The Unintended Consequences of the Over-Regulation of Small-Dollar Loans

Some state and federal regulators have called for an annual percentage rate (APR) cap on the fees for small-dollar loans and/or a limit on the number of loans a consumer can borrow each year.

Attempts to over-regulate small-dollar lending harm consumers by eliminating a critical choice for thousands of people who need credit. Consumers' need for credit does not disappear once these regulations are in place. Instead, they either cannot meet their financial obligations, or they are forced to choose costlier or less regulated options, such as overdraft programs, unregulated loans or bankruptcy. For these reasons, **more than two-thirds (69 percent) of short-term, small-dollar loan users oppose government restrictions on the loans, according to a national poll**.

Consumers face real risks when they are forced to resort to unregulated loans, which are widely available online even in states that have banned small-dollar loans. Unlicensed lenders offer loans that involve higher costs, and none of the consumer protections that regulated companies provide.

Lenders that operate outside of the jurisdiction of federal and state regulators are not subject to state examinations, lender compliance standards, or formal complaint processes. As a spokesperson for a state chapter of the Better Business Bureau warns, "If we do away with payday loan companies in this state, we are literally pushing the poor to these websites [for unregulated or offshore loans] where they will be, in my opinion, completely taken advantage of."

> Following the implementation of an interest rate cap on small-dollar loans extended to active duty military, many military families have turned to costlier overdraft programs offered by banks, according to a representative from the Navy-Marine relief society:
>
> **"[O]verdraft programs have replaced payday lending as the leading financial problem for many military personnel."**

In recent years, several states and the District of Columbia have implemented APR caps and other restrictions on small-dollar credit. Below are some of the unintended consequences states have experienced after limiting or effectively banning small-dollar lending.

- **South Dakota:** After South Dakotans passed a ballot initiative in 2016 that used a 36 percent rate cap to effectively eliminate the state's regulated small-dollar lending industry, a little over a year later, reports found that at least 162 small-dollar lenders did not renew their licenses. Regulators estimated only a few dozen licensed lenders remain. Credit counselors in the state suspect borrowers simply migrated to online lenders, while pawn shops reported a rise in business.

- **Georgia and North Carolina:** A Federal Reserve Bank of New York study reported that people "bounced more checks, complained more about lenders and debt collectors and have filed for Chapter 7 ('no asset') bankruptcy at a higher rate" after small-dollar lending was banned through interest rate caps in Georgia and North Carolina.

- **Oregon:** One year after implementing a 36 percent interest rate cap, 75 percent of Oregon's 360 small-dollar lending stores closed their centers. Consumer complaints against unregulated Internet lenders doubled, and nearly 70 percent of such complaints filed in 2010 were against unregulated online lenders.

- **Virginia:** In 2020, the commonwealth passed a mandatory longer term for small-dollar loans on top of existing state regulations, including an interest rate cap. As a result, many of Virginia's regulated consumer lenders closed their doors ahead of the law's January 2021 effective date, leaving residents with fewer regulated options amid the COVID-19 pandemic.

- **Ohio:** In the first six months after Ohio's restrictive lending law went into effect, eliminating two-week loans in favor of mandatory installment loans with a 28 percent interest rate cap, the number of regulated lenders operating with licenses in the state dropped from 161 at the end of 2018 to only 30.

- **Colorado:** In 2010, Colorado eliminated two-week loans and mandated only longer-term installment loans, resulting in the closure of roughly half of the state's lenders. As a result, a leading lender in the state reported that more than a quarter of customers were paying their six-month loans off within the first 59 days, in order to re-borrow and avoid incurring monthly maintenance fees. The state's adoption of a 36 percent rate cap further consolidated the number of regulated lenders in the state.

- **Washington State:** In the first year under an eight-loan limit on small-dollar loans, the number of small loans made to consumers was down 66 percent, while consumer complaints were up 50 percent year-over-year, with 76 percent of the complaints against Internet lenders.

- **Arkansas:** A 2008 ruling of the Arkansas Supreme Court ended storefront lending in Arkansas. However, the Arkansas Attorney General filed suits in 2011 and 2012 against unregulated online lenders engaged in aggressive collections practices.

- **District of Columbia:** An interest rate cap of 24 percent closed all small-dollar lending operations in the District. Since the closure, officials report an increase in unscrupulous, unlicensed lenders charging as much as 2,000 percent interest, taking payments from a borrower's checking account without authorization and initiating harassing telephone calls.

- **Montana:** Following a 2010 ballot initiative implementing a 36 percent rate cap on all lending, all but 18 of Montana's 150 small-dollar lending stores closed. One year later, the Commissioner of Banking reported that complaints against Internet lenders were up substantially over the previous year, with illegal lenders making loans up to 1,000 percent APR.

- **New York:** In an effort to crack down on unregulated lenders, the New York State Department of Financial Services ordered 35 lenders to cease lending to state residents in August 2013. Subsequently, the state attorney general filed a lawsuit against an unlicensed online lender and two of its affiliates.

- **Pennsylvania:** During a field hearing, then-CFPB Director Richard Cordray shared a story of a Pennsylvania borrower who struggled with small-dollar loan debt. However, Cordray failed to acknowledge that storefront lending is illegal in Pennsylvania; the customer had undoubtedly borrowed from a lender that was not operating legally in Pennsylvania.