STATE LAWS CAN GIVE CONSUMERS MORE LOAN CHOICES[1]

Changing state laws can invite competition into the small-dollar loan landscape.

Violet's sink is clogged (again). She calls HP Plumbers.

HP Plumbers unclogs the drain, and presents Violet with a bill for $300.

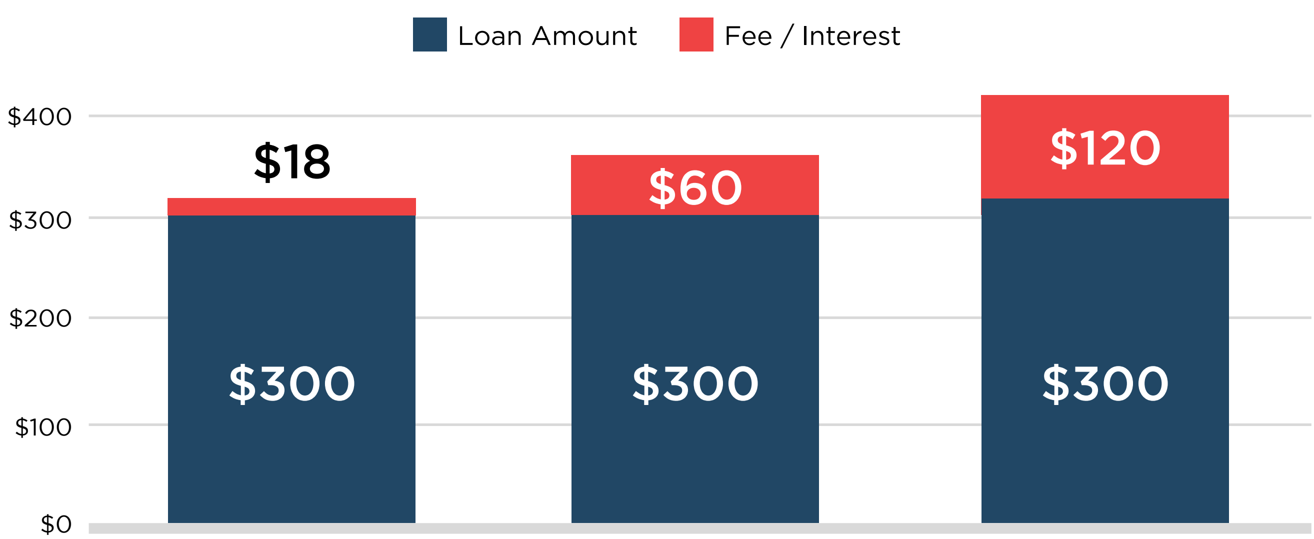
Violet does not have $300 in cash (or room on a credit card).

Violet needs to borrow $300.[2]

WHAT CAN VIOLET DO?

Consumers likely want to choose the cheapest way to borrow money. Violet might have friends or family she could ask for help. But, like most consumers she might prefer to keep financial matters private. She needs to borrow money from a lender. State laws limit and shape the small-dollar loans available to consumers from legal lenders. Suppose Violet's unsecured borrowing options are those below.

TOTAL COST BREAKDOWN FOR THREE LOANS



UNICORN LOAN
36 APR
Monthly Payments: $106
Unprofitable

SCARCE LOAN
118 APR
Monthly Payments: $120
Profitable

PAYDAY LOAN
521 APR
Lump Sum Repayment
Profitable

[1] 1 By Thomas W. Miller, Jr., Professor of Finance and Jack R. Lee Chair in Financial Institutions and Consumer Finance, Mississippi State University and senior research fellow at Consumers' Research

[2] Klutsey, Benjamin, Thomas W. Miller, Jr., Sloane Sherman, and Vera Soliman, "Violet Needs a Loans," https://www.mercatus.org/essays/violet-needs-a-loan. The details of the workings of four different important small-dollar loan products appear in Miller, Thomas W., Jr., "How Do Small-Dollar, Nonbank Loans Work?" https://www.mercatus.org/publications/financial-markets/how-do-small-dollar-nonbank-loans-work.

