseholdsFareafterPaydayCreditBansAttachment.pdf; Adair Morse, *Payday Lenders: Heroes or Villains?*, Booth School of Business, University of Chicago, August 2010; and Paige Marta Skiba and Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy*, The Wharton School, University of Pennsylvania, March 10, 2015.

[7] This will be discussed in more detail below in the section entitled "Implications of the CFPB-Proposed Rule."

Short-Term, Small-Dollar Product Descriptions and Selected Metrics

Table 1 provides descriptions of various small-dollar and short-term lending products. Depository institutions typically provide products such as credit cards, overdraft protection, and installment loans. AFS providers typically provide small-dollar short-term credit products such as payday loans, auto title loans, and tax-refund anticipation loans.[8]

Table 1. Summary of Short-Term, Small-Dollar Lending Products

Short-Term Lending Products	Description
	Offered by Depository Institutions
Credit Card Loans[a]	Credit cards are a form of revolving credit that allows individuals access to credit to pay for purchases. The credit card holder subsequently has the option to pay the loan at the end of the statement or grace period or pay a smaller amount and carry the remaining balance over subsequent statement periods.[b] The loan tends to be less costly if the consumer never carries a balance or quickly pays down the outstanding balance. If consumers choose to pay only a portion of the outstanding balance, then the remaining balance is rolled over to the next period and additional interest is incurred on the remaining balance. Hence, although credit cards may be considered short-term products, they may also be considered medium- or longer-term loans depending upon how long borrowers choose to carry outstanding balances. Specific types of credit cards include the following: • Subprime credit cards are those typically made to borrowers with impaired credit. Fee harvester cards refer to a type of subprime credit card in which the total fees amount to a large proportion of the credit limit. • Some credit cards allow borrowers to get cash advances or write checks against the credit card issuer. The consumer generally starts paying interest on the cash advances as of the transaction date. The interest rate for using the credit card is generally different from the one associated with the cash advance, and the interest rate for the cash advance or writing the checks may also differ.
Overdraft Protection Loans	Many banks offer *overdraft protection* to their customers. An overdraft occurs when a customer's checking account does not have enough funds to cover the total amount of a purchase made with a check or debit card. An overdraft coverage limit would "effectively constitute the amount an institution is willing to advance to a consumer on future deposits in return for paying the per-item overdraft fees."[c] The consumer is responsible for repaying the amount owed to the bank and any subsequent fees. Different banks offer different programs. For example, some charge fees for each overdrafting incident; others may determine the charge based upon the amount that is overdrawn, similar to having a credit card attached to the checking account.[d]
Direct Deposit Accounts (Paycheck Advances)	Deposit advances are short-term advances offered to some bank customers, which allow them to borrow up to a certain amount of money against their next direct deposit for a fee.[e] Customers must be employed and must set up direct deposit with their checking accounts. The bank is automatically repaid by deducting the amount that it is owed from the next recurring deposit. This cash advance product allows depository institutions to serve the overdraft-market segment.

[8] See Federal Deposit Insurance Corporation, "Alternative Financial Services: A Primer," *FDIC Quarterly*, vol. 3, no. 1 (2009), at https://www.fdic.gov/bank/analytical/quarterly/2009_vol3_1/AltFinServicesprimer.html.

Short-Term Lending Products	Description
Payday Alternative Loans	Payday alternative loans (PALs), which are similar to direct deposit advances, may be offered by credit unions in accordance with the regulations stipulated by their regulator. PAL amounts may range from $200 to $1,000; they must have fully amortizing payments; the term length must range from at least 46 to 180 days; and the application fee cannot be more than $20.[f]
	Offered by Alternative Financial Service (AFS) Providers
Payday Loans	A payday loan is a short-term loan that, as the name alludes, is often "timed to coincide with the borrower's next payday or other receipt of income,"[g] typically about two weeks. Payday loans are available in a store or online. The payday lender typically requires a borrower to "either provide a personal check to the lender or an authorization to electronically debit her deposit account for the loan amount or associated fee."[h] Hence, a payday borrower typically has a checking account with either a bank or credit union where their paychecks are directly deposited.
Auto-Title Loans	Auto-title lenders operate in a manner similar to payday lenders, but they require borrowers to pledge their car titles as collateral for loans. If the borrowers do not repay their loans, the lender can repossess their cars.
Tax Refund Anticipation Loans	A tax refund anticipation loan is a cash advance made to a borrower based upon the borrower's expected federal income tax refund. The cash advance is typically made with the cost of interest and fees already deducted for the loan, and the full amount must be repaid to the lender even if the refund is lower than the amount anticipated. The lenders may be tax preparation businesses, check cashers, and businesses such as car dealers or furniture stores.
Pawnshop Loans	Pawnshop lenders operate in manner similar to auto-title lenders. Potential borrowers can receive pawnshop loans by leaving behind items pledged as collateral. If borrowers do not return to repay their loans and interest as scheduled, the pawnshop may sell the items.[i]

Source: Congressional Research Service, drawn from definitions used by federal regulators including the CFPB.

Notes: Although the short-term products listed in Table 1 may be more widely recognized, other similar short-term products may exist.

a. Credit cards, for example, technically are not small-dollar loans given that they have limits that can exceed $1,000, and some minimum payment is due when the billing statement arrives. However, they have features comparable to small-dollar loans. Credit cards are open-ended loans, meaning that borrowers may repeatedly reborrow up to preapproved limits, and paying off the entire balance is optional. If individuals routinely pay minimum balances such that reborrowing occurs at a faster pace than principal balances are fully repaid, then total interest and fee charges may quickly increase and add to rising debt burdens.

b. By comparison, a charge card requires the full balance to be paid at the end of each statement period.

c. CFPB, *CFPB Study of Overdraft Programs*, June 2013, p. 14, at http://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf.

d. Ibid., p. 54. Different variations of overdraft protection also include linking a consumer's checking account to another account or to a credit card.

e. The definition of a deposit advance is provided by the CFPB at http://www.consumerfinance.gov/askcfpb/1103/my-bank-offers-direct-deposit-advance-or-checking-account-advance-what.html. For an overview of deposit advances, see CFPB, *Payday Loans and Deposit Advance Products*, April 24, 2013, at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

f. See National Credit Union Administration, "Short-Term, Small Amount Loans," 75 *Federal Register*, September 24, 2010; and National Credit Union Administration, *Permissible Interest Rate Ceiling Extended*, Letter No: 14-FCU-02, NCUA Letter to Federal Credit Unions, Alexandria, VA, January 2014.

g. The Federal Trade Commission defines payday lending as a cash advance by a personal check or electronic transfer, at http://www.consumer.ftc.gov/articles/0097-payday-loans. The Consumer Financial Protection Bureau defines payday lending as a cash advance in which the lender has access to the customer checking account, at http://www.consumerfinance.gov/askcfpb/search?selected_facets=category_exact:payday-loans.

CFPB, *Payday Loans and Deposit Advance Products*, April 24, 2013, p. 6, at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

h. Ibid., p. 8.

i. For more on pawnshop lending, see Susan Payne Carter and Paige Marta Skiba,"Pawnshops, Behavioral Economics, and Self-Regulation," at http://www.bu.edu/rbfl/files/2013/09/Pawnshops-Behavioral-Economics-and-Self-Regulation.pdf.

Small-dollar loan or cash advance products may be an expedient option during unexpected periods of income shortfalls, particularly for individuals lacking sufficient emergency savings as well as those with impaired credit. According to the Survey of Household Economics and Decisionmaking (SHED), conducted in October 2014 by the Board of Governors of the Federal Reserve System, approximately 25% of U.S. households experienced a form of economic hardship that may have resulted in a temporary disruption in income.[9] According to a study released in 2012 by Pew Charitable Trusts, 69% of respondents used a payday loan (for the first time) to cover a recurring expense, such as rent, utilities, and other bills; and 16% of the respondents reported using a payday loan for unexpected expenses.[10]

Apart from credit cards, full (lump-sum) payment is normally expected when small-dollar loans are due. The costs of small-dollar loans may quickly escalate if they are repeatedly renewed because little or none of the initial principal amount is being repaid. The failure to make full and timely payments results in rollovers with additional interest charges on the outstanding principal balance and fees. Indebtedness levels quickly rise if borrowers repeatedly roll over their small-dollar loans.[11]

The text box below contains information on average loan sizes and costs to use various small-dollar loan products. Short-term, small-dollar market aggregate data metrics vary in availability due to nonstandardized reporting requirements. Metrics can vary depending upon the definitions used when constructed (e.g., metrics can be computed with or without the inclusion of individuals who have outstanding balances; interest rates and fees can be reported separately or combined into a single metric). Data are also collected from different years and sources. Maturity lengths also differ among loan product types, raising questions about their comparability.[12] Hence, comparing the relative costs of small-dollar loan products is challenging.

[9] SHED survey participants were asked, "Over the past year, have you or your family living with you experienced any financial hardship such as a job loss, drop in income, health emergency, divorce, or loss of your home?" The most popular response was for a health emergency, followed by job loss of a household head or spouse, a pay cut, or other unforeseen incidents. See Board of Governors of the Federal Reserve System, *Report on the Economic Well-Being of U.S. Households in 2014*, May 2015, at https://www.federalreserve.gov/econresdata/2014-report-economic-well-being-us-households-201505.pdf.

