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Ending Payday Lending Would Harm Consumers

Consumer Financial Protection Bureau's Proposed Rule Threatens to Cut off Access to Credit for Those Who Need It Most

By Hilary Miller *

Payday loans are unsecured short-term loans made at storefronts and online. The average loan amount is $375, ranging generally from $100 to $500, most often due in two weeks or on the borrower's next payday. It is estimated that approximately 12,000,000 Americans have taken a payday loan in the last year.[1] To be eligible for a loan, borrowers must have a steady source of income and a checking account. In many states, the law requires that the borrower not have other payday loans outstanding.

Payday loans are most frequently used by constrained consumers who have few or no liquid assets and limited opportunities to borrow on credit cards or from other mainstream lenders. The proceeds are generally applied to expenses that are either unexpected or cannot be postponed. Since many borrowers live from paycheck to paycheck and have very little discretionary income, even small interruptions in income, or unexpected expenses, may cause hardships and financial emergencies. Payday loans thus provide an opportunity for consumers to smooth income or consumption under circumstances where their rainy-day savings may be near zero and where other forms of credit are already fully utilized or unavailable. In such cases, payday loans, though expensive, may be economically preferable to alternatives such as defaulting on other obligations or foregoing needed goods and services.

Some large storefront lenders, and nearly all online lenders, employ the services of a subprime credit bureau, such as Clarity or Teletrack, to confirm the applicant's eligibility. In some states, lenders are also required to query a statewide database to determine whether an applicant has other payday credit outstanding.

Payday lending is highly regulated at the state level—including through usury limits, maximum loan amounts, and proscribed collection practices—and is subject to existing federal laws covering consumer credit generally, such as the Truth in Lending Act, Equal Credit Opportunity Act, Electronic Funds Transfer Act, and the Gramm-Leach-Bliley Act. In multiple surveys, consumers overwhelmingly reported being satisfied with their payday borrowing experiences. Nevertheless, the Consumer Financial Protection Bureau (CFPB), a regulatory agency established by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, is set to issue a rule that could destroy most of the payday loan industry. On June 2, 2016, the CFPB published a comprehensive notice of proposed rulemaking covering payday loans and most other forms of high-cost consumer credit.[2]

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The CFPB's own impact analysis suggests that the rule will result in an industry-wide revenue reduction of roughly three-fourths.[3] Furthermore, industry studies show that around three fourths of the nation's 20,000 storefront payday outlets will be rendered unprofitable and forced to close by the CFPB's rulemaking. Assuming an average of about $15 billion of average payday credit outstanding, then, in the 75-percent-off proportion, roughly $11 billion of credit will be eliminated by the rule.[4] The soon-to-be-excluded borrowers of that $11 billion will be forced to seek inferior substitutes, such as illegal loansharking or more expensive "mainstream" credit vehicles for which they will incur late charges and bank overdraft fees. The burden of this loss of credit access will be felt disproportionately by lower income and minority borrowers.

Who Uses Payday Loans and Why. Payday borrowers tend to be younger, lower- to middle-income consumers, with incomes averaging about $35,000.[5] Consumers with incomes under $40,000 are three times as likely to use payday loans as those with incomes over $40,000. They are employed and have checking accounts—required to obtain a payday loan—and are not poor. Borrowers are disproportionately female, African-American, or both.[6] On balance, they are financially constrained and have credit scores in the "deep" subprime range, around 550, compared with about 695 for the general population.[7]

While a majority of payday borrowers have mainstream credit in some form, typically payday borrowers have no material unused and available credit under their credit lines. Payday borrowers are more likely than consumers in general to have credit-card delinquencies. Such delinquencies are likely the most important contributing cause of their low credit scores. They have searched—sometimes extensively—and failed to obtain mainstream credit, so payday borrowing is something of a last resort. They are considerably more likely than average consumers to have bounced a check or paid a late fee.[8]

Unsurprisingly, given the limited creditworthiness of the typical payday-loan applicant, the initial default rate on new payday loans is high: around 18 percent.[9] However, borrowers who have rolled over, rather than default on, their loans have much lower default rates. Lenders thus face a challenging underwriting experience, as they initially have only very little information about the borrower's creditworthiness, much of it adverse. However, once the borrower demonstrates willingness and ability to pay, the lender's information about the borrower expands by orders of magnitude. The combined default rate for first-time and rolled-over payday loans is approximately 3-5 percent.[10] That means lenders have significant incentives both to minimize the initial default rate and also to pool risky initial loans with seasoned, well-performing rollover loans. Industry opponents routinely decry the latter incentives as perverse, in that lenders benefit from repeated borrowing and multiple rollovers. However, those incentives are no different from the incentives applicable to installment or credit-card lenders, since lenders of all kinds earn higher profits if their loans remain outstanding and interest-earning for longer periods.