THE UNICORN LOAN

If Violet could find a 36 APR **Unicorn Loan**, she would choose it. Unfortunately, with a 36 APR cap, this loan type generates only $18 in revenue for the lender. This revenue is not nearly enough to cover the lender's costs to produce the loan. So, **lenders will not offer these unprofitable loans.** Because a 36 APR loan is unprofitable, its existence is mythical—it is a Unicorn.[3]

THE SCARCE LOAN

Depending on the state where Violet lives, she might have an option to take a small dollar consumer loan with an APR of 118 percent. That APR might sound jarring, but for Violet the payment on this loan would only be $14 a month more than the payment on the Unicorn Loan. Unfortunately, despite its affordable dollar cost, state APR caps ban this choice in all but sixteen states. Unless Violet lives in one of those sixteen states, this loan is a **Scarce Loan**.

THE PAYDAY LOAN

The remaining legal consumer loan option for Violet might be a **Payday Loan**. These loans are legal in 34 states. If Violet borrows $300 and repays the payday loan in two weeks, the total cost is $60 plus the loan amount of $300. If Violet is unable to repay the payday loan in two weeks, then Violet must pay a fee of $60 for each two weeks. So, if Violet pays her loan back in four weeks, her cost is $120 plus the loan amount of $300.

WHAT CAN STATE LEGISLATURES DO TO HELP CONSUMERS LIKE VIOLET?

Many consumer advocates believe that a 36 APR cap is high enough to incent lenders to make Unicorn Loans. This view represents the triumph of hope over experience. A 36 APR on a three-month $300 installment loan yields only $18 in revenue, which does not does not cover the cost of making these loans.

State legislatures can give consumers more choices in the small-dollar loan market. How? States can allow for payday loans. States can also remove or greatly increase interest rate caps to makes small-dollar installment loans profitable. Raising the APR cap to a level like 118 percent would introduce more options for consumers who use small-dollar loans. Although the APR might be viewed as high, the additional dollar cost to consumers is low. Violet and other consumers could have access to previously **Scarce loans** with payments of only $14 more per month than the wished-for imaginary **Unicorn Loan**.[4]

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[3] For a loan with a 36 percent APR, the breakeven loan size is about $2,700—far more than Violet needs and could repay Chen and Elliehausen, 2020. https://www.federalreserve.gov/econres/notes/feds-notes/the-cost-structure-of-consumer-finance-companies-and-its-implications-for-interest-rates-20200812.htm

[4] **Some Details of the Three Loans Above.**

Unicorn Loan. This Traditional Installment Loan, with a 36 Percent APR, is a Legal Loan in about 37 states. In this 3-month loan, Violet receives $300 today and repays the loan completely with three monthly payments of $106. This loan costs Violet $18, plus the loan amount of $300. But lenders cannot profit from making these loans with their 36 percent APR. At least 13 states do not allow for an APR as high as 36 percent. Source: Private conversation with AFSA officials (American Financial Services Association, the trade association for traditional installment loans. https://afsaonline.org/.)

Scarce Loan. This Traditional Installment Loan, with a 118 Percent APR, is a Legal Loan in about 16 states. [Source: AFSA Officials.] In this 3-month loan, Violet receives $300 today and repays the loan completely with three monthly payments of $120. This loan costs Violet $60 plus the loan amount of $300.

Payday Loans. These loans are legal in about 34 states. In a payday loan, the consumer receives $300 today and promises to repay this loan plus a fee in two weeks. If the consumer repays the payday loan in two weeks, the total cost total is $60, plus the loan amount of $300. Payday loans give borrowers the option to defer paying the loan amount by paying only the fee when the loan is due. This process is called "rolling over" the loan. In the example above, the cost to the consumer is $120 plus the loan amount of $300, or $420. In both cases, the *annualized* percentage rate is 521 percent. Source: Payday Loan Consumer Information. https://paydayloaninfo.org/state-information.