[10] See Nick Bourke, Alex Horowitz, and Tara Roche, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, The Pew Charitable Trusts, July 2012, at http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.

[11] By contrast, medium- and longer-term fixed-rate loans frequently have amortization schedules that allow principal to be paid down, thus reducing interest costs on the outstanding balance.

[12] The challenges associated with comparing the costs of small-dollar loans with different maturity lengths are discussed in the "Challenges Comparing Relative Prices of Small-Dollar Lending Products" section of this report.

Small-Dollar Loan Metrics: Sizes, Costs, and Usage Patterns

- Multiple approaches may be used to compute average credit card debt.[13] The metric may be computed using all cards or using just those cards that typically carry an outstanding balance. When computed as an average per card that usually carries a balance, the amount is $7,494 per card as of May 2016.[14] The Federal Reserve reports that the average annual interest rate on revolving credit during 2016 was 12.35% for all accounts and 13.56% for all accounts assessed interest.[15]
- The CFPB conducted a 12-month study in 2012 that included a small number of depository institutions that offered direct deposit account advances, with a common loan limit of $500.[16] The fees were typically disclosed in terms of dollars per amount advanced, such as $10 per $100. From mid-2013 to 2014, the CFPB reports that bank fees charged on deposit advance products on average were estimated to be approximately $2 per $20. The median average daily balance was $343, translating into $34.30 in fees for the borrower. According to the CFPB, consumers who used deposit advance products were also more likely to have had overdraft transactions or incurred insufficient funds fees.
- The median amount of funds insufficient to cover a check or debit card transaction, which would trigger an overdraft fee, was $50.[17] Accountholders who incurred one or more overdraft or insufficient funds fees paid a weighted average (by banks grouped into high and low fee categories) of $225 in 2011. In 2014, the CFPB reported that 8% of customers incur approximately 75% of overdraft (and insufficient funds) fees. Overdrafts generally decline with the age of the account holder.
- The CFPB reports the cost of a payday loan expressed as a dollar fee may range from $10 to $20 per $100; however, $15 per $100 for 14 days was most common, and the average balance was $350.[18] The median consumer in the sample participated in 10 transactions during a 12-month period and paid $458 in fees.[19] A study shows that younger households, those between the ages of 25 and 49 (38%), and particularly those between the ages of 25 and 29 (9%), have used a payday loan; respondents with incomes below $40,000 (36%), particularly those with incomes between $15,000 and below $25,000 (11%), have used a payday loan.[20]
- The credit union industry offers small-dollar loans designed to be an alternative to traditional payday loans. These small-dollar loans were estimated to have had an average loan balance of $678 with a median interest rate of 25% in 2014.[21]
- The CFPB obtained data from 10 states during 2010-2013 and found that the median auto-title loan size in its sample of 3.5 million single-payment vehicle title loans made to 400,000 borrowers was $694, and the median average percentage rate (APR) was 317%.[22]

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[13] See Jamie Gonzalez and Tamera E. Homes, "Credit Card Debt Statistics," at http://www.creditcards.com/credit-card-news/credit-card-debt-statistics-1276.php.

[14] Data are reportedly provided by Experian. See Fred O. Williams "Measuring Average Credit Card Debt," at http://www.creditcards.com/credit-card-news/average-credit-card-debt.php. As previously stated in **Table 1**, a credit card may be considered a medium- or longer-term loan even though borrowers have the option to use it for short-term borrowing purposes.

[15] See Board of Governors of the Federal Reserve System, *Consumer Credit—G. 19*, December 2016, at https://www.federalreserve.gov/releases/g19/current/.

[16] See CFPB, *Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings*, April 24, 2013, at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf. The $500 limit offered with the direct deposit cash advance is similar to the median credit limit for overdraft protection as reported in the *FDIC Study of Bank Overdraft Programs*.

[17] See CFPB, "Data Point: Checking Account Overdraft," at http://files.consumerfinance.gov/f/201407_cfpb_report_data-point_overdrafts.pdf.

[18] See CFPB, *Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings*, April 24, 2013, at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

[19] The Conference of State Bank Supervisors also provides a detailed chart that consists of payday lending terms for each state. See Conference of State Bank Supervisors, "Payday Lending Chart of State Authorities (released July 2014)," at https://www.csbs.org/regulatory/resources/Pages/JobAids.aspx.

[20] See Nick Bourke, Alex Horowitz, and Tara Roche, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, The Pew Charitable Trusts, July 2012, at http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.

[21] This information was provided by the CFPB from information that was obtained from the NCUA. See CFPB, "Payday, Vehicle Title, and Certain High-Cost Installment Loans," June 2, 2016, p. 102, footnotes 315 and 316, at https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf.

Overview of the Current Regulatory Framework and Proposed Rules for Small-Dollar Loans

Consumer lending is largely regulated for the protection of consumers and to ensure compliance with fair-lending laws. The regulatory framework for small-dollar lending involves different compliance regulators and different approaches, which apply to different products. A detailed assessment of the regulation of all small-dollar products is beyond the scope of this report, but broad observations of the consumer regulatory framework are discussed in this section.

Both bank and nonbank lenders are subject to federal consumer protection and fair-lending laws and regulations if they offer a credit (loan) product covered by those laws and regulations. The Consumer Financial Protection Bureau is a federal regulator that has the authority to issue regulations pursuant to most federal consumer financial protection laws that cover an array of consumer financial products and services.[23]

Different lenders are supervised by different regulators. Depository institutions (i.e., banks and credit unions) having assets below $10 billion are supervised for consumer protection compliance by their prudential regulators. Banks are supervised by the federal prudential regulators, namely the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). The federal prudential regulator of credit unions is the National Credit Union Administration (NCUA). Depository institutions having assets above $10 billion are supervised for consumer protection compliance by the CFPB. Banks and credit unions may also receive state charters and may face additional regulations at the state level, but they would still be required to comply with federal prudential regulations if their deposits are federally insured. Depositories with national charters are generally exempt from additional state consumer regulations, but there may be exceptions for certain circumstances. Financial firms that offer consumer products and do not have national or state bank or credit union charters will be referred to as *nonbank lenders* in this report. Nonbank lenders include many AFS providers, such as payday and auto-title lenders, and they may be supervised by the CFPB or state financial regulators.

Approaches to Small-Dollar Regulation

Different approaches are used to regulate small-dollar products, including disclosure requirements; usury laws; product-feature requirements; underwriting requirements; and unfair, deceptive, or abusive acts or practices (UDAAP) requirements. *Disclosure laws* are a form of consumer protection designed to ensure that borrowers are aware of the costs of their loans. The Truth in Lending Act (TILA; P.L. 90-321), passed in 1968, is currently implemented by Regulation Z. TILA applies to nearly all forms of consumer credit and requires covered lenders to disclose the total cost of credit, which includes both the loan rate and fees, in the form of the annual percentage rate (APR).[24] TILA is not a usury law, meaning that it does not regulate what

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[22] See CFPB, *Single-Payment Vehicle Title Lending*, May 2016, p. 7, at http://files.consumerfinance.gov/f/documents/201605_cfpb_single-payment-vehicle-title-lending.pdf.

[23] See CRS Report R42572, *The Consumer Financial Protection Bureau (CFPB): A Legal Analysis*, by (name red acted) .

[24] See Federal Reserve Board, "Regulation Z Truth in Lending," at https://www.federalreserve.gov/boarddocs/caletters/2009/0909/09-9_attachment.pdf; and Federal Trade Commission, "Consumer Information: Payday Loans," at (continued...)

lenders may charge for loans. TILA does not apply to business loans.[25] Financial institutions operating in certain states may face additional state disclosure requirements.

Usury laws are another form of consumer protections broadly designed to cap or limit the amount of interest that can be charged on loans. Usury laws are frequently promulgated at the state level, meaning that loan originations are subject to the caps in the applicable state; some states have multiple usury rates that apply to different forms of credit.[26] The National Consumer Law Center reports that the Uniform Small Loan Laws, which place caps of 36% to 42% per year on loans of $300 or smaller, were adopted in 34 states over 1914-1943 to encourage lenders to make small-dollar loans and ultimately reduce widespread loan sharking.[27]

There is no federal usury limit for short-term, small-dollar loans, and federal law expressly prohibits the CFPB from establishing usury limits.[28] Congress, however, did pass legislation capping both the interest rate and the fees, or the APR, for consumer loans offered to military personnel.[29] The Military Lending Act of 2006 (MLA; P.L. 109-364) was passed to protect active duty military personnel and their eligible family members from predatory lending.[30] The final rule implementing the MLA in 2007 required that payday loans have terms of 91 days or less; that vehicle title loans have terms of 181 days or less; and that short-term small-dollar loans to military personnel be limited to a 36% annual interest rate, which is known as the *military APR* (MAPR).[31] On July 22, 2015, the Department of Defense announced final rules to extend the MAPR to a wider array of credit products, which includes credit cards.[32] As of October 3, 2016, lenders receive safe harbor protection if they verify whether a consumer is eligible for the MLA protections by using information provided by the MLA database maintained by the Department of Defense.[33] As of October 3, 2017, the MAPR will apply to credit card products offered to military servicemembers.

