

Hearing Before the United States Senate Committee on Banking, Housing, and Urban Affairs

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Chairman Brown, Ranking Member Toomey, and members of the committee—thank you for the opportunity to appear before you today. The matter you are considering remains tremendously important for consumers, especially low-income consumers with poor credit.

The focus of my testimony is on the effects of a binding interest rate cap. An interest rate cap is binding when loan revenue is less than the cost of loan production. Thus, a binding interest rate cap reduces the supply of loans because lenders will not make unprofitable loans.

An interest rate cap does not make loans less expensive; it makes loans less available.

Because banks do not make small-dollar loans to borrowers with damaged credit, the marketplace has responded with an array of nonbank supplied loan products. Americans who rely on nonbank supplied small dollar loans are not wealthy, and many live from uncertain paycheck to uncertain paycheck. Today, few Americans have a rainy-day fund big enough to cover unexpected bills, paycheck shortfalls, or unplanned work absences.¹

Imposing a 36 percent interest rate cap eliminates the supply of much needed nonbank supplied small-dollar credit products. The demand for credit, however, will remain. If there is still demand for loans to cover some basic living expenses, but no available loans, what will low-income consumers do? How are they better off with fewer credit options? Imposing an interest rate cap is disastrous for the very people it allegedly protects.

Consider the tough, life-impacting decisions affected consumers must make if they do not have access to credit. Perhaps people will delay going to the doctor, or the dentist, or a taking a pet to the veterinarian. Perhaps they will not buy needed school supplies for their children. Perhaps they will defer necessary maintenance or repairs to their home or vehicle, or they might bounce a check to pay a utility bill. They might even seek the much-needed credit from illegal loan sharks. Proponents for interest rate caps deny these stark realities.

Small-dollar nonbank lenders not only provide consumers with much needed loans, but access to small-dollar nonbank supplied loan products also helps consumers build their credit rating. In

¹ See Annamaria Lusardi, Daniel Schneider and Peter Tufano. Financially fragile households: Evidence and Implications, Brookings Papers on Economic Activity, Spring 2011.

this way, small-dollar credit products help sub-prime consumers build access to credit from banks. Every ladder has a lowest rung. If the lowest rung is missing, how can consumers climb the credit-building ladder?

Access to credit is a fundamental freedom for all Americans. Consumers are smart—they know their own financial situation better than others know it. Americans should be able to make their own decisions about credit matters.

The decision to take out a small-dollar loan does not involve a lot of money. The average payday loan, for example, is for about \$375.² Consumers routinely make decisions involving much higher dollar amounts. Consumers rent or buy a house. They buy vehicles. They take out student loans. We trust consumers to make these decisions.

It is incumbent on anyone legislating, regulating, advocating, or studying any small dollar credit product to understand and know the differences among these products. Small-dollar nonbank supplied credit products differ significantly in terms of loan size, length of loan, costs, repayment method, and their underwriting processes. As a result, they are not perfect substitutes for one another. I present an overview of four of these products in my freely available 2019 Primer, “How Do Small- Dollar, Nonbank Loans Work?”³

The CFPB’s 2021 Report of the Taskforce on Federal Consumer Financial Law contains detailed discussions of the demand for consumer credit (Chapter 3), the supply of consumer credit (Chapter 4), and the “perennial problem of small-dollar lending (Chapter 5).⁴

My testimony contains three main points:

1. Interest rate caps reduce the supply of credit—resulting in consumer harm.
2. A high interest rate does not mean high dollar costs to the consumer.
3. Lawmakers should search for ways to expand access to credit for all Americans.

² Bolen, J.B., G. Elliehausen, and T. W. Miller, Jr. 2020. “Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research, *Economic Inquiry* 58, pp. 1577-1613.

³ <https://www.mercatus.org/publications/financial-markets/how-do-small-dollar-nonbank-loans-work>. Also see the effects of a 36 percent interest rate cap in Miller and Zywicki,(2020).

<https://www.cato.org/commentary/wrong-kicks-route-36>

⁴ https://files.consumerfinance.gov/f/documents/cfpb_taskforce-federal-consumer-financial-law_report-volume-1_2021-01.pdf

1. Interest rate caps reduce the supply of credit—resulting in consumer harm.

Economic theory predicts that binding price ceilings create shortages, limit gains from trade, and impose costs on consumers.