By the time a consumer uses a payday loan, he has likely exhausted both existing and most possible future mainstream credit opportunities, and decided that payday credit is the "least bad" remaining credit option. Other options generally bear much higher effective borrowing costs and other adverse effects—as anyone who has ever incurred late or insufficient-funds fees, paid utility reconnection charges, had a car repossessed, or sought credit from a loan-shark can attest.

Studies showing the mean effects of payday-loan usage on credit scores repeatedly demonstrate that loan users fare no worse, post-loan, than comparably situated non-users.[11] While some studies have produced ambiguous or confounding results, the bulk of academic research suggests that access to payday loans may improve performance on other loans,[12] reduce bounced checks and collection items,[13] decrease chapter 7 filings,[14] and lower bill-paying difficulties.[15] Thus, evidence of widespread consumer harm to the average payday-loan borrower is absent. Borrowers report that proceeds are most frequently used to repay preexisting obligations, such as rent, car, utility, or credit-card payments, as well as financial emergencies. There is no reliable evidence that payday loans are used for gambling, illicit drugs, alcohol, or impulse purchases. While some critics of payday lending assert that lenders target minority borrowers or charge much higher fees than necessary to earn a fair return, these claims are unsupported empirically.[16]

Payday loans are simple and easy to obtain. Borrowers overwhelmingly understand the nature of the transaction and the cost of credit. The author's experience is that most payday-loan retail outlets staff the locations with employees who reside nearby and whose demographics are similar to those of the customers, so borrowers are comfortable in these stores and are treated with respect as paying customers, not as supplicants.

In practice, only a small minority of payday borrowers report difficulty in repaying their loans, and the satisfaction rate is greater than 90 percent.[17] The fees charged for these loans average about $17 per $100 loaned for two weeks, although fees as low as $10 and as high as $30 per $100 are not uncommon.[18] A typical fee of $15 per $100 borrowed for two weeks is equivalent to a simple annual interest rate of 391 percent, but this annualized calculation is not relevant for most borrowers, whose loans terminate after a few weeks. Rather, borrowers tend to focus on the dollar amount of the finance charge, which is not irrational when considering an ultra-short-term loan.

At loan origination, the borrower executes a note and provides the lender with a postdated check for an amount equal to the principal of the loan plus the finance charge—for example, $115 for a $100 loan with a $15 finance charge. In most cases with storefront loans, and in nearly all online loans, the borrower also authorizes the lender to initiate an automated clearing house debit entry to the borrower's checking account for the amount due. At maturity of the loan, the borrower's check (or ACH authorization) is presented for payment if the borrower has not theretofore redeemed the loan in cash.

Where permitted by state law, the borrower may generally elect to renew, or "roll over," the loan, by paying the accrued finance charge and deferring the maturity of the loan principal. Thus, using the example above, if a storefront borrower wished to extend a typical two-week loan for an additional like term, at initial maturity the borrower would pay the $15 accrued finance charge in cash and execute a new note payable four weeks from the initial loan's origination. This process may continue as long as the borrower desires and the lender permits, subject to state-law limitations on rollovers.

The process of paying the accrued interest with each renewal is important, because interest is never added to principal, and therefore there is no possibility of a "spiral" of debt—a term of derision used by antagonists of the industry.

Existing Regulation. The substantive terms of payday lending are regulated by states, and regulation is disparate. In general, states determine the maximum finance charge that may be imposed—generally, the most salient feature to consumers—as well as the maximum number of permissible rollovers. States also determine other terms, such as lenders' remedies on default, non-uniform disclosures, and requirements for a physical check.

Some states maintain a real-time statewide database of payday loans outstanding, with a view toward limiting the amount of credit outstanding to a single borrower and requiring the repayment of existing advances before new loans can be granted.

In all states, lenders are subject to standard federal consumer-credit laws, including the Truth in Lending Act, Electronic Funds Transfer Act, and Gramm-Leach-Bliley Act. Examples of current state regulation include the following:

- Florida permits a maximum finance charge of 10 percent of the loan plus $5. The minimum loan term is seven days, and the maximum term is 31 days. The maximum loan amount is $500. Rollovers are not permitted, and there is a one-day cooling-off period between repayment of a loan and incurrence of a new loan. The state has a database to enforce a one-loan-per-borrower rule.[19]
- California permits a maximum effective finance charge of 17.65 percent of the loan principal (expressed as 15 percent of the check amount; a typical structure is a two-week loan with a $45 finance charge on a principal amount of $255). There is no minimum loan term, but the maximum term is 31 days. The maximum effective loan amount is $255. Rollovers are not permitted. However, in practice, borrowers in California may obtain a "same-day" refinancing transaction of an existing loan.[20]
- Colorado has one of the newest state payday-loan laws, which requires loans to be structured as installment loans with a minimum term of six months. It permits a graduated fee of 20 percent of the first $300 of principal and 7.5 percent of the principal amount above $300. It also limits simple interest to 45 percent annually and monthly maintenance fees to $7.50 per $100 loaned, up to $30 per month for each month the loan is outstanding. The initial fee is prorated over six months and the unearned portion is required to be rebated to the borrower if the loan is prepaid. The effective APR on these loans is in the range of 130 percent, or about one-third of the average rate nationwide. A majority of retail locations in Colorado closed after the adoption of this current law in 2010, finding the pricing structure insufficiently remunerative.[21]