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https://www.consumer.ftc.gov/articles/0097-payday-loans.

[25] Merchant Credit Advances, which are similar in structure to payday loans, are structured as commercial transactions and, therefore, subject to the Uniform Commercial Code in each state instead of by TILA. See Ellyn Terry, *Collateral Requirements and Nonbank Online Lenders: Evidence from the 2015 Small Business Credit Survey*, Federal Reserve Bank of Atlanta, March 15, 2016, at http://macroblog.typepad.com/macroblog/2016/03/collateral-requirements-and-nonbank-online-lenders-evidence-from-the-2015-small-business-credit-survey.html.

[26] For example, see American Lawyers Quarterly, "Summary of Maximum Permissible Rates Under State Usury Laws," March 2010, at http://alqlist.com/InterestRateSummary.html.

[27] See Lauren K. Saunders, *Why 36%? The History, Use, and Purpose of the 36% Interest Rate Cap*, National Consumer Law Center, April 2013, at https://www.nclc.org/images/pdf/pr-reports/why36pct.pdf.

[28] Section 1027(o) of the Dodd-Frank Act.

[29] Payday loan interest rates provided by AFS lenders, for example, are typically subject to state usury laws, but the origination fees may not be covered or capped. See "Lending, Usury: Highest Interest Rate Allowed vs. APR," Independent Bankers Association of Texas, at https://www.ibat.org/legal-ease/2010/34/week-august-23-highest-interest-rate-allowed-vs-apr. Hence, payday interest rates may comply with state usury caps, but the APRs may still exceed the state usury rate ceilings by large multiples given that lending fees are included in the APR computations.

[30] See Consumer Federation of America, "Predatory Lending Protections for Service Members," at http://huachuca-www.army.mil/files/ACS_Protections_for_Service_Members_Military_Lending_Act.pdf.

[31] See "CFPB Statement on Department of Defense Military Lending Act Final Rule," at http://www.consumerfinance.gov/about-us/newsroom/cfpb-statement-on-department-of-defense-military-lending-act-final-rule/.

[32] See Department of Defense, "Limitations on Terms of Consumer Credit Extended to Service Members and Dependents," 80 *Federal Register* 43560-43612, July 22, 2015.

[33] The granting of safe harbor in this context means that a lender's conduct will be deemed as being compliant with the law if the MLA database was used to determine whether the borrower was eligible for MLA protections. For more (continued...)

Consumer protection regulation may exist in the form of substantive *product feature requirements* or *restrictions*. For example, some states ban certain types of lending and impose other restrictions. Payday lending is currently permitted in 38 states, and some states apply limits to or altogether prohibit rollovers.[34] As an example of federal product feature restrictions, in 2009 Congress passed the Credit Card Accountability Responsibility and Disclosure Act (CARD Act; P.L. 111-24), which protects credit card and overdraft users from products with features that automatically recalculated and applied additional finance charges using complex methodologies that borrowers, who were likely to extend their loans, may not have been able to understand.[35]

Underwriting and *UDAAP* are also forms of consumer protection regulation. Underwriting regulations can require lenders to verify specific documents or consider other factors when underwriting applicant credit requests. The CFPB issued a proposed rule that could establish federal underwriting requirements for small-dollar loans, which is discussed in the next section. The CFPB has the broad authority "to prescribe rules declaring certain acts or practices to be unlawful because they are unfair, deceptive, or abusive."[36] For example, the CFPB used its UDAAP authority to issue a bulletin related to the marketing and sale of "add-on" products with credit cards (e.g., debt protection, identity theft protection, credit score tracking) that are supplementary to the credit provided by the card itself.[37] The CFPB provided guidance for institutions to avoid harming consumers when offering products with add-on features.[38]

Overview of the CFPB-Proposed Rule

The CFPB was established by the Dodd-Frank Act to implement and enforce federal consumer financial law while ensuring consumers can access financial products and services.[39] Although its regulatory authority varies by financial entity types, the CFPB generally has regulatory authority over providers of an array of consumer financial products and services, including short-term, small-dollar payday lenders.

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information on the Department of Defense's Manpower Data Center Database, see Military Lending Act (MLA) Website, at https://mla.dmdc.osd.mil/.

[34] See National Conference of State Legislatures, "Payday Lending State Statutes," September 9, 2016, at http://www.ncsl.org/research/financial-services-and-commerce/payday-lending-state-statutes.aspx. Some states do not have explicit payday lending statutes, meaning that lenders must comply with state usury caps that apply to all consumer loans.

[35] Pricing practices such as *hair-trigger* and *double-cycle billing* effectively eliminated the grace period for credit card users who wanted to carry loan balances for additional billing cycle periods, thus resulting in higher finance charges. Borrowers arguably may not have understood how to compute the additional finance charges or realized that they had forfeited their grace periods.

[36] For information regarding authority at the federal level to prohibit unfair, deceptive, or abusive acts or practices, see CRS Report R42572, *The Consumer Financial Protection Bureau (CFPB): A Legal Analysis*, by (name redacted) . For information about state UDAAP laws, see Carolyn L. Carter, *Consumer Protection in the States: A 50-State Report on Unfair and Deceptive Acts and Practices Statutes*, National Consumer Law Center, February 2009.

[37] See CFBP, "CFPB Bulletin 2012-06: Marketing of Credit Card Add-on Products," July 18, 2012, at http://files.consumerfinance.gov/f/201207_cfpb_marketing_of_credit_card_addon_products.pdf.

[38] This regulatory response may also be considered an example of a disclosure requirement or product feature requirement.

[39] See CRS In Focus IF10031, *Introduction to Financial Services: The Consumer Financial Protection Bureau (CFPB)*, by (name redacted) and (name redacted).

On June 2, 2016, the CFPB released a proposed rule that would establish minimum requirements on small-dollar lending, including underwriting requirements for lenders.[40] The CFPB states that the rule's primary purpose is to end payday debt traps.[41] The CFPB considers loan payments to be unaffordable if borrowers have only three options when unable to repay the full amount due: (1) default on the loan, (2) take out an additional loan, or (3) make the loan payment while failing to meet other major financial obligations or basic living expenses.[42] The comment period closed on October 7, 2016.

The CFPB proposal would establish at the federal level a floor for consumer protection requirements, covering loans lasting 45 days or less, such as payday loans, auto-title loans, and direct deposit advances. In addition, loans for more than 45 days in which the cost of credit exceeds 36% and the lender has a security interest (e.g., the ability to repossess a borrower's vehicle if the loan is not repaid, or access to a paycheck or a checking account) would be covered. The rule would exclude loans solely for the purchase of durable goods, mortgage loans, credit card loans, student loans, overdrafts, and pawnshop loans. The rule would apply to all lenders of covered products. Some of the specific requirements follow.[43]

- **The Full-Payment (Ability-to-Repay) Test for Covered Short-Term Loans.** All lenders would be required to consider and verify the borrower's income, the timing of the income, major financial obligations, and borrowing history using information from at least one credit bureau. Lenders would be required to ensure that borrowers can pay off their loans and all finance charges without having to reborrow for a proximate 30 days. Borrowers would be unable to reborrow or refinance the same amount of debt, and the total number of successive short-term loans would be capped. A lender would not be able to make a loan to a consumer who already has taken three loans within 30 days of each other.
- **Alternative Compliance Option for Covered Short-Term Loans.** For lenders who prefer not to meet the full payment test, the rule includes an alternative compliance option that stipulates required loan features. A lender would still be able to make loans up to $500 without underwriting if the borrower does not have any other outstanding short-term loans or loans with balloon payments. Borrowers would be allowed to have up to two extensions as long as at least one-third of the principal balance is repaid with each extension. The lender would still

[40] See CFPB, "Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps," press release, June 2, 2016, at http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-rule-end-payday-debt-traps/; Consumer Financial Protection Bureau, "Payday, Vehicle Title, and Certain High-Cost Installment Loans; Proposed Rule," 81 *Federal Register* 141, July 22, 2016, at https://www.gpo.gov/fdsys/pkg/FR-2016-07-22/pdf/2016-13490.pdf; CRS Legal Sidebar, *CFPB Issues Proposal to Regulate Payday, Car Title, and other Small-Dollar Loans*, by (name redacted); and Leonard N. Chanin, Obrea O. Poindexter, and Joe Rodriguez, *The CFPB's Payday Lending Rulemaking Is Here With Sweeping Implications for the Short-Term Credit Industry*, Morrison Foerster, Client Alert, June 3, 2016.

[41] "The Consumer Financial Protection Bureau today proposed a rule aimed at ending payday debt traps by requiring lenders to take steps to make sure consumers have the ability to repay their loans," see CFPB, "Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps," press release, June 2, 2016, at http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-rule-end-payday-debt-traps/.

[42] See CFPB, "Payday, Vehicle Title, and Certain High-Cost Installment Loans," press release, June 2, 2016, p. 268, at http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf.

