January 15, 2019

comments@fdic.gov
Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th St NW
Washington, D.C. 20429

RE: Small-Dollar Lending RFI; RIN 3064-ZA04

Dear Mr. Feldman,

As finance professors who have studied payday loans, banking, and small credit generally for years, we wanted to offer some thoughts on the FDIC's request for information on small-dollar lending. Our work has covered the geographic relationship between banks and payday lenders, how which political party is in office in states affects payday lending regulation, the relationship between access to small credit and crime rates, and how payday lending regulation affects the density of payday loan stores and the availability of credit. Recent articles and papers we have written include:

Banks and Payday Lenders: Friends or Foe? (2015), published in *International Advances in Economic Research*, Vol. 21, No.2.

Where Banks are Few, Payday Lenders Thrive (2014), published in *Milken Institute Review*.

Do State Regulations Affect Payday Lender Concentration? (2016), published in *Journal of Economics and Business*, Vol. 84.

Payday Lending: Does Regulation Depend on Which Party Holds Power? (2015), published in *Viewpoints*, Center for Financial Markets, Milken Institute.

It's Time to Let Banks Compete with Payday Lenders (2016; see appendix).

Our research suggests that access to credit is helpful for consumers during difficult times. The regulatory barriers to banks and credit unions offering small loans profitably are a primary driver of the high-cost credit market. Because every payday loan borrower has an income and checking account, clear, simple, affirmative guidelines from regulators that enable banks and credit unions to offer small loans at scale would be likely to disrupt this market. The bulk of evidence suggests that people use payday loans because they do not have better options. Enabling banks to offer their customers lower-cost alternatives is likely to enhance their welfare.

We recommend that the FDIC encourage banks to offer small-dollar loans in a safe and sound way to their customers. Doing so has the potential to bolster financial inclusion and provide high-cost lenders with much-needed competition. For example, the four largest banks in the U.S. have more branches than all the payday lenders in the U.S. combined.

We also have observed that when it comes to small-dollar loans with terms of just a few months usually, a 36 percent rate cap is too low for payday lenders to operate profitably, as it is for banks. But banks have such large competitive advantages over payday lenders, that they offer small installment loans profitably at a fraction of the price. Because of the slim revenue available on a small loan, interest rates in the mid-to-high double digits are likely to be necessary for banks to scale products with adequate volume and provide competition to the nonbank high-cost lenders.

As we noted in our 2016 article, competition in the payday loan market doesn't bring prices down- the states with the highest prices often have the most firms and store locations. That is in part because payday lenders spend so much of their revenue on overhead, and most of their costs are fixed, not variable. But banks are more diversified and amortize these fixed costs over more products and more customers. Their customer acquisition costs for small-dollar loans are negligible because they lend to their existing checking account holders. As we also noted in that article, it makes little sense to allow a depository institution to charge $75-90 for three small overdrafts but not to allow them to charge the same amount for a few months of safe small installment credit. As evidenced by U.S. Bank's launch of a new 3-month installment loan this past September, banks can indeed offer small credit profitably, and the 71-88 percent APRs on these loans are within the range our research suggests makes sense for banks and customers.

The FDIC can harmonize policies with other federal regulators to ensure that credit is widely available at the lowest sustainable prices without being overly burdensome to lenders or putting consumers as risk. When the CFPB initially proposed an ability-to-repay test with heavy documentation, staff time, external data requirements, and compliance, we were concerned that it may lead to adverse selection, where lenders such as banks that have a comparative advantage elect not to compete in the market because of these regulatory requirements. This concern was addressed when the CFPB ultimately scaled back the rule creating a pathway for installment loans of longer than 45 days from banks. The Office of the Comptroller of the Currency deserves credit for taking complementary steps in May 2018 to make it easier for nationally chartered banks to offer small-dollar loans. That move probably helped the U.S. Bank product reach market. We encourage the FDIC to follow suit with similarly straightforward guidelines so that supervised banks can make small loans sustainably to the benefit of consumers who need a safe alternative to payday and other high-cost credit.

