**BEFORE THE**
**BUREAU OF CONSUMER FINANCIAL PROTECTION**
**WASHINGTON D.C. 20552**

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| In the Matter of | ) | Docket No. CFPB-2016-0025 |
| Payday Loans, Vehicle Title | ) | |
| Loans, Certain High Cost | ) | |
| Installment Loans | ) | RIN 3170-AA40 |
| | ) | |

**COMMENTS OF**
**THE COMPETITIVE ENTERPRISE INSTITUTE**

October 7, 2016

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On behalf of the Competitive Enterprise Institute (CEI), we are pleased to provide the following comments on the Consumer Financial Protection Bureau's (CFPB) proposed rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans. Though justified as cracking down on payday lenders, many believe this rule will have a much broader effect in discouraging other financial service providers – including credit unions, community banks, and non-profit lenders – from providing short-term credit to lower-income consumers.

Founded in 1984, the Competitive Enterprise Institute is a non-profit research and advocacy organization that focuses on regulatory policy from a pro-market perspective. A strong focus of CEI is on removing regulatory barriers that deny access to capital and credit to businesses, consumers, and investors.

**INTEREST OF THE COMMENTERS**

The Competitive Enterprise Institute has long advocated competition and choice in credit options for consumers. We believe that, while federal and state governments should punish fraud and encourage transparency, they should refrain from interest-rate controls that limit options for borrowers. Most importantly, we have spoken out against regulatory barriers that block certain lenders from competing to provide the financial products that consumers believe best suit their needs.

For instance, CEI strongly defends the ability of credit unions to provide financing options for consumers and small businesses. We have highlighted the burden on credit unions from both general regulations, such as those that stem from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[1] as well as those rules that specifically target credit unions – often at the behest of banks seeking to limit competition.[2]

Credit unions, community banks, and many other financial institutions that are frequently praised for treating consumers fairly express strong concern that this proposed rule will impair their ability to offer borrowers financial products that fit their needs. What makes this proposal so problematic for all parties involved is its imposition of an "ability to repay" requirement – a standard that is arbitrary when applied to credit card and mortgages (as it is, respectively, under the Credit Card Accountability, Responsibility and Disclosure Act of 2009 and Dodd-Frank), but is a complete mismatch for disadvantaged borrowers with much higher risk profiles.

## I. THE BUREAU HAS EXCEEDED THE STATUTORY AUTHORITY OF DODD-FRANK BY TRYING TO REGULATE PAYDAY LOANS

### a) The Bureau's powers are constrained by Dodd-Frank

The Dodd-Frank Act created the CFPB and gave it a mandate to ban or restrict financial products that are "unfair, deceptive, or abusive."[3] But these powers, while broad, are not unlimited. Dodd-Frank prohibits

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[1] John Berlau, "Dodd-Frank's Burden on Credit Unions Highlighted at Hearing," CEI Blog, April 13, 2013, https://cei.org/blog/dodd-franks-burden-credit-unions-highlighted-hearing

[2] John Berlau and Lindsay Lewis, "A Simple Way to Grow America's Economy and Jobs," *The Hill,* September 29, 2015, http://thehill.com/blogs/congress-blog/economy-budget/255228-a-simple-way-to-grow-americas-economy-and-create-jobs

[3] U.S. Code › Title 12 › Chapter 53 › Subchapter V › Part C › § 5531

the CFPB from imposing interest rate caps or regulating consumer credit prices.[4] Yet this proposed rule does precisely that, because it puts a much greater regulatory burden on loans that exceed certain thresholds of interest, fees, or both. Even though the rule does not ban loans exceeding a 36 percent annual percentage rate (APR), it imposes "ability to repay" and other rules on most loans in excess of this rate, which discourages the offering of these products. And, unfortunately, a wide variety of financial products would be affected, including loan products viewed by experts as helping troubled borrowers break the cycle of debt. As we argue in the section about insurance products regulated by the rule, the Bureau has created a de facto usury cap.

**b) The Bureau's study fails to properly consider costs and benefits**

Under the Bureau's rulemaking authority as described in 12 USC §5512,

> (A) the Bureau shall consider-
>
> (i) the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule; and
>
> (ii) the impact of proposed rules on covered persons, as described in section 5516 of this title, and the impact on consumers in rural areas.

Part VI of the proposed rule purports to examine costs and benefits to providers and consumers. However, the proposal fails to consider dynamic effects adequately. People respond to new rules, and unexpected effects can take place if dyanamic effects are not properly taken into account. One pertinent example is how the interchange fee caps authorized in Dodd-Frank may have driven up to 1 million people out of the U.S. banking system.[5]

At no point does the Bureau discuss the cumulative effect of what is likely to be a major shock to the U.S. credit system, with up to $11 billion worth of credit offerings being eliminated from the market.[6] The likely effects of such a shock will be substantial, and the burdens will largely fall on the poorest in American society (see further discussion below).