[43] Some of the possible lender responses are discussed in the section entitled "Implications of the CFPB-Proposed Rule."

be required to confirm that a customer does not have outstanding loans with other lenders, and the customer would not be permitted to have any more than six loans over a consecutive 12-month period.

- **Alternative Compliance Option 1 for Longer-Term Loans.** Lenders would be allowed to make loans (without meeting the ability-to-repay requirement) that meet criteria established by the National Credit Union Administration for the payday alternative loan (PAL) product that may be offered by credit unions. The interest rate permitted for credit unions is currently 28%, with an application fee of no more than $20.
- **Alternative Compliance Option 2 for Longer-Term Loans.** Lenders would be allowed to make loans (without meeting the ability-to-repay requirement) that meet the following criteria: The maturity of the loan must be a minimum of 46 days, up to a maximum of 24 months. The APR may not exceed 36%, and the origination fee cannot exceed $50. In addition, lenders must refund all origination fees collected on these loans if the default rate on all such loan types held in their portfolios exceeds 5%.
- **Advance Notice to Borrowers When Collecting Funds Owed.** When collecting funds owed, small-dollar lenders would be required to give advance notice to borrowers before attempting to debit payment from their depository checking, savings, or prepaid accounts. After two consecutive attempts to collect payment, a new authorization would be required from the borrower before the lender could make another attempt to collect payment.

Policy Issues

Borrowers' total charges associated with payday loans are presumed to be expensive especially in light of triple-digit APRs.[44] An understanding of price dynamics in the small-dollar lending markets may shed light on the degree of market competitiveness, which may in turn inform the policy debate about the affordability and available options for consumers who use these loan products. A market is considered competitive when a sufficient number of firms exist such that no individual firm has the ability to set prices significantly above the costs to supply the product, as they would risk losing market share to competitors. The small-dollar lending markets exhibit both competitive and noncompetitive market pricing dynamics; consequently, determining whether the prices borrowers pay for their loans are "too high" is challenging. These issues are discussed in more detail below after a discussion of the implications of the CFPB-proposed rule, which also focuses on affordability.

Implications of the CFPB-Proposed Rule

The CFPB maintains that financial injury to borrowers occurs when lenders make unaffordable loans.[45] The CFPB collected data indicating that 37% of the average payday borrower's biweekly

[44] Loans with excessive or hidden costs may even be considered predatory if they contribute to borrowers' financial distress. Predatory lending practices may be considered fraudulent, deceptive, and unfair, but there is no consensus definition of a predatory loan. For a description of predatory lending features or practices discouraged by a financial institution regulator, see Federal Deposit Insurance Corporation, *Predatory Lending: FDIC's Supervisory Policy on Predatory Lending*, Financial Institution Letters, FIL-6-2007, January 22, 2007, at https://www.fdic.gov/news/news/financial/2007/fil07006.html.

[45] See CFPB, "Payday, Vehicle Title, and Certain High-Cost Installment Loans," press release, June 2, 2016, p. 202, at (continued...)

paycheck would be required to repay both principal and finance charges in full; and 49% of the average vehicle-title borrower's biweekly paycheck would be required for full repayment.[46] The CFPB found that small-dollar loans offered by payday and vehicle-title lenders were advertised as short-term solutions, and borrowers were not made aware that frequent rollovers could transform the loans into longer-term obligations.[47] Requiring more disclosures about the possible financial harm associated with reborrowing may have been one approach employed to protect consumers; however, the CFPB chose to require lenders to consider loan affordability.[48]

Underwriting loans for affordability generates costs for lenders. *Automated underwriting* refers to a computerized scoring method typically used when evaluating and pricing credit for higher-credit-quality borrowers. The CFPB estimates that the costs of complying with the proposed rule may not be large for lenders that already underwrite their loans, particularly for those already engaged in automated underwriting.[49] By contrast, manual underwriting is a labor-intensive method of evaluating and pricing credit for borrowers with impaired credit who cannot be priced using automated underwriting. Payday lenders, therefore, would likely incur large costs to comply with the rule, given that their customer bases frequently include larger shares of individuals with weak or invisible credit histories.[50] Payday lenders typically do not underwrite for default risk and, therefore, may need to increase staffing to administer relatively more expensive manual underwriting. In addition to verifying income, manual underwriting costs would include estimation or verification of major financial obligations (e.g., housing expense, child support, current delinquencies, some recurring expenses), and perhaps costs to investigate information related to borrowers' extenuating circumstances.[51]

The CFPB estimates a 55% to 62% decrease in the number of small-dollar loans offered by AFS providers and a decrease in their revenue of 71% to 76%.[52] A study commissioned by the AFS industry also predicts a large market contraction, closer to an 82.5% decrease in small-dollar loan offerings.[53] The CFPB anticipates that, in light of the higher underwriting costs, many AFS lenders are likely to choose the alternative compliance option for covered short-term loans. The CFPB maintains that contractions in the small-dollar loan market, therefore, would be largely due

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http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf.

[46] Ibid., p. 215.

[47] Ibid., p. 216.

[48] Ibid., pp. 246-248. The CFPB chose not to enhance discloses because it determined that disclosure provisions did not appear to reduce reborrowing, and enhanced disclosures would not provide lenders with incentives to underwrite short-term loans more rigorously.

[49] Ibid., p. 941.

[50] See Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, "Payday Loan Choices and Consequences," *Journal of Money Credit and Banking*, vol. 47, no. 2-3 (March 2015), pp. 223-259.

[51] See CFPB, "Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps," press release, June 2, 2016, p. 520, at http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-rule-end-payday-debt-traps/.

[52] See CFPB, "Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps," press release, June 2, 2016, p. 955, at http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-rule-end-payday-debt-traps/.

[53] According to private-sector estimates, the decline in loan volume would be 82.5%, and lender revenues would decline by 90.5%. See Arthur Baines, Marsha Courchane, and Steli Stoianovici, *Economic Impact on Storefront Lenders of the Payday Lending Rules Proposed by the CFPB*, Charles Rivers Associates, October 7, 2016, at https://www.crai.com/sites/default/files/publications/Economic-Impact-on-Storefront-Lenders-of-the-Payday-Lending-Rules-Proposed-by-the-CFPB.pdf.

to fewer rollovers, thus benefiting consumers by having fewer opportunities to default and get into worse financial situations.[54] Conversely, the industry maintains that the small-dollar market contraction would likely result from the inability of lenders to recover compliance costs. The typical payday loan of $500 or less is unlikely, the industry argues, to generate a sufficient yield to justify incurring the additional costs to perform manual underwriting.[55] Furthermore, some individual AFS lenders (e.g., storefront lenders) may lack sufficient loan volume to cover the additional underwriting, documentation, and verification expenses.[56] Hence, the industry maintains that borrowers are likely to experience unmet credit needs or be forced to use less preferable loan products.[57]

In anticipation that the CFPB's proposed rule is finalized, AFS providers have increased offerings of medium- and longer-term installment loans.[58] An installment loan is a closed-end loan, meaning that it must be repaid in regular installments at the end of a preset period. Installment loans are preapproved for a specific amount, and the borrower does not have the option to redraw any funds that have been repaid over the life of the loan. An installment loan may have a term of 6 months to 12 months; such a loan is thus considered a medium-term rather than a short-term consumer loan. The repayment of debt obligations in regular installments, which allows for principal amortization and smaller regular payments, may arguably be a preferred alternative to reliance upon sequences of short-term rollovers for some borrowers.[59] In contrast, some borrowers may still prefer smaller loans with the option to determine how many times to roll them over, which they may consider to be preferable product features (discussed in the "Challenges Comparing Relative Prices of Small-Dollar Lending Products" section) or allow for the opportunity to reduce total costs in some circumstances (discussed in the **Appendix**).

Competitive and Noncompetitive Market Pricing Dynamics

As previously mentioned, affordability is a central issue in the debate surrounding small-dollar loans, with some pointing to high prices (i.e., APRs) as evidence. The state of being expensive, however, is subjective, which is why economists consider the degree of market competitiveness for additional context. A market is considered competitive if individual firms lack the ability to set prices higher than their competitors, meaning that they would likely lose market share by pricing their products too aggressively. Luxury goods (e.g., cars, fashion, travel, entertainment), for example, may be unaffordable for some consumers, yet luxury good providers may still be forced to price their products competitively to maintain the business of consumers who may still aggressively shop for the best price. Likewise, evidence of competition in the small-dollar loan market may indicate that even though prices appear expensive, they are more likely to be driven

[54] See CFPB, "Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps," press release, June 2, 2016, p. 977, at http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-rule-end-payday-debt-traps/.

[55] According to the American Financial Services Association, which is the national trade association for the consumer credit industry, loan amounts generally must be $2,500 or higher to justify the cost of underwriting. See Kate Perry, "Will Installment Loans Get Painted with CFPB's Payday Brush," *American Banker*, July 6, 2016.

[56] See The Pew Charitable Trusts, *Understanding the CFPB Proposal for Payday and Other Small Loans*, July 2015.

[57] See Arthur Baines, Marsha Courchane, and Steli Stoianovici, *Economic Impact on Storefront Lenders of the Payday Lending Rules Proposed by the CFPB*, Charles Rivers Associates, October 7, 2016, at https://www.crai.com/sites/default/files/publications/Economic-Impact-on-Storefront-Lenders-of-the-Payday-Lending-Rules-Proposed-by-the-CFPB.pdf.