Nobel prize winner Milton Friedman once said: "We economists don't know much, but we do know how to create a shortage. If you want to create a shortage of tomatoes, for example, just pass a law that retailers can't sell tomatoes for more than two cents per pound. Instantly you'll have a tomato shortage."⁵

In Professor Friedman's example, the tomato shortage is created because revenue from selling tomatoes for two cents per pound does not cover the costs of producing tomatoes. Setting the price of tomatoes at two cents a pound does not make tomatoes less expensive; it makes tomatoes less available.

Loan Revenue Must Exceed the Cost of Producing the Loan.

A commonly proposed interest rate cap is 36 Annual Percentage Rate (APR). How does a 36 APR render loans unprofitable? The same logic Professor Friedman used for tomatoes also applies to loans. Setting the rate lenders can charge for loans does not make loans less expensive; it makes loans less available. If the revenue received from a loan is less than the cost of producing the loan, lenders will not produce the loans.

The attached Figure 1 illustrates the problem of a binding rate cap.

The Progressives of the early 20th century teamed up with capitalists to create the Uniform Small Loan Law of 1916. This model legislation allowed licensed lenders to make loans at an APR of 36 percent. At the time, lenders could profit from making loans of \$100 at a 36% APR—loan revenue exceeded the costs of production.

The horizontal line in Figure 1 shows that the revenue from a \$100 loan made at 36 percent APR is the same today as it was in 1916. Costs of production have increased since 1916. I proxy these costs with the Consumer Price Index (CPI), which has increased by a factor of about 26 from 1916 to 2021. What do these two lines tell us? In 1916, revenue exceeded costs for a \$100 loan made at an APR of 36 percent. In 2021, the costs of making a \$100 loan far exceed the revenue.

Chen and Elliehausen (2020) show that a breakeven loan size at 36 percent APR is about \$2,500.⁶ But suppose a consumer only needs to borrow \$500? Access to \$500 loans is lost

⁵ <https://blog.acton.org/archives/80641-6-quotes-milton-friedman-on-freedom-and-economics.html>

⁶ <https://www.federalreserve.gov/econres/notes/feds-notes/the-cost-structure-of-consumer-finance-companies-and-its-implications-for-interest-rates-20200812.htm>

under a 36 percent interest rate cap. In Chapter 4 of the CFPB's Taskforce report, a range of breakeven interest rates by loan size are presented.

Installment loans less than \$2,500 must have a higher APR than 36 percent. Revenue from the loan must cover production costs and generate a normal, competitive return for the lender. If rates cannot rise higher than 36 percent, access to credit levels less than \$2,500 is lost.

Extending the 36 percent interest rate cap to all consumers will be a disaster for millions of Americans with subprime credit histories. Why? Instead of lowering the cost of small-dollar loans, a 36 percent cap destroys small-dollar credit supply.

A Specific Example of how the MLA interest rate cap eliminates supply.

In a payday loan, the amount of interest paid equals the amount loaned, times the annual interest rate, times the amount of time the loan is held. So, under a 36 percent interest rate cap, if you borrow \$100 for two weeks, the interest you would pay is \$1.38 ($\$100 \times .36 \times 2/52$).

So, the revenue to the lender from this \$100 payday loan would be only \$1.38. A [2009 study by Ernst & Young](#), however, showed the cost of making a \$100 payday loan was \$13.89. The cost exceeds the loan revenue by \$12.51 – probably more, since over a decade has passed since the E&Y study. Logically, lenders will not make unprofitable loans. Under a 36 percent APR cap, consumer demand will continue to exist, but the legal supply will dry up.

While the MLA interest rate cap does not explicitly outlaw payday loans, it has the effect of eliminating this legal supply of credit.

2. A high interest rate does not mean high dollar costs to the consumer.

Suppose a consumer has an emergency that costs \$300 now. Suppose the consumer does not have \$300 in cash or on a credit card or available from family or friends. This situation calls for a loan.

Consider two loans.

The first one is for \$300, paid back in three equal monthly installments of \$106. This loan costs \$18 in interest.

The second loan is also for \$300 and is paid back in three equal monthly installments of \$120. This loan costs the consumer \$60 in interest.