For example, the Bureau dismisses the possibility that borrowers who no longer have access to a simple, easy-to-understand payday loan may turn to criminal lenders:

> *It has been suggested that some borrowers might turn to traditional in-person illegal lenders, or "loan sharks." The Bureau is unaware of any data on the current prevalence of illegal lending in the United States by individuals. Nor is the Bureau aware of any data suggesting that such illegal lending is more prevalent in States in which payday lending is not permitted than in States which*

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[4] Hilary Miller, "Ending Payday Lending Would Harm Consumers," *CEI OnPoint*, No. 220, October 5, 2016, https://cei.org/content/ending-payday-lending-would-harm-consumers

[5] Zywicki, Todd J. and Manne, Geoffrey A. and Morris, Julian, Price Controls on Payment Card Interchange Fees: The U.S. Experience (June 4, 2014). George Mason Law & Economics Research Paper No. 14-18. Available at SSRN: https://ssrn.com/abstract=2446080

[6] Miller, p.2

> *permit payday lending or any evidence that the amount of such lending increased in States which repealed their payday lending prohibitions.*[7]

Given the importance and the cost of criminal activity, and the continued presence of such activity, the Bureau should have commissioned such research rather than simply dismiss the problem of illegal lending. The work of former Columbia University professor Sudhir Venkatesh documented the use of loan sharking by the urban poor in the early 2000s.[8] A proper analysis of the costs and benefits of the payday loan (and other short-term loans) market would have examined the legal market's effect on providing alternatives to these illegal activities and counted those as benefits, rather than simply dismissing the possibility of substitution by illegal markets in a footnote.

It is inexcusable for the Bureau to have failed to assess the likely effects of its actions adequately, especially when it spends thousands of words purporting to discuss costs and benefits. As such, not only has the Bureau exceeded its authority, it has no rational basis for its rule, but merely assertion.

## II. ABILITY-TO-REPAY STANDARD ESPECIALLY INAPPROPRIATE FOR SHORT-TERM UNSECURED LOANS

### a) The proposed rule will worsen the financial situation of millions of customers of short-term unsecured loans

In promulgating the proposed rule, the CFPB overlooks the "chicken and egg" contradiction that barring poor people from getting loans for which they may not have the "ability to repay" means that those denied credit will then lack the ability to *pay* for basic goods and services. Thus the rules reinforce an existing cycle of poverty.

The vast majority of creditors strive to make loans to borrowers they believe have a good chance of repaying them. If they did not do so they would not be in business for long (barring government bailouts).

But even among the most creditworthy borrowers, unexpected life events can cripple their "ability to repay." While a professor at Harvard Law School, now-Sen. Elizabeth Warren (D-Mass.) and other researchers concluded that around half of all U.S. bankruptcies occur after the emergence of a serious medical problem.[9] Warren's figures on the extent of medical-related bankruptcies have been vigorously disputed,[10] but there is no doubt they account for a significant share of all bankruptcies. Divorce is a similar issue, unforeseen when a loan is made, that can play a major role in a bankruptcy.[11]

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[7] Proposed rule, footnote 955

[8] Sudhir Venkatesh, Off the Books: The Underground Economy of the Urban Poor (Cambridge, MA: Harvard University Press, 2006).

[9] Elizabeth Warren, "Medical Bankruptcy in the United States," *American Journal of Medicine*, 2009, http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0ahUKEwiksZDhucXPAhXGGD4KHRexCVsQFggkMAE&url=http%3A%2F%2Fcohealthinitiative.org%2Fsites%2Fcohealthinitiative.org%2Ffiles%2Fattachments%2Fwarren.pdf&usg=AFQjCNEbtCnJ_eaxTTMZ5mosHVja6_PfCA

[10] Megan McArdle, "Elizabeth Warren and the Terrible, Horrible, No Good, Very Bad, Utterly Misleading Bankruptcy Study," *The Atlantic*, June 4, 2009, http://www.theatlantic.com/business/archive/2009/06/elizabeth-warren-and-the-terrible-horrible-no-good-very-bad-utter ly-misleading-bankruptcy-study/18826/

[11] Laura S. Mann, "Till Debt Do Us Part: The Interplay Between Bankruptcy and Divorce," GPSolo, Vol. 32 No. 4, July/August 2015, http://www.americanbar.org/publications/gp_solo/2015/july-august/til_debt_do_us_part_interplay_between_bankruptcy_and_divorce.html

