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HOW DO SMALL-DOLLAR, NON-BANK LOANS WORK?

Thomas W. Miller Jr., senior affiliated scholar at George Mason University's Mercatus Center and professor of finance at Mississippi State University, authored, "**How Do Small-Dollar, Nonbank Loans Work?**" in which he examines the small-dollar lending landscape and the detrimental effects of limiting these loans through interest rate caps. While the distinct products offered by non-bank lenders often are conflated by those who have never used them, Miller provides a clear picture and an independent, expert perspective on the utility and importance of small-dollar loans and non-bank consumer lenders – critical context for understanding this industry and its customers.

> "Today in the United States, a crucial section of the broad consumer credit landscape hides in plain sight. This portion of the credit landscape consists of small-dollar loan products offered to subprime borrowers by lenders that are not banks or credit unions. These important consumer credit markets are not widely known and are even less understood."
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> ***– Thomas W. Miller Jr.,***
> ***senior affiliated scholar, Mercatus Center***

The Landscape of Small-Dollar Lending

Those who are in a less advantageous economic position use credit differently than those in better financial standing. Non-bank lenders provide financial inclusion and access to small-dollar credit to the millions of American consumers who are underserved by traditional banks and credit unions, either due to their subprime credit, lack of credit, or financial standing. The small-dollar consumer loans offered by these lenders include a diverse range of products serving an equally diverse range of subprime consumer needs.

Miller identifies the most common types of small-dollar products, across varying terms and loan sizes: personal loans, pawn loans, vehicle title loans, and payday loans. For each, he describes the typical transaction, including fees associated, collateral, and the repayment process, as well as the relevant regulations in place. Payday loans in particular come in varying forms, from single-payment to installment-style payday loans, available in storefronts and online.

Effects of a 36 Percent Rate Cap on Small-Dollar Loan Customers

One hundred years ago, consumer advocates worked with lenders to determine that 36 percent was a reasonable interest rate for consumer credit. Miller notes that over time, while the revenue generated by loans of a particular size has remained constant, the costs of producing loans – employee salaries, employee benefits, rent and other operating expenses, regulatory compliance costs and taxes – have increased, making this cap less viable. Yet consumer advocates, policymakers, and the media continue to view 36 percent as "reasonable."

While 36 percent might sound "high" and "profitable," actual profitability is only achieved at much higher rates, significantly larger loan sizes, or much more rigorous underwriting, which would mean fewer consumers would qualify to borrow, harming Americans' access to credit. Economic theory, according to Miller, predicts that a 36 percent interest rate cap will create a shortage in the number of loans being made: the quantity demanded will exceed the quantity supplied. Such restrictions can result in "loan rationing" – borrowers are unable to borrow all they need – and "jurisdiction shopping" – consumers residing in states with interest rate caps, or "credit deserts," travel to borrow from lenders in neighboring states.

Revenue and Costs for a Payday Loan, With and Without a Rate Cap

	With a fee of $15 per $100	With a 36 percent rate cap
Revenue, per $100 loan:	$15.00	$1.38
Costs, per $100 loan		
Operating expenses:	$9.41	$9.41
Bad debt expenses:	$3.74	$3.74
Costs of debt/equity capital:	$0.74	$0.74
Total costs:	$13.89	$13.89
Pretax profit:	$1.11	−$12.51
Rational decision:	**provide loans**	**do not provide loans**

Source: Ernst & Young, "The Cost of Providing Payday Loans in a US Multiline Operator Environment," 2009.

"Lending small amounts of money for a short time to borrowers who have displayed a tendency to be unable to pay back loans is a high-risk, and therefore costly, business. Imposing a 36 percent interest rate cap on this market eliminates the supply of payday loans. Eliminating payday loans pushes borrowers with poor, or nonexistent, credit histories toward other options."

In light of the significant consequences of rate caps on consumers' ability to access credit, Miller suggests more research is necessary to understand how and why consumers use credit products to inform regulations.