



PolicyPerspective

How Access to Short-Term Credit Helps Consumers

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TALKING POINTS

- Consumers are worse off when lending options are restricted.
- It is better to promote competition within the short-term lending industry rather than erecting restrictive barriers of entry for new competitors.
- Consumers make lending decisions that they believe are in their best interest.
- Effective APR rates for late payments and bank fees often vastly exceed those of small, short-term loans.

Bankers and businessmen are far from the only Americans that are feeling increasingly anxious over the state of the credit markets. As traditional banks tighten lending standards, many consumers find themselves unable to readily borrow when the need arises, often unexpectedly.

According to the July 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices by the Washington, D.C. Federal Reserve Board, about 65 percent of domestic banks indicated that they had tightened their lending standards on consumer loans and credit card loans over the past three months.¹

The survey goes on to report:

In addition, considerable fraction of respondents reported having increased minimum required credit scores on both types of consumer loans and reduced the extent to which such loans were granted to customers who did not meet their bank's credit-scoring thresholds. Finally, large net fractions of banks noted that they had lowered credit limits on credit card accounts over the past three months, and increased interest rate spreads on consumer loans other than credit card loans. On balance, about 35 percent of domestic banks—up from roughly 25 percent in the April survey—expressed a diminished willingness to make consumer installment loans relative to three months earlier.²

The tightening credit market is affecting all consumers. But those with poor credit, especially with short-term credit needs, may be the most impacted.

Even before the credit crunch borrowers had relatively few available options for short-term credit. Traditional borrowers have the option of dealing directly with a consumer bank or federal or employee credit unions. But those consumers who do not meet bank or credit union lending criteria, particularly when borrowing smaller amounts for short-time periods, have to turn elsewhere.

Some borrow from friends or family. Still others, following a venerable precedent, make their way to the pawnshop. Other options are to skip utility and credit card payments, seek out loan sharks, or file for bankruptcy. Few of these options are optimal for consumers and may ultimately damage a person's long-term credit.

A survey of 521 low-income Texans conducted by Texas Appleseed, a public-interest law center based in Austin, TX, confirms some of the obstacles facing those in need of small, short-term loans. It found that 40 percent of respondents that used payday loans* indicated that they were turned away by banks or credit unions.³ Half of these respondents said they needed short-term loans to pay bills, while 46 percent needed money for gas or groceries. Over a third of people surveyed using payday loans were faced with an emergency.⁴

*Payday loans are a form of short-term lending characterized by the use of a personal, post-dated, check as collateral for the loan. These checks are generally dated to coincide with the check issuer's next scheduled payday.

Consumers in need of STLs are often challenged in finding a source of funds. The Texas Applesseed survey noted that 60 percent of those surveyed turned to family or friends for loans while 23 percent chose to borrow money from payday lenders. Respondents did not turn to banks nearly as much and 40 percent indicated that they were turned down for loans at banks and credit unions anyway.⁵ The study concluded that rejection from traditional banks and credit unions is a major factor in a consumer's decision making process to borrow from payday lenders.⁶

Short-Term Credit and Related Financial Services

There are a many types of financial services that consumers can seek out in order to help them structure their financial life or gain access to credit. The following are some typical options for consumers.

Traditional Bank Loans, Lines of Credit, Credit Cards, and Home Equity Loans

Banks and credit unions offer financial consumers many different options when it comes to loans and credit, but many of these options aren't suitable for a significant portion of borrowers in the short-term credit market. Banks traditionally offer unsecured or secured personal loans, unsecured or secured lines of credit, credit cards and credit card cash advances, or equity lines of credit tied to property or home ownership.

While personal loans may seem like a good option for consumers in need of short-term credit, it isn't always the case that they will be served at a traditional bank. Large minimum loan amounts and strict credit thresholds set limits on what type of consumer may seek out personal loans. For example, the minimum loan amount that can be taken out at Wells Fargo for a personal loan is \$3000⁷ while the minimum amount at Capital One is \$2500.⁸ Other consumers—particularly those with poor or non-existent credit—who are not discouraged by the loan amounts may be rejected based on lending practices. Those people who are seeking shorter, smaller loans have no options at a traditional bank.