With uncertainties as large as these in middle-class and even wealthy borrowers' "ability to repay," it should come as no surprise that the ability of lower-income borrowers to pay back a loan is even less certain. As attorney and statistician Hilary Miller writes in the CEI study that we attach as part of our comments, typical consumers of payday loans "are financially constrained and have credit scores in the 'deep' subprime range, around 550, compared with about 695 for the general population."[12] Moreover, the very fact that a short-term loan is most often credit of last resort illustrates why "ability to repay," is an especially inappropriate standard for these types of loans. Anyone with a strong "ability to repay" would likely not get a payday loan for short-term borrowing; he or she would likely use a credit card already in possession.

b) The proposed rule would discourage loans that lift up lower-income borrowers

Rather than effectively banning credit products it deems distasteful, the CFPB should encourage a vibrant market of credit products for all income levels. Many credit unions, at the behest of their regulator, the National Credit Union Administration, offer a Payday Alternative Loan (PAL), a short-term loan with lower rates and fees than many payday loans. PALs are sometimes issued with the express purpose of helping consumers *pay off* payday loans.

Yet the Credit Union National Association, which represents credit unions, has expressed strong concerns that the proposed rule will effectively ban PAL loans and restrict other small-dollar loans offered by credit unions.

As CUNA President Jim Nussle recently wrote:

> *Not only will this proposed rule disrupt, and arguably crush, the ability of credit unions to offer small dollar loans, it also sweeps in and detrimentally impacts the ability to offer other types of loans such as refinanced auto loans.*[13]

Though the proposal does contain a technical exemption for loans from the PAL program, Nussle and other credit union officials believe this exemption is too narrow for any credit union to utilize. "Not only do we believe that some of the new conditions the Bureau proposed in the rule would make PAL loans unsustainable, we believe the sheer complexity of the proposed rule alone will force credit unions to stay out of this market," Nussle concluded.[14]

## III. THE PROPOSED RULE WILL ADVERSELY AFFECT THE MARKET FOR VOLUNTARY PROTECTION PRODUCTS

### a) The Bureau Lacks the Legal Authority to Regulate VPPs

Voluntary Protection Products (VPPs) form an important and valuable part of the auto loan market, providing peace of mind to car buyers. VPPs include products like credit insurance as a form of debt protection against unforeseen events, such as unemployment or illness, in order to keep vehicle payments and other such contracts up to date. They are generally sold alongside and bundled with

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[12] Miller, p. 2.

[13] Jim Nussle, Letter to National Credit Union Administration, June 27, 2016, http://www.cuna.org/uploadedFiles/CUNA/Legislative_And_Regulatory_Advocacy/Track_Regulatory_Issues/Pending_Regulatory_Changes/2016/NCUA%20Small%20Dollar%20letter.pdf

[14] Ibid.

vehicle financing. The prime purpose is that of insurance. Because they are bundled in with vehicle financing, their fees and monthly costs can easily drive a loan's effective APR above the 36 percent "all-in APR" floor for regulation under the proposed rule. Because the regulation of loans above 36 percent all-in APR is onerous, we can expect auto dealers to stop offering these products to their customers.

1. **The Dodd-Frank Act bans regulation of insurance as a financial product or service**

The Dodd-Frank Act, which provides the authority under which the Bureau is issuing the rules, specifically exempts the business of insurance from its definition of a financial product or service.[15] Under the McCarran-Ferguson Act,[16] the regulation of insurance is reserved to the states unless specifically authorized by Congress. Congress has given no such explicit authority to the Bureau to regulate insurance products in the Dodd-Frank Act. Furthermore, Dodd-Frank excludes regulation of insurance agents, who instead are regulated by their respective state insurance regulator.[17] Therefore, the activities of lenders, as far as they pertain to the marketing, selling, or closing of any product as agents of an insurance company, are explicitly excluded from regulation by the Bureau.

2. **The proposed rule includes specific regulation of credit insurance**

Nevertheless, the proposed rule explicitly includes credit insurance costs in its definition of the total cost of credit. It states:

> *<u>Total cost of credit</u> means the total amount of charges <u>associated with a loan</u> expressed as a per annum rate and is determined as follows: ... Any charge that the consumer incurs <u>in connection with</u> credit insurance before, at the same time as, or within 72 hours after the consumer receives the entire amount of funds that the consumer is entitled to receive under the loan, including any charges for application, sign-up, or participation in a credit insurance plan, and any charge for a debt cancellation or debt suspension agreement*...[18] [Emphasis added]

Moreover, the costs of VPPs need not be bundled with the loan under this definition. Because the costs only have to be incurred "associated with" or "in connection with" the loan to be included in the total cost of credit, VPPs that are sold with the loan, but are accounted for separately via a cash payment or a separate agreement with a third party agent, will count against the 36 percent "all in" ceiling.

Therefore, it appears that the Bureau has explicitly decided that it wants to regulate these products out of the auto vehicle market entirely. This is contrary to the direction of Congress as laid out in the Dodd-Frank Act.

3. **The Dodd-Frank Act bans a usury cap, but the 36 percent threshold is a *de facto* usury cap**

The Dodd-Frank Act also specifically bans the Bureau from instituting any usury provisions (limits beyond which the charging of interest is illegal) on credit. It states:

[15] 12 U.S.C. §5481(15)(C)

[16] 15 U.S.C. §1011 et seq.

[17] 12 U.S.C. §5517(f)

[18] Proposed Rule at 1131

> No provision of this title shall be construed as conferring authority on the Bureau to establish a usury limit applicable to an extension of credit offered or made by a covered person to a consumer, unless explicitly authorized by law.[19]

The proposed rule provides a *de facto* prohibition on loans to persons who do not meet "ability-to-repay" requirements when those loans present a total cost of credit greater than 36 percent APR. As such, it presents a *de facto* usury limit applicable to an extension of credit in violation of the law.

While the CFPB argues that its 36 percent limit is not a usury limit, the requirements for extending a loan beyond that limit are so onerous that many potential borrowers cannot qualify, and most lenders will not attempt to see if they can. Without the 36 percent requirement, some of these loans would probably be made. That makes the 36 percent figure an effective limit.

The 36 percent figure appears to derive from the Military Lending Act, which states that:

> A creditor ... may not impose an annual percentage rate of interest greater than 36 percent with respect to the consumer credit extended to a covered member or a dependent of a covered member.[20]

While such a limit was authorized by Congress, it was done so specifically for the purposes of the Military Lending Act, which gives no authorization to the Bureau to replicate it in other areas where the McCarran-Ferguson Act or Dodd-Frank Act provisions apply. Once again, the Bureau appears to have acted in direct violation of the terms of its remit from Congress.

b) The Bureau has not Recognized the Utility of VPPs to Borrowers

1. **Insurance can achieve the aims of regulation, including the proposed rule**

Financial regulation is intended to protect people from financial harm. Indeed, the proposed rule is intended to help people not get into uncontrollable debt. But this is also precisely the purpose of the VPPs the rule attempts to eliminate from the marketplace. VPPs are intended to protect consumers in the event of unforeseen circumstances, such as death, disability or unemployment, the loss of a vehicle in an accident, or the mechanical breakdown of vehicles or appliances.

Such circumstances can send households into significant difficulties. According to the Federal Reserve, an unforeseen expense of just $400 would prove difficult to pay off in a single month for about half of all American households.[21] This is confirmed by Bankrate.com's consumer survey, which found that over six in 10 Americans said they could not handle a $500 car repair or a $1000 medical emergency bill.[22]

These are the sort of circumstances that send people to payday lenders, who are the target of much of the proposed rule, as discussed above. However, VPPs insure people against having to take that option.

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[19] 12 U.S.C. §5517(o)
[20] 10 U.S.C. §987(b)
[21] Board of Governors of the Federal Reserve System, "Report on the Economic Well-Being of U.S. Households in 2015, May, 2015
[22] Bankrate.com, "Survey: How Americans contend with unexpected expenses," December 2015. http://www.bankrate.com/finance/consumer-index/money-pulse-1215.aspx

By paying a small amount each month, they can be sure that unforeseen negative events will not send them into debt or provide such a hit to their finances they will struggle to cover it.

By forcing a *de facto* ban on VPPs, the proposed rule will therefore worsen many Americans' financial situation. That is a perverse outcome.

**2. Government regulation has increased the cost of new vehicles to consumers**

One significant issue in vehicle financing has been the growth of "negative equity" in cars – owners owing more on their vehicles than the vehicles are worth.[23] This trend is likely to increase as the administration's tightened corporate average fuel economy (CAFE) standards become ever more severe. The National Highway Traffic Safety Administration estimates that CAFE standards will add $2,937 to the average cost of new vehicles during model years 2017-2025. This increase could drive about 4 million households, and up to 7 million drivers, out of the new car market, according to a 2012 National Auto Dealers' Association report.[24] Given the cost of a new car, the size of monthly payments, and the prospect of negative equity, at least some drivers will be more likely to opt for a new car if they had the peace of mind provided by VPPs. Without those options, the effect of artificially increased new car prices will be more severe. More people will go without the car they need, or choose to drive an older, less safe vehicle.

**3. The 36 percent "all in" rate is inappropriate and without rational basis**

The Bureau admits that it has no basis for choosing the figure of 36 percent as the limit beyond which its onerous provisions will apply. Instead, it simply asserts that the figure is "a useful line of demarcation."[25] As noted above, it probably originates from the figure chosen by Congress for the Military Lending Act. But the proposed rule offers no reasoning whatsoever for why the figure is applicable to the loans in question here.