How Rollovers Work. The CFPB proposed rule effectively concedes that payday loans, in small doses, are fine.[22] Its proposed rule permits such loans as long as they are limited to $500 principal amount, fully amortized over six weeks, not re-borrowed within 30 days, and limited to a total of 90 days in any year. Instead, the CFPB argues that the problem lies with "overuse" of payday loans, and, to a lesser extent, collection mechanics. Indeed, in its rulemaking, the CFPB has focused nearly entirely on eliminating perceived overuse.

Consumers use rollovers to varying degrees. The principal trade association of storefront lenders, Community Financial Services Association of America, Ltd. (CFSA), has issued "best practices" under which its members voluntarily limit rollovers to four—10 weeks of successive credit, composed of the initial loan plus four rollovers of two weeks each.[23] Nearly all states that permit payday lending impose limitations on rollovers, in some instances prohibiting them altogether. In general, state-law limitations are more economically restrictive than the CFSA best practices. But the CFPB claims these state-law rollover limitations are inadequate to protect consumers from the harms of being "forced" to borrow again. The evidence of such harms is missing from the CFPB's analysis to date.

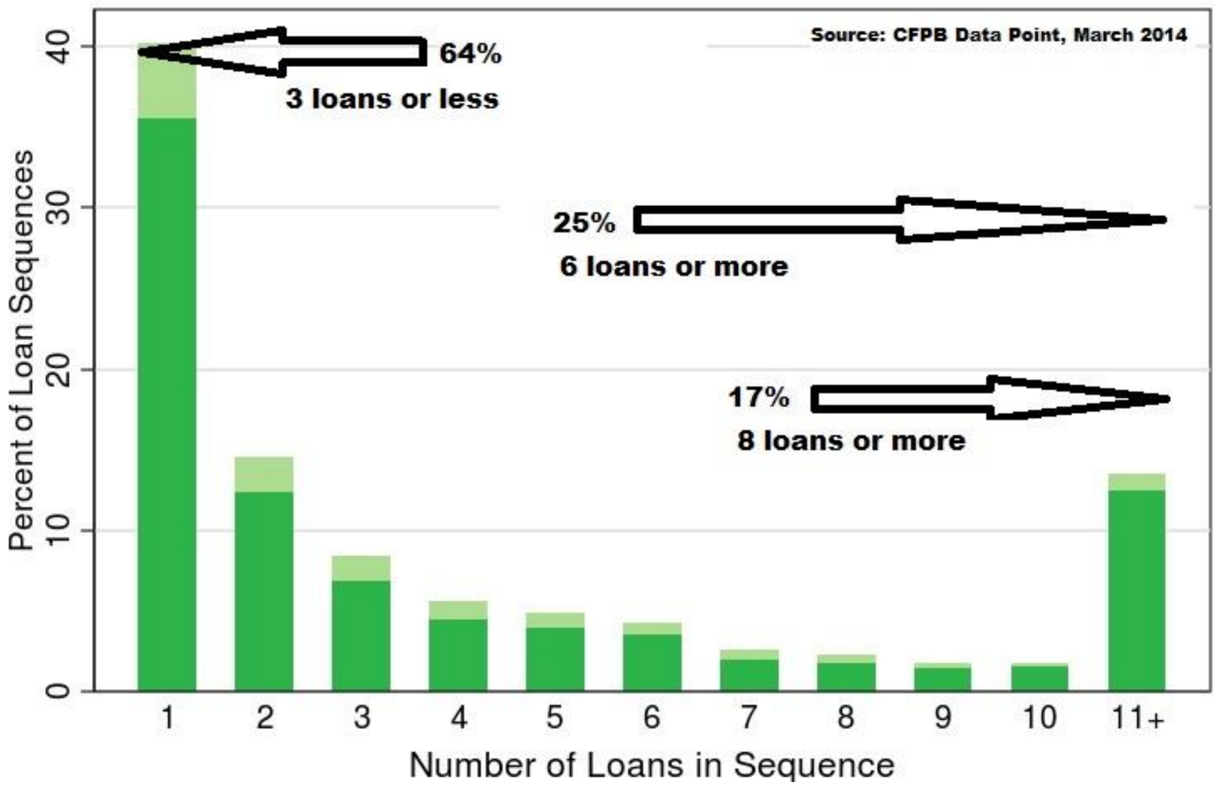
The CFPB has produced two reports detailing its position regarding rollover usage, drawing from a combined dataset of lender administrative records the CFPB obtained through the examination process. In the first of its reports, which the CFPB called a "White Paper," the authors used confused methodology[24] and combined analytical findings with its speculations regarding harms from overuse.[25] The latter paper, dubbed a "Data Point," mainly stuck to the facts. Unlike the White Paper, the Data Point presented its findings using conventional sampling and loan-analysis methodology.[26] Neither paper even purported to study the harms or benefits to consumers beyond the amount of interest they paid.

