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The Annual Percentage Rate Is the Wrong Metric for Assessing the Cost of a Short-Term Loan

Use of Misleading Measure Can Justify Misguided Regulation

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Think calculating the cost of a loan is simple? Not under the longtime rules of the federal government and many states. Consider the following recent exchange in Congress.

During a House Committee on Financial Services hearing in 2019, Rep. Katie Porter (D-CA) pressed then-Consumer Financial Protection Bureau (CFPB) Director Kathy Kraninger to calculate the cost of a payday loan.[1] During her questioning, Rep. Porter posed the hypothetical example of a single mother who had hastily obtained a payday loan to fix her car so she could get to work on time. She took out a two-week $200 payday loan with a $20 interest charge and a $20 origination fee. After explaining the example, she asked Kraninger to calculate the annual percentage rate (APR) of the loan. Kraninger replied that the hearing was supposed to be "a policy conversation" and "not a math exercise." Porter cut off Kraninger, saying she was "reclaiming my time," before Kraninger had a chance to answer. The problem is that it was difficult for Kraninger to give a clear answer.

APR is the mathematical calculation that adds up the amount financed, interest, fees, and payment schedule into the cost of credit expressed as a yearly rate. Its disclosure is required by laws that govern all types of loans, including those with durations of much less than a year.

However, APR disclosure rules have led to a distorted view of short-term lending. Under the traditional formula for calculating APR, the loan in Rep. Porter's example would total a colossal *520 percent* interest rate. However, the single mother in question would only have had to pay 20 percent interest, or $40, if she paid back the loan on time, within the two-week duration of the typical payday loan.[2]

That is because few, if any, borrowers take a whole year to pay off their payday loans. Data suggest most borrowers pay back the initial amount borrowed within six weeks, so it is highly unlikely that most borrowers would end up paying anywhere near the purported APR of the loan.[3]

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Payday loan critics, including Rep. Porter and organizations like the Center for Responsible Lending (CRL) and the National Consumer Law Center (NCLC), often cite APR as evidence of the high cost of payday loans. NCLC and CRL claim that the average payday loan carries a 400 percent APR and that these loans are high-cost and predatory.[4] Payday loan critics have recently expanded their critique to new financial technology (FinTech) firms. They claim that earned wage access companies like Earnin and Dave, which allow workers to access money they have already earned during a pay period, are actually payday lenders in disguise. That, they further ague, allows them to charge high interest, despite the fact that these companies operate on voluntary tips or nominal membership fees rather than on fees assessed each time users access their earned wages.[5] But, as economist Thomas Sowell has pointed out, "Using this kind of reasoning—or lack of reasoning—you could … say a hotel room rents for $36,000 a year, [but] few people stay in a hotel room all year."[6]

That distortion in the measurement of credit costs threatens to limit or even cut off access to credit to the struggling Americans who need it most during a stressful time for the economy and public health. Interest rate caps and other proposed restrictions prompted by this misleading measure of the cost of short-term credit could curtail beneficial financial products that could aid America's economic recovery from the pandemic. It is crucial that policy makers understand the limits of the APR as a measuring tool, and do not use it to inadvertently harm the remarkable resilience shown by American consumers and entrepreneurs during this crisis.

The Truth in Lending Act Helps Distort the Cost of Short-Term Credit. Much of this problem exists because the Truth in Lending Act (TILA), for more than five decades, has required lenders to disclose the APR on loans for consumers to use while comparison shopping.[7] While annualization of the interest rate might be well suited to gauge the cost of a mortgage or auto loan, APR is a poor measure of the cost of a payday loan or the array of innovative new short-term lending products created by FinTech firms.

Discussing the problems created by inaccurately measuring the cost of short-term credit through the use of APR, Federal Reserve Board economists Thomas Durkin and Gregory Elliehausen wrote in a 2013 paper:

> Since its effective date of July 1, 1969, TILA has imposed commonality in disclosures among the states and across kinds of credit. Foremost among the requirements is a uniform definition of the finance charge and a corresponding unit price, the Annual Percentage Rate (APR). Congress intended that the finance charge and APR reflect the total price of credit. TILA's extensive regulatory structure applies to virtually all consumer credit. Yet despite the uniformity and comprehensiveness of its disclosures, it is not obvious that TILA has produced greater credit cost disclosure clarity in all cases. It seems that TILA provisions have simplified cost disclosures in some complex areas (for instance, automobile leasing), but they also have complicated disclosures in some simple ones (for instance, short-term cash loans).[8]

