Interest rate caps harm consumers

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Lawmakers in Virginia appear poised to "fix" an elusive "predatory lending problem." Their focus is the small-dollar loan market that allegedly teems with "outrageous" interest rates. Bills before the Assembly would impose a 36 percent interest rate cap and change the market-determined nature of small-dollar loans.

Other state legislators across the country have passed similar restrictions. To enhance consumer welfare, the goal should be to expand access to credit. Interest rate caps work against that, choking off the supply of small-dollar credit. These caps create shortages, limit gains from trade, and impose costs on consumers.

Many people use small-dollar loans because they lack access to cheaper bank credit – they're "underbanked," in the policy jargon. The FDIC survey classified 18.7 percent of all US households as underbanked in 2017. In Virginia, the rate was 20.6 percent.

So, what will consumers do if lenders stop making small-dollar loans? To my knowledge, there is no easy answer. I do know that if consumers face a need for money, they will meet it somehow. They will: bounce checks and incur an NSF fee; forego paying bills; avoid needed purchases; or turn to illegal lenders.

Supporters of interest rate caps claim that lenders, especially small-dollar lenders, make enormous profits because desperate consumers will pay whatever interest rate lenders want to charge. This argument ignores the fact that competition from other lenders drives prices to a level where lenders make a risk-adjusted profit, and no more.

Supporters of interest rate caps say that rate restrictions protect naïve borrowers from so-called "predatory" lenders. Academic research shows, however, that small-dollar borrowers are not naïve, and also shows that imposing interest rate caps hurt the very people they are intended to help. Some also claim that interest rate caps do not reduce the supply of credit. These claims are not supported by any predictions from economic theory or demonstrations of how loans made under an interest rate cap are still profitable.

A commonly proposed interest rate cap is 36 Annual Percentage Rate (APR). Here is a simple example of how that renders certain loans unprofitable.

In a payday loan, the amount of interest paid equals the amount loaned, times the annual interest rate, times the period the loan is held. If you borrow $100 for two weeks, the interest you pay is $1.38. So, under a 36 percent APR cap, the revenue from a $100 payday loan is $1.38. However,

a 2009 study by Ernst & Young showed the cost of making a $100 payday loan was $13.89. The cost of making the loan exceeds the loan revenue by $12.51 – probably more, since over a decade has passed since the E&Y study. Logically, lenders will not make unprofitable loans. Under a 36 percent APR cap, consumer demand will continue to exist, but supply will dry up. Conclusion: The interest rate cap reduced access to credit.

Currently, state law in Virginia allows for a 36 APR plus up to a $5 verification fee and a charge of up to 20 percent of the loan. So, for a $100 two-week loan, the total allowable amount is $26.38. Market competition likely means borrowers are paying less than the allowable amount.

Despite the predictable howls of derision to the contrary, a free market provides the best quality products at the lowest prices. Government interference in a market lowers quality or raises prices, or does both.

So, to the Virginia Assembly and other state legislatures contemplating similar moves, I say: Be bold. Eliminate interest rate caps. Allow competitive markets to set prices for small-dollar loans. Doing so will expand access to credit for all consumers.

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