Some rollovers are undertaken shortly after repayment of the previous loan, not necessarily on the same day as the end of the previous loan term. In the White Paper, the CFPB ignores breaks of less than 14 days, reasoning that, if the borrower repays his loan but borrows again during the same pay period, then the borrower has not changed his financial circumstances sufficiently to remain loan-free. The Bureau calls all loan transactions not broken by a 14-day debt-free period "sequences."

Some key findings of the CFPB's Data Point are as follows:

- The total duration of about two-thirds of all new payday loan "sequences" is three loans or fewer (an initial loan plus two rollovers, including any loans undertaken within 14 days of repayment of the previous loan).
- Only about one-quarter of all new payday loan "sequences" are longer than five loans (longer than approximately 10 weeks of borrowing, which, assuming that the loans were contiguous, would be the maximum duration authorized by the CFSA's Best Practices).
- Only about 17 percent of new loan "sequences" are eight loans or longer.
- Few borrowers amortize, or have reductions in principal amounts, between the first and last loan of a loan sequence. For more than 80 percent of the loan sequences that last for more than one loan, the last loan is the same size as or larger than the first loan in the sequence.
- Most borrowing involves multiple renewals following an initial loan, rather than multiple distinct borrowing episodes separated by more than 14 days.

The following histogram shows the distribution of sequence durations by borrower count (prepared by the CFPB; arrows are by the author):



The CFPB has found that a minority—less than a fifth—of payday-loan "sequences" are for more than seven loans. But the effect of the CFPB's proposed intervention is to preclude nearly all short-term uses in excess of three loans, or two rollovers. Yet, there is no evidence to support the Bureau's apparent conclusion that long "sequences" are harmful to consumers or that borrowing-duration limits provide any benefits.

The Shifting "Overuse" Debate. Claiming the proposed rule will eliminate "overuse" of the product—despite the absence of evidence that such overuse might lead unfavorable welfare outcomes for consumers—the CFPB seeks to impose ability-to-repay underwriting requirements on payday lenders for the first time, similar to the requirements applicable to "qualified" mortgages. Alternatively, the CFPB will allow lenders who are unable or unwilling to assess borrowers' ability to repay—given that such assessments are impracticable for this form of credit—to limit consecutive loan renewals to two—for a total of six weeks of interest-bearing indebtedness, assuming a conventional two-week loan—subject to an aggregate maximum of six two-week loans per year and other protections.

Because of the high effective APR on payday loans, the cumulative amount of interest paid on a payday loan will generally exceed the loan principal after three months of borrowing. Not coincidentally, the CFPB "alternative" rule limits borrowing to three months in any 12-month period. While a 100-percent-of-principal cutoff is as arbitrary as it might be if set at 80 percent or 120 percent, the CFPB appears to believe that any benefits to the borrower must diminish with protracted re-borrowing. That might be a worthy hypothesis to test, but the CFPB provides no empirical support for this position.

Concerns about long-term payday-loan indebtedness are not new. Criticisms of payday loans, mainly by the Center for Responsible Lending (CRL), a credit-union-affiliated advocacy group, have focused on the observation that a high proportion of borrowers use more than one two-week payday loan before "leaving the system." CRL's efforts to quantify a consumer's mean time in debt yielded varying results, generally in excess of 100 days, not all necessarily consecutive.[27]

CRL has campaigned against payday loans on the ground that they are inherently deceptive, arguing that they are advertised as a short-term solution, but end up being used by consumers over much longer periods of time. Since consumers would never knowingly put themselves in such a position, CRL reasons, lender misconduct can be assumed.

CRL even put together a crude financial model showing how the average $35,000-income borrower would have insufficient cash at his payday to make the required repayment on a typical loan, primarily because of the sky-high interest charged.[28] CRL posits that repeat borrowing is not the consumer's ex ante intention, but instead happens through inadvertence because the borrower's limited funds are applied to payment of interest, leaving few assets to reduce principal. Thus, CRL claims, the borrower becomes "trapped" in a "cycle of debt." (Notably, CRL does not use the phrase to describe borrowers allowing their credit-card debt to revolve by paying the minimum payment or those who refinance their homes.) Some other critics refer to a "spiral" of debt, suggesting ever-increasing consumer liability.[29] In practice, however, interest is not permitted by lenders—and forbidden by state law—to be added to principal, and liabilities may remain unamortized but do not increase.