Under the Dodd-Frank Act, the Bureau is required to show a "substantial injury" to consumers to justify regulation and conduct a cost-benefit analysis of its proposed rules. It has done neither. As such, the Bureau has provided no rational basis for its choice of 36 percent as a threshold for requiring stricter regulation.

This is particularly the case regarding its de facto prohibition of VPPs. As suggested above, VPPs provide considerable consumer value, not least in peace of mind. So, the cost of their prohibition should be assessed before the proposed rule can be considered properly.

Moreover, the rule's arbitrary origination fee provisions have odd effects. A loan for the same amount with VPPs but no origination fee could be subject to the rule despite it being less expensive to the

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[23] Automotive News, "Softer used-vehicle prices behind uptick in negative equity deals", January 20, 2016, http://www.autonews.com/article/20160120/FINANCE_AND_INSURANCE/301209996/softer-used-vehicle-prices-behind-uptick-in-negative-equity-deals

[24] David Wagner, Paulina Nusinovich, Esteban Plaza Jennings, "The Effect of Proposed MY 2017-2025 Corporate Average Fuel Economy (CAFE) Standards on the New Vehicle Market Population," http://www.nadafrontpage.com/upload/wysiwyg/The%20Effect%20of%20Proposed%20MY%202017-2025%20CAFE%20Standards%20on%20New-Vehicle%20Market.pdf

[25] 81 Fed. Reg. 47,864, at 47,913 (July 22, 2016)

consumer than a similar loan with an origination fee (that is thereby not subject to the rule) and no VPPs. This is an arbitrary and capricious result. [26]

**4. VPPs are not regarded as a cost of credit by other Federal laws and regulations**

The proposed rule also breaks precedent with the Truth in Lending Act and Regulation Z, which specifically exclude insurance and “debt cancellation and debt suspension coverage” from being included in loan Annual Percentage Rate calculations.[27] The reason for the exclusion is that VPP services are not themselves part of the cost of credit, which consists of origination costs, servicing costs, funding costs, and risk bearing costs. As noted, VPPs function as insurance against unforeseen events, rather than a cost of credit. Therefore, it is inappropriate for the Bureau to include them in its total cost of credit calculation.

**IV. CONCLUSION**

For the above reasons, we recommend that the Bureau withdraw the proposed rule. At the very least it should:

- Provide a proper cost-benefit analysis that examines the dynamic effect of the proposed rule, including a full examination of the possibility of illegal market substitution;
- Provide an adequate explanation for its choice of cut-off for the total cost of credit;
- Present less onerous regulations for loans beyond that figure, so as to avoid a de facto usury limit; and
- Exclude all insurance products from the total cost of credit.

We attach below the study by Hilary Miller referred to above as part of these comments

[26] Comments of Tom Keepers, Executive Director, CCIA, submitted October 7

[27] 15 U.S.C. §1605; 12 C.F.R. §1026.4(c)-(e)

**October 5, 2016** **No. 220**

# 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* [28]

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.[i] 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.[ii]

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*[28] Hilary B. Miller is an attorney and statistician. He is chairman of the Consumer Credit Research Foundation.*

The CFPB's own impact analysis suggests that the rule will result in an industry-wide revenue reduction of roughly three-fourths.[iii] 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.[iv] 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.[v] 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.[vi] 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.[vii]

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.[viii]

Unsurprisingly, given the limited creditworthiness of the typical payday-loan applicant, the initial default rate on new payday loans is high: around 18 percent.[ix] 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.[x] 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.[xi] 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,[xii] reduce bounced checks and collection items,[xiii] decrease chapter 7 filings,[xiv] and lower bill-paying difficulties.[xv] 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.[xvi]

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.[xvii] 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.[xviii] 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.[xix]
- 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.[xx]
- 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.[xxi]

**How Rollovers Work.** The CFPB proposed rule effectively concedes that payday loans, in small doses, are fine.[xxii] 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.[xxiii] 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[xxiv] and combined analytical findings with its speculations regarding harms from overuse.[xxv] 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.[xxvi] Neither paper even purported to study the harms or benefits to consumers beyond the amount of interest they paid.