More recently, the Consumer Financial Protection Bureau's Taskforce on Federal Consumer Financial Law, of which Durkin was a member, also noted that APR is not always the best measure of the cost of credit. The 2021 Taskforce Report stated:

> Both the finance charge and the APR can be more or less useful in decision making depending on the circumstances. As with a home chef contemplating a new and difficult recipe, a low unit price offered on a huge jar of some new and previously obscure ingredient may not represent the best bargain. The small jar of the right amount at a higher unit cost but lower dollar cost may be a better choice than the one at a lower unit price but costing more dollars.[9]

The Myth of a High-Cost Payday Loan. Most payday loans have a finance charge of around $15 per $100 borrowed over a two-week period. Based on that, if a borrower takes out a $200 loan with a $30 finance charge for two weeks, the interest rate totals 15 percent. Yet, when that figure is annualized by multiplying it by the 26 two-week periods in a year, the APR becomes 390 percent, even though nothing about the loan's features has changed.

Moreover, when compared to the costs of a bounced check or overdraft fee, the APR on the average payday loan is also much less. If these charges were treated as "interest" rather than "fees," and measured the same way as APR is on payday loans, their APR would far exceed that of payday loans. For instance, a Federal Deposit Insurance Corporation (FDIC) study found that the average APR for a two-week checking account overdraft fee is 1,067 percent.[10] A study from the Federal Reserve Bank of Kansas City found that the median interest rate of an overdraft fee expressed as an APR would surpass 4,000 percent.[11] Yet, it is hard to find the same level of outrage over the APR or cost of a bounced check or overdraft fee as there is for payday loans.

While some would still maintain that the APR on payday loans is intolerably high, one FDIC study found that "the high APRs implied by payday loan fees can be justified by the fixed costs of keeping stores open and the relatively high default losses suffered on these loans."[12] To stay afloat, lenders must account for the costs of capital, operating a storefront, paying employees, and writing off bad debts. In a 2009 report for the Financial Services Centers of America, the consultancy firm Ernst & Young found that a $15 fee on a $100 loan only turns $1.11 in pretax profit.[13]

While online payday lenders today are the fastest growing sector of the industry and do not necessarily incur the same fixed costs, brick-and-mortar storefronts still constitute a very large portion of the business as a whole. As Lisa Servon, professor of city planning at the University of Pennsylvania, writes in her widely cited 2017 book on consumer credit, *The Unbanking of America*, "there are more payday lending stores than there are McDonald's restaurants and Starbucks shops combined."[14] In summarizing the often unremunerative nature of payday lending, Servon notes that "banks have retreated from small-dollar credit because they don't find it sufficiently profitable."[15]

Moreover, payday loans are also unsecured. That makes them different from mortgages or even pawn shop or vehicle title loans, which require some form of collateral to "secure" the loan. If a payday loan borrower defaults, there is not much a lender can do to take punitive action other than not to grant another loan. In most circumstances, it is not even economically worthwhile for the lender to file a collection suit.[16]

Interest Caps' Effect on FinTech Innovation. In the emerging FinTech field, earned wage access companies help workers tap into money they have already earned during a pay period, before their next payday. This is useful for covering unforeseen expenses and avoiding overdraft fees or other costly alternative means of accessing cash quickly.

However, like payday lenders, FinTech companies are often accused of charging high interest. Earned wage access companies like Earnin and Dave have been criticized for their business practices in recent years. For example, in August 2019, the New York Department of Financial Services and other state regulatory agencies launched an investigation into a number of earned wage access companies, alleging that their tip-based business model allows them to "collect usurious or otherwise unlawful interest rates."[17]

Instead of charging interest or fees for its service, Earnin gives users the option to leave a voluntary tip. Earnin caps the tips at $14 per cash advance. Similarly, Dave gives users the option to leave a voluntary tip, but also charges a nominal $1 monthly membership fee. Furthermore, most earned wage access companies offer users other free or low-cost financial services, including budget management tools.[18]

In short, earned wage access companies are not payday lenders and do not charge high interest or high fees.[19] Yet, despite sound industry standards and extensive federal and state regulation, critics have continued to push for more stringent oversight.[20] Fortunately, the CFPB excluded most earned wage access companies from its finalized payday loan rule, released in July 2020.[21]

The Myth of the "Debt Trap." Progressive critics also allege that supposed high-cost payday loans trap borrowers in a cycle of debt.[22] While it is true that some payday loan borrowers may struggle to pay off their debts, more often than not these borrowers get into that situation because they either repeatedly rolled over loans, defaulted, or borrowed from one lender to pay off another.