Of course, consumers would rather pay \$18 instead of \$60. But here is the catch: The first loan is unprofitable, so lenders will not make this loan. This loan does not exist: It is a Unicorn.

The interest paid on the preferred, but unavailable, Unicorn loan is calculated at a 36% APR. The second loan that would be available from lenders, costs consumers \$14 more per month.

The APR on the second loan is 118%. The APR on this loan sounds “high” and “shocking,” but a cost of only \$14 more per month does not sound high, shocking, or unaffordable.⁷

It is important to remember that consumers spend dollars, they do not spend “percents.”

If the consumer needs a loan to cover an emergency, the consumer could very well be willing to pay \$60 interest over three months to get the needed money today.

3. Lawmakers should expand access to credit for all Americans.

Helping Consumers

Small-dollar credit products serve millions of people. According to a banking regulator, nearly 33 million families have no or [limited access](#) to bank credit. A recent [study](#) by the Federal Reserve Bank of New York suggests millions more may be “credit insecure.” That is, they tend to max out their credit limit, have a low credit score, and a history of late payments. Also, 45 million primarily young, low-income, and minority Americans have [poor or thin credit histories](#). They are ineligible for prime credit cards and bank loans.

Many consumers use small-dollar loans because they lack access to cheaper bank credit – they are “underbanked,” in the policy jargon. According to the [FDIC](#), 18.7 percent of all U.S. households were classified as underbanked in 2017. For one in five households in America, small-dollar nonbank loans are vital.

[More than a third](#) of households making under \$50,000 experience month-to-month spikes and dips in their income. For these Americans, credit cards and consumer loans from banks are not a reliable option. Instead, small-dollar credit products help them deal with volatile incomes and unforeseen expenses. The choice for these consumers is between using small-dollar credit products, or simply going without needed goods and services.

So, what will consumers do if a binding interest rate cap causes lenders to stop making small-dollar loans? To my knowledge, there is no easy answer. I do know that if consumers face a need for money, they will meet it somehow. They will: bounce checks and incur an NSF fee; forego paying bills; avoid needed purchases; or turn to illegal lenders.

A Summary of Arguments used by Interest Rate Cap Advocates

For a variety of reasons, since the beginning of recorded history, lawmakers have looked upon the ownership of money, and the charges for its use, differently from the ownership of other assets and the charges for their use. Consequently, setting interest rate caps on loans has long been a focus of religious leaders and governments and their agents. A belief in the effectiveness

⁷ For more details, see <https://x2u.731.myftpupload.com/state-laws-can-give-consumers-more-loan-choices/>

of interest rate caps endures despite many empirical studies showing that not only are interest rate caps ineffective, but they actually harm their intended beneficiaries.

Fundamentally, because interest rate caps are a market-distorting action, imposing an interest rate cap or banning loan products reduces the well-being of parties who would have otherwise engaged in trade. Nonetheless, advocates continue to argue for interest rate caps.

Professor Harold Black and I summarize a large body of rigorous, peer-reviewed academic research. We sort their arguments into four general categories.⁸

1. Borrowers are naïve and simply do not understand the loan terms.
2. Groups thought to be most vulnerable to exploitation by lenders—namely minorities, women, and the poor—need even more protection from “predatory” lenders.
3. Even if consumers are willing to borrow at high interest rates, society should protect these consumers from themselves because they are making themselves worse off.
4. Lenders, especially small dollar lenders, make abnormally high profits from lending at high interest rates because they have considerable market power.

In our work, we find no published empirical evidence that supports any of these four arguments.

Supporters of interest rate caps say that interest-rate restrictions protect naïve borrowers from so-called “predatory” lenders. Academic research shows, however, that small-dollar borrowers are not naïve.⁹

Supporters of interest rate caps often claim that interest rate caps do not reduce the supply of credit. These claims are not supported by any predictions from economic theory or demonstrations of how loans made under a binding interest rate cap are still profitable.

Supporters of interest rate caps claim that lenders, especially small-dollar lenders, make enormous profits because desperate consumers will pay whatever interest rate lenders want to charge. This argument ignores the fact that competition from other lenders drives prices to a level where lenders make a risk-adjusted profit, and no more.

⁸Black, Harold and Thomas W. Miller, Jr. 2016. Examining Arguments Made by Interest Rate Cap Advocates. Hester Peirce and Benjamin Klutsey, eds., *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*. Chapter 13. Arlington, VA: Mercatus Center at George Mason University.

https://www.mercatus.org/system/files/peirce_reframing_ch13.pdf

⁹See, for example, Elliehausen, G., and E. Lawrence, 2008. A Comparative Analysis of Payday Loan Customers, *Contemporary Economic Policy* 28, pp. 299-316 and Allcott, H., J. Kim, D. Taubinsky, and J. Zinman, 2021. Are High-Interest Loans Predatory? Theory and Evidence from Payday Lending, *Review of Economic Studies*, *forthcoming*.

Questions about the MLA's Performance

Extending the MLA's 36 percent interest rate cap to all Americans kicks many consumers to the curb. Their option to use small-dollar credit products will not be outlawed, but there will be no legal supply of loans for amounts less than \$2,500.

Evidence has accumulated that the MLA has provided no benefit. In 2015, [Carter and Skimmyhorn](#) found that access to payday loans did not increase bad outcomes, like poor job performance, documented by previous [Carrell and Zinman \(2008\)](#). "Our analysis," they conclude, "suggests no significant benefits to servicemembers from the MLA." A 2016 [study](#) by Mary Zaki showed access to payday loans made it easier for military personnel to buy food and other goods before their biweekly paycheck.

Why extend the MLA? What evidence exists that the MLA has helped military personnel and their immediate family members? Is there evidence that it has harmed members? Why extend it now? Why not wait for a significant amount of research to inform such a crucial decision?

In science, the gap between beliefs and current research results drives further research. Before instituting a law with wretched outcomes for many borrowers, Congress should call for government and independent researchers to build a mosaic of transparent and replicable research results on the effects of interest rate caps on consumers.

Concluding Thoughts

In my scholarly work on consumer credit, I study how small dollar loan markets work and how best to help lawmakers restructure laws to improve the welfare of borrowers.

Every day, consumers make choices based on the price of money—just as they respond to prices of other goods and services. Despite the age-old teeth gnashing and hand wringing by philosophers, advocates, reformers, legislators, and others, the market for loanable funds is not "special" or "different." Simply stated, the market for credit obeys the laws of supply and demand. As in any market that obeys the laws of supply and demand, letting the competitive market determine prices and quantities will greatly benefit the participants in the small dollar loan market.

Conversations about consumer credit often reflect utopian visions of the world. Many people simply imagine that a few tweaks to regulations would ensure that everyone had the money needed to feed, clothe, and shelter the family.

We can all afford low prices for any good. But will the good be supplied at a low price?

No matter how hard we all try, a well-crafted regulatory framework cannot bring us a credit utopia. Deliberate, empirically informed regulators, however, can do much to preserve and expand consumers' options along the nonbank supplied small-dollar loan landscape.

I urge Congress to read more about interest rate caps before making any decision on them. A particularly good place to begin is the 2021 Report of the CFPB's Taskforce on Federal Consumer Financial Law.