Many banks offer credit cards as a way for consumers to utilize and gain credit. Credit cards provide consumers with an easily accessible source of liquidity for purchasing items or paying bills. Consumers are required to pay down

their credit card balance at the end of each month with a minimum payment amount. Those who fail to pay down their balance are subject to interest rate increases and penalty fees. Cardholders can also take out what is known as a "cash advance" which enables consumers to borrow currency against his or her remaining credit card balance. Cash advances are also subject to fees.⁹

According to Donald Morgan of the NY Federal Reserve Bank, 60 percent of short-term borrowers reported that they had maxed out their credit cards and needed access to additional credit to meet other financial obligations such as utility bills.¹⁰ Given no other alternative for access to more credit, these consumers could miss payment on bills and credit cards and be subject to card fees and other penalties.

Another avenue for consumers looking for short-term credit is a home equity line of credit through their bank. A home equity line of credit is a form of credit in which a person's home serves as collateral. Typically, a person's home is their most valuable asset and many homeowners use home equity lines of credit to pay off major expenses.¹¹ This option is only available to those seeking short-term credit who are homeowners, not renters. The Applesseed survey found that renters are more likely to seek out payday loans.¹²

Short-Term Loan Options: Direct Deposit Loans, Cash Advances, and Payday Lending

For those consumers in need of smaller, short-term cash loans that are not served by traditional banking institutions, there are some other options that may keep them from having to go without meeting their financial needs.

Certain banks offer what is known as a "direct deposit loan" in which funds are made available in a person's account before their next direct deposit from their employer. It is essentially allows a person to have access to future guaranteed funds. This type of loan is known by many different names including, a "cash advance loan," a "payday loan," "or a "salary advance loan." Those seeking payday loans are not unbanked nor are they unemployed.¹³

Some credit unions have begun experimenting with salary advance or payday loans.¹⁴ The North Carolina State Employees Credit Union is one example. However, Dan Mica, the president of the Credit Union National Association (CUNA), indicated in an interview for *USA Today* that

many of these loan programs were barely breaking-even due to the poor credit quality of borrowers.¹⁵ Given this scenario, it is unlikely that credit unions will engage in the short-term lending market in large numbers.

Consumer credit service organizations (CSOs) have come in to fill the market for smaller, short-term loans not offered by banks and credit unions. A CSO provides retail financial and credit services to consumers, including securing or obtaining short-term loans (STLs).

CSOs are not lenders, but rather a CSO will help consumers in need of a STL locate a third-party lender (TPL) who is willing to issue loans to short-term borrowers. These loans, in turn, are underwritten based on the lender's risk criteria and are often secured by the CSO by a letter of credit or issuance of guarantee. Retail financial services organizations are not primary lenders and should not be confused with the third-party lenders that actually charge interest on short-term loans.

The Texas Constitution sets a limit on interest rates at 10 percent per annum, unless otherwise set by the Legislature.¹⁶ All short-term lenders must abide by this constitutional provision by law unless exempted or given special consideration by law. Payday or cash advance lenders are subject to this cap in Texas.

Other Retail Financial Alternatives: Pawn Shops, Prepaid Debit/Phone Cards, and Money Orders

Another option available for consumers in need of immediate or short-term funds is to pawn certain possessions. When someone "pawns" an item what it really means is that they will get a short-term cash loan with that item as the collateral. Pawn shops are regulated under state law (*Texas Finance Code Chapter 371*). Typically, a borrower will enter into an agreement with a pawn broker and a contracted period of time. The broker may charge what is known as a "finance charge" on any transaction. After the transaction has been made, the person who pawned the item will have a set period of time to repay the loan with interest and reclaim their personal property. If they are unable to repay, the item becomes the property of the pawn broker. According to the Texas State Attorney General's Office, pawn shops can have a maximum rate of 240 percent APR.¹⁷

In addition to the services mentioned in previous sections, retail financial service organizations, including CSOs, may provide consumers with access to prepaid debit or phone cards. This gives consumers the option to pre-load a debit card with a specific amount of cash, which then allows consumers to control or limit spending based on the value on the card. Similarly, pre-paid phone cards enable consumers to control the specific costs of long-distance telephone service.

