CATO INSTITUTE | Center for Monetary and Financial Alternatives

Testimony
Before the U.S. House of Representatives Committee on Financial Services
Subcommittee on Consumer Protection and Financial Institutions
Hearing on "Ending Debt Traps in the Payday and Small Dollar Credit Industry"

Diego Zuluaga
Policy Analyst, Center for Monetary and Financial Alternatives, Cato Institute

April 30, 2019

Chairman Meeks, Ranking Member Luetkemeyer, members of the subcommittee, thank you for the opportunity to testify before you this afternoon.

My name is Diego Zuluaga and I am a policy analyst at the Cato Institute's Center for Monetary and Financial Alternatives.

Creating the conditions for a dynamic and competitive market for short-term credit is essential to promoting financial security and financial inclusion. At a time when 24 percent of American families, and 50 percent of low-income families, lack enough liquid savings to cover a $400 emergency expense,[1] broad and immediate access to credit is a matter of great urgency. Furthermore, with 8.4 million households unbanked and another 24.2 million underbanked,[2] a share of that emergency credit is bound to come from nonbanks, including payday and vehicle title lenders.[3]

Payday loans are often one of very few options available to cash-strapped households. 16 percent of payday borrowers use these loans to cover emergency expenses, while 69 percent borrow to pay for recurring items, such as rent and utility bills.[4] Payday loans offer a way to cope with unexpected events and month-to-month income volatility, which affects more than a third of American households with incomes below $50,000.[5]

---

[1] Neil Bhutta and Lisa Dettling, "Money in the Bank? Assessing Families' Liquid Savings using the Survey of Consumer Finances," Board of Governors of the Federal Reserve System, November 19, 2018, https://www.federalreserve.gov/econres/notes/feds-notes/assessing-families-liquid-savings-using-the-survey-of-consumer-finances-20181119.htm.

[2] Federal Deposit Insurance Corporation, "2017 FDIC National Survey of Unbanked and Underbanked Households," October 2018, 1, https://www.fdic.gov/householdsurvey/2017/2017report.pdf. "Unbanked" means no member of the household owns an account at an FDIC-insured institution. "Underbanked" means the household has an account but used products from alternative financial services providers – such as check cashers, payday lenders, pawn shops, and auto title lenders – in the last 12 months. Vehicle title lenders, because they use car titles as collateral, do not require a bank account. See Thomas W. Miller, Jr., *How Do Small-Dollar, Nonbank Loans Work?* (Mercatus Center at George Mason University, 2019), 12 and 34-39, https://www.mercatus.org/system/files/miller_small-dollar_nonbank_loans.pdf

[3] Traditionally, payday lenders have required borrowers to have a checking account. However, some lenders now accept proof of income or a savings account.

[4] Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why," July 2012, 14, https://www.pewtrusts.org/-/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.

[5] Jonathan Morduch and Rachel Schneider, *The Financial Diaries: How American Families Cope in a World of Uncertainty* (Princeton University Press, 2017), 33.

While the media often describe payday loans as predatory, the evidence suggests otherwise. Prof. Ronald Mann of Columbia Law School, in a study quoted extensively by the Consumer Financial Protection Bureau, finds that 60 percent of payday borrowers accurately estimate the time it will take them to repay the loan.[6] Importantly, there is no systematic bias in borrowers' predictions of repayment: borrowers overestimate roughly as much as they underestimate the time it will take them to repay.[7]

Prof. Mann's results contradict the assertion that payday borrowers are misled by predatory lenders, or that they suffer from behavioral biases. His results are not atypical of the empirical academic literature on payday lending, which finds that these loans are helpful to borrowers, and payday loan bans harmful, at least as often as it finds the opposite.[8]

Payday borrowers are not stupid. They make the best of limited options. As Prof. Lisa Servon of the University of Pennsylvania writes, "The question […] is whether expensive credit is better than no credit at all."[9] Like Prof. Servon, I worry that placing an interest cap on short-term credit would altogether remove access to emergency funds for the most vulnerable Americans.

I have had the opportunity to study in detail the impact of payday loan interest-rate caps in the United Kingdom. While UK regulators expected loan volume to decline by 11 percent after the introduction of the cap, it dropped by 56 percent – five times what regulators estimated – within 18 months.[10] The number of borrowers dropped by 53 percent, versus the 21 percent that regulators estimated.[11] Given that regulators' forecasts aimed for the "optimal" amount of payday borrowing, this miscalibration of the interest cap's impact almost surely left hundreds of thousands of borrowers worse off.

---

[6] Ronald Mann, "Assessing the Optimism of Payday Loan Borrowers," Columbia Law & Economics Working Paper No. 443 (2013), 18, https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=2798&context=faculty_scholarship.