Sincerely,
James R. Barth, Auburn University, Eminent Finance Scholar
Jitka Hilliard, Auburn University, Associate Professor of Finance

Appendix

http://www.al.com/opinion/index.ssf/2016/01/its_time_to_let_banks_compete.html

It's time to let banks compete with payday lenders

By James R. Barth and John Jahera
January 21, 2016

James R. Barth is Eminent Finance Scholar at Auburn University, Senior Fellow at Milken Institute and served as a federal financial regulator appointed by Presidents Ronald Reagan and George H.W. Bush. John S. Jahera, Jr. is Bobby Lowder Professor of Finance at Auburn University and has authored more than 80 journal articles.

Arguments over the benefits or evils of payday loans have been around since these products first appeared in the U.S market 25 years ago. Do they provide a benefit, or should we outlaw them altogether?

But this is the wrong way to address the issue. With other consumer products, we don't limit our choices to a thumbs up or down. Instead, we devise methods to help the product work while protecting the customer by enacting safety standards when necessary.

With respect to payday loans, this has been the work of the federal Consumer Financial Protection Bureau (CFPB). The CFPB will propose new rules for this market in the next few months and has already made public a preliminary framework of those rules.

But first, to help understand how this industry is currently regulated and how the regulations affect the number and location of payday lenders, we assembled a database of the laws in the 36 states where payday loans are offered and the numbers of payday loan stores per state. This enabled us to analyze the differential impact of state laws on the operations of payday lenders. This research helps shed new light on how consumer safeguards affect operations in the various states.

Where some states (for example, Montana and New Hampshire) enacted unrealistically low interest rate limits—in the range of 36% APR, for example--payday loan stores have disappeared altogether. But surprisingly, when states enact moderate interest rate limits—as happened in Colorado and Oregon--credit continues to be readily available to consumers.

Also surprisingly, states like Wisconsin, Missouri and Texas—which allow lenders to charge very high interest rates or operate without rate limits, and where rates can be three to four times higher than in the lowest-cost states—have the most payday loan firms and locations. Thus competition doesn't appear to bring prices down.

The payday loan industry maintains that there's a good reason why its loan rates are so high: payday lenders are small operators that spend up to two-thirds of their revenue to run their stores and they have to pass that cost on to customers.

Being more diversified, banks and credit unions don't have this problem; they've already built out their branches and staff them to offer other services. In fact, the top four banks in the U.S. have more locations than all the payday lenders in the U.S. combined. They also don't need to spend heavily on customer acquisition.

This is why the CFPB has been identifying processes by which banks and credit unions can enter the short-term loan market as less-expensive alternatives. The CFPB's proposal is likely to shift the market toward installment loans with smaller payments and make the process less costly for traditional lenders to provide small loans that would otherwise be unprofitable.

The CFPB framework would allow loans that limit monthly installment loan payments to an affordable 5 percent of a borrower's monthly income and limit loan terms to six months. Banks could issue these loans successfully because the underwriting requirements would also be streamlined, i.e., made low-cost (though if federal regulators like the Office of the Comptroller of the Currency require banks to conduct full underwriting, lending a few hundred dollars for a few months will be so expensive that banks would have to charge high prices, like payday lenders).

If banks are allowed to use the CFPB's streamlined procedures, the Pew Charitable Trusts estimates that they could offer loans profitably at prices six times lower than payday lenders. That would put a remarkable amount of money back in the pockets of working Americans, who collectively spend $9 billion annually on payday loan fees.

Today banks mostly serve their customers living paycheck to paycheck with overdraft penalty fees that carry annualized rates even higher than those of payday loans. It makes little sense to allow them to charge $35 for a few days of overdraft credit, or $70 for two small overdrafts, but not permit them to charge the same amount for three or four months of safer, consumer-friendly installment credit.

Our research indicates that consumers can benefit from having small loans available to let them address urgent needs. At the same time, the loans are much too expensive, considering lenders charge four times more in some states than in others. To preserve access to small installment credit without the exorbitant prices, banks must be allowed to get involved. Consumers will embrace these lower-cost small loans—regulators should too.