California passes new rules that cap payday loan interest at 36%

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There are approximately 23,000 payday lenders in the U.S., almost twice the number of McDonald's restaurants.

More than 23 million people relied on at least one payday loan last year. On Friday, Sep. 13, California passed legislation that would make these loans less expensive for residents.

The California State Legislature passed the Fair Access to Credit Act, which blocks lenders from charging more than 36% on loans of $2,500 to $10,000. Previously, there was no interest rate cap on loans over $2,500, and the state's Department of Business Oversight found over half of these loans carried annual percentage rates of 100% or more.

Payday loans are typically small, personal loans consisting of a few hundred dollars, and for some they can be the only way to get cash quickly. You can get these in most states by walking into a lender's store with a valid ID, proof of income and a bank account. No physical collateral is needed. In recent years, lenders have even made them available online.

Personal loans were the fastest-growing debt category among all consumers in 2018, bigger than auto loans, credit cards, mortgages and student loans, according to credit agency Experian. But payday loans can be extremely risky, in large part because of the expense: The national average APR for a payday loan is almost 400%. That's over 20 times the average credit card interest rate.

The high cost of these loans, and their short repayment period, means that it's easy to get sucked into a cycle of taking out loans and rolling them over instead of paying them off.

"The California Legislature took a historic step today toward curbing predatory lending," Marisabel Torres, California policy director for the Center for Responsible Lending, a nonprofit, said Friday, adding she hopes Governor Gavin Newsom acts quickly and signs this bill into law.

Why lawmakers are taking on payday loans

Payday lending is not a new phenomenon, and there are already federal and state laws on the books to help consumers. But payday loans have been a hotly contested issue since the Consumer Financial Protection Bureau (CFPB), the government agency tasked with regulating

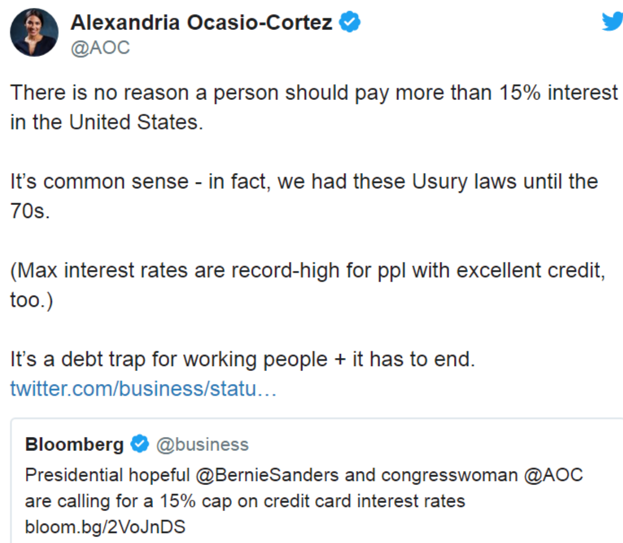
financial companies, said it planned to revisit Obama-era payday loan stipulations that required lenders to ensure borrowers could repay their loans before issuing cash advances.

That rankled many federal Democratic lawmakers, who argued the agency isn't upholding its mandate. So much so, Democrats on the U.S. House Committee on Financial Services also rolled out federal draft legislation in May that, among other things, would cap the APR rate for payday loans nationally at 36%, about double the current credit-card APR.

"I'm not saying to you that all payday lenders are loan sharks, but a good many are," Rep. Al Green (D-Texas) said during the May committee hearing on the legislation. "They have found a way to feast on the poor, the underprivileged and the people who are trying to make it."

Rep. Alexandria Ocasio-Cortez (D-N.Y.) and Sen. Bernie Sanders (D-Vt.) also introduced new legislation in May taking aim at payday loans. They jointly released the Loan Shark Prevention Act, which would cap interest rates on credit cards and other consumer loans, including payday loans, at 15% nationally.

"This is an important issue," said Sanders, who is seeking the 2020 Democratic nomination for President. "If you think Wall Street is disgusting, think about payday lenders." Ocasio-Cortez, meanwhile, said under the current guidelines, credit card companies and big banks have a "blank check" to charge "extortion-level interest rates to the poor."



Payday loans have long been criticized by consumer advocates as "debt traps," because borrowers often can't pay back the loan right away and get stuck in a cycle of borrowing. In research conducted ahead of its rule-making, the CFPB found that nearly one in four payday loans are re-borrowed nine times or more. Pew Charitable Trusts found that it takes borrowers roughly five months to pay off the loans — and costs them an average of $520 in finance charges. That's on top of the amount of the original loan.

To help ensure borrowers were not getting sucked into "debt traps," the CFPB finalized new, multi-part payday loan regulation in 2017 that, among other things, required payday lenders to

double-check that borrowers could afford to pay back their loan on time by verifying information like income, rent and even student loan payments.

But the agency's 2019 review of the rule found the "ability to pay" requirements would restrict access to credit. The new leadership at the agency proposed abandoning these stipulations.

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Critics worry new rules will make cash harder to get.

What happens if more lawmakers succeed in capping interest rates on payday loans? It depends on who you ask.

Some Republican lawmakers and supporters of law-abiding payday lenders say that capping the rates would make it difficult for storefronts to continue to provide these types of loans without collateral. Without these lenders, consumers may not have a lot of options if they need a cash advance.

"Regulations that curb choice and stifle access to credit have no place in our economy," Rep. Blaine Luetkemeyer (R-Mo.) said earlier this year. "Restricting the availability of short-term credit will not solve the financial problems facing so many American families, but it will push them toward riskier and unregulated products."

Diego Zuluaga, a policy analyst at the libertarian think tank the Cato Institute, pointed out in the May congