CEI OnPoint

Competitive Enterprise Institute
1899 L Street, NW • 12th Floor • Washington, DC 20036
202.331.1010 • www.cei.org
Advancing Liberty – From the Economy to Ecology

February 6, 2011 **No. 176**

The 400 Percent Loan, the $36,000 Hotel Room, and the Unicorn

Why the Annual Percentage Rate is a Poor Tool for Measuring Short-Term Credit

By John Berlau[*]

Is a $16 surcharge on a $100 product unfair, unjust, and "predatory"? Hardly anyone flinches, for instance, at a $16 "resort fee" on a $100 hotel room. But when it comes to short-term loans offered by non-bank institutions, mostly payday loans, politicians call for banning the practice, using dubious arguments about such loans' true cost.

Before he was installed in a controversial "recess" appointment in January,[1] the White House issued a report urging the confirmation of former Ohio Attorney General Richard Cordray as director of the new Consumer Financial Protection Bureau (CFPB), "because some studies have found that payday lenders on average charge fees of roughly $16 for a two-week loan … this translates into an annual percentage rate of roughly 400 percent."[2]

How does that work? Quite simply, it does not. The Obama administration and other politicians who make this argument are using a flawed method of calculating interest that is an apples-and-oranges application of annual percentage rate (APR) to loans of a much shorter duration than one year.

A typical payday loan in the U.S. covers a period of two weeks, tracking the interval of time between paychecks. Interest and fees[3] come to $10 to $20 per $100 of the amount of the loan, the total amount of which is usually $500 or less. Such loans are often taken out during emergencies to pay immediate costs that can be covered with the arrival of the next paycheck.

Were a borrower to take out a new loan every two weeks for a year, the total would indeed equal 420 percent. The only problem with that scenario is that it does not match

---

[*] *John Berlau is director of the Center for Investors and Entrepreneurs at the Competitive Enterprise Institute.*

reality. State government data on payday loans show that hundreds of thousands of borrowers take out just one loan per year and pay back the loan within the two-week duration. Even staunch critics of payday loans have yet to name a single individual who has paid close to 400 percent over a year from a law-abiding lender.

The 400-percent interest rate is the financial equivalent of a unicorn, yet it has driven public policy regarding short-term credit with destructive results for the neediest of borrowers.

APR Is the Wrong Tool for Measuring Short-term Credit. Federal financial disclosure laws such as the Truth in Lending Act mandate the use of the annual percentage rate as a disclosure tool for comparison shopping of the interest rates on both loans and savings accounts. But the APR loses its usefulness in the evaluation of short-term loans that are outstanding for only a few weeks, particularly when legislative proposals go beyond disclosure and aim to restrict the availability of financial products and services.

Were the financing costs of other goods and services measured on an annual basis, it would be easy to lob "predatory pricing" charges against their producers as well. As the prolific economist Thomas Sowell points out, "Using this kind of reasoning—or lack of reasoning—you could … say a hotel room rents for $36,000 a year, [but] few people stay in a hotel room all year."[4]

Similarly, were other financial fees—such as late payment and overdraft charges—subject to that measurement, their APRs would exceed those of payday loans, sometimes by more than four times. Yet several states have imposed interest rate caps on payday loans based on an APR that few if any borrowers will ever pay. And as the White House report indicates, the federal government is considering following suit.

APR Limits are Destructive Price Controls. All price controls, including interest rate ceilings, produce destructive effects in limiting the availability of a product for consumers. For instance, nearly all economists agree that rent control greatly reduces the stock of affordable housing. Even Paul Krugman, today's most prominent left-leaning economist, has decried rent control's "adverse side effects," which include "the absence of new apartment construction." He cites an American Economic Association survey that found 93 percent of its members agreeing that "a ceiling on rents reduces the quality and quantity of housing."[5]

Imagine how much worse things would be if a rent control statute intended to put the rent ceiling at $2,000 per month, but thanks to a typo, ended up capping it by this amount *per year*. Existing landlords, unable to cover maintenance and other costs, would withdraw apartments for rent, and black markets would explode. Yet this is roughly analogous to the APR caps for short-term credit enacted in several states and proposed at the federal level.

Many states have imposed APR limits of 36 percent or lower. While that may sound high, the key word is *annual*. Divided into 26 two-week periods, the usual duration for most payday loans, this means that payday lenders could only charge $1.38 on a loan of $100. Expressing a sentiment that has been echoed by many in the industry as well as independent researchers of short-term credit, a spokesman for the Utah Consumer Lending Association says, "Payday advance lenders could not even meet employee payroll at that rate, let alone cover other fixed business expenses and make a profit."[6]

In response to these concerns, some of the states enacting APR limits have compromised by allowing lenders to replace some interest charges with fees to cover costs of making the loan. While this approach has preserved options for short-term emergency credit, it also has created needless complexity for both lenders and consumers.

