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Comment Letter on CFPB's Proposed Regulations for Payday Lending

Dear Consumer Finance Protection Bureau,

I am writing this note to offer my academic perspective concerning the Payday Lending proposed regulation.[1] I commend the CFPB in trying to take a balanced approach, despite the polarized views on payday lending. The interest groups are reacting quite vocally to the proposal, with one side arguing that the rules proposed do not go far enough in shutting down a lending product with extreme interest rates, and the other side claiming that the proposed rules will cost thousands of jobs and paternalistically prohibit access to finance when surveyed customers indicate satisfaction with having access to the product. I urge you to judge the arguments being expressed based on economics, not ideology.

In my note below, I try to confine my comments to knowledge or intuition learned through scientific method, certified by publication in top academic journals. Before I discuss the regulatory innovations, I first characterize the landscape in a way that I believe would be acceptable to almost all top academic researchers in the field.

[1] I am restricting attention to payday loans per se, and not the regulation proposal covering title loans or the loan products for lower-risk borrowers.

Economic Characterization of Payday Lending Market: Items Relevant for Policy Discussion.[2]

(i) There is demand by the population for some kind of distress finance.

One need not look far beyond revealed preference; a startling percent of the population uses distress financial product such as payday loans, pawn loans, title loans, etc.

(ii) There is an incomplete understanding of distress finance situations, in particular:

a. What gets people into distress financial situations.[3]
b. What people would do to cope once in distress if there were no formal access to distress finance.
c. To what extent people would ex ante avoid getting themselves into distress financial situations if they knew that they did not have access to distress finance.

(iii) Despite the incomplete understanding of point (ii), it is straightforward to assert that people's need for and use of distress finance products is heterogeneous. Numerous academic articles consider whether payday lending existence is welfare improving or destroying as a whole.[4] A general conclusion is that economists can imagine that a payday loan may destroy welfare in some situations and may improve welfare in others. There is little consensus among academics as to which view represents the majority of borrowers. In my opinion, resolving this consensus is not first order, as I describe in the next point.

a. Payday lending is likely to be welfare improving for some individuals using payday loans as bridge finance to cope while working out a longer-term solution (e.g., downsizing expenses or assets, restructuring or finding new lower-cost debt, increasing income). Note that it need not be that a borrower resolve his or her financial distress situation in a single payday loan cycle (usually about 14 days) for payday borrowing to be welfare improving, although it is unlikely that a prolonged rolling-over of payday loans reflects a welfare improving situation. The key insight is that the alternatives for people in distress situations are often bleak. A lack of access to distress finance likely implies an even larger cost in dollar or APR terms in some situations (e.g., getting evicted, fees on utilities, job risk, etc.).

[2] The CFPB, in the text of the proposed regulation, also offered a characterization of the market. My short characterization is more economic in nature, ignoring issues of governance abuse. I mention this because the CFPB is charged with being both a policy-maker and a watchdog. I want to emphasize that policy formation regarding the form of financial products should be based on the economics of optimization. Indeed, governance policies are absolutely needed to ensure that abuses do not happen, thus the need for watchdogging. However, in this case, we need to be careful to optimize the product for the people of the United States first, assuming that (and acting upon making this assumption happen) governance standards can also be implemented to curb abuse situations. In my opinion, the proposed regulation does this, but the text of the literature review sometimes ventures into a tone suggesting that the proposal heavily weighs anecdotes. I would encourage the CFPB to make its arguments crisp to the economic benefits. I am not at all discouraging watchdogging, just separating the functions.

[3] I define a distress financial situation as one in which the liquidity of cash available to an individual or household is insufficient to cover necessary expenses in the short term. This definition imposes no need to have a "distress event" for a household to arrive in a distress financial situation.