Rollovers are common in the payday loan industry. While rollovers may not seem ideal, many borrowers intentionally choose to roll over their loans because the benefits of not defaulting outweigh the costs of defaulting. This is illustrated by the fact that there is an inverse relationship between borrower rollovers and defaults.[23] The default rate on payday loans is less than 2.5 percent, which is lower than the rollover rate.[24]

Additionally, data indicate that most borrowers who roll over expect to do so from the moment they take out their first loan, which indicates that they are well aware of the cost of the loan and of their own ability to repay.[25] Ultimately, a majority of payday loan borrowers expect to pay back what they owe within three pay periods, or six weeks, and a majority of these borrowers are correct in their estimations.[26]

There is also growing evidence that increases in rollover and default rates in certain states are a result of interest rate caps.[27] Interest rate caps decrease the supply of credit, but the demand remains constant, so borrowers often turn to unsavory alternatives, such as loan sharks, and end up worse off. There is also evidence that repeat borrowing can be attributed to government-mandated caps that limit the size of a payday loan.[28] To get around these caps, borrowers often take out several smaller loans simultaneously or sequentially, thus maintaining the same level of debt they would have had without the cap, but with a more complicated payment process, and possibly higher total monthly payments.

How Interest Rate Caps Ultimately Hurt Consumers. Time and time again the results have shown that interest rate caps are a form of price control that reduces the availability of credit.[29]

A 2014 study by Jennifer Priestley of Kennesaw State University found that payday loans have modest consumer benefits beyond access to credit. Priestley concluded that her work adds to a "growing body of literature which shows that payday loans may not only fail to harm borrowers, but may actually contribute to an improvement in borrower welfare."[30]

In a 2016 study, Neil Bhutta of the Federal Reserve, Jacob Goldin of Stanford Law School, and Tatiana Homonoff of Cornell University found that payday lending restrictions reduce lending rates and that borrowers usually switch to other forms of high-cost credit when payday loans are not an option. They also found that payday lending restrictions result in an increase in involuntary checking account closures, which suggests that consumers are more likely to bounce checks and overdraw their bank accounts when they do not have access to payday loans.[31]

Similarly, in a 2017 study, University of Idaho economist Stefanie Ramirez found that payday lending restrictions result in significant increases in the use of costly pawn shop and second-mortgage lending, which puts people's homes at risk.[32]

There are several ways in which governments can restrict payday lending. Short of an outright prohibition, states can de facto ban payday lending through the use of rate caps that restrict the APR, usually to 36 percent.[33] Since a 36 percent rate cap is too low for payday lenders to make a profit, most businesses are forced to shutter their doors.[34] Currently, 17 states and the District of Columbia ban or de facto ban payday lending.[35]

In August 2020, Virginia Governor Ralph Northam signed into law the Virginia Fairness in Lending Act, which caps the fixed interest rate and fees at 36 percent. Other states have taken similar measures in recent years and their results have shown that rate caps and other attempts to change the market-determined value of payday loans are detrimental to consumers.[36]

Take, for example, Ohio's payday loan reform law, which then-Governor John Kasich signed in 2018 and came into full effect in April 2019. Just six months later, in October 2019, Ohio saw a substantial decrease in the availably of payday loans, with the number of payday lenders or licensees dropping from 161 to 30. By that time, the state had 700 fewer credit service organizations than it did at the end of 2018.[37]

After Colorado implemented an onerous payday loan law in 2010, a majority of the state's payday loan lenders closed, finding the pricing structure insufficiently profitable.[38] In 2014, National Consumer Law Center Associate Director Lauren Saunders argued that the Colorado law did not go far enough and urged Colorado and other states to implement a 36 percent rate cap to "[reduce] costs for borrowers" and "stop the payday loan debt trap."[39] In 2018, Colorado voters approved Proposition 111, which imposes a statewide 36 percent rate cap. Alex Horowitz, a senior officer with Pew Charitable Trusts, said, "In 15 other states that have a similar law on the books, there are no payday loan stores," adding, "There won't be payday loans anymore in Colorado."[40]

Federal lawmakers have sought to enact similar policies. The Veterans and Consumer Fair Credit Act (H.R.5050, S.2833, 116th Congress) sought to mandate a national 36 percent rate cap on consumer credit for all consumers.[41] The legislation was modeled on the 2006 Military Lending Act (MLA), which imposed a 36 percent interest rate cap on consumer credit for active-duty service members and their dependents.