[58] See The Pew Charitable Trusts, *From Payday to Small Installment Loans Issue Brief*, August 11, 2016.

[59] See The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions (Report 3)*, October 2013.

closer to the lenders' costs to provide the loans and less likely to reflect large markups above costs. Conversely, prices may reflect markups in less competitive markets.

Some research has found evidence of competitiveness in the payday lending industry such that pricing appears to be commensurate with costs.[60] The leading expenses incurred by AFS lenders were wage costs, occupancy costs (e.g., rents), and loan loss rates. Payday lenders were found to have double-digit loan loss rates (in comparison to banks over the same period, with loss rates below 2% on all outstanding loans), which diminish profitability.[61] Industry profitability was found to be highly dependent upon volume and loan-loss rates.[62] For this reason, rollovers increase loan volumes but simultaneously increase loan-loss-rate risks. Additional academic research found that the risk-adjusted returns at publicly traded payday firms were comparable to those of other financial firms.[63] Hence, recent research was unable to show that current pricing practices generate revenues for payday firms at levels significantly higher than costs.

Other evidence is consistent with some noncompetitive pricing practices. Price collusion, for example, refers to an explicit or implicit collaboration by industry firms to charge similar prices.[64] The existence of state usury ceilings may facilitate implicit price collusion behavior among AFS providers, which would be consistent with a behavioral response predicted by economic theory.[65] Hence, research has found that many payday lenders charge the maximum usury rates allowed in a state even though some firms might be able to offer their loan products for lower costs.[66] Usury caps may incentivize firms to set their prices at usury ceilings because any evidence of uniform and unlawful price fixing among competitors, given that caps theoretically are set below free-market prices, is arguably more concealed.[67]

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[60] See Mark Flannery and Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?*, Federal Deposit Insurance Corporation, FDIC Center for Financial Research Working Paper 2005-09, June 2005; and Aaron Huckstep, "Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits," *Fordham Journal of Corporate & Financial Law*, vol. 12, no. 1 (2007), pp. 202-231.

[61] See Mark Flannery and Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?*, Federal Deposit Insurance Corporation, FDIC Center for Financial Research Working Paper 2005-09, June 2005. The authors data was collected in 2002-2004. For bank loss rates, see Board of Governors of the Federal Reserve System, "Charge-off and Delinquency Rates on Loans and Leases at Commercial Banks," at https://www.federalreserve.gov/releases/chargeoff/delallsa.htm.

[62] The CFPB reports that 90% of all loan fees over the course of a year come from consumers who borrowed seven or more times, and therefore concludes that the payday business model depends upon a large volume of reborrowing or rollovers. Although Flannery and Samolyk also find that loan rollovers and repeat borrowers account for a large share of payday lender profits, they reach a different interpretation than the CFPB. Flannery and Samolyk conclude that payday industry profitability depends upon maximizing the number of loans made per store, and they find no evidence to suggest that repeat borrowers are more profitable on a per-loan basis than infrequent borrowers. Consequently, the relevant profitability factor, which is true for depositories and AFS lenders, is loan volume. Frequent borrowers pose greater default risk and, therefore, pose larger threats to profitability.

[63] See Robert DeYoung, Ronald J. Mann, and Donald P. Morgan, *Reframing the Debate About Payday Lending*, Federal Reserve Bank of New York, Liberty Street Economics, October 19, 2015, at http://libertystreeteconomics.newyorkfed.org/2015/10/reframing-the-debate-about-payday-lending.html.

[64] See Federal Trade Commission, *Price Fixing*, at https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/dealings-competitors/price-fixing.

[65] See Robert DeYoung and Ronnie J. Phillips, *Strategic Pricing of Payday Loans: Evidence from Colorado, 2000-2005*, Federal Reserve Bank of Chicago, submitted to the Federal Reserve System Community Affairs Research Conference, July 14, 2006.

[66] See Susanna Montezemolo, *Payday Lending Abuses and Predatory Practices*, Center for Responsible Lending, The State of Lending in America and Its Impact on U.S. Households, Durham, NC, September 10, 2013, at http://www.responsiblelending.org/state-of-lending/payday-loans/.

[67] See Cristopher R. Knittel and Victor Stango, "Price Ceilings as Focal Points for Tacit Collusion: Evidence from (continued...)

Because the small-dollar loan market reflects both competitive and noncompetitive pricing dynamics, other factors that affect competition in this market are further examined. Permissible activities as well as borrower preferences for certain product features are likely to have some influence on small-dollar loan pricing.

Permissible Activities of Depositories

Depository institutions face various restrictions on their permissible activities that may limit their ability to offer small-dollar loan products similar to those offered by AFS providers. For example, a *subprime (fee harvester) credit card* is one in which the total fees amount to a large proportion of the credit limit, making it similar in characteristics to a payday loan. Depositories offered subprime credit cards to people with impaired credit, meaning that they posed a higher probability of default risk relative to more creditworthy customers. The CARD Act mandates that the total fees of subprime credit cards cannot exceed 25% of the initial credit limit. The fee cap on subprime credit cards arguably may limit a loan product option for borrowers unable to qualify for traditional revolving credit, thus curtailing some ability of depositories to compete in the subprime small-dollar credit market with AFS providers.[68]

Federal banking regulators expressed concern when banks began offering deposit advance products due to the similarities to payday loans.[69] On April 25, 2013, the OCC, FDIC, and Federal Reserve issued final supervisory guidance regarding the delivery of these products.[70] The prudential regulators expressed concerns that the high costs and repeated extensions of credit could add to borrower credit (default) risks.[71] The guidance recommended that customers with impaired credit should not be eligible for this product, each deposit advance should be repaid in

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Credit Cards," *The American Economic Review*, vol. 93, no. 5 (December 2003), pp. 1703-1729.

[68] The percentage of individuals with credit scores at or below 659 may be correlated with overall macroeconomic performance, meaning that lending to riskier borrowers may increase during expansionary periods and contract during recessions. Hence, the CARD Act is unlikely to be the sole factor influencing bank offerings of subprime credit cards. See Graham Campbell, Andrew Haughwout, and Donghoon Lee, et al., *Just Released: Recent Developments in Consumer Credit Card Borrowing*, Federal Reserve Bank of New York, Liberty Street Economics, August 6, 2016, at http://libertystreeteconomics.newyorkfed.org/2016/08/just-released-recent-developments-in-consumer-credit-card-borrowing.html; and letter written by the American Bankers Association to the Consumer Financial Protection Bureau at https://www.aba.com/Advocacy/commentletters/Documents/clCardAct2013Feb.pdf.

[69] Reportedly, six banks, four large and two regional, have offered direct deposit advances. See http://www.americanbanker.com/issues/178_80/new-regs-could-wipe-out-bank-payday-loans-1058655-1.html, http://www.npr.org/2013/04/25/179052559/regulators-warn-banks-on-direct-deposit-loans, and http://www.creditcards.com/credit-card-news/bank-advance-direct-deposit-loan-cfpb-1282.php.

[70] See Office of the Comptroller of the Currency, "Office of the Comptroller of the Currency Releases Guidance on Direct Advance Products," press release, April 25, 2013, at http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-69.html; Federal Deposit Insurance Corporation, "FDIC Issues Proposed Guidance on Deposit Advance Products," press release, April 25, 2013, at http://www.fdic.gov/news/news/press/2013/pr13031.html; and Board of Governors of the Federal Reserve System, "Statement of Deposit Advance Products," press release, April 25, 2013, at https://www.federalreserve.gov/supervisionreg/caletters/CA13-07attachment.pdf. The FDIC released final guidance on direct deposit advances. See FDIC, "Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products," press release, November 21, 2013, at http://www.fdic.gov/news/news/press/2013/pr13105a.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery.

[71] In addition to reminding banks of their vulnerability to various risks (e.g., credit, reputational, legal) and potential compliance violations (e.g., Truth in Lending Act, Truth in Savings Act, Equal Credit Opportunity Act, Electronic Funds Transfer Act), the agencies listed their expectations with respect to loan classification policies, underwriting and administration policies, the length of customer relationships, and customer credit histories.

full before extension of a subsequent advance loan, and no more than one loan may be offered per monthly statement cycle.[72] Most banks subsequently discontinued offering deposit advances.[73]

Similarly, the ability of the credit union system to compete in the small-dollar loan market depends upon regulatory requirements. The portion of the small-dollar lending market that credit unions can potentially serve is limited due to membership restrictions.[74] In addition, the credit union system is permitted to make payday alternative loans (PALs) to its membership, but these products are different from traditional payday loans. PALs typically have longer maturities in comparison to AFS products and, therefore, lower APRs.[75] The CFPB argues that PALs protect consumers because the interest rate is no greater than 28% and the application fee is no greater than $20.[76] Despite the relatively lower total borrower costs, the NCUA requested an exemption from the 36% MAPR for PALs to avoid lending reductions to military service customers by credit unions.[77]

In short, limitations on permissible activities may affect the extent to which mainstream depositories can compete with AFS providers.[78] According to a 2015 survey of 132 community banks, 39% of them reported making personal loans under $1,000 (i.e., survey definition of small-dollar) for less than 45 days (i.e., survey definition of short-term).[79] Another survey found

[72] Offering deposit advance raises concerns related to prudential requirements, namely determining and holding sufficient loan loss reserves for delinquent loans. When loans become delinquent and default risks increase, depository institutions are required to treat those balances as charge-offs, meaning that the repayment obligations must be recognized as uncollectible and charged against allowances for loan and lease losses (ALLL) reserves. Open-ended loans, such as credit card balances, must be charged-off when they become 180 days overdue. When an overdraft is not repaid by customers within 60 days, depository banks and credit unions are required to charge-off unpaid overdraft balances; credit unions are also required to establish for members repayment plans that do not exceed 45 days. See FFIEC, "Federal Financial Institution Regulators Issue Revised Policy for Classifying Retail Credits," at https://www.ffiec.gov/press/pr021099.htm; and "Joint Guidance on Overdraft Protection Programs," at http://www.federalreserve.gov/boarddocs/SRLETTERS/2005/SR0503a1.pdf.