[4] I am not making judgements on the form of the utility in my statements. I believe the statements are sufficiently general. Many academic references for this discussion are available on my website in the form of a recent discussion from the NBER Summer Institute 2016.

b. Payday lending is likely welfare destroying in other situations. First, because of the expense of payday lending, welfare is likely to decline if individuals use payday loans when they had access to another way to cope initially. Second, welfare is also likely to decline for those who might have been in the above paragraph (with the alternatives for coping being more expensive), but who did not alter spending patterns to save during the payday cycle to pay back the loan. The payday loan product is designed to be a short term bridge product, not lifecycle finance. In this case, the dollar cost of continued borrowings of payday loans becomes worse on budgets than many of the failure-to-cope costs which the individual would have incurred up front. Third, welfare is likely to decline for some of those who do not avoid ex ante getting into distress situations because of the knowledge that payday loans are available. The extent to this third category depends on the model of welfare and utility imposed by the researcher.

(iv) The answer to this welfare debate may be relevant for policy-makers forced to, or choosing to, make a yes/no decision as to whether payday lending should be fully banned versus being fully allowed in its present form. However, if regulators are concerned with seeking pareto-improving regulations (i.e., those helping some people but not hurting any people), the heterogeneity discussed above suggests that the policy should not be focused on a yes/no decision about payday loans as is, but rather on the prospect of individuals in distress financial situations having access to better forms of existing finance products or better products.

(v) These better finance products may or may not evolve out of payday lending storefronts.[5]

a. In the CFPB's document, the authors use anecdotes to criticize the storefronts, in particular the encouragement of having borrowers return to the payday loan store to service their debt. This criticism is applicable to those payday lending firms' policies that encourage store clerks to encourage rolling-over of loans unnecessarily. However, this part of the CFPB's commentary implies somewhat incorrectly that it is bad to have individuals borrow and service loans from a physical location. The academic literature shows in different contexts that physical interaction of households with financiers leads to more saving in the interim, which in this case, would lead to better use of bridge finance. Likewise, the necessity of going to a storefront to procure a loan in the first place is likely to decrease impulse borrowing. Needless to say, however, given the anecdotes in the CFPB's documents, more governance regulation or enforcement of lenders is needed to curb abuses that happen at payday lending stores whereby borrowers are steered into suboptimal use of loan products.

b. A notion exists in policy and academic circles that individuals should be "banked". In fact, all payday loan borrowers are banked. But the notion implies that a system should not emerge such that people's financial needs (liquidity, savings, borrowing, bill payment, etc.) are met by non-traditional financial structures. The academic literature

[5] Note that I am ignoring access to online payday lending in this section. In the United States, storefront payday lenders are the main subject of discussion. In the UK, interestingly, much of payday lending happens remotely. It is not a coincidence, in my opinion and only as a proposition, that the much wider population use of payday lending in the UK than the US comes from the combination of the lack of stigma associated with remote payday lending combined with the fact that the main accepted lenders are online.

does not support or reject this proposition, in part because there is very little discussion. Some relevant points to consider are:

i. The extent to which bank products cater to those with wealth and/or are expensive for those in distress or in certain income brackets.
ii. The extent to which either traditional or non-traditional financial products cater to behavioral biases or cognitive limitations of individuals.
iii. The extent to which banks or non-banks can package services to those in distress or in certain income brackets that can be viable for the financier.

My point here is that it is not at all obvious that storefronts need to be considered inferior modes of provision of finance to some members of the population. I do not think academic research supports this view. Rather, the question is about the product and conduct.

(As a side note, for a long time, I have favored the idea of at least exploring how Post Offices might serve as location of providing finance as in many other countries (e.g., Japan, France). This is an idea now being floated in Washington. I agree with the economics of that proposal.)

(vi) The payday lending *product* has certain characteristics that are suboptimal.

a. The payday loan mechanism design does not endogenously sort individuals.
If we know that some individuals need bridge finance and others would be better without it, should not the goal of any policy be to design products which by their features accomplish this sorting. Two examples of ideas include (i) implementing a delay in borrowing to remove temptation spending as a cause of borrowing and (ii) structuring loans with timelines and payback features that are more onerous to those viewing payday loans as anything other than a bridge loan. More research and testing needs to be done to create and broaden ideas on mechanism design that endogenously sort individuals.