Research since the MLA was signed into law shows that the legislation has offered no benefit to members of the military and their families, and may even have caused some harm. In 2017, researchers at the U.S. Military Academy at West Point found that payday lending has had no adverse effects on members of the military and that the MLA was unnecessary.[42] Further, since the MLA was enacted, the number of financial services companies operating near military bases and serving military families has dropped. This has contributed to the high number of military personnel suffering from financial distress, which more than doubled between 2014 and 2019.[43]

Bureaucrats at the Consumer Financial Protection Bureau have also made inroads into regulating payday loans. In 2010, the Dodd-Frank Act authorized the Consumer Financial Protection Bureau to oversee the payday loan industry but prohibited the bureau from imposing an interest rate cap on any type of consumer credit, including payday loans.[44] However, in October 2017, then-CFPB Director Richard Cordray issued a rule to regulate the payday loan industry without necessarily implementing an interest rate cap.[45] The 2017 payday loan rule proposed restrictions on loan underwriting and on lenders' ability to collect payment from borrowers.

In a report for the Community Financial Services Association of America, the economic research firm Charles River Associates found that the rule would have resulted in an 82.5 percent, or $19.5 billion, reduction in the availability of payday loan credit.[46] The report also found that the rule would have made it impossible for payday lenders to stay in business, as it would have resulted in an 82 percent reduction in revenue. In a scenario where the rule went into effect, the average storefront would have gone from making a yearly $37,000 in profit to taking $28,000 in losses. That would have left millions of Americans without access to credit.

In July 2020, the CFPB, under Director Kathy Kraninger, finalized a revision of the rule that rescinds the underwriting provisions but keeps the payments provision in place.[47]

Payday Loans Serve Consumer Preferences. Many payday loan consumers view the products as beneficial. In a 2018 survey of payday loan borrowers by Troy University economists Christy Bronson and Daniel Smith, 96 percent of participants responded that they believed payday lenders provided a useful service. Eighty-eight percent responded that they "did not believe that the government should limit the number of payday loans that individuals can receive in a year," 79 percent responded that they "did not believe that the government should be able to put a limit on the dollar amount of loans that individuals can take out yearly," and *100 percent* "indicated that they did not believe that the government should ban payday lending."[48]

Bronson and Smith went on to conclude that their research contributes to "the growing literature challenging the regulation of the payday lending industry as a mechanism for helping consumers," and that their results corroborate the findings of other studies that show "customers use payday lending to meet short-term financing needs, are overwhelmingly satisfied with their payday lending experience, believe they have adequate information when taking out a payday loan, and largely do not support further regulation of payday lending."[49]

Researchers outside the U.S. have contributed to this body of evidence. In a 2014 paper, Lithuanian researchers Valdonė Darškuvienė and Paulius Astromskis characterize access to credit as a fundamental human right and conclude that the payday loan industry "deserves special scrutiny and very careful regulation in order to avoid unreasonable and severe consequences." They go on to warn, "The error in preemptive restriction of access to credit … may be as harmful as over-indebtedness: shadow borrowing, opportunistic activities, crimes, divorces, and depression with its extreme suicidal form."[50]

Alternatives to APR to More Accurately Price the Cost of Short-Term Credit. The Truth in Lending Act was passed into law over 50 years ago. In the years since, it has become increasingly clear that APR is not an appropriate indicator of the cost of a payday loan. As of late, Congress has ignored this problem and instead has engaged in efforts to ban payday loans. However, there was a time when this was not the case.

During the 112th Congress (2011-2012), the Federal Financial Services and Credit Companies (FFSCC) Charter Act was introduced, which, among other things, would have mandated lenders to provide "a clear prominent statement in the loan agreement that states the *true cost* of the loan in terms of an actual finance charge per dollar of credit extended to such person instead of the annual percentage rate disclosure required under the Truth in Lending Act."[51] [Emphasis added] It attracted 20 cosponsors from both parties and was supported by the Competitive Enterprise Institute.[52]

During the 113th Congress (2013-2014), Rep. Blaine Luetkemeyer (R-MO) introduced the Consumer Credit Access, Innovation, and Modernization Act (H.R.1566), which built upon the FFSCC Charter Act by more closely defining "true cost," requiring that lenders provide "a clear and conspicuous statement in the loan agreement that discloses the true cost of the loan, including all interest, fees, and other loan-related charges, as a dollar amount and as a percentage of the principal amount of the loan in lieu of the annual percentage rate disclosure that otherwise would be required under the Truth in Lending Act (15 U.S.C. 1601 et seq.) or regulations prescribed pursuant to such Act."[53]

Both pieces of legislation would have helped consumers better understand the cost of payday loans and make more informed choices. Neither bill was passed by Congress.