There is another problem with this theory: It is unsupported by empirical evidence. To the contrary, in multiple surveys, consumers were overwhelmingly satisfied with the loan product and reported repayment difficulties only in a small minority of cases.[30] In a 2011 randomized field experiment, in which consumers were sorted into cohorts that received either conventional payday loans or interest-free loans, high-cost loans remained outstanding for no longer than zero-interest loans of comparable duration—rebutting the antagonists' theory that the high cost of payday loans caused borrowers to be "trapped" in a "cycle of debt."[31]

Thus, the CFPB needed a different, less mechanical, explanation for repeat usage. Enter behavioral economics. The neoclassical model of consumer-credit usage is founded on an assumption that consumers are rational actors who seek to increase household wealth and use credit to shift consumption through time. By contrast, behavioral economics assumes that consumers are systematically irrational, including in their use of credit. A leading behavioral commentator, Harvard Law and Economics Professor Oren Bar-Gill, asserts that consumers show imperfect self-control in adhering to their repayment intentions ("underestimation bias") and inadequately take into account adverse events that might cause them to fail to repay ("optimism bias").[32]

In 2008, Bar-Gill published a law review article with a then-obscure co-author, a Harvard bankruptcy law professor named Elizabeth Warren, in which the authors asserted for the first time that optimism bias was the real culprit with payday loans. Specifically, they theorized, borrowers systematically underestimate multiple demands on their inflows and experience a shortfall at payday, necessitating re-borrowing.[33] The CFPB codifies this theory in the proposed payday rule.[34]

Yet, contrary to the CFPB's assertions, the empirical evidence does not support the theory. It was easy to design a field experiment to test the Bar-Gill andWarren formulation. In 2011, Ronald Mann of Columbia University administered a survey to borrowers at the time of their first loan origination, and tracked borrowers' actual repayment performance over time using lender administrative data. His two main findings were that:

- Consumers expected and understood *ex ante* that they were likely to keep borrowing after the first loan, and
- About 60 percent of borrowers predicted *ex ante* within one pay period the date when they would finally be free from debt. Importantly, the estimation errors were randomly distributed—not the product of excessively optimistic repayment expectations.[35]

Mann's study should have been the final nail in the behavioral coffin. But despite the absence of empirical evidence for optimism-driven renewed borrowing, the CFPB has made deterrence of loan renewal the centerpiece of its regulatory proposals.

What Is the Harm in Re-borrowing? Despite the centrality of rollovers to the CFPB's proposal, rollover economics is one of the least-studied aspects of consumer credit. The conventional theory of consumer credit, developed in the 1960s by F. Thomas Juster of the University of Michigan and Robert P. Shay of Columbia University, assumes that consumers make decisions about their own finances in ways that are similar to business-investment decisions. Because credit was traditionally incurred for the purchase of a specific durable asset, such as a home, car, or appliance, this analysis focused on whether the stream of benefits received by the consumer from ownership of the asset exceeded the consumer's cost of borrowing.[36] For example, a consumer who borrows to buy a washing machine might enjoy future benefits in the form of avoided costs at the laundromat. The transaction might be said to be welfare-enhancing if the present value of the imputed benefits exceeded the present value of the loan payments.

However, this school of thought does not provide a framework that fully explains consumers' non-asset-linked, unsecured borrowing decisions. It was not until 2001 that Gregory Elliehausen of Georgetown and Edward C. Lawrence of the University of Missouri demonstrated, using a straightforward present value computation, that a payday loan taken out to avoid late payments on utility and credit card bills would be welfare-enhancing—that is, the avoided late charges would exceed the payday-loan interest, after considering the time value of the cash flows. They used the same methodology to determine the net savings to a consumer by using a payday loan to pay for a car repair and avoid public-transportation expenses. In their analysis, the payday loan provided a net discounted benefit, even at a 391 percent annualized interest rate.[37]

Elliehausen and Lawrence assumed that consumers repaid the loan in one pay period and did not account for the possibility that consumers might roll over the loan multiple times before repayment. For example, while it might be facile to demonstrate that a consumer would derive a net-present-value benefit from incurring a single $45 charge for borrowing $350 for two weeks, the theory has not been expanded to show either further benefit or harm from more protracted borrowing—by, for example, paying $90 to borrow the same $350 for four weeks or $135 to borrow for six weeks. But other empirical evidence addresses this gap.