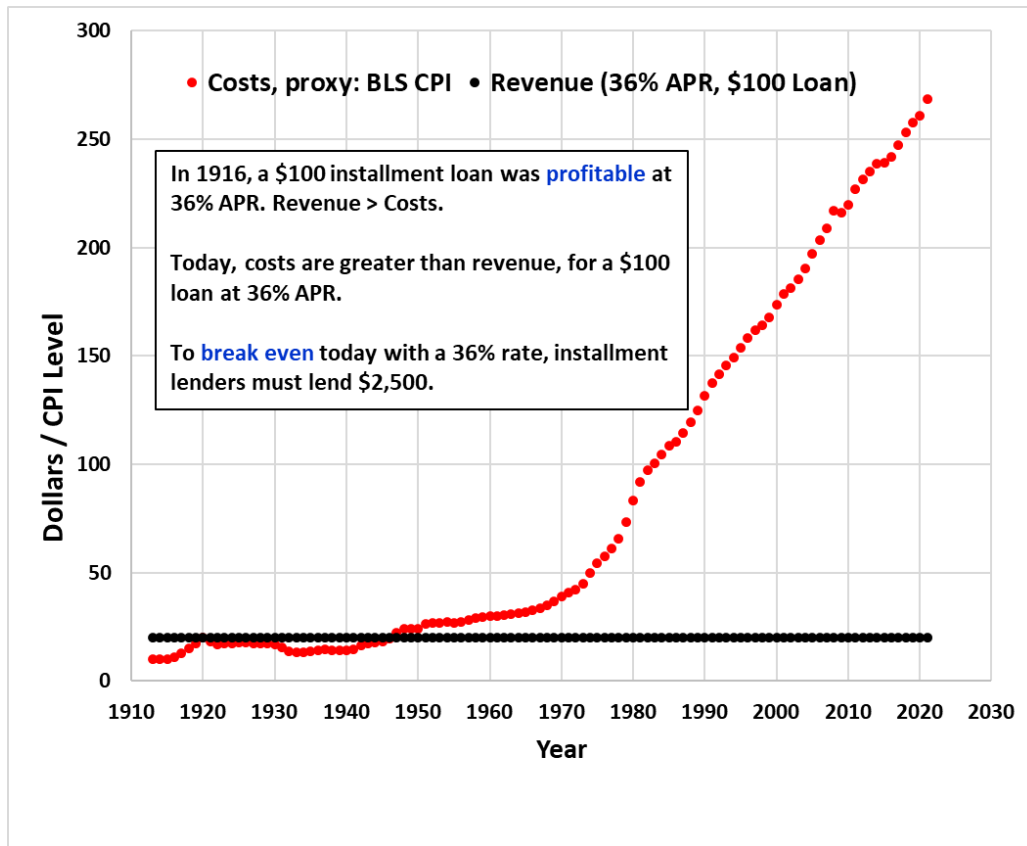
I also urge Congress to follow the scientific evidence on the impact of interest rate caps.

Finally, I urge Congress to heed the 1972 National Commission on Consumer Finance which concluded: "...competition is the best regulator of consumer credit markets." Competition breeds innovation. Innovation provides more choices. Consumers benefit with more choices. Rather than setting arbitrary caps on important financial products, law makers should increase competition by raising, or removing, interest rate caps.

Thank you. I stand ready to answer any questions.

Figure 1.

Then and now. Profits and losses from a 36% interest rate cap.



The revenue from a \$100 loan with a 36% interest rate cap is the same today as it was in 1916 (black line). Costs have increased (red line).¹⁰

1. At 36% rate, a profitable loan size is at least \$2,500.¹¹ But suppose a borrower only needs \$500 and has poor credit? Access to credit is lost.
2. Installment loans less than \$2,500 must have a higher interest rate attached, to generate a profitable level of income to the lender. Lenders will not make unprofitable loans. Access to credit is lost.

¹⁰ Think about wages, for example.

¹¹Chen and Elliehausen (2020). <https://www.federalreserve.gov/econres/notes/feds-notes/the-cost-structure-of-consumer-finance-companies-and-its-implications-for-interest-rates-20200812.htm>

Appendix: A (Brief) History of the 36% Interest Rate Cap

- In the early 20th century, the Progressive Movement focused on major social reforms (i.e., Vote for Women, Temperance, Child Labor, Food Processing, and the Illegal Loan Shark Problem).
- In 1909, Reformers, spearheaded by Mr. Arthur Ham of the Russell Sage Foundation, sought ways to spread access to credit to workers. Reformers at the time recognized that lenders AND borrowers had to be satisfied for a sustainable market-based alternative to the illegal “loan shark problem.”
- After research and collaboration with Capitalists, these Reformers set out to pass state laws allowing specially licensed lenders to make small-dollar consumer loans at rates **six times above** usury rates at the time, 6% APR.
- Their collective efforts resulted in the Uniform Small Loan Law (USLL) of 1916. By 1940, all but nine states had adopted some version of it. When they wrote the model law, through rigorous study, it was determined that the costs and risks merited: 3.50% per month (for loans up to \$100), and 2.50% per month on amounts over \$100. The average is 36% APR.
- The Reformers noted: “...The rate is designed to attract aggressive competition by licensed lenders [when the law is enacted] to drive unlicensed lenders out of business...This rate should be reconsidered after *a reasonable period of experience with it....*”