Federal officials have signaled that they may also impose such flawed interest rate caps, without even allowing fees to cover costs. The Federal Deposit Insurance Corporation, which insurers and regulates banks but has considerable influence over policies affecting all financial firms, recommended in 2010 what it calls a "best practices model for safe, affordable, and feasible small-dollar lending" with an APR of no more than 36 percent.[7]

And assurances from CFPB architect Elizabeth Warren that the agency's primary mission is to improve disclosure of financial products rather than impose bans or interest rate caps[8] notwithstanding, the agency's head, Richard Cordray, is on record supporting Ohio's highly restrictive APR cap of 28 percent and pushing further to ban fees lenders are allowed to charge to cover basic costs.[9]

The Debt Cycle Trap Myth. In a 2008 speech as Ohio's Attorney General, Cordray admitted that payday loans do not "sound quite so bad when it's $15 every two weeks for a one-time loan," but then went on to say that the loans must be curbed because they "trap" consumers in a cycle of debt. "But we know and we've seen that what happens is many people fall into a debt cycle trap. It's just not sustainable for many families in our community."[10]

This argument comes straight from the advocacy group that has led the charge against payday loans, the Center for Responsible Lending (CRL). CRL strongly supports applying APR to payday loans and a federal APR cap of 36 percent, claiming that "long-term payday debt" is "the norm for the industry."[11]

In CRL's reading of payday loan statistics, 90 percent of loans are made to borrowers who take out five or more transactions per year. But scratching the surface of the group's methodology, one finds that it paints a distorted picture. CRL's 2006 report, *Financial Quicksand*, has provided the basis for much of the group's assertions before the media, state legislatures, and Congress. The report consists of a sloppy overlay of mostly Washington state data, coupled with subjective estimates and assumptions, onto payday lending in the nation as a whole.[12]

An examination of payday lending data from California, the nation's most populous state, belies many of CRL's assertions. A 2007 report from the California Department of Corporations contains a comprehensive database of transactions from payday lenders licensed by the state. According to the report, 74 percent of payday loans made in California went to borrowers with five *or fewer* transactions—an inverse image of CRL's findings. The report also found that 27 percent of borrowers—nearly 400,000 individuals—took out only one loan per year, paying 15 percent interest.[13]

The difference is partly explained by the fact that CRL inflates the number of loans based on the assumption that many borrowers go to multiple lenders. But it is a stretch to simply assume that, the most chronic borrowers aside, a majority of individuals would get loans from multiple lenders.

The validity of the California data is buttressed by a Western Economic Association paper by Edward C. Lawrence of George Washington University and Gregory Elliehausen of the University of Missouri at Saint Louis. Using a data set of 427 payday customers, and taking into account those who went to more than one lender, the study found results that were similar to the California and in contrast to that of the CRL. The Lawrence-Elliehausen study found that, "almost 52% of customers used advances six or fewer times per year," and that, "a quarter of borrowers did not renew any payday advance in the previous 12 months."[14]

For frequent borrowers, it is important to note that it is not the payday loan entrapping them, but a combination of their own circumstances, financial education, and habits, as well as laws that bar alternative credit products that may be more suited to their needs. As Sowell writes, noting the $45 that California lenders charge for a $300 loan: "$45 is not going to trap anyone in a never-ending cycle of debt, even if they are making only the bare minimum wage. Personal irresponsibility in managing money can trap anyone, but that is true regardless of whether or not they take out payday loans."[15]

There are many reasons why people take out payday loans. Unexpected circumstances, such as a car breaking down or the need for emergency travel, can hit folks who are low on cash at the moment but can pay back their loan in full when their paycheck arrives.

A May 2011 National Bureau of Economic Research study underscores the widespread need for the availability of small, short-term loans. The study found that nearly half of U.S. adults say they definitely or probably could not come up with $2,000 in 30 days.[16] While there are many options to be explored in public policy and financial education to help improve Americans' ability to save, the last thing consumers need is for policy makers to limit their options for cash flow emergencies.

Payday Loans Are often the Most Affordable Alternative. In evaluating the pricing of payday loans, it is useful to identify the alternatives. Most of the time, they are not loans from a federally insured depository institution. Banks are not in the habit of making loans of $500 or less to individuals with marginal credit, and even if they did, the loan approval process would be too cumbersome for people in need of emergency cash.