Studies by Neil Bhutta of the Federal Reserve and others show that, using credit scores as a welfare proxy, payday borrowing has small, generally positive mean effects on welfare.[38] These results align closely with studies by other investigators that show small, mostly positive welfare benefits from payday-loan usage as measured by various proxies, such as bounced checks, defaults on "mainstream" credit, and chapter 7 filings.[39] Because a majority of borrowers roll over their loans at least once, and some borrowers roll over many more times than that, these positive-welfare outcomes would not be possible unless those results held true *not only for zero-rollover borrowers but also for multiple-rollover borrowers*. But Bhutta *et al*. only study the mean effects and do not provide results that are conditional upon different borrowing durations.

Teasing out this result took a separate study by Jennifer Priestley of Kennesaw State University, who looked at the distribution of credit-score-change outcomes for borrowers of different durations. Sure enough, borrowers whose credit was outstanding for longer had larger positive changes in credit scores than those whose borrowing was more time-limited.[40]

Longer-term borrowers pay more interest than short-term borrowers. But without more data, the price paid for borrowed money cannot be used to determine whether the transaction was welfare-enhancing for the borrower. To date, the CFPB has not articulated a theory of harm for multiple-rollover payday-loan borrowers, and the empirical evidence appears all but to exclude the possibility of such harm.

The CFPB's Proposed Rule. The CFPB is prohibited by the Dodd-Frank Act, which created the Bureau, from regulating consumer credit prices. But high costs are precisely what the CFPB seeks to address via its payday lending rule. So, when the CFPB issued an outline of its rulemaking proposals in March 2015, it made the proposed rule applicable only to loans with an APR of over 36 percent. The current notice of proposed rulemaking preserves this threshold. The CFPB's plan is thus to sharply curtail the frequency of lending with respect to certain "expensive" forms of credit, but to impose no such restrictions on less expensive loans. Whether this disguised usury limitation will survive judicial scrutiny remains an open question until after the rule becomes final.

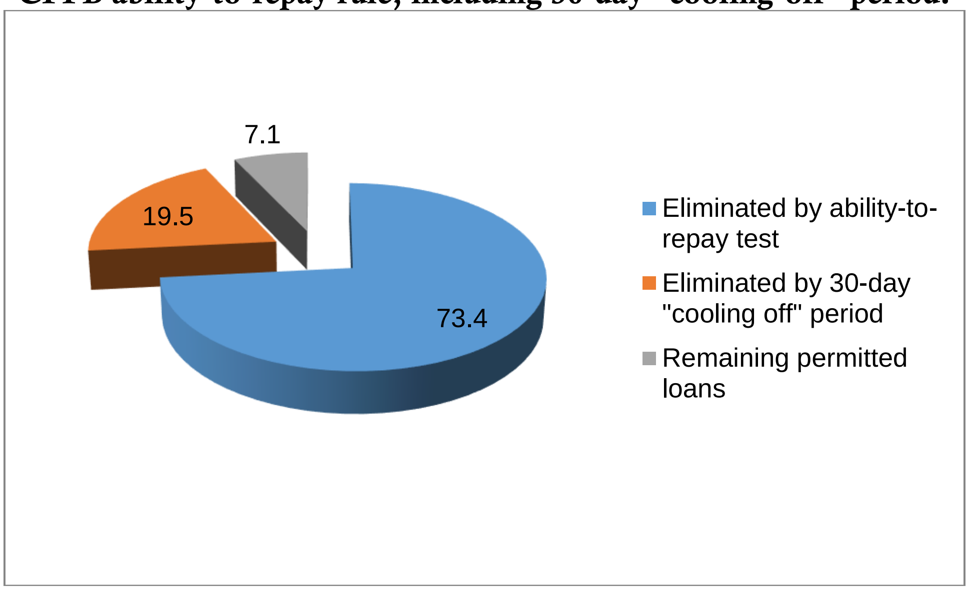
In its rulemaking proposal, the CFPB seeks to impose "ability to repay" requirements for payday loans and similar forms of credit, similar to the requirements for mortgages under the so-called Qualified Mortgage rule,[41] and for credit cards under the CARD Act.[42] Whether the CFPB has statutory authority to impose such a requirement is another open question. However, the income-and-expense verification requirements of the payday rule proposal are unwieldy and expensive, in a manner disproportionate to the loan size.

Certain loans deemed by the CFPB to have a low propensity to cause consumer harm will be permitted without ability-to-repay verification. These non-ability-to-repay loans are sharply limited in rollovers (two, amortizing to zero principal) and loans per year (six), and a lender would be required to await a 30-day cooling-off period between the borrower's repayment and incurrence of new credit. The loans have a maximum principal amount of $500 and cannot have more than one finance charge.