The pricing structure is also not set up to sort individuals. This suggestion is of course problematic for a number of reasons. First is the reality that as a deferred payment structure, state regulation may make risk-pricing more complicated regulation-wise across jurisdictions. Second is the problem that one does not want pricing to reward volume-based "good payday customers" in the sense of those individuals who use payday loans a lot. Rather, the pricing should be favored toward those using the product in conjunction with their efforts to pay back the loan as quickly as they can. For example, price discounts could be offered ex post for making larger progress on paying down the principle than mandated by law.

b. The timeline of pay back in the payday loan product is unrealistic in many cases. Recent FINRA surveys of financial capacities of Americans find that approximately 38% of people have expenses that approximately equal their incomes. Another 18% spend more than their incomes. This suggests that perhaps up to half of the population (incorporating spending out of wealth in the assessment) live month-to-month. Thus, when expense shocks arrive, given consumption commitments, many people cannot feasibly save out of income or rebalance consumption commitments in a single income cycle sufficiently to pay back the loan. The fact that the paying back of a loan in a single pay cycle is

infeasible in many cases can encourage a culture of rolling-over rather than saving toward a goal. It also leaves freedom for lenders to encourage greater use of the product.

The term structure has historical precedent coming out of court rulings on this product being a deferred deposit product rather than a loan product. Nevertheless, the timeline is not realistic for many and may imply more fees (not just the fixed costs part of the fee covering the cycle loan, but late fees and draw fees) than would be seen in products with maturity matched to people's ability to pay.

c. As suggested in the points above, the product design does not encourage saving-for-payback behavior. In a study I did with Marianne Bertrand, published in the Journal of Finance in 2011, we find that people can change their saving-for payback behavior if they are encouraged to think about the costs of borrowing. It matters that if a person has $100 in her pocket and an outstanding loan of $400, she should use the cash to lower the principle as much as she can, rolling over a smaller loan. In practice, this is not the behavior observed in many cases. People often defer paying back a payday loan until they possess the entire sum. If the loan product forced principle payback, the evidence suggests that people would hold the debt a shorter period of time.

d. A more coordinated registration of loans across lenders and states will matter. Before states individually began mandating databases that record loans across lenders, people would get into deep debt trouble by borrowing from multiple lenders simultaneously. Curbing this practice is very likely to be optimal on average for both borrowers and upstanding lenders.

Much has been said about the large fees in payday loans. Indeed they are large. However, if a borrower defaults immediately on a loan, a payday lender by definition loses money. Thus, payday lenders are not well served by extending loans with no feasibility of ultimate payback. Lenders indeed care about borrowers' ability to pay and in most firms, incorporate such a criterion in loan issuance. Thus, if a person's borrowing need is greater than their ability-to-pay to such extent that that person is borrowing maximum amounts from multiple lenders and a prospective lender sees this information, a lender[6] who is trying to make a viable business off loans given and repaid would not want to provide that loan. Thus, lenders can benefit from knowing if a customer has an outstanding payday loan from another firm, even if volume falls.[7]

Likewise, although borrowers may desire the flexibility of access to multiple lenders to meet larger borrowing needs, it is likely that the payday product is not going to enable the borrower to bridge such a large cash shortfall if the amount

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[6] I am assuming the lender is not among those considered rogue by peer lenders in the sense of trying to make money only off delinquency rather than off successful loans. I ignore rogue lenders' welfare.

[7] Individual lenders, particularly small ones, may argue that the distribution of costs in a registration process favors larger lenders. This is surely true. However, most researchers would probably calculate that any negative societal welfare coming from this imbalance in costs more than offset by welfare benefits of coordination of information in this sector.

needed requires multiple loans simultaneously. In such a situation, the borrower likely would be better off by finding a way to restructure ex ante.

e. As I head into commenting on the proposed regulations, one more product feature is relevant. It is important to consider that payday loans are expensive, on both sides. The loan cost to the borrow looks (and is) terrible for the borrower in annualized terms – about 400% APR usually. However, to be clear, the lender also faces a product that is expensive to provide, not just in the fixed costs of provision of a small dollar product, but in the reality of an extremely high default rate (about 50 cents on the dollar according to this CFPB report). Thus, any reduction in price for this product must consider default and viability calculations.