[73] See Danielle Douglas, "Wells Fargo, U.S. Bank to End Deposit Advance Loans, Citing Tougher Regulation," January 17, 2014, at https://www.washingtonpost.com/business/economy/wells-fargo-us-bank-to-end-payday-loans-citing-tougher-regulation/2014/01/17/b65f0512-7f82-11e3-93c1-0e888170b723_story.html.

[74] See CRS Report R43167, *Policy Issues Related to Credit Union Lending*, by (name redacted).

[75] For the mathematical explanation, see the **Appendix**.

[76] See Consumer Financial Protection Bureau, "Prepared Remarks of CFPB Director Richard Cordray at the Field Hearing on Payday Lending," press release, March 26, 2015, at https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-field-hearing-on-payday-lending/.

[77] Because the MAPR and terms were set by regulation, the APR formula would predict that either the fees would need to be subtracted from the calculation of the total, or the loan amounts would need to increase to comply with the regulations. Restating this point using the variables defined in the **Appendix** (in parenthesis): Because the MAPR and terms (the DAYSOUT variable) were set by regulation, the APR formula would predict that either the fees would need to be subtracted from the calculation of the total (reducing the INTFEES variable), or the loan amounts would need to increase (increasing LNAMT variable) to comply with the regulations. In accordance with the MAPR exemption, PAL amounts may range from $200 to $1,000; they must have fully amortizing payments; the term length must range from at least 46 to 180 days; and the application fee cannot be more than $20. (See National Credit Union Administration, *Complying with Recent Changes to the Military Lending Act Regulation*, Enclosure to Regulatory Alert 16-RA-04.) On October 5, 2015, the NCUA Chairman requested a blanket exemption for PALs made by federal credit unions completely from coverage of the CFPB's small-dollar lending rule should it be finalized. (See National Credit Union Administration, "Metsger Asks CFPB to Exempt Payday Alternative Loans in Proposed Rule," October, 5, 2016, at https://www.ncua.gov/newsroom/Pages/news-2016-oct-metsger-asks-exempt-payday-alternative-loans.aspx.)

[78] Certain credit card fees were exempted from the calculation when the MAPR was extended to credit cards, thus reducing the likelihood of lending reductions to military servicemembers. See Federal Deposit Insurance Corporation, "FIL-37-2015: Issuance of Final Rule Implementing the Military Lending Act," press release, September 8, 2015, at https://www.fdic.gov/news/news/financial/2015/fil15037.html.

[79] See Independent Community Bankers of America, *Comment Letter: CFPB Payday, Vehicle Title, and Certain High-* (continued...)

that in 2014, banks offered only 1% of small-dollar loans for $500 or less (with maturities for 30 days or less).[80] Because banks and credit unions are required to adopt loan underwriting standards, depositories generally offer products with longer maturities that facilitate the recovery of compliance costs.[81] Hence, the regulatory differences between mainstream depositories and AFS lenders may prevent full-scale competition between these types of lenders in the small-dollar loan market.

Can Banks Compete in the Small-Dollar Loan Market?

Although some regulatory actions may make it more difficult for banks to compete in the small-dollar loan market, regulators have attempted to facilitate depositories' participation in this market. The FDIC conducted a two-year small-dollar pilot program between December 2007 and December 2008 with 31 participating banks to observe the feasibility of offering lower-credit-cost alternatives to payday loans and fee-based overdraft programs.[82] Unlike typical short-term, small-dollar loan products, the customers in the pilot program were offered loans of $2,500 or less for approximately 90 days or more with APRs of 36% or less; the streamlined underwriting process included proof of identity, proof of income, and a credit report.[83] The FDIC reported that banks found the small-dollar lending to be a useful business strategy, facilitating the ability to build or retain profitable, *long-term* relationships with customers as well as the opportunity to get favorable Community Reinvestment Act consideration.[84] The banks, however, found small-dollar lending programs to be more successful or cost-effective when targeted to *existing* customers who use financial products over longer time periods (as opposed to new customers with financial behaviors and histories that have not been previously observed).[85] The fixed costs associated with evaluating financial risks (e.g., purchase of credit reporting data; past banking relationships; verification of identity, income, and employment) are similar, regardless of whether a financial product is offered for two weeks or a credit card loan is made for a year. For this reason, recovering the costs incurred to accommodate customers who have relatively small-dollar and infrequent transactions is difficult.

Challenges Comparing Relative Prices of Small-Dollar Lending Products

In addition to regulatory factors, consumers may pay less competitive prices under circumstances when product comparisons cannot be made solely on the basis of relative prices. Product price comparisons may be difficult when total fees, loan amounts, and maturities are not equal. Furthermore, borrowers may have strong preferences for certain product features even if they are more expensive. These issues are discussed below.

(...continued)

Cost Installment Loans Proposed Rule, October 7, 2016, p. 8, at http://www.icba.org/docs/default-source/default-document-library/small_dollar_letter_16-10-07.pdf.

[80] See Community Financial Services Association of America, "New ABA Survey Finds Banks Almost Never Offer Loans Under $500," press release, December 15, 2015, at http://cfsaa.com/our-resources/communications/recent-news/article-detail/newsid/119.aspx.

[81] For more information about the CAMELS rating system, which is designed to ensure that depository institutions have sound financial risk management practices, see Federal Financial Institutions Examination Council, *Uniform Interagency Trust Rating System*, October 7, 1998, at https://www.ffiec.gov/press/pr100798.htm.

[82] See "A Template for Success: The FDIC's Small-Dollar Loan Pilot Program," *FDIC Quarterly*, vol. 4, no. 2 (2010), at http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf.

[83] Ibid.; see Figure 1: A Safe, Affordable, and Feasible Template for Small-Dollar Loans.

[84] For information on the Community Reinvestment Act, see CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by (name redacted).

[85] See Kevin Wack, "Five Reasons Why Small-Dollar Credit Is So Expensive," *American Banker*, July 30, 2013, at http://www.americanbanker.com/issues/178_146/five-reasons-why-small-dollar-credit-is-so-expensive-1060965-1.html?zkPrintable=1&nopagination=1; and See Dennis Shaul, "Banks Stepping into Payday Lenders' Shoes? I'm Not Buying It," *American Banker*, May 16, 2016, at http://www.americanbanker.com/bankthink/banks-stepping-into-payday-lenders-shoes-im-not-buying-it-1081011-1.html.

When choosing a small-dollar loan product, the *ideal* comparison for a potential borrower would consist of (1) the prices of two loans of the same type (e.g., two payday loans) or (2) the prices of one type of small-dollar product with its next-best alternative. In light of TILA disclosure requirements, the APR would be deemed the key metric for such comparisons. The mathematical relationships (discussed in the **Appendix**) show that small-dollar loans, all else equal, will always have higher APRs in comparison to loans for larger amounts; and loans with maturities of less than one year, all else equal, will always have higher APRs in comparison to loans with maturities equal to or greater than one year. For these reasons, APR comparisons are meaningful when loans are of similar amounts and have similar maturity lengths.[86]

However, making ideal comparisons is not always possible. Even slight differences in product pricing and maturities increase the difficulty of comparing costs. For example, suppose a borrower is trying to decide whether to use a bank overdraft product or a payday loan. Banks are allowed to set their own overdraft policies. Some banks may charge a fixed fee for each overdraft regardless of the amount borrowed, whereas others have a tiered pricing structure as the amount of the loan increases.[87] Some banks require repayment sooner than the two-week period typically associated with a payday loan; other banks may allow slightly longer repayment periods, such as 30 days. For this reason, the variances in pricing structure and maturities make APR comparisons problematic, not only for comparisons of small-dollar products across lender types, but also for comparisons among the same type of lenders (e.g., different banks).[88]

In addition, making loan comparisons based solely on product prices may not be possible if borrowers have strong preferences for certain product features or place value on the conveniences associated with the products. Under such circumstances, prices may reflect more specialized market segmentation. The situations below illustrate when borrowers may place greater weight on nonprice factors relative to the total loan price.