Thus, the alternatives most in competition with payday loans are the unattractive options of bounced checks, overdraft fees, and late fees on bills. And if these charges were treated as "interest" rather than "fees," and measured via the same APR sophistry that has been used to attack payday lenders, their APRs would often well exceed those of payday loans.

As Federal Reserve Bank of Kansas City Senior Economist Kelly Edmiston points out, the median interest rate for bounced check fees—if they were measured as interest payments—would be "well in excess of 4,000 percent, or up to 20 times that of payday loans."[17] Edmiston notes that one other advantage of payday loans is preserving what is called "credit standing." He writes, "Unlike traditional lenders, payday lenders do not report to credit agencies," Thus, a person needing a loan might go to a payday lender precisely to avoid a future black mark with a traditional lender or prospective employer.[18]

Finally, Edmiston and researchers from Dartmouth and the Federal Reserve Bank of New York find that banning or severely restricting the ability to obtain payday loans has several pernicious effects. States that passed restrictive payday legislation experienced a substantial increases in bounced checks and late payments, a reduction in credit scores, and higher rates of bankruptcy.[19]

Conclusion: Punish Fraud and Liberalize Legitimate Lending. Are there some payday lenders who engage in deceptive practices? There probably are, as there are with all types of financial institutions. Are there borrowers who misuse the product or whom the loan is ill-fitted to serve? Yes, as is the case with all types of credit. But the answer is not to ban payday lenders and loans any more than the answer to home defaults is to do away with banks and mortgages.

In the case of lender misbehavior, the answer is to swiftly punish fraud and deception. And in the case of ill-fitted or misused products for borrowers, the answer is more education and, in many cases, more liberalization of the types of loans that can be offered.

For instance, some borrowers have to take out multiple payday loans because they need amounts greater than the $500—sometimes less—maximum that some states allow nonbank lenders to make available in a single loan. Many states also prohibit nonbank lenders from making small installment loans with payment plans.

In California, for instance, a nonbank lender can make a payday loan in the maximum amount of $300 or an installment loan in the minimum of $2,500.[20] This leaves a big gap in the middle—which could be filled creatively by traditional payday loan providers, pawn shops, and emerging online and peer-to-peer lenders if the rules were made more rational.

The California Department of Corporations, in a 2007 report, recommended raising the maximum for payday loans and lowering the minimum for installment loans,[21] but the state legislature has yet to act on these recommendations. In addition, a survey by the

Carleton consulting firm found that 32 states severely restrict or effectively ban consumer installment loans by nonbank firms.[22]

In Congress, the FFSCC Charter Act (H.R. 1909) would create greater options for nonbank lenders and their customers. It would give nonbank lenders the option of being chartered federally by the Comptroller of the Currency (OCC), and thus be designated as Federal Financial Services and Credit Companies, or stay with the state as their regulator, if they so chose.[23] Under an OCC charter, firms could offer products across state lines unencumbered by state rules. This is similar to the framework banks have operated under for decades with the National Bank Act, in which their financial products such as credit cards can be exported to other states.[24]

H.R. 1909 also would help much of the fog in the discussion of short-term loans' risks and benefits by getting rid of APR as a measure for the costs of short-term loans.[25] Ending the destructive myth of 400 percent interest would lead to a more informed debate and therefore better policy.

America needs alternatives in short-term credit. Liberating the market for such credit offers the best prospect of expanding it.

Notes

[1] The Senate was not in "recess," but in "pro forma" session, gaveling in and out every three days. The legality of Cordray's appointment will likely be challenged. See John Berlau, "Obama's Power Grab Sets Precedent Democrats Will Regret," *U.S. News & World Report*, January 6, 2012, http://www.usnews.com/debate-club/is-the-cordray-appointment-constitutional/obamas-power-grab-sets-precedent-democrats-will-regret.

[2] The White House, "Improving Americans' Financial Security: The Importance of a CFPB Director," December 2011, http://www.whitehouse.gov/sites/default/files/cfpb_-_master_final_120411.pdf.

[3] This is a distinction that often lacks meaning in the marketplace but is a crucial factor in the legality of the loan.

[4] Thomas Sowell, "Payday Loans," National Review Online, November 2, 2011, http://www.nationalreview.com/articles/281908/payday-loans-thomas-sowell.

[5] Paul Krugman, "Reckonings; A Rent Affair," *New York Times*, June 7, 2000, http://www.nytimes.com/2000/06/07/opinion/reckonings-a-rent-affair.html?src=pm.