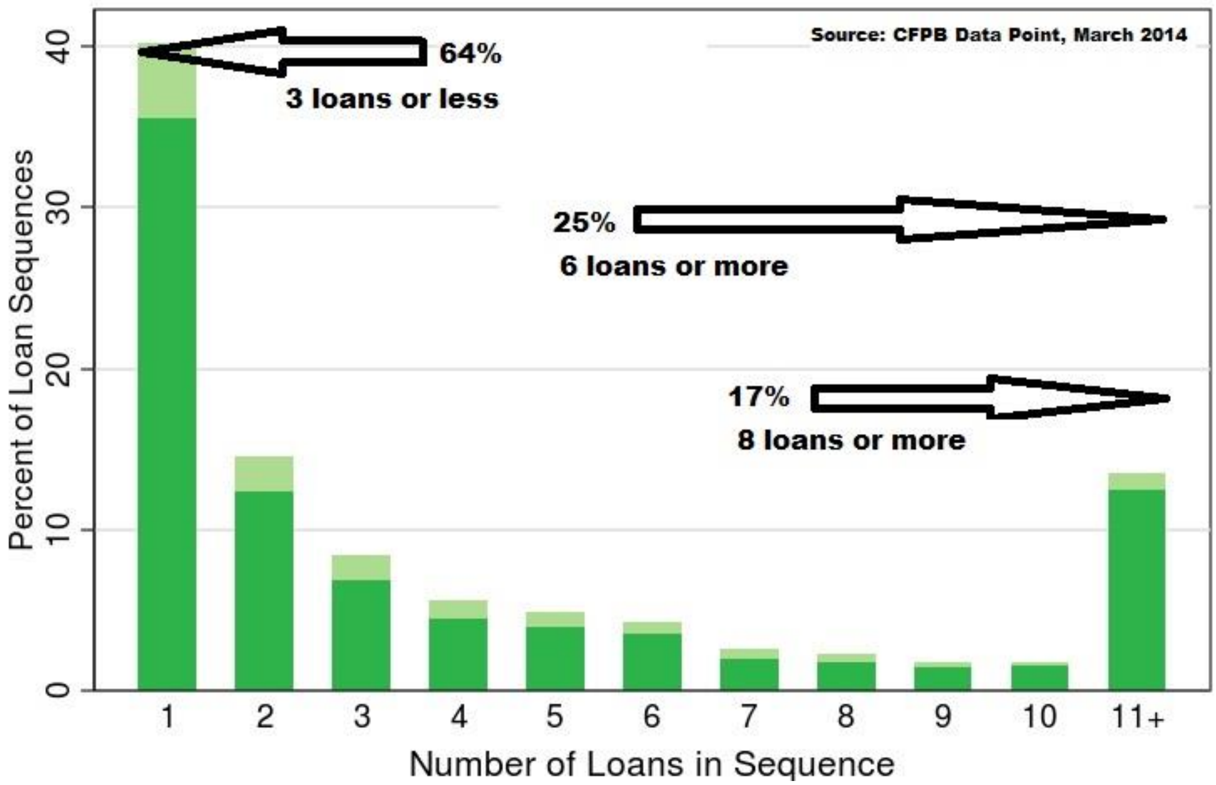
Some rollovers are undertaken shortly after repayment of the previous loan, not necessarily on the same day as the end of the previous loan term. In the White Paper, the CFPB ignores breaks of less than 14 days, reasoning that, if the borrower repays his loan but borrows again during the same pay period, 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.[xxvii]

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.[xxviii] 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.[xxix] 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.[xxx] 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."[xxxi]

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").[xxxii]

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.[xxxiii] The CFPB codifies this theory in the proposed payday rule.[xxxiv]

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.[xxxv]

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.[xxxvi] 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.[xxxvii]

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.[xxxviii] 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.[xxxix] 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.[xl]

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,[xli] and for credit cards under the CARD Act.[xlii] 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.

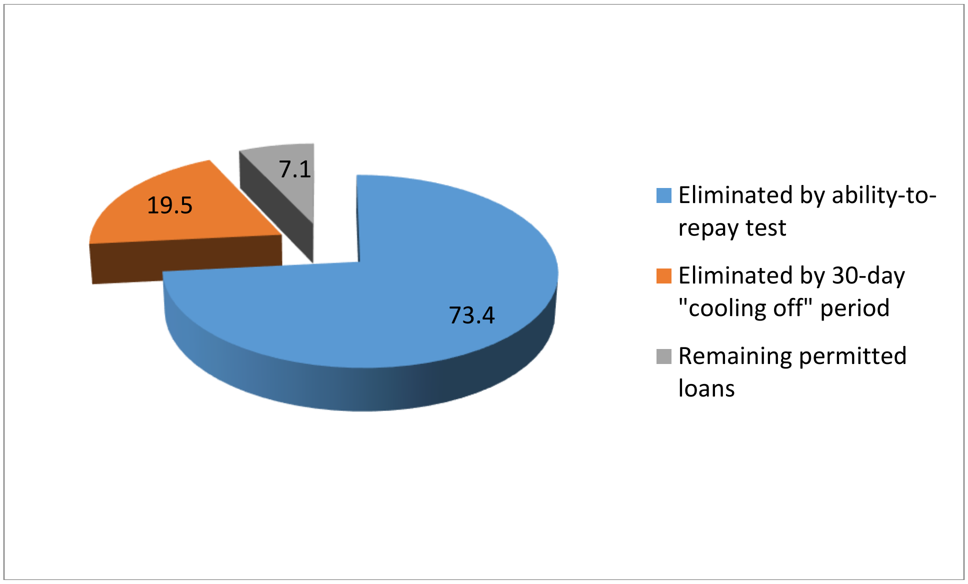
Certain loans deemed by the CFPB to have a low propensity to cause consumer harm will be permitted without ability-to-repay verification. These non-ability-to-repay loans are sharply limited in rollovers (two, amortizing to zero principal) and loans per year (six), and a lender would be required to await 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**

