

## The Risks of New Restrictions on Payday Lending and Title Lending

Todd J. Zywicki  
Mercatus Center Senior Scholar

**Although there is no evidence that non-traditional lending products such as payday and title lending contributed to the financial crisis, Congress is considering new regulations on such products. However, economic theory and empirical evidence suggest that these proposals would hurt the very people they are intended to help.** Payday lending has served as a valuable source of lending to wage earners with steady employment but a critical need for short-term emergency funds. The auto title lending industry serves mainly unbanked customers, and provides operating capital for small independent businesses, allowing borrowers to obtain larger loans by using one of their most valuable assets as collateral. Further, auto title loans are better for the consumer than pawnshop loans, because the consumers can borrow against a more valuable asset, they can keep the collateral, and they are also subject to lower default rates. Proposed regulations on payday lending and auto title lending would cut many people off from much needed cash, create more dangerous lending practices, and lead to more detrimental outcomes such as bounced checks and bankruptcy.

### RESEARCH FINDINGS

- **Non-traditional lending products meet a critical need for a variety of consumers.** Contrary to the stereotype that payday and title lenders prey on low-income borrowers who are unable to repay the loans, forty percent of payday loan customers earn between \$25,000-50,000 per year, and 56 percent between \$25,000-75,000.<sup>1</sup> Research has also found that auto title lending seems to be catering to a group of moderate-income borrowers who use this method as a means to obtain needed credit because theirs has become impaired. According to the American Association of Responsible Auto Lenders, the typical title loan for its members is 44 years old and has a household income of more than \$50,000 per year.
- **Additional regulation of the payday and auto title lending industries will create unintended consequences for consumers.** Economic theory and empirical evidence strongly suggests that proposed regulations included in H.R. 1214, the Payday Loan Reform Act of 2009,<sup>2</sup> would make consumers worse off, stifle competition, and do little to protect consumers from excessive debt and high-cost lending. Congress is also considering the Protect Consumers From Unreasonable Credit Rates Act of 2009, which would place a flat interest cap of 36 percent on all consumer credit products, and legislation that would create a new Consumer Financial Protection Agency (CFPA) to determine the types of financial products that consumers can choose. Regulation that deprives consumers of access to non-traditional lending products is likely to force many of them to turn to even more expensive lenders or to do without emergency funds. This is because substantive regulation, such as price caps on interest rates (often referred to as “usury” regulations) limits the interest rate of loans made to borrowers. This can be extremely harmful to consumers, who would be adversely impacted in three main ways: term re-pricing, product substitution, and credit rationing.

<sup>1</sup> Michael S. Barr, “Banking the Poor,” *Yale Journal on Regulation* 21 (2004): 121, 153.

<sup>2</sup> This bill would limit the charge for a single-payment loan to an effective 391% annual rate for a two-week loan

**Term Re-pricing:** The process by which lenders offset limits on what they can charge on regulated terms by increasing the price of other terms of the loan or related loan products, like the minimum required amount of the loan, so as to amortize the costs of issuing the loan over a higher loan amount.<sup>3</sup> This can force borrowers to borrow larger amounts than they prefer or can reasonably manage, thereby reducing the usefulness of the loan and, perversely, promoting over-indebtedness.<sup>4</sup>

**Product Substitution:** Arises when certain types of regulation make it impossible to price a particular consumer loan product in a manner that makes it economically feasible for the lender and borrower to enter into a transaction, but when other lending products are available instead. Those forced to substitute to greater use of revolving credit likely end up paying even higher costs for credit and run into greater financial difficulty.<sup>5</sup>

**Credit Rationing:** Limiting credit to particular borrowers if it is impossible for them to obtain any formal credit on affordable terms. Such rationing could force borrowers to turn to the informal sector (friends and family or illegal loan sharks) or to do without credit entirely.

## RECENT RELATED RESEARCH BY TODD J. ZYWICKI

[“Potential Restrictions on Title Lending,”](#) *Mercatus on Policy* No. 62, November 2009.

[“Loans are Not Toasters: The Problems with a Consumer Financial Protection Agency.”](#) *Mercatus on Policy* No.60 October, 2009.

[“Consumer Welfare and the Regulation of Title Pledge Lending,”](#) Mercatus Center Working Paper No. 09-36, September 2009.

[“The Case Against New Restrictions on Payday Lending,”](#) Mercatus Center Working Paper No. 09-28, July 2009.

## TODD J. ZYWICKI IN THE NEWS

[“Let’s Treat Borrowers Like Adults.”](#) *Wall Street Journal Online*, July 8, 2009.

## ABOUT TODD J. ZYWICKI



Todd S. Zywicki is a Senior Scholar at the Mercatus Center, Foundation Professor of Law at George Mason University School of Law, Member of the Mercatus Center’s Financial Markets Working Group. His work focuses primarily on consumer credit and consumer lending, bankruptcy law, and law and economics. The ideas presented in this document do not represent official positions of the Mercatus Center at George Mason University.

For more information or to meet with the scholars, contact:

Satya Thallam, Director, Financial Markets Working Group, (703) 993-8921, [sthallam@gmu.edu](mailto:sthallam@gmu.edu)  
Mercatus Center at George Mason University • [www.mercatus.org](http://www.mercatus.org)  
3301 North Fairfax Drive, Suite 450 • Arlington, VA 22201

<sup>3</sup> Mark H. Haller and John Alvit, “Loansharking in American Cities: Historical Analysis of a Marginal Enterprise,” 21 *American Journal of Legal History*, 125, 140 (1977).

<sup>4</sup> *Economic and Social Risks of Consumer Credit Market Regulation*, Policis Publication (London, UK: Policis, 2006), 74, 78-79.

<sup>5</sup> Anne Ellison and Robert Forster, *The Impact of Interest Rate Ceilings: The Evidence from International Experience and the Implications for Regulation and Consumer Protection in the Credit Market in Australia*, 55 (2008).