Online Lenders Alliance

Interest Rate Caps Do Not Work

Rate caps eliminate credit options for nonprime consumers and steer them towards more expensive credit options like pawn loans, overdraft fees, and late bill payments.

APR is Not a Good Barometer of the True Cost of Credit

The annual percentage rate, or APR, is an “annual” representation of the cost of credit as a percent of the amount borrowed, but it doesn’t provide an accurate reflection for fee-based financial products since it assumes a long-term product.

For example, compare the fees on a $600, 3-month loan with an APR of 100% to a $600, 12-month loan with an APR of 36% (see Table 1). For consumers looking for a $600 loan, the loan fees for the loan with a 100% APR is smaller and possibly more affordable, than the 12-month loan. In the end, there are many factors at play when considering whether a loan is safe and affordable for consumers – including loan amount, loan duration, and loan fees – than just APRs.

Table 1: APRs Are Not Everything

Loan Amount	$600	$600
Loan Duration	3 Months	12 Months
Loan APR	100%	36%
Loan Fees	$148	$216

36% Rate Cap Cannot Work

Capping interest rates using “Annual Percentage Rates” (APR) can lead to a reversal of the hard-earned gains made by laws combatting discriminatory lending and lead to millions of creditworthy borrowers losing access to credit. 36% APR is a common limit proposed on small dollar credit since 1916, when small dollar loans were defined as up to $300, or about $7,000 in today’s dollars. However, the 36% APR cap has never been independently researched as a viable economic price point for risk-based borrowers. In fact, Federal Reserve economists published a study in 2020 that found that interest rates for small-dollar loans must exceed triple digit APRs just to breakeven for some small-dollar loans.[1]

[1] Lisa Chen, Gregory Elliehausen, “The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates,” Federal Reserve, August 12, 2020.

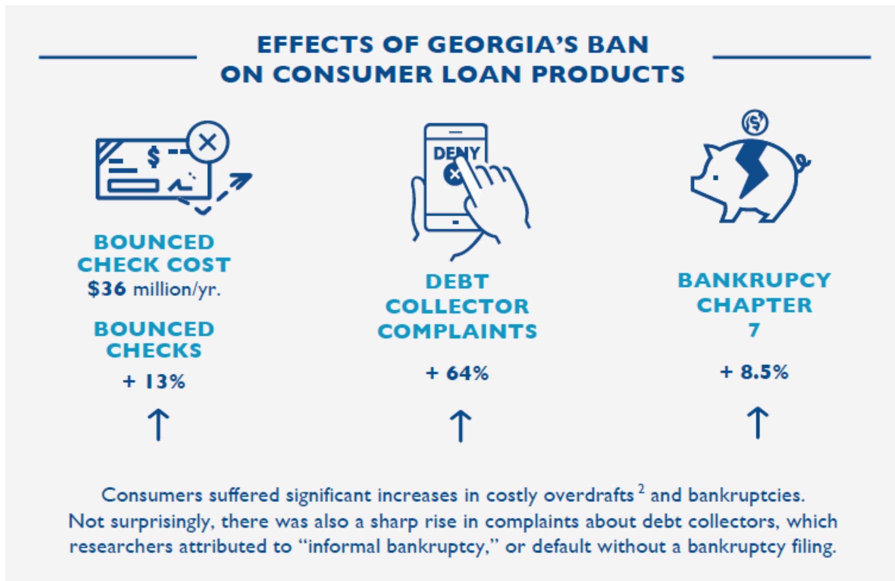
OLA Online Lenders Alliance

Interest Rate Caps Do Not Work

Rate Caps Lead Consumers to Inferior Loan Products

A 36% rate cap will leave millions of Americans without access to the credit they want or need. They will be consigned to more costly credit options (or face the expensive consequences of not being able to meet they financial needs and obligations) including possibly:

- Overdraft or bounced check fees
- Pawn loans
- Late payment penalties
- Utility shut off (and reconnection fees)
- Credit score reduction (contributing to a credit exclusion spiral)



After interest rate caps were imposed in Georgia and North Carolina, consumers bounced more checks, submitted more complaints about debt collectors, and filed for Chapter 7 bankruptcy at higher rates, according to economists at the Federal Reserve Bank of New York.[2]

The Failure of the FDIC Small-Dollar Loan Pilot Program

In 2008 the FDIC launched its Small-Dollar Loan Pilot Program, which was a case study designed to illustrate how banks could profitably offer affordable small-dollar loans. The program proved to be largely unprofitable for banks, as most used the program to drive consumers into fee-based checking accounts where they could be subject to overdraft and insufficient fund fees.

The program's low participation rates only highlighted the banking industry's challenges with this market. Loans were capped at $1,000, and origination and other upfront fees plus interest charges were capped at 36 percent APR. **The program demonstrated that a 36% APR cap on small-dollar loans was unworkable for most banks.**

[2] Donald Morgan, Michael Strain, "Payday Holiday: How Households Fare After Payday Credit Bans," Federal Reserve Bank of New York, November 2007.

Interest Rate Caps Do Not Work

Online Lenders Alliance

U.S. Bank's Small-Dollar Loan

In 2018, US Bank, the fifth largest US commercial bank, announced their new small-dollar loan: The Simple Loan. Existing US Bank customers may apply online for a small dollar loan up to $1,000, repayable over 3 months at 70-88% APR. That is equivalent to 6-7% interest per month.

<u>Loan Terms</u>

- Installment loan from $100 to $1,000
- Monthly Repayment with 3 fixed payments over 3 months
- Risk-based pricing
  - These rates are possible because these loans are less risky than standard installment loans as they are only available to existing customers who have held a checking account for at least 6 months; have limited underwriting have their paychecks deposited directly into their account; and entail little marketing and underwriting costs.

> "I am glad to see U.S. Bank and other OCC-regulated banks working to provide more responsible choices to meet the short-term, small-dollar needs of consumers… Consumers need more choices that are safe and affordable."
>
> Comptroller of the Currency
> Joseph Otting

The Cost of Doing Business

Online lenders do not enjoy the same competitive advantages as banks when supplying credit. Banks, credit unions, and other financial services companies operate from two positions of strength – a lower source of funding through deposits, and a captive customer base. The following is derived from the US Bank example:

Fixed/Administrative:

- **Marketing:** Existing customers only
- **Cost of capital:** Deposited, insured funds at much lower rates
- **Application:** Automated, limited underwriting due to the fact they are existing customers
- **Collection:** Drawn from existing account holders, direct deposit accounts ($3 per $100 additional charge if no automated payment)