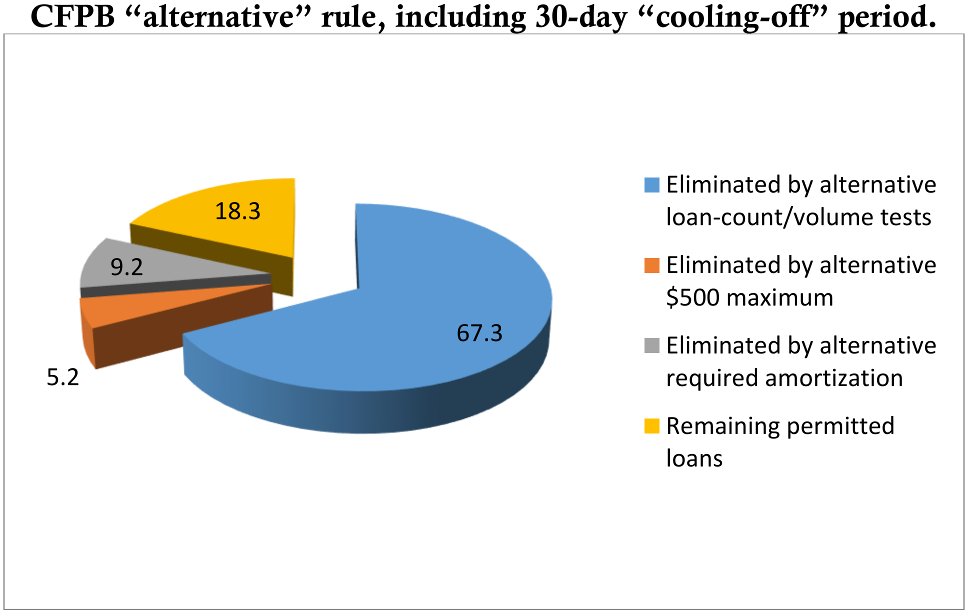
**CFPB ability-to-repay rule, including 30-day "cooling-off" period.**




*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](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.[xliii] 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.[xliv]

**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.[xlv] To the contrary, allowing consumers to borrow for the duration of their choice appears to provide the best outcomes.[xlvi]

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.[xlvii]

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."[xlviii]

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

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[i] 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.

[ii]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).

[iii] CFPB (2015) "Supplemental findings on payday, payday installment, and vehicle title loans, and deposit advance products," http://www.consumerfinance.gov/data-research/research-reports/supplemental-findings-payday-payday-installment-and-vehicle-title-loans-and-deposit-advance-products, p. 137. See also Arthur Baines, Marsha Courchane, and Steli Stoianovici, "Economic Impact on Small Lenders of the Payday Lending Rules under Consideration by the CFPB," Charles River Associates, Prepared for the Community Financial Services Association of America, May 12, 2015, http://www.crai.com/sites/default/files/publications/Economic-Impact-on-Small-Lenders-of-the-Payday-Lending-Rules-under-Consideration-by-the-CFPB.pdf. More detailed estimates, based on a larger and more recent sample, are provided by Hackett, R. (2016) "Evaluating CFPB Simulations of the Impact of Proposed Rules on Storefront Payday Lending," available at https://www.nonprime101.com/report-9-evaluating-cfpb-simulations-of-the-impact-of-proposed-rules-on-storefront-payday-lending (estimating true effect at an 82 percent reduction in loan volume under the "alternative" rule and an approximately 91 percent reduction under the ability-to-repay rule).

[iv] 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.

[v] Gregory Elliehausen and Edward C. Lawrence, E. (2001), "Payday Advance Credit in America: An Analysis of Customer Demand," Credit Research Center, McDonough School of Business, Georgetown University, April 2001, http://www.cfsaa.com/Portals/0/analysis_customer_demand.pdf. Pew Charitable Trusts.

