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A Good Day for Loan Sharks

By Ronald L. Rubin

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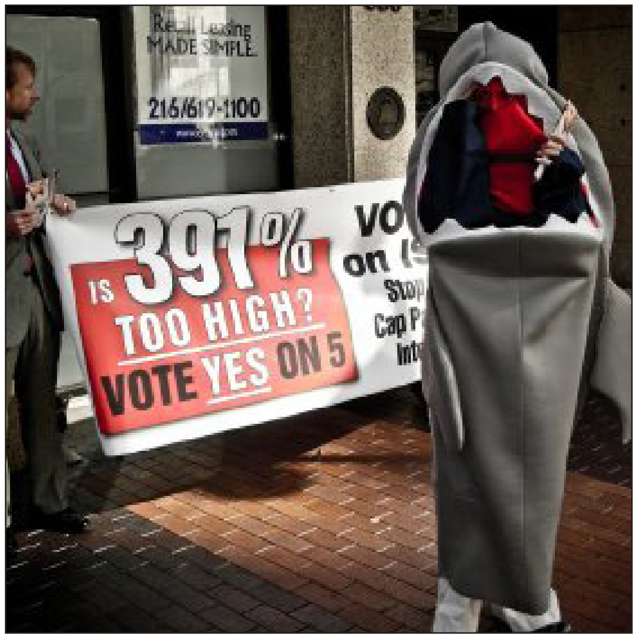
Despite strong opposition from federal and state elected officials of both parties, including a bill sponsored by Democratic National Committee chair Debbie Wasserman Schultz, the Consumer Financial Protection Bureau is about to eliminate the only credit available to millions of low income Americans. Earlier today, the bureau unveiled proposed regulations so onerous that they will make many payday loans, deposit advance products, open-end lines of credit, and vehicle title loans unprofitable.



JOSHUA ROTHHAAS

The CFPB's main target is payday loans, which are generally limited to $500 or less, must be repaid every two weeks, and come with fees around $15 per $100 borrowed. More than two thirds of states have exempted the loans from interest rate caps. Studies consistently find that consumers like payday loans and understand their terms. The meddling bureaucrats think they know better.

The heart of the 1,334-page rule proposal is a requirement that lenders do a lengthy investigation and analysis of borrowers' ability to repay the small loans. The process will be so costly that it won't be a serious option, especially since anyone who passed the test would probably have no trouble repaying his or her loan without subsequent loans. A borrower who doesn't clear the ability-to-repay hurdles can still get a loan, but will be limited to two progressively smaller loans to repay the first one.

The CFPB knows that it costs more than one loan fee to attract and initiate each new customer, so as with credit cards, profitability depends on loans being rolled over. The proposed rules both increase borrower acquisition expenses and make it nearly impossible to spread those expenses over repeat loans.

The 2010 Dodd-Frank law that created the CFPB forbids it from capping interest rates, but the powerful regulator routinely circumvents inconvenient obstacles like the law. Killing payday loans is just an underhanded way of capping their interest rates.

This is not consumer protection. The barriers to offering payday loans are low, so rival lenders must compete for customers by reducing fees until excess profits disappear. As the CFPB's director, Richard Cordray, recently testified, "It's actually a difficult product economically; there's high costs involved in defaults, there's high costs involved in customer acquisition, so there are not supernormal profits being made."

And yet opponents continue to call the loans "predatory" because the $15 fee can be characterized as 15 percent interest on a two-week loan, multiplied by 26, and tagged with a usurious 390 percent interest rate.

Discussing annualized interest rates on payday loans as if they were secured mortgages, auto loans, or even credit card debt is absurd. A big part of every payday loan fee is not interest at all. Rather, it is the cost of manufacturing the product – the store rent and salaries that create access to emergency cash. Consumers are willing to pay for convenience. ATM fees are not labeled interest.

Furthermore, all interest rates have two primary components, the time value of money and the likelihood of default. For the past eight years, the time value of money—the risk-free interest rate—has been close to zero. Therefore, competitive interest rates are now almost entirely based on the second component, default risk.

At a Congressional hearing last year, a consumer advocate testified that the interest rate for payday loans should be capped at 36 percent, the legal limit for loans to armed service members. A congressman responded with a question that perfectly illustrated the fallacy of converting payday loan fees into annualized interest rates: Would you loan me $100 for two weeks in return for one dollar? That's about a 36 percent interest rate.

The obvious answer is no because the dollar earned is not worth the risk of losing $100, especially when the borrower is financially strapped. The fate of that $100 rests in the same precarious hands whether the loan term is two weeks or one year. Risk rather than time drives current interest rates, so even if convenience-related fees are characterized as interest, 15 percent, not 390 percent, is the fair measure of payday lenders' avarice.

Cordray doesn't deny that the proposed rules will put most payday lenders out of business, but he believes he can convince community banks and credit unions to fill the void at lower prices. Earlier this year, he announced discussions with financial institutions aimed at getting them to offer inexpensive small dollar loans, which he calls "rescue products."

The former Jeopardy champion is no fool. He knows that banks would not need a push if such products were profitable, and that the CFPB's new rules will make the loans even bigger money losers.

There is only one reason Cordray might expect his jawboning to succeed—fear. The CFPB is judge, jury, and executioner over consumer financial laws. It determines which institutions to investigate, what laws they violated, whether their business practices are "abusive," and how many millions of dollars in fines they owe. The director and his suggestions cannot be ignored.

And so the banks will promise to offer cheap payday loan substitutes, and then drag their feet and pray for a Republican president to replace Cordray. The CFPB's media machine will trumpet the demise of the evil payday lenders and herald the imminent arrival of cheap rescue products. In the meantime, the remaining options for many cash-strapped Americans will be loan sharks, bankruptcy, and crime.

Ronald L. Rubin was an enforcement attorney at the Consumer Financial Protection Bureau and chief advisor on regulatory policy at the House Financial Services Committee.