The CFPB's rule would be overlaid on state-law limitations. To the extent that the federal rule is more restrictive in any respect than state law, the federal rule would be controlling. As noted, the application of these limitations would eliminate about three-quarters of payday loans and force an approximately equal proportion of lenders' retail outlets to close.

What is Wrong with the CFPB's Intervention? The CFPB has imagined harm to borrowers who engage in protracted payday borrowing, and established an arbitrary set of interventions in order to avoid that harm—mainly cutting off rollovers at two. Borrowers who have a legitimate need for three rollovers or more need not apply. The CFPB's numerical limits include not only a maximum of three consecutive loans but also an equally arbitrary six-loan-per-year total limit, so the effect of these combined limits will be to suppress approximately 75 percent of all present payday borrowing.

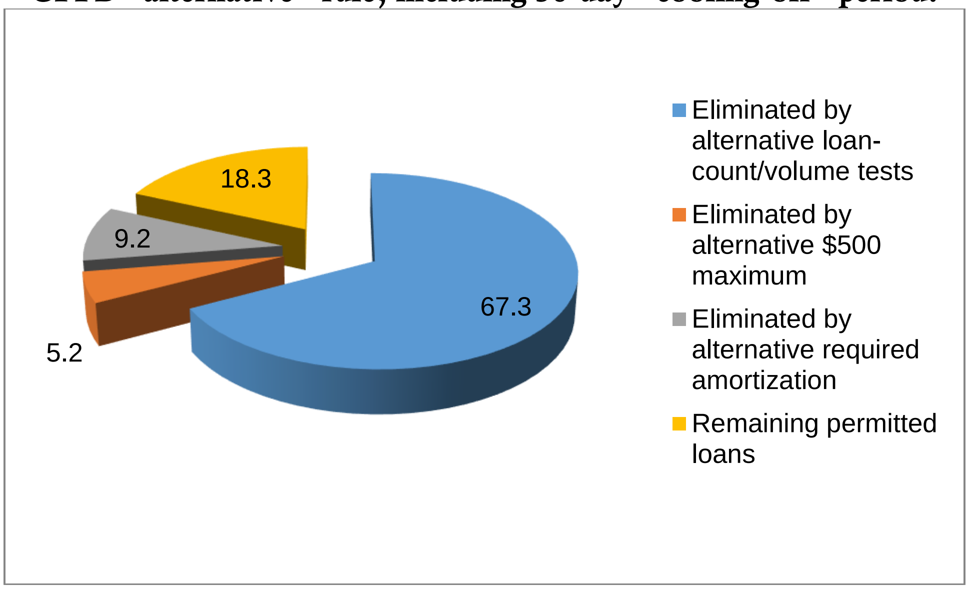
Loans made at storefronts, 2013, showing effect of the CFPB ability-to-repay rule, including 30-day "cooling-off" period.



Source: Rick Hackett, "Evaluating CFPB Simulations of the Impact of Proposed Rules on Storefront Payday Lending," NonPrime101.com, https://www.nonprime101.com/report-9-evaluating-cfpb-simulations-of-the-impact-of-proposed-rules-on-storefront-payday-lending.

On a simplistic level, the CFPB's desire to cut off the right tail of the usage distribution seems laudable. But the problem is the arbitrary nature of the cutoff. As with many arbitrary regulatory limits, some consumers will benefit, and others will not. Those who benefit are most likely to will be the subset of consumers whose borrowing is "behavioral"—subject to optimism bias or some other cognitive infirmity, as posited by Bar-Gill, that a rational consumer would not suffer.[43] As Columbia law professor Ronald Mann's research shows, those consumers are only a small proportion of all borrowers. By contrast, nearly 60 percent of borrowers understand, prior to borrowing, approximately how long they will be in debt, and the period of indebtedness they have in mind is generally more than two weeks.[44]

Actual loans made at storefronts, 2013, showing effect of the CFPB "alternative" rule, including 30-day "cooling-off" period.



Source: Rick Hackett, "Evaluating CFPB Simulations of the Impact of Proposed Rules on Storefront Payday Lending."

The CFPB rule will deprive this much larger "rational" group, who need credit of a duration longer than six weeks per year, of the opportunity to borrow for their desired terms. Some, possibly a majority, of these borrowers will be forced to seek inferior substitutes at the end of their CFPB-permitted maximum borrowing term, and others will not borrow from legitimate lenders at all. Instead, they will seek illegal or inferior credit options that do not offer the legal protections of the state-regulated payday-credit market. If they do not seek such credit, they may instead have to accept problems that will cost them much more than the finance charge of a payday loan—utilities cut off, cars repossessed, late fees, missed work time, eviction from homes. These are merely the static costs. Because the number of retail outlets will shrink so substantially under the CFPB's rule, borrowers of all types who desire payday credit will be unable to find it conveniently—if at all.