- Some borrowers may not find the APR to be a useful disclosure. Interpreting APRs may not be widely understood, and some users of small-dollar loans report that the flat-fee pricing structure of AFS credit providers is easier to understand in comparison to banks' fee structure disclosures.[89] Furthermore, some borrowers facing cash flow shortages may value the actual dollar cost of credit rather than the APR.

[86] In other words, claims that loans with triple-digit APRs are more expensive than loans with double-digit APRs may be inaccurate unless the maturities and loan amounts for the loans being compared are the same.

[87] CFPB, *Data Point: Checking account overdraft*, July 2014, p. 11, at http://files.consumerfinance.gov/f/201407_cfpb_report_data-point_overdrafts.pdf; and "Bank Overdraft Fees Reach a New High," at http://www.cbsnews.com/news/bank-overdraft-fees-reach-a-new-high/.

[88] The less expensive product, in some circumstances, may depend upon whether the loan amount is above or below a certain dollar threshold. See "Overdraft Fees vs. Payday Loans," *Payday Loans Reviews.org* at http://paydayloansreviews.org/overdraft-fees-vs-payday-loans; and Erin Lowry, "Should You Ever Use a Credit Card Cash Advance?" *U.S. News and World Report*, at http://money.usnews.com/money/blogs/my-money/2015/06/02/should-you-ever-use-a-credit-card-cash-advance. Generally speaking, however, as bank overdraft and insufficient funds fees have risen (particularly at depositories with assets over $10 billion), the usage of AFS products have subsequently increased. See Andy Peters, "Cost of Overdrafts on Rise and Reg Action Looms," *American Banker*, July 11, 2016; and Gregory B. Mills, *As the Recovery Progresses, Use of Nonbank Credit Rises*, Urban Institute, January 2015, at http://www.urban.org/sites/default/files/publication/43701/2000137-as-the-recovery-progresses-use-of-nonbank-credit-rises.pdf.

[89] See Lisa Servon, "Are Banks Too Expensive to Use?" *New York Times*, October 29, 2014, at http://www.nytimes.com/2014/10/30/opinion/are-banks-too-expensive-to-use.html?_r=0.

- Borrowers may consider factors pertaining to product delivery, such as the convenience of locations and business hours or the length of the application process. The FDIC reported that some (unbanked) individuals chose AFS lenders because they viewed the process of applying for small-dollar credit to be easier than applying for credit at traditional depository institutions, and they feel that banks do not provide small-dollar loans (e.g., loans for less than $500 or, more broadly, for $1,000).[90] Hence, borrowers may be willing to pay premiums for the expediency and ease of obtaining credit from AFS lenders.[91] Reportedly, the increase in usage of AFS products by millennials as well as by middle- and high-income individuals may partly reflect preferences for convenience.[92]
- Borrowers may consider how using depository products, such as credit cards, might affect their credit scores. For example, some borrowers' decisions to use a bank or AFS product would not depend solely upon an APR comparison if they consider how factors such as their credit utilization rates (i.e., the amount of outstanding debt relative to a credit card limit) may affect their credit scores.[93]
- Some borrowers may ascribe their own functionality to certain product types. For example, when given the choice of using a credit card or payday loan, some borrowers may prefer using credit cards on a regular basis and payday loans for emergencies; others may prefer to use credit cards sparingly to ensure having access to a line of credit for emergencies.[94] For instance, the function of a loan product may depend upon how borrowers have formed their perceptions of how to access credit.

In short, both price and nonprice factors influence product choice, meaning that some customers may be willing to pay a premium in some instances for loans that provide them with unique (nontraditional) or convenience features. Survey respondents, however, are seldom asked how much value they place on the APR versus the total dollar amount, maturity lengths, and convenience of delivery when choosing between bank and AFS products. Furthermore, little information is known about the nature of relationships with mainstream institutions that current users of AFS products had or may still have. Hence, the prices borrowers are willing to pay arguably may reflect the relative scarcities resulting from the limited availability of products with features or delivery methods they may prefer. For this reason, determining whether the prices borrowers pay for small-dollar credit are "too high" is arguably challenging.

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[90] See Federal Deposit Insurance Corporation, "Minutes of the FDIC Advisory Committee on Economic Inclusion (ComE-IN)," September, 12, 2012, p. 257.

[91] See Victor Stango, "Some New Evidence on Competition in Payday Lending Markets," *Contemporary Economic Policy*, vol. 30, no. 2 (April 2012), pp. 149-161.

[92] See Shannon Schuyler, Eileen Buckley, and Annamaria Lusardi, *Millennials & Financial Literacy—The Struggle with Personal Finance*, Global Financial Literacy Excellence Center, George Washington University, 2015, at http://www.pwc.com/us/en/about-us/corporate-responsibility/assets/pwc-millennials-and-financial-literacy.pdf. For a discussion on findings that conflict with the stereotypes of typical users of alternative financial services, see Susan Herbst-Murphy, "Millennials Set to Influence the Future of Financial Services," *International Banker*, March 21, 2016; and Susan Herbst-Murphy and Greg Weed, *Millennials with Money Revisited: Updates from the 2014 Consumer Payments Monitor*, Federal Reserve Bank of Philadelphia, Discussion Paper Payment Cards Center, December 2015.

[93] Whether a small-dollar loan would increase a borrower's credit utilization rate depends upon the size of the small-dollar loan relative to the credit card limit, but the perceptions of borrowers influence their decisions.

[94] See Sabrina Karl, "4 in 10 Americans See Credit Cards As Their Emergency Fund," *CreditCards.com*, December 3, 2015, at http://www.creditcards.com/credit-card-news/pew-survey-emergency-fund-1701.php.

Appendix. Understanding the Annual Percentage Rate (APR)

This Appendix explains how the APR is computed and summarizes the mechanics of loan pricing, thus explaining why it may be difficult to conclude that small-dollar loans are less affordable than larger loans by relying solely on the APR metric.

The APR represents the total annual borrowing costs of a loan expressed as a percentage. The APR is calculated using both interest rates and origination fees.[95] For the most part, the APR may be calculated using the following standard formula:

APR	=	[(INTFEES)/(LNAMT)]*(365/DAYSOUT)*100, where
INTFEES	=	Total interest and fees paid by the borrower;
LNAMT	=	Loan amount or total borrowings; and
DAYSOUT	=	Number of days that the loan is outstanding (term length).

The formula shows that the APR rises due to increases in interest and fees paid by the borrower, which is determined by both demand and supply factors discussed in the below text box. Borrowers may ask lenders to disclose the interest rate and fees separately, which may be helpful for negotiating the costs of each component separately, but borrowers are likely to care more about the total costs they must pay in comparison to other competing offers. Furthermore, it is not possible to ascertain from looking solely at the interest and fees paid whether higher supply-side costs (e.g., costs to acquire the funds or to process the loans) or higher demand-side factors (e.g., volume of customers, lack of feasible options for prospective borrowers) had a greater influence on the negotiated APR.

Loan Pricing: Demand and Supply Factors

The total price of a loan consists of both interest and fees, reflecting both the demand and supply for credit. The demand for credit captures what borrowers are willing to pay to spend in the present, thereby avoiding the need to save or delay spending until some future point in time. Some borrowers may be willing to pay more for credit because they are impatient and prefer more current spending; some borrowers may experience sudden and unforeseen occurrences that would necessitate more immediate spending.

Loan underwriters are likely to factor financial risks that are idiosyncratic to the borrower into the loan pricing. For example, risk-based pricing is the practice of charging riskier borrowers higher rates to reflect their additional credit or default risk.[96] Risk-based pricing strategies may lead to fewer credit denials and greater credit accessibility for higher-risk borrowers, but riskier borrowers are likely to pay higher prices, or risk premiums, for credit in

[95] See Board of Governors of the Federal Reserve System, "Determination of Finance Charge and Annual Percentage Rate ('APR')," in *Regulation Z: Truth in Lending*, at http://www.federalreserve.gov/boarddocs/caletters/2008/0805/08-05_attachment1.pdf.

[96] See Raphael W. Bostic, "Trends in Equal Access to Credit Products," in *The Impact of Public Policy on Consumer Credit*, eds. Thomas Durkin and Michael Staten (Massachusetts: Kluwer Academic Publishers, 2002), pp. 171-202; Wendy M. Edelberg, "Risk-based Pricing of Interest Rates in Household Loan Markets," *Finance and Economics Discussion Series 2003-62*, Board of Governors of the Federal Reserve System, 2003; Wendy M. Edelberg, "Risk-based Pricing of Interest Rates for Consumer Loans," *Journal of Monetary Economics*, vol. 53 (November 2006), pp. 2283-2298; Mark Furletti and Christopher Ody, "Another Look at Credit Card Pricing and Its Disclosure: Is the Semi-Annual Pricing Data Reported by Credit Card Issuers to the Fed Helpful to Consumers or Researchers?" Payment Cards Center Discussion Paper, Federal Reserve Bank of Philadelphia, July 2006; and Kathleen W. Johnson, "Recent Developments in the Credit Card Market and the Financial Obligations Ratio," *Federal Reserve Bulletin*, vol. 91 (September 2005), pp. 473-486.

comparison to lower-risk borrowers.