[vi] Payday-loan users are 41 percent female, compared to 27 percent of nonusers. Users of payday credit are 22 percent African American, compared to 12 percent of nonusers. See Donald P. Morgan and Kevin J. Pan, "Do Payday Lenders Target Minorities?" Federal Reserve Bank of New York, Liberty Street Economics, February 8, 2012, http://libertystreeteconomics.newyorkfed.org/2012/02/do-payday-lenders-target-minorities.html.

[vii] Neil Bhutta, "Payday Loans and Consumer Financial Health," *Journal of Banking and Finance*, Vol. 47, October 2014, pp. 230–242. Jennifer Priestley, "Payday Loan Rollovers and Consumer Welfare," Kennesaw State University, http://ssrn.com/abstract=2534628. Ethan Dornhelm, "U.S. Credit Quality Continues To Climb—But Will It Level Off?" FICO Blog, Fair Isaac Corp., August 18, 2015, http://www.fico.com/en/blogs/risk-compliance/us-credit-quality-continues-climb-will-level.

[viii] Ibid.

[ix] Kathleen Burke, Jonathan Lanning, Jesse Leary, and Jialan Wang, "CFPB Data Point: Payday Lending," Consumer Financial Protection Bureau, March 2014, http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.

[x] Ibid. Tim Worstall, "Why Payday Loans Are So Expensive," *Forbes*, December 20, 2011, http://www.forbes.com/sites/timworstall/2011/12/20/why-payday-loans-are-so-expensive/#7384bef219cf.

[xi] Bhutta, "Payday Loans and Consumer Financial Health." Priestley. Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman "Payday Loan Choices and Consequences," *Journal of Money, Credit and Banking*, Vol. 47, Nos. 2-3 (April 2, 2014), http://www.calcfa.com/docs/PaydayLoanChoicesandConsequences.pdf.

[xii] Chintal A. Desai and Gregory Elliehausen, "The Effect of State Legislation Restricting Payday Lending on Consumer Credit Delinquencies: An Investigation of the Debt Trap Hypothesis," March 31, 2014, http://www.calcfa.com/docs/Theeffectsofstatelegislationrestrictingpaydaylending.pdf.

[xiii] Donald P. Morgan, Michael R. Strain, and Ihab Seblani, "Payday Credit Access, Overdrafts, and Other Outcomes," *Journal of Money, Credit, and Banking*, Vol. 44, Nos. 2-3, pp. 519–531.

[xiv] Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans," Staff Report No. 309, Federal Reserve Bank of New York, November 2007, revised February 2008, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr309.pdf; Petru S. Stoianovici and Michael T. Maloney, "Restrictions on Credit: A Public Policy Analysis of Payday Lending," October 28, 2008, http://ssrn.com/abstract=1291278. Lars Lefgren, and Frank McIntyre, "Explaining the Puzzle of Cross-State Differences in Bankruptcy Rates," *Journal of Law and Economics*, Vol. 52, No. 2 (May 2009), pp. 367-393, http://www.journals.uchicago.edu/doi/10.1086/596561.

[xv] Jonathan Zinman, "Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap" Journal of Banking and Finance, Vol. 34 (March 2010, pp. 546–556, http://www.sciencedirect.com/science/article/pii/S0378426609002283.

[xvi] Neighborhood racial composition has little influence on payday lender store locations. Neil Bhutta, "Payday Loans and Consumer Financial Health." Lenders' firm-level returns differ little from typical financial returns; data is consistent with high per-loan and per-store fixed costs in a competitive market. Paige Skiba and Jeremy Tobacman, "The Profitability of Payday Loans," December 10, 20017, http://cpla-acps.ca/english/reports/Vanderbilt%20Oxford%20profitability%20study%2012%2010%202007.pdf.

[xvii] Harris Interactive, "Payday Loans and the Borrower Experience," Prepared for the Community Financial Services Association of America, December 2013, p. 5, http://cfsaa.com/Portals/0/Harris_Interactive/CFSA_HarrisPoll_SurveyResults.pdf.

[xviii] CFPB (2013), "What is a payday loan," http://www.consumerfinance.gov/askcfpb/1567/what-payday-loan.html.

[xix] Fla. Stat. § 560.401 et. seq.

[xx] Cal. Fin. Code § 23000 et seq.

[xxi] Colo. Rev. Stat. § 5-3.1-101 et seq.

[xxii] Notice of Proposed Rulemaking, 81 *Federal Register* at 47938.
[xxiii] Community Financial Services Association of America, "CFSA Member Best Practices," accessed October 3, 2016, http://cfsaa.com/cfsa-ember-best-practices.aspx.
[xxiv] The White Paper derived its pertinent conclusions from an unrepresentative sample of payday loan borrowers heavily weighted toward repeat users. It also failed to fully disclose the nature or source of its underlying data.
[xxv] CFPB, "Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings," April 24, 2013, http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.
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[xli] 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.
[xlii] 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.

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[xliv] Mann.
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