[7] Ibid., 26.

[8] For evidence of the positive welfare effects of access to payday loans, see Neil Bhutta, Jacob Goldin, and Tatiana Homonoff, "Consumer Borrowing after Payday Loan Bans," *Journal of Law and Economics* Vol. 59 No. 1 (February 2016): 225-259, https://www.journals.uchicago.edu/doi/abs/10.1086/686033; Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans," Federal Reserve Bank of New York Staff Report no. 309, November 2007, revised February 2008, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr309.pdf; Adair Morse, "Payday Lenders: Heroes or Villains?," *Journal of Financial Economics* 102.1 (October 2011): 28-44, https://www.sciencedirect.com/journal/journal-of-financial-economics/vol/102/issue/1; Jonathan Zinman, "Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap," Journal of Banking and Finance 34.3 (March 2010): 546-556, https://www.sciencedirect.com/science/article/pii/S0378426609002283.

[9] Lisa Servon, *The Unbanking of America* (New York: Houghton Mifflin Harcourt, 2017), 83.

[10] Financial Conduct Authority, "High-Cost Credit: Including Review of the High-Cost Short-Term Credit Price Cap," Feedback Statement FS 17/2, July 2017, 11, https://www.fca.org.uk/publication/feedback/fs17-02.pdf; FCA, "Proposals for a price cap on high-cost short-term credit," Consultation Paper CP14/10, July 2014, 6, https://www.fca.org.uk/publication/consultation/cp14-10.pdf.

[11] Consumer Finance Association, "Impact of Regulation on High Cost Short Term Credit: Hoe the Functioning of the HCSTC Market Has Evolved," March 2017, 8, https://cfa-uk.co.uk/wp-content/uploads/2017/03/030317-HCSTC-and-market-functioning-Oxera.pdf.

I worry that the CFPB's payday rule, which predicts loan volume to drop by 62 to 68 percent but expects 90 percent of borrowers to retain *physical access* to payday facilities, will prove similarly over-optimistic. The consequences of regulatory error could be very damaging.

Low usury caps were once widespread across American credit markets. But Progressive reformers in the early 1900s recognized that these caps harmed low-income people by throwing them into the hands of loan sharks. Gradually, they persuaded legislators to lift or remove interest caps, helping the formal market for small-dollar credit to flourish.[12] Placing a cap on small-dollar loans risks leaving vulnerable households at the mercy of family members and unscrupulous providers – or forcing them to go without basic necessities.

Policymakers can, however, do more to promote financial inclusion. I welcome efforts to bring a greater focus on underserved households to financial regulators. For example, the CFPB and FDIC should conduct a joint review of the regulatory costs to banks of maintaining deposit accounts. This will permit them to compare the costs of regulation with its benefits and determine whether financial regulation excludes low-income and minority borrowers.

But I would not limit this work to fostering access to depository institutions, important as such access is. Financial innovations like mobile money accounts have delivered impressive results in Africa and Asia.[13] With 81 percent of Americans now owning a smartphone, and another 13 percent owning a more basic cell phone,[14] mobile money accounts could bring essential financial services to households which, for reasons related to cost, trust, or both, do not own a bank account.[15] Mobile payments could help low-income consumers avoid account fees and gradually gain access to other financial services.

Thank you. I'd be happy to answer any questions.

---

[12] Miller, *How Do Small-Dollar, Nonbank Loans Work?*, 30-31. See also "The Uniform Small Loan Law," *Columbia Law Review* Vol. 23 No. 5 (May 1923): 484-487, https://www.jstor.org/stable/1112339?seq=1#metadata_info_tab_contents.

[13] Asli Demirgüç-Kunt, Leora Klapper, Dorothe Singer, Saniya Ansar, and Jake Hess, "Global Findex Database 2017: Measuring Financial Inclusion and the Fintech Revolution," World Bank Group, 2018, 22, https://globalfindex.worldbank.org/.

[14] Kyle Taylor and Laura Silva, "Smartphone Ownership Is Growing Rapidly Around the World, but Not Always Equally," Pew Research Center, February 5, 2019, https://www.pewglobal.org/2019/02/05/smartphone-ownership-is-growing-rapidly-around-the-world-but-not-always-equally/.

[15] According to the FDIC, 53 percent of the unbanked cite not having enough funds as a reason for lacking a bank account; 30 banks say they do not trust banks; 28 percent believe being unbanked gives them more privacy; and 25 percent say bank account fees are too high. See FDIC, "2017 FDIC National Survey of Unbanked and Underbanked Households," October 2018, 4.