The supply of credit reflects the costs borne by the lender to obtain the funds subsequently used to provide small-dollar loans. Lenders may acquire funds by borrowing, soliciting investors (e.g., shareholders), or both. A portion of the revenues generated from providing financial services is used to repay creditors. Investors typically own some share of the firm, meaning that they generally assume more risk because they receive compensation only after all creditors are repaid. For this reason, investors generally require higher compensation than creditors.

Different lender types rely on different funding sources. Depositories typically finance a large percentage of their loan portfolios using federally insured deposits, and they pay rates to depositors comparable to the federal funds short rates for the use of those funds.[97] In contrast, AFS providers may borrow funds from depository institutions and would pay higher borrowing rates (relative to the rates depositories would pay to their depositors). AFS providers also obtain funds from subordinate investors. Some payday lending firms may be wholly owned by hedge funds or publicly traded and owned by shareholders.[98] Hence, AFS providers generally pay more relative to depositories to acquire the funds that are subsequently used to make consumer loans.[99]

Borrowers may also pay fees for costs that are unrelated to borrower financial risks. For example, there may be fixed costs associated with evaluating financial risks (e.g., purchasing credit report data; examining past banking relationships; verifying identity, income, and employment) that are similar, regardless of whether a financial product is offered for two weeks or a credit card loan is made for a year.[100] The interest and fees charged by depositories or AFS providers may also include factors that would not necessarily be obvious without further scrutiny.[101]

[97] For more information about the financial intermediation process, specifically information regarding financial lending spreads between the rates received from borrowers and the rates paid to depositors, see CRS Report R44488, *Overview of Commercial (Depository) Banking and Industry Conditions*, by (name redacted).

[98] See Zeke Faux, "Secret Network Connects Harvard Money to Payday Loans," *Bloomberg*, September 4, 2014, at http://www.bloomberg.com/news/articles/2014-09-04/secret-network-connects-harvard-money-to-payday-loans; U.S. Congress, House Financial Services Committee, "Waters Calls for Universities, Retirement Plans to Divest from Payday Lenders," press release, July 16, 2015, at http://democrats.financialservices.house.gov/news/documentsingle.aspx?DocumentID=399246; Ron Lieber, "A Private Equity Alum's Guide to Better Payday Lenders," *New York Times*, April 30, 2016, at http://www.nytimes.com/2016/04/30/your-money/at-nerdwallet-guide-to-better-payday-lenders-james-zhang.html?_r=0; and Edward Siedle, "Public Pensions Finance Payday Lenders," *Forbes*, September 4, 2013, at https://www.forbes.com/sites/edwardsiedle/2013/09/04/public-pensions-finance-payday-lenders/#53d0824ef9a8.

[99] See Danielle A. Douglas, "Banks to Payday Lenders: Quit the Business or We'll Close Your Account," *The Washington Post*, April 11, 2014, at https://www.washingtonpost.com/business/economy/banks-to-payday-lenders-quit-the-business-or-well-close-your-account/2014/04/11/afd34976-c0c6-11e3-bcec-b71ee10e9bc3_story.html; and Evan Weinberger, "FDIC Tells Banks They Can Serve Payday Lenders," *Law360*, November 16, 2015, at http://www.law360.com/articles/727625/fdic-tells-banks-they-can-serve-payday-lenders.

[100] Bank and credit union customers' repayment histories are generally reported to consumer reporting agencies. Loan repayment histories are reported to credit reporting bureaus, and the maintenance histories of checking accounts to specialty bureaus. See AAACreditGuide, "ChexSystems—Credit System for Checking Accounts," at http://aaacreditguide.com/chexsystems/. AFS providers may use consumer data, such as the management of checking accounts or the payment of telecommunications bills, to determine the likelihood of failure to repay small-dollar cash advances. Although AFS providers typically do not report data to consumer repositories, some may still choose to report payment history information to a consumer data repository that specializes in reporting for the underbanked, near-prime, and subprime consumer segments, including those with minimal recorded data. For example, see Clarity Services, Inc., at https://www.clarityservices.com/about/, which focuses on higher-risk borrowers and collects data from financial service providers, such as auto financers, check cashers, prepaid card issues, peer-to-peer micro lenders, and small-dollar credit lenders. Some consumer bureaus, such as Chex Systems, may also specialize in reporting checking account abuses, see http://aaacreditguide.com/chexsystems/. For more examples of specialty consumer reporting services, see CRS Report R44125, *Consumer and Credit Reporting, Scoring, and Related Policy Issues*, by (name redacted) .

[101] The price of credit may consist of premiums that borrowers pay as a result of not shopping for lower-priced loans or factors such as disparate treatment or discrimination, which would be identified using statistical analyses similar to those employed in depository fair lending exams.

The formula shows that the APR is inversely related to (1) the loan amount (LNAMT) and (2) the length of time the loan will be outstanding (DAYSOUT). If interest and fees (INTFEES) are held constant, a small-dollar (payday) loan expected to be repaid in 30 days or less (in a single balloon payment) would have a higher APR relative to a larger loan, in which the repayment of principal and total charges occur over a longer period of time in multiple installment payments. Thus, the interpretation of the APR for loans originated for less than 365 days has been debated.[102] An APR based on a term length of *one year* or greater accurately reflects the *annual* cost of credit. By contrast, an APR for a loan expected to be repaid in less than 365 days, such as a deposit cash advance or payday loan with term lengths of 30 days or less, is arguably overstated.

Furthermore, APR comparisons are easier to interpret when the loans' maturity lengths are identical.[103] A comparison of two payday loans with identical two-week maturities would be meaningful even though both APRs would likely be in the triple digits; a comparison of loans with identical medium- or longer-term maturities also would be meaningful. In contrast, APR comparisons of loans with different maturities, such as APR comparisons of a 30-day payday loan to a loan with a maturity of at least 365 days, would be misleading. The APR of the longer-term loan will mathematically be lower, and the interest and fees paid by borrowers could possibly be higher, reflecting increases in the loan amount or the number of days the loan is outstanding.

Table A-1 provides examples of the estimated costs to borrowers of various short-term loans and installment loans. Suppose borrowers are charged $15 on every $100 borrowed, or $150 on Payday 1 and $75 on Payday 3 for $500; both loans would have an APR of 391%. Payday 2 has been set to 36% to illustrate the impact of implementing a price cap. In this case, the borrower would pay $13.80 in interest and fees for Payday 2. Under all lending scenarios, lenders would profit when the costs to fund and deliver the loan products are sufficiently below what borrowers pay. Hence, the total costs must be sufficiently lower than $13.80 for Payday 2 to be profitable; otherwise, a lender arguably would seek relatively more profitable lending opportunities, including the installment loan discussed below.

Table A-1. Loan Cost Comparisons

Loan Types	Loan Amounts (LNAMT)	Days Outstanding (DAYSOUT)	APRs	Interest and Fees (INTFEES)
Payday 1	$1,000.00	14	391%	$150.00
Payday 2	$1,000.00	14	36%	$13.80
Installment	$1,000.00	365	36%	$360.00
Payday 3	$500.00	14	391%	$75.00

Source: CRS calculations.

The comparison between a payday and an installment loan shows a trade-off between total loan costs (assuming no rollovers) and affordability (time to repay). If the borrower obtained an installment loan with the APR set at 36% for an entire year, the total cost would be $360 on a loan for $1,000. Assuming the borrower did not roll over Payday 1, the total cost would be less than

[102] See Randy Mitchelson, "Why APR Can Be Misleading," *Daily Dollar*, October 1, 2009, at http://dailydollarnewsletter.com/2009/10/01/why-apr-can-be-misleading/.

[103] See American Financial Services Association Education Foundation, *Personal Loans 101: Understanding APR*, at http://afsaef.org/Portals/0/Resources/Understanding_APR1.pdf.

the total cost associated with the installment loan. The installment loan, however, gives the borrower more time to repay the higher costs, which arguably may be more affordable.

Borrowers who are unable to qualify for depository installment loans may have used sequences of payday loans as a substitute for installment credit. For illustrative purposes, **Table A-1** provides an example of a payday loan for $500 with $75 in total costs for comparison to the $1,000 installment loan. Suppose a borrower obtains Payday 3 and rolls it over five times for a total cost of $375. The total cost of Payday 3 with the sequences of rollovers would arguably approximate the total cost of the installment loan.[104] The borrower has less time to repay the small-dollar loan in full to avoid the accrual of more charges, which arguably makes Payday 3 more expensive (also depending upon the number of rollovers). Nevertheless, a borrower unable to obtain installment credit from a depository institution or facing a time constraint may be willing to pay the higher charges associated with Payday 3. Hence, regulations that encourage lenders to substitute away from small-dollar loan products and into medium- and longer-term loan products (i.e., increase LNAMT and DAYSOUT) may not significantly reduce the total costs borrowers would incur by taking out a payday loan with additional (or the average number of) rollovers.

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[104] Although INTFEES is held constant to illustrate the relationship among other variables, the INTFEES variable calculated for larger loans using larger principal balances and longer time periods would be expected to increase. Thus, total costs of a longer-term loan could still be similar to or greater than the total costs associated with small, shorter-term loans, even after factoring in multiple rollovers.

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