<u>Comments on the CFPB proposal</u>

Comment Topic 1: Ability-to-pay calculation

The proposal lays out a new process by which payday lenders would be required, for the mainstay payday loan product, to go through an ability-to-pay calculation. Much has been made of this innovation in the media. I appreciate the ability-to-pay concept. It is, for a reason, a concept that lenders have used in customer loans since the beginning of loans. However, it is not clear to me how much the take-up will be of the ability-to-pay product given my comments below and the availability of the alternative restricted payday loan product (discussed in Comment 2). Why might this be?

We have to ponder which parties desire to go through the ability-to-pay calculation. As I understand the proposal, the lenders would take the customer's income information (as they already do), pull the other debt / debt payments information from one of the national credit agencies, and then add-in a geography-based estimate of living expenses to determine how much cash flow a potential customer might have to cover the loan.

Would a lender desire to do this calculation? It is worth nothing that they could have already done such a calculation if it had been profit maximizing to do so. There is a cost involved, however, of paying the credit agency and participating with the credit agency on reporting. The benefits of getting a more precise estimate of the debt position of each customer may not be larger than that cost. It is likely that payday lenders already have a fairly good sense of the credit condition of their borrowers on average. Over time, the underwriting departments of payday lenders have used scoring techniques to estimate what levels of income are needed to cover costs in different geographies, based on their proprietary default data. Thus, it may be that the benefits to the lender in terms of getting the precise view of each potential borrower's debt obligations are not large enough to cover costs involved.

The other side of this assessment is that borrowers are unlikely to favor processes whereby an inquiry from a payday lender shows up on their credit registry. This is likely to be true even if the lender reports good borrowing behavior back to the credit registry. I could not completely discern whether the CFPB had in mind the formal credit scoring agencies, but in their summary, the CFBP states:

> "In addition, lenders would be required to check a consumer's credit report to verify the amount of outstanding loans and required payments."

It is unlikely that a payday loan inquiry sends a good signal on one's credit history, even with a good payback record. The CFPB's proposal mentions the following about credit agencies:

“From market outreach, the Bureau is aware that the specialty consumer reporting agencies contractually require any lender that obtains data to also report data to them, although compliance may vary.”

If the process has built in it ways for payday lenders to silently participate (how?) with credit registries, then the concern is only about the cost to the lender being passed on to the borrower.

Out of this, I have a few suggestions for the CFPB:

1a. To the extent that I am correct about the credit agencies, which the CFPB seems to suggest in their report, would it not be feasible to implement a simpler ability-to-pay calculation without the credit agency data (other than the payday loan registry data)? The CFPB could work with lenders on estimates of debt payments, based on assumptions of debt capacity being a certain proportion of income on average and being maxed out for payday customers. Estimates of the cost of living based on geography would still apply.

1b. I would argue that regulators might use the selection of borrowers who choose to go through the ability-to-pay assessment as an opportunity to mandate [lower] risk pricing. Imagine that a state has a set price cap of a certain fee *f* per $100 loan. Based on the notions of endogenous selection I previously outlined, one could mandate that those potential customers *choosing* to select into being appraised through their formal credit records would be given a mandated discount off the standard fee (e.g., *f*.75* for the best bucket credit score, *f*.8* for the second best bucket,… , *f*1* for the worst bucket), without increasing the fee to others. Credit scores are not subjective; thus the CFPB could offer guidance or rules of this bucketing, based on their own calculations of default by credit score, income and geography in combination with lenders. The idea here is not to take away all of the economic incentive of lenders, but to viably offer a lower-cost product by sorting borrowers.

Why would this work? One has to ask who would select into this credit score procedure. The answer is that those with better credit scores would want to be assessed. Thus, the offering of the additional rigor would sort types, with less risky types choosing the more formal procedure. Lenders could then viably offer lower rates without facing the same default probability.

