CATO INSTITUTE | Center for Monetary and Financial Alternatives

October 7, 2016

Mark Morelli
Office of Regulations
Consumer Financial Protection Bureau
1700 G Street N.W.
Washington D.C., 20552

Re: Docket No. CFPB-2016-0025

Dear Mr. Morelli:

Thank you for the opportunity to comment on the CFPB's proposed rule governing payday and other types of short-term lending.

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Because the proposed rule implicates issues of both individual liberty and limited government, I have chosen to submit the following letter. Thank you for your attention to these comments.

First, I understand that several scholars at the Mercatus Center, including Thomas Miller, Todd Zywicki, and Brian Knight, have also submitted a letter, which describes in detail many of the issues that the CFPB should resolve before moving forward with this rule. I agree with Messrs. Miller, Zywicki, and Knight, and urge the Bureau to consider carefully the issues their letter raises.

Second, I am concerned about the Bureau's authority to issue the rule as proposed. As the Bureau is aware, the Dodd-Frank Act explicitly withholds from the CFPB the authority to "establish a usury limit."[1] The proposed rule, it is true, includes no express cap on the interest

[1] 12 U.S.C. § 5117(o).

1000 Massachusetts Ave., N.W. • Washington, D.C. 20001 • 202.789.5271 • tknight@cato.org

rate a lender may charge. And indeed the CFPB has noted that it lacks the authority to impose such a cap.[2] But the structure of the rule nonetheless is likely to have the effect of banning covered loans that charge fees equivalent to a rate greater than a 36 percent effective annual percentage rate. The structure of the rule therefore could be interpreted as a means of evading the limits on the Bureau's authority imposed by Dodd-Frank. Furthermore, past experience has shown that such loans cannot be profitably offered at a rate lower than 36 percent, suggesting that the CFPB's rule will have the effect of banning payday and other short term, low value loans altogether.[3] Just as the CFPB does not have the authority to "establish a usury limit," it also lacks the authority to ban payday and other short term loans outright.

Under the proposed rule, lenders offering a loan that could result in an APR greater than 36 percent must make certain determinations regarding the borrower's financial situation. These determinations, according to the proposed rule, will help to promote lending only to people able to repay the loans when they come due, or at least to repay a substantial proportion of them. One of the chief virtues of payday and other covered loans is their lack of underwriting. The cost of fully underwriting a loan is such that it is unprofitable to underwrite small dollar loans. The business model used by most payday lenders by-passes this process, instead taking a senior position through the use of a post-dated check. This method has made it feasible for lenders to offer loans for as little as $100. If underwriting is required, it is unlikely that businesses will be interested in making such small loans.

But this assumes that it is even possible to complete the underwriting required in the proposed rule. While it is likely that any amount of underwriting would decrease the availability of short term, small value loans, there are some pieces of financial information that are at least possible for a borrower to produce. The proposed rule includes some such requirements. For example, the lender must determine the borrower's net income, housing cost, and debt obligations. But it also goes far beyond that. In addition, the lender must "forecast a reasonable amount of basic living expenses for the consumer – expenditures (other than debt obligations and housing costs) necessary for a consumer to maintain the consumer's health, welfare, and ability to produce income[.]"

To produce even the roughest estimate, the lender must determine the number of dependents the borrower has, how the borrower travels to work, what type of work the borrower does, whether the borrower or any of the borrower's dependents has any health problems that might either incur cost or limit the borrower's ability to work, whether the borrower has health insurance and what sort of injuries or illness it might cover for the borrower and the borrower's family. But even if

[2] 81 F.R. 47864, at 47912 (Jul 22, 2016).

[3] See, e.g., Colin Morgan Cross and Marieka Klawitter, "Effects of State Payday Loan Price Caps & Regulation," Policy Brief, Evans School of Public Affairs (December 2, 2011) University of Washington.

the lender were to delve this deeply into the borrower's most personal matters, it is unclear whether this information would be enough to determine how much the borrower would need to secure ongoing "health" and "welfare." Most households may have a rough estimate of how much cash it would take to get through a month, or six months, or a year in an emergency. But these estimates depend on the intimate knowledge household members have of their own needs and the costs of meeting these expenses. Even with this very specific and very personal knowledge, these estimates are still very rough. Lenders underwriting multi-million dollar mortgages do not engage in such a deep dive into their borrowers' living situations. The breadth of information required under the proposed rule is simply unprecedented.

And yet the lender must not only forecast the borrower's present needs, but also the borrower's likely income and needs over the term of the loan. Many payday borrowers are hourly workers, not salaried employees. Their income can fluctuate wildly depending on the number of hours they're able to secure (thus necessitating a payday loan to assist with income smoothing). If the borrower is unable to forecast either need or income, it is unclear how the lender could do the same. Arguably, it cannot be done.

Because of the difficulty a lender would have simply in complying with the rule as proposed, even aside from the feasibility given the cost, it raises the question of whether the intent of the Bureau is to wipe out this type of lending altogether. Or at least to wipe out any lending above 36 percent APR. While this does not constitute setting a rate cap *per se*, it is difficult to see any meaningful distinction between setting a rate cap and writing rules that make it impossible to lend at a rate higher than 36 percent. And because past experience has shown that a 36 percent rate cap tends to reduce drastically the availability of short term, low value loans, it seems that the rule as proposed could also be viewed as a means of eliminating the industry as a whole. This goes beyond the authority granted to the CFPB by Congress. Indeed, Congress expressly encouraged the facilitation of small value loans in Section 1205 of Dodd-Frank. These loans, Dodd-Frank states, are to be "made on terms and conditions, and pursuant to lending practices, that are reasonable for consumers" but never suggests that lenders must undertake the unprecedented underwriting required by the proposed rule. [4]

It seems the Bureau missed an excellent opportunity in writing this rule. The guidance presented for the lender is not incorrect, *per se*, but incorrect only in that it is directed at the lender. These questions are exactly the questions that borrowers should pose to themselves when determining whether a payday or other short term loan is the right choice for them. Determining whether a loan can be repaid at the time it is due, or whether it will take a longer amount of time and, if so, how much time and at what cost are essential to making sound financial decisions. But these questions are questions for borrowers, who are deeply familiar with their own needs and resources, and not for lenders. There is no reason to believe that lenders are in any better

[4] Dodd-Frank Act § 1205(b)(1).

position to make these determinations than borrowers and it is therefore misguided to place them in that role.

Thank you again for your attention to these concerns. I hope that the Bureau will consider carefully whether it is authorized to issue the proposed rule, and will also consider alternative, lawful measures to help educate the public about making sound financial choices.

Sincerely,

Thaya Brook Knight
Associate Director, Financial Regulation Studies