Testimony of

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S. 257, The Consumer Credit Fairness Act

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Thank you for the opportunity to testify before you today on S. 257, the Consumer Credit Fairness Act. My name is David John. I am Senior Research Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Let me make it clear from the start that my purpose today is not to defend in any way abusive credit practices. I find them as abhorrent as those who are testifying in support of this bill, but I have strong reservations about the approach used in S. 257, and believe that it will end up making the situation for low and moderate income workers in need of credit even worse than it is now.

Unfortunately, economic literature on the economic effect that high interest lenders have on their customers is spotty, with many studies as interested in proving a point as in objective research. Activists take it for granted that there is a "debt trap" where customers of high interest lenders find themselves deeper and deeper in debt to the lender as interest rates and fees combine to make it impossible for them to repay their loans. Such a trap may well exist in both specific cases and in general. However, there is research from the New York Federal Reserve Bank which suggests that the debt trap may not exist in all situations, and in fact some consumers may be better off with the presence of high interest lenders than they are without them. This paper looks at Georgia and North Carolina after payday lenders were banned, and found higher incidences of bounced checks, complaints about the collection methods of lenders and bankruptcy filings after the ban than before it. This suggests that high interest lenders meet a definite need, and raises questions that legislation like S. 257 may end up causing more problems than it solves.

The first question is who the affected borrowers would be. While it is clear from many data sources that individuals from any and all socio-economic levels can be customers of high interest lenders due to either sudden income shocks or poor financial management skills, the largest proportion of customers fall into three groups. These are low-to-moderate income workers who have limited access to other credit sources either because of low income, poor credit histories, or the simple fact that few banks and other lenders have branches that are easily accessible to these consumers. Second are first time borrowers who may have high potential to become good credit consumers, but for now have no credit history and no one willing to co-sign their loan application. Finally, there are consumers who have poor credit histories or who may have just emerged from bankruptcy, and are seeking to rebuild their credit records.

Credit products are primarily priced by the risk of the customer. Thus, customers with either poor credit histories or none at all, can expect to pay significantly higher interest rates than those with better credit records. The high interest rates cover significantly higher chance of default along with much higher collection costs. However, these high rates are usually temporary. As new borrowers demonstrate their ability to responsibly handle credit, they qualify for lower and lower interest rates, often by switching lenders. The same is true for borrowers with poor credit records who are seeking to restore their reputations.
While it may seem that this legislation will encourage lenders to reduce their interest rates to these borrowers so that they will fall below the caps in this legislation, it will not. For responsible lenders who base their interest rates and fees on the risk that the borrower will either not repay the loan or that it will require extensive contact with him or her to get payments, a very costly process, the added risk that such products will not be recoverable in bankruptcy will simply result in their withdrawing from the market. The products will become too risky for reputable financial institutions to offer.

Certain other reputable lenders will continue to offer products to these borrowers, and may even lower their fees, but they will increase the requirements to qualify for such loans in a way that will reduce the number of potential customers. The combination of higher credit standards and fewer credit providers will leave high risk borrowers with either no credit available, or force them into the hands of less reputable lenders.

Some less reputable lenders will react to the inability to recover high interest loans in bankruptcy by raising their fees even higher so that they can make their profits faster. Their customers will not find any relief from the passage of this bill. Other even less reputable lenders, who never use the legal system for collections in the first place, will be delighted if the result of this legislation is a rise in the number of consumers forced to use their services.

The sad fact is that changing the interest rates charged for high risk loans is very unlikely to change the demand for them. This is especially true in hard economic times when record numbers of Americans are already losing jobs, having their hours of work reduced, or for other reasons finding it ever harder to meet their financial obligations. At the same time financial institutions are raising credit standards so that fewer and fewer customers qualify for their lowest rate products and raising both fees and interest rates for riskier customers and in many cases cancelling the credit lines of higher risk customers. All of these actions simply serve to increase the demand for higher cost credit products.

These tighter credit standards are likely to last for some time. In addition, recent massive increases in the money supply and federal spending may result in renewed inflationary pressures, which will further increase interest rates. This is where the specific language of S. 257 could cause additional problems.

The bill's definition of "high cost credit consumer transactions" is too broad and could encompass transactions that no one regards as usurious, especially as regards "costs and fees". This would subject more lenders to having their loans disallowed when borrowers file for bankruptcy - perhaps, in some cases, to that lender's great surprise. The bill's definition specifically includes any credit transaction where the combination of interest rate and fees exceeds "at any time while the credit is outstanding" the sum of 15 percent plus the yield on 30-year Treasury bonds.

Under this definition, a traditional 30-year mortgage issued in October 1981 when mortgage interest rates peaked at an 18.45 percent annual percentage rate came under the bill's definition as a "high cost credit consumer transaction" in December of 2008, when the interest rate on 30-year Treasury bonds dropped to 2.87 percent. Depending on fees paid during closing, it may have come under the bill's definition well before then.

The bill's definition is even more stringent than that contained in the last Congress' H.R. 3915, the Mortgage Reform and Anti-Predatory Lending Act of 2007, which limited its reach to loans where the rate exceeded a spread over a Treasury bond rate on "the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor." S. 257's open ended liability places any fixed rate loans made during periods of high inflation at risk of being considered as high cost credit and being inexcusable under bankruptcy.

Other areas of the bill are also troubling. By granting a bankruptcy filer "who has any debts arising from a high cost consumer credit transaction" relief from requirements that those who have sufficient income to repay some of their debts must do so before receiving a discharge. This language invites gaming of the system. A prospective filer could take out a small, high-interest-rate loan for the express purpose of getting into Chapter 7 rather than Chapter 13 and thus avoiding any obligation to repay from future income. Such a loophole would provide hundreds of new customers for the very lenders that proponents claim to oppose, some of whom might be directed to the lenders by less reputable bankruptcy attorneys. This provision effectively guts the 2005 bankruptcy reforms.

In conclusion, S. 257 is unlikely to reduce high interest rate lending. All that it is likely to do is to either make it harder for certain populations to find credit at all, or to make it even more expensive for them to do so. The sad fact is that the customers of such lenders only utilize them because those customers have no other choice. The demand for those credit services will be there no matter what the cost. This bill, which is essentially a price cap or attempted prohibition, is not likely to reduce that demand at all.

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1. Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans", Federal Reserve Bank of New York Staff Report no. 309, November 2007 revised February 2008, at: