A Misguided Campaign Against Payday Lenders

By Ronald L. Rubin

A lawsuit filed last month by the payday lending industry's trade group, the Community Financial Services Association of America, against several federal agencies offers a study in government paternalism. The lawsuit is a long shot, attempting to stop regulators from harassing payday lenders through coercive advice to banks and intrusive investigations. But the association's complaint has drawn sufficient interest in Washington to have prompted a House Financial Services Committee hearing on Tuesday.

The payday-lending business, which is legal in 35 states, involves lending small amounts of money—$375 on average—to people in need of quick cash, and using their next paychecks as collateral. The loans typically carry fees of about $15 for every $100 borrowed, and must be repaid within 14 days (by the next payday). Many borrowers repeatedly "roll over" their loans by taking out identical new ones and repaying the fees.

Payday lenders are widely vilified as predators who take advantage of desperate people, though research doesn't support that view. Studies by the Pew Charitable Trusts of storefront payday lenders over the past two years found that six out of seven borrowers say the "terms and conditions are clear." Most borrowers have other options to deal with a cash shortfall, such as cutting back expenses or borrowing from friends and family.

Borrowers are "deeply conflicted" about the loans, expressing "relief upon receiving credit at a tough time," saying the loans relieve stress, rather than cause it,

> Short-term borrowers, it turns out, tend to know what they're getting into.

by a 56% to 31% margin, but also feeling "that the loans take advantage of them." Lenders, Pew found, rely on "repeat borrowing, because they would not earn enough revenue to stay in business if the average customer paid off the loan within a few weeks." Even with annualized interest rates that exceed 300%, the loans are small relative to payday lenders' overhead, which eats up 66% of revenue.

Expensive short-term loans can be a burden if they become long-term, but they are often lifesavers. Payday loans are available to individuals who might otherwise be denied credit, are preferable to loan sharks, are frequently cheaper than overdraft fees, and often are used out of simple convenience. Consumers like payday loans; they just don't like the price.

Federal regulators don't dispute Pew's findings and similar research. Still, they think they know better than the consumers who choose these loans and the state legislators who legalized them. The Federal Deposit Insurance Corporation and the Comptroller of the Currency have issued informal guidance that discourages banks from performing payment-processing services for payday lenders. The agencies warn that the "reputational risk" of doing so is a threat to the banks' safety and soundness, and many have responded by discontinuing the service.

The Justice Department has achieved similar results through its "Operation Chokepoint." The initiative's stated objective is stopping fraudulent businesses by cutting off their access to bank payment-processing services. Even the possibility of investigation has led many banks to stop doing business with payday lenders that Justice deems "risky."

The biggest threat to payday lenders is the Consumer Financial Protection Bureau, the powerful agency created by the Dodd-Frank law in 2010. The CFPB will soon issue new industry regulations and has signaled that it may require lenders to pre-screen borrowers' finances, and limit borrowers' ability to roll over loans.

In other words, the CFPB wants to keep payday loans available to people who repay them quickly and deny the loans to those who don't. That may sound reasonable, but as is the case with credit cards, rejecting profitable borrowers while lending to unprofitable ones is not a viable business. Payday lenders would be forced to charge even higher interest rates or shut down. Either outcome would limit access to credit, contrary to the CFPB's official mission.

The CFPB should only create programs to educate consumers about payday loans, pass regulations to ensure that lenders follow existing laws and prosecute businesses that don't treat borrowers honestly. The Dodd-Frank law requires these actions, and no more. The CFPB wasn't created to protect consumers from themselves.

Informed consumers who take out a loan have calculated that they are better off with that loan than without it. A borrower's desperation does not alter this equation. A man whose car is about to be repossessed may calculate that he is better off taking out a payday loan than losing his job because he lacks transportation. The government is blind to such motivations, and it can harm consumers by substituting its judgment for theirs. It is better to help consumers make good decisions than to make decisions for them.

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