Retail financial service providers in Texas may also help consumers secure money orders. A money order is an alternative form of payment when a consumer doesn't want to send a personal check. Money orders do nothing to help people in need of short-term credit and only serve as a form of direct payment.

The Effects of Restricting Access to Forms of Short-Term Credit

A study by the Federal Reserve Bank of New York concluded that state bans on payday credit in Georgia and North Carolina had caused more people to bounce checks, file for Chapter 7 bankruptcies ("no assets"), and experience greater difficulty with lenders and debt collectors. The opposite was true for consumers in Hawaii, whose legislature increased the level of individual payday loans from \$300 to \$600.¹⁸

Many critics of payday lending fail to take fully into account the unintended consequences of banning the practice or passing legislation making it impossible for these lending companies to continue to operate. The Federal Reserve study found that the lack of access to short-term loans for people in need of funds have significant impacts as people may be subject to bankruptcy due to the lack of credit.

When judging the appropriateness of a certain consumer service, one should compare the alternatives. In the case of short-term loans, the alternative is often making late payments on bills, bouncing checks, or facing bank penalties for insufficient funds. The New York Federal Reserve study cites a survey of eight large Chicago banks conducted by the Woodstock Institute that calculated the implicit APR of bounced check protection offered by banks at an average 2,400 percent. Sheila Bair, chairman of the U.S. Federal De-

posit Insurance Corporation (FDIC), noted that overdraft and bounced check protection discouraged traditional banks and credit unions from offering payday or short-term loans. Instead, she said, these institutions reap huge financial gains from offering this type of consumer protection. She warned that consumers were catching on and turning to payday loans as a cheaper alternative.¹⁹

In the last decade banks have nearly quadrupled their overdraft fees while credit-card late charges and over-limit charges have nearly tripled.²⁰ In 2006, banks made \$36 billion on checking/savings account fees. Bank of America for example, has raised the limit of the number of times a person can be charged an account fee to seven times per day.²¹ Given the increasing level of bank fees and other finance charges, some consumers may find it beneficial to mitigate these costs by taking out small loans.

Legislative Restrictions on Short-term Lending

New Hampshire has passed a law capping short-term loan interest rates at 36 percent, forcing many payday lending locations to close.²² Similar caps have passed in Pennsylvania and Arkansas with similar effects.²³ Jonathan Zinman argues that shutting off payday loans could lead some people to riskier behavior, such as bouncing checks or seeking out illegal loan sharks.²⁴

Part of the impetus for restrictions on short-term loans comes from the opposition to the high interest rates that are cited when CSOs are viewed as primary lenders that are collecting interest on loans. This is not the case. Instead, Credit Service Organizations charge a finder's fee for helping consumers locate and secure a STL from a third-party lender. Although required by law, factoring in these types of charges for the purpose of calculating APR interest rates on short-term loans may be inappropriate in drawing an accurate comparison with other annualized loans. Many people often decry what they perceive as "excessive interest rates," yet they fail to take into account that the lenders are capped at 10 percent interest rates per annum. The Federal Truth-in-Lending act requires that service fees are included in calculating the effective APR. For the purposes of comparing consumer alternatives however, citing these interest rate calculations alone doesn't accurately describe the whole picture.

Fourteen bills filed in the Texas Legislature's current session follow the trend of regulating short-term loans. House Bills 3021, 3304, 3744, 3772 and 4391 as well as Senate Bills 242, 243, 244, 248, 1285, and 2131 collectively increase transactions costs of short-term lenders and cap interest rates. House Bills 2211 and 2408 and SB 189 restrict short-term loan access with respect to loan collateral and military service affiliation. If passed, these bills would reduce consumer options in matters of personal finance.