The CFPB has had five years to study individual consumers and their behavior around payday borrowing. But it has not performed, contracted for, or purchased research in any way related to the effects of protracted payday borrowing on consumers. Instead, it has relied solely on limited lender administrative data, which provide no information about consumer welfare outcomes from borrowing of different durations. Rather, these studies show simply the number of loans borrowers have used. Meanwhile, most of the academic research does not support borrowing-duration limitations as a welfare-enhancing market intervention.[45] To the contrary, allowing consumers to borrow for the duration of their choice appears to provide the best outcomes.[46]

Moreover, the CFPB has not tested any of its proposed interventions, despite ample opportunity to do so through field experiments. What is particularly shocking is that the CFPB has evidence that disclosure-based interventions may actually reduce payday borrowing by 13 percent or more, but the CFPB has not chosen to implement these interventions or even to test them.[47]

Without detailed testing and other information regarding the effects of the proposed rule on consumers, the CFPB cannot know whether its proposed intervention will make consumers better off. There is no reason to assume that it will. Rather, through guesswork and arbitrary prescriptive limits, the CFPB will deprive a majority of rational payday borrowers, who have few, if any, other alternatives, of the legitimate and regulated credit they need.

At bottom, the CFPB simply finds the interest rates charged by payday lenders distasteful. Never mind that they are necessary to cover high fixed costs and the labor-intensive nature of these extensions of credit. But the Dodd-Frank Act denies the CFPB the ability to regulate interest rates. Thus, lacking the ability to regulate the output it abhors, the CFPB plans to limit, in a purely arbitrary way, the inputs over which it believes it has authority.

There is no pressing need for action by the CFPB. Payday lending accounts for an infinitesimally small proportion of complaints to the CFPB complaint portal. Nearly all of these complaints relate to the misconduct of non-lender entities, such as collection agencies, or the behavior of unlicensed and illegal lenders. The overwhelming weight of economic evidence suggests that payday borrowing has subtle, if any, effects on consumers, principally because the loans are so small and cannot cause much damage even if misused. As Fed economist Neil Bhutta notes: "One possible conclusion is that payday loans are, financially, neither destabilizing nor greatly beneficial simply because they are small and unsecured, which limits their potential risks and benefits."[48]

Severe restrictions on the supply of payday credit will not eliminate the demand for these loans. Borrowers will not stop seeking the credit they need. It is precisely under these circumstances that illegal lenders thrive. And lenders who are willing to extend illegal credit are just as likely to engage in illegal collection practices when the loans come due. In fact, the development of payday loans can be viewed as a private, market solution to the problem of such criminality.

The CFPB has insisted that it develops policy based on evidence. But to date, it has not provided evidence for its own proposed regulatory actions. There is no evidence that payday lending traps consumers in a cycle of debt, that it is harmful, or that the particular numerical limits on reborrowing the CFPB has proposed will improve consumer welfare. It is essential that the CFPB study consumers in detail and determine whether these—or any other proposed interventions—will improve consumer welfare in the aggregate.

Moreover, it is impossible that all consumers will benefit—or be harmed—equally by any regulation. Borrowers and lenders should retain the ability to fashion their own market-based credit solutions based on the borrowers' individual circumstances and the lenders' risk appetites. The effect of the CFPB's rule will be to prevent fully informed parties from entering into the business relationships they voluntarily choose.

Notes

[1] Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why," July 2012, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.
[2]The notice of proposed rulemaking was later officially published in the Federal Register (at 81 *Federal Register* 47863 [July 22, 2016]) (to be codified as 12 C.F.R. Part 1041).
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[4] Author's calculations based on the amount of credit outstanding from published estimates of fees generated in the industry, average price, average loan size, average number of loans a borrower incurs in a year, and average loan duration. The CFPB estimates the total payday-loan market as smaller. These estimates compare with roughly $10 trillion of one-to-four-family residential mortgage loans, $3.5 trillion of credit card debt, $1.5 trillion of student-loan debt, and $900 million of automotive debt, payday credit seems hardly worth the fuss.
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[22] Notice of Proposed Rulemaking, 81 *Federal Register* at 47938.

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[40] Priestley.
[41] The Qualified Mortgage rule implements Sections 1411 and 1412 of the Dodd-Frank Act, which, among other things, requires home mortgage lenders to make a reasonable, good faith determination of a consumer's ability to repay and establishes a "safe harbor" from lender liability under this requirement for mortgages that comply with certain minimum underwriting criteria. 12 C,.F.R. § § 1026.43.
[42] A card issuer is prohibited from opening a credit card account or increasing a line of credit for any consumer unless it considers the consumer's ability to make the required payments under the terms of the account. 12 C.F.R. § 1026.51.
[43] Bar-Gill.
[44] Mann.
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