1c. Important Note: There is one hindrance to my assessment of this positive selection. The way that the CFPB’s proposal is written, *in my reading*, it appears that the mandated installment-like feature of the ‘Certain Short-Term Loan’ option (my comment 2 below) is not mandated for this ability-to-pay payday loan product. In other words, in Comment 2, I praise the innovation of the required payback of principle in steps over three cycles. The mainstay payday loan (ability-to-pay) product does not seem to have this feature. This may encourage lifecycle borrowers, i.e., those not using payday loans as *short term* bridge products as they were designed, to use the ability-to-pay payday loan rather than the ‘Certain Short-Term Loan’ as outlined below. I strongly encourage the CFPB to consider the implication of allowing longer-term borrowers to sort themselves into a longer-term product. I understand that the ability-to-pay assessment is intended to prune this option. However, it seems suboptimal to facilitate lifecycle use of payday loans rather than use the innovation of these two products to provide an opportunity for individuals to sort into a lower-cost product. As I mentioned in my characterization, although you will find many economists who believe there are situations in which (expensive) bridge borrowing can be optimal, you will find a much fewer number who would

support a notion that payday lending is welfare improving if individuals are using the product over many, many cycles.

1d. The CFPB must be clear as to what it means to have the ability to repay, in particular considering how borrowers' inability to make a first repayment affects the ability to pay assessment in the next cycle and so forth dynamically. In other words, to avoid continued rollovers, the CFPB might provide rules as to how an inability to pay back in a cycle affects the assessment of ability to repay in the next cycle.

Comment Topic 2: Features of 'Certain Short-Term Loan' option.

As I mentioned above, much has been said about the ability-to-pay test, but I believe this to be a bit of a sideshow. With the existence of the Certain Short-Term Loans option, it is unlikely that many lenders or borrowers would want to go through the process of compliance with the ability-to-pay calculations.

First, let me commend the CFPB on the principle paydown feature of this loan. For many years, I have been advocating a mechanism that forces borrowers to save in the interim to make incremental progress on the principle of payday loans. This feature of the CFPB's proposal does exactly this, and I believe it will make a large difference in the livelihoods of people. Upon returning to the payday loan store after one payday cycle, individuals can only re-borrow two-thirds of the original amount, and one third after two payday cycles. This effectively forces principle paydown, in combination with the registry whereby borrowers cannot cross-borrow from other payday lenders. It is furthermore, in my opinion, more realistic to the timing of people's situation than some state laws which prohibit any re-borrowing. In my opinion, sometimes two weeks (the median pay cycle) is simply not long enough to save up or restructure in order to service the whole principle for many expense shock situations. Bridge loan products should be realistic to the tensions of budgets, but also encourage use of the product only as a bridge.

I have one suggestion on this product:

As mentioned in my summary, the reason that payday loans are so expensive is primarily the default rate. Thus, those paying back the loan on time are subsidizing those who default. Would not the implementation of the three-cycle loan be an opportunity to ex post re-balance this bearing of the costs? Let me assume for the moment (this is not that way that the CFPBs proposal is written) that people who could take out the new 'Certain Short-Term Loan' are doing so with the view that it is a three cycle installment loan, whereby the borrower must service the loan installments in the interim periods in order to stay in good standing. Otherwise, the loan is called. If a borrower happens to be able to pay back the loan in two periods or one period, rather than three, is it not that this person was ex post lower risk in behavior? Or, even if the borrower is able to make bigger payments in the interim periods, and thus taking a lower third cycle loan, would not this person also be considered ex post to have been deemed a lower risk?[8] My point here is to make strides to remedy the low risk borrowers from subsidizing the high risk types. Let me give an example of how this could be implemented using ex post fee reduction.

Imagine the three cycle installment payday loan (my terminology for the `Certain Short-Term Loan') with a face value of L charging a fee of F per \$100 per cycle. This fee will be the fair fee for the pool of borrowers who keep the loan to the maximum allowed (L, $2/3L$, and $1/3L$ in the three cycles), including

[8] The notion of prepayment risk from the mortgage market is not the right way to think about costs in payday loans, where the structure of costs is dominated by default.

those defaulting along the way. Thus, this fee is appropriate fee for those who do not have the financial or behavioral capacity to sort themselves into a better payback regime. For individuals who are able to pay back the loan quicker, the fee F reflects an interest rate higher than the borrowers' risk. But, the payday lender does not know this ex ante.