U.S. lawmakers are not the only ones who realize that APR is not well suited for measuring the cost of payday loans. A 2012 paper by the Innovation and Skills Committee of the British House of Commons recommended that "APR should no longer be used to measure and compare the cost of payday loans" and that the cost figure advertised should only account for the amount borrowed, interest, and fees. The paper went on to recommend that "the total cost of the loan should be made clear" and show "how much it costs if paid back a week late, 2 weeks late, and so on, so consumers are made clear of the realities and penalties."[54]

Unfortunately, those recommendations fell on deaf ears, and in 2015 the Financial Conduct Authority implemented an interest rate cap and fee restrictions. These regulations have led to a £800 million ($1.035 billion) reduction in credit lending in just a few years, all but shutting down the payday lending industry in the United Kingdom.[55]

In Canada, legislators have been less critical of the pitfalls of APR but have expressed interest in alternative disclosures. Because Canada's federal government generally leaves consumer credit regulation to provinces and municipalities, there is a wide variance in payday loan regulation among jurisdictions.[56] In certain cases, some authorities forego more draconian interest rate caps in favor of more stringent yet consumer-friendly disclosures that deemphasize APR and instead emphasize charges, fees, and the total cost of the loan.[57] However, like the U.K., Canada has seen a decrease in payday lending because of the adoption of heavy-handed regulation in recent years.[58]

There is also much that the payday lending industry can do to pivot away from APR as a measure of cost. Gary Wolfram for the Mackinac Center for Public Policy in 2019 argued that "the financial services industry would benefit from developing and adopting an alternative measure that provides the borrower with clear, comparative cost information that will help them make an informed choice."[59] Since lenders work closely with borrowers directly, they may be better suited to tackle the APR challenge.

Furthermore, consumers tend to think in terms of dollars and cents, not percentages. Since most payday loan borrowers pay back their loan on time, this annualized calculation means little to the borrower. In a survey of payday loan borrowers by Federal Reserve economist Gregory Elliehausen, a large majority of respondents reported that they knew the finance charge on their most recent payday loan but that relatively few could accurately recall what the APR was.[60] An experimental study by economists Marianne Bertrand of the University of Chicago and Adair Morse of the University of California, Berkeley, also found that payday loan borrowers responded more to finance charges and disclosure of fees than they did to APR comparisons.[61]

That behavior is not unusual. Like payday loan borrowers, credit card users pay little attention to the APR but pay substantial attention to other features of the product, specifically the annual fee and rewards.[62]

Conclusion. Payday lending helps millions of marginalized Americans make ends meet every year. While not ideal for everyone, payday loans are often more affordable, convenient, and transparent than the realistic alternatives. Critics claims that these loans have high costs and are predatory, but existing research proves otherwise. Despite their relatively high APR, the loans are less expensive than bounced checks or overdraft fees. Furthermore, the bulk of evidence shows that government efforts to restrict their cost or availability hurt consumers.

Nevertheless, as is often the case, there appears to be a gap between public policy and the research literature on this issue. Discussing this at end of their 2013 paper, Federal Reserve economists Thomas Durkin and Gregory Elliehausen write:

> In passing TILA, Congress intended that nothing be hidden and that the most important disclosures be highlighted. For long-term loans, such as mortgage loans or automobile credit, the APR seems like the correct choice. But for short-term, small-dollar loans, the finance charge seems to be the most useful measure of credit price under common circumstances. Maybe it is time to consider a revision in thinking in this area and for experimental research to supplement the survey work with the goal of determining the best form for the finance charge disclosure on these forms of credit.[63]

Durkin and Elliehausen sum it up well. More research is needed to show what works best for consumers. Since current research seems to suggest that better disclosure of the finance charge and "true cost" of a loan might be the remedy, the federal and state governments should get out of the way to allow researchers and lenders to test new disclosure regimes.

To improve the small-dollar loan marketplace, lenders should continue to innovate with their products and voluntarily test new disclosure methods to help consumers better understand the cost of a loan. Researchers should work with lenders toward growing the body of research on payday lending and consumer welfare. At the same time, federal and state governments should take a hands-off approach to allow lenders and researchers to do their work without facing unnecessary red tape. Lawmakers and bureaucrats should avoid enacting laws or regulations that have a well-documented track record of being detrimental to consumers, especially rate caps.

Markets provide. Payday lenders and FinTech companies like Earnin and Dave provide a vital financial option to those who need it the most. If lenders are allowed to innovate, consumers will ultimately reap the benefits and prosper, leading to a smoother recovery from the pandemic.

Notes

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