[6] Lee Davidson, "Companies Refusing Loans at Mandated Lower Rates," *The Deseret News*, October 2, 2007, http://www.deseretnews.com/article/695214983/Payday-lenders-tells-military-no.html. See also John Berlau, "Keep Virginia Market Free," *The Washington Times*, February 2, 2008, http://cei.org/op-eds-and-articles/keep-virginia-market-free.

[7] Federal Deposit Insurance Corporation, Press Release, June 24, 2010, http://www.fdic.gov/news/news/press/2010/pr10140.html.

[8] In April 2011, Warren told the House Oversight Committee: "[T]here's a lot of space between banning a product and making a product clearer to consumers." Peter Schroeder, "Elizabeth Warren Fends off GOP Critics at Oversight Hearing," *The Hill*, July 14, 2011, http://thehill.com/blogs/on-the-money/banking-financial-institutions/171509-warren-fends-off-gop-critics-at-oversight-hearing.

[9] John Berlau, "Consumer Financial Protection Bureau Nominee Richard Cordray Supports Price Controls and Borrower Bailouts," OpenMarket.org, July 19, 2011, http://www.openmarket.org/2011/07/19/consumer-financial-protection-bureau-nominee-richard-cordray-supports-price-controls-and-borrower-bailouts/.

[10] Vote YES for Issue 5 Press Conference, with Richard Cordray, ProgressOhio, October 8, 2008, video available at http://www.youtube.com/watch?v=RSxBpI79s_8&feature=player_embedded.

[11] Center for Responsible Lending, "APR Matters on Payday Loans," July 23, 2009, http://www.responsiblelending.org/payday-lending/research-analysis/apr-matters-on-payday-loans.html.

[12] Uriah King, Leslie Parrish, and Ozlem Tanik, *Financial Quicksand,* Center for Responsible Lending, November 30, 2006, http://www.responsiblelending.org/payday-lending/research-analysis/rr012-Financial_Quicksand-1106.pdf.

[13] California Department of Corporations, "Report to the Governor and the Legislature: California Deferred Deposit Transaction Law," December 2007, pp. 13-14, http://www.corp.ca.gov/pub/pdf/CDDTL07_Report.pdf.

[14] Edward C. Lawrence and Gregory Elliehausen, "A Comparative Analysis of Payday Loan Customers," *Contemporary Economic Policy* Vol. 26 No. 2, April 2008, 299–316, http://www.umsl.edu/services/ora/pdfs/lawrence-payday-loan-final-journal-paper.pdf .

[15] Sowell

[16] Anamaraia Lusardi, Daniel J. Schneider, and Peter Tufano, "Financially Fragile Households: Evidence and Implications," National Bureau of Economic Research Working Paper 17072, May 2011, https://www.fdic.gov/news/conferences/lusardi.pdf.

[17] Kelly D. Edmiston, "Could Restrictions on Payday Lending Hurt Consumers," *Economoic Review*, First Quarter 2011, http://www.kansascityfed.org/publicat/econrev/pdf/11q1Edmiston.pdf.

[18] Ibid.

[19] Ibid.

[20] California Department of Corporations, pp. 42-45

[21] Ibid.

[22] Carleton Inc., "State Small Loan Lending Law Categories," undated, http://www.carletoninc.com/services/Small_Loan_Comparison.pdf.

[23] John Berlau, "H.R. 1909 Brings Competitive Regulation to Small Loan Market," OpenMarket.org, September 13, 2011, http://www.openmarket.org/2011/09/13/h-r-1909-brings-competitive-regulation-to-small-loan-market/. See FSCC Charter Act of 2011 (H.R. 1909), http://www.govtrack.us/congress/bill.xpd?bill=h112-1909. The bill, sponsored by Joe Rep. Baca (D-Calif.), has gained co-sponsors from across the ideological spectrum, from Reps. Jesse Jackson, Jr. (D-Ill.) and Betty McCollum (D-Minn.) on the left to Reps. Ed Royce (R-Calif.) and Dave Schweikert (R-Ariz.) on the right.

[24] The Competitive Enterprise Institute has long supported expanding the "competitive federalism" approach of the National Bank Act to other areas of financial services, such as insurance. See Jennifer Smith-Bozek, "Pros and Cons of Optional Federal Chartering for Insurers," Competitive Enterprise Institute, *WebMemo* No. 1, January 15, 2008, http://cei.org/sites/default/files/Jennifer%20Smith-Bozek%20-%20Pros%20and%20Cons%20of%20Optional%20Federal%20Chartering%20for%20Insurers.pdf.

[25] The legislation requires the measurement of "the true cost of the loan in terms of actual finance charge per dollar of credit extended to such person instead of the annual percentage rate."