The key insight here is that an ex ante price structure differential would not encourage an altering of saving-for-payback behavior, but a refund ex post might do so. My suggestion is that when a borrower pays back a loan ahead of the full three cycle maximum (L, $2/3L$, and $1/3L$), the customer could earn an ex post refund of part of F. With microdata, the CFPB can appropriately calculate what that discount should be. It is important that the fee refund be a continuous proportion for any early payback, rewarding any effort on the part of the borrower. For example, imagine that a fair fee, including economic returns to the lender, for an [unobservable] lower risk payday borrower is a fee of $80\%F$. (I do not know at all is 80% is a correct number, but chose a number based on a norm of 20% discount used in business applications broadly.)

- If the borrower pays back the loan in one cycle, she gets a refund of $20\%F$.[9]
- Imagine that the borrower instead re-borrows $2/3L$, per the max allowed, but pays back after cycle 2. The borrower would only get a refund on $20\%F$ on the second loan. The effective interest rate could then be calculated off the average fee over two cycles of $(F+80\%F)/2 = 90\%F$.
- If the borrower instead takes out a loan of 1/3L in cycle two, the borrower would receive a refund at the end of cycle 1 of (1/2*20%)F, as a reward for making progress on the loan. (The ½ comes from the fact that the borrower only re-borrowed half for the total allowed amount (2/3L).) Thus the borrower gets a reward and also pays a lower total fee for the next round because the principle (1/3L) is smaller.

Let me be my own devil's advocate here. My proposal of refunds takes money out of the payday lenders coffers and reward those who can afford to alter their payback behavior. Does this mean the F has to be larger than the f standard I was discussing earlier in order for payday lenders to stay in business? I do not believe this to be the case, but this is not crystal clear. If borrowers make better consumption-saving decisions, defaults fall because of inducing better patterns of payback. In addition, the opportunity to offer refunds could be packaged in a way to use payday loan storefronts to offer more complete financial services whereby lenders evolve to profit on other aspects of customer relationships.

Details of this suggestion need to be worked out with data, but the point I want strongly to make is that advocates like to argue that payday loans are way too expensive. Indeed they are expensive. But they are costly too because if default. If the product itself discourages default by designing incentives to improve borrowers saving for payback, then the overall rates needed to cover the provision of these loans will decline.

Comment Topic 3: Collections

The proposed regulation offers restrictions on the frequency of ACH pulls as well as on announcements of pulls forthcoming. These are gatekeeping regulation proposals, and I am completely sympathetic to the CFPBs writing of these rules coming from bad governance practices of some lenders. I agree with the proposals. I do have one comment, however, from the vantage of thinking holistically about collections.

[9] Note that if a \$300 14-day loan costs \$45 in fees (F=\$15), the standard APR is 391%. In this scenario, the effective ex post APR is instead 313%. These calculations, while informative, mask the truth that it is not the APR that gets individuals in debt trouble per se, but the duration of paying back the loan at any such high APRs. Thus, any innovation that induces individuals to shorten duration is desirable.

The CFBP's document has the flavor that collecting on loans is bad. But how are we ever going to get the product to be offered at a lower cost if lenders cannot collect what they have loaned? I think the market would benefit from some clarification offered to lenders on what they *can* do to collect on loans, removing policy uncertainty that inhibit their being able to enact collections to recover delinquent loans. One might wonder what good is a right to access a borrower's bank account to recover loan balances if that right expires.

Comment Topic 4: Counseling

As the CFPB implements mechanisms to curb use, especially among heavy users, policy makers should be very cognizant that these individuals might instead pursue more expensive/dangerous sources of liquidity. This is a bit of a dilemma for policy makers, because we have an incomplete picture of what people will do instead. (Please see the work of Neil Bhutta, Paige Skiba and Jeremy.) We do not want to alienate these people, but rather help them learn to manage financial options better. It would be helpful if the CFPB had a long-term strategy to implement programs offering financial counseling. These programs are direly needed, especially reaching out to those for whom the new payday restrictions would be a binding constraint. Of course, costs are involved, but the societal welfare costs of debt distress may be larger than preventative engagement.

I want to end my comments by again commending the CFPB for their hard work and their efforts in trying to balance perspectives and create a better financial environment for the people of the United States.

Sincerely,

Adair Morse