All lenders, including banks, credit unions, or short-term lenders determine interest rates based on the consumer's credit risk. Consumers without existing credit, or with poor credit, are generally charged higher than average interest rates to mitigate the potential risks of defaulting payment. Lending, by nature, is a somewhat risk-intensive venture and appropriate interest rates allow lenders to continue to do business. Similarly, any profits made from successful lending in the past acts as a hedge against future defaults.

Legislation that caps interest rates below the established market value will put short-term lenders out of business and reduce lending options and choices for consumers seeking out immediate or emergency short-term loans, most of whom are urban members of the lower-middle class.²⁶ Thus, legislation to restrict access to short-term loans would disproportionately harm lower income Texans.

Established Consumer Protection Measures in Texas for Short-Term Lenders

Contrary to the claims of "predatory, unregulated credit lending," leveled against payday lenders, retail financial service providers in Texas are subject to many consumer protection regulations including:

- Texas Credit Service Organization Act (Texas Finance Code Chapter 393)
- Texas Deceptive Trade Practices Consumer Protection Act (Texas Business and Commerce Code §17.41 et seq.)
- Texas Constitutional Article XVI, §11
- Texas Finance Code Chapter 302
- Federal Truth in Lending Act (15 USC §1601 et seq.)

- Regulation Z (12 CFR part 226)
- Texas Debt Collection Practices Act (Texas Finance Code Chapter 392)
- Federal Debt Collection Practices Act (15 USC §1692 et seq.)
- Federal Equal Credit Opportunity Act (15 USC §1691 et seq.)
- Regulation B (12 CFR part 202)
- Federal Trade Commission Act (15 USC §41 et seq.)
- Federal Gramm Leach Biley Privacy Laws (15 USC §§6801 et seq.)
- Federal Trade Commission Regulations (16 CFR part 313 and 16 CFR part 314)
- Fees charged by credit service organizations are different from interest charged by lenders. Calculating service fees or guarantor charges into the effective APR does not provide a completely an accurate picture of the cost.
- Passing laws that cap effective APR rates will drive short-term lending organizations out of the market and make consumers worse off when their credit options are restricted.
- Market forces of supply and demand will set reasonable interest rates. Some consumers prefer access to more money now at the expense of paying interest later.
- Consumers make lending decisions that they believe are in their best interests—passing restrictions on short-term lending amounts to telling consumers what is best for them.

Additionally, retail lenders follow industry standards of only extending loans to people who have a valid checking account, a photo I.D., and a verifiable source of repayment. To put the matter simply, it is not in the best interests of either a short-term lender or to a borrower to take out loans that can't be repaid. Credit Service Organizations in Texas are required by law to display prominently all charges, fees, and interest rates associated with taking out loans. Consumers are also given a grace period of three days to return the loan without incurring interest charges and may not take out more than one loan at a time.

Findings

- It is best to keep options open for people with poor credit histories to take out short-term loans. Eliminating options has proved to be harmful in states such as Georgia and North Carolina.
- Certain consumers will always need access to short-term credit markets to overcome emergency situations or tough times. It is better to promote competition for this industry rather than erect restrictive barriers of entry for new competitors.

Conclusion

As credit markets continue to tighten, it is important for Texas consumers to have access to a variety of financial options. Many people who are turned away by traditional banks or credit unions are often left in a precarious situation of limited choices, most of which lead to higher debts, late payments, or bank fees. Consumers in need of short-term loans and credit are generally aware of the alternatives to taking out loans, such as skipping payments or bouncing checks. There is and will continue to be a market demand for small, short-term loans.

Critics cite what they claim to be high effective APR rates in their condemnation of payday loans and credit service organizations. However, they fail to look at the other side of the issue and don't take into account the alternatives that consumers face. Effective APR rates for late payments and bank fees often vastly exceed those of small, short-term loans. A competitive and vibrant short-term credit market promotes consumer choice and access to needed financial services. ★

Endnotes

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- ²⁶ Morgan and Strain, November 2007.

About the Author

Chris Robertson graduated from the University of Texas with a B.A. in Government and joined the Foundation's Center for Fiscal Policy in January 2007. He returned to the Texas Public Policy Foundation's Center for Economic Freedom this spring after having served on a prominent U.S. presidential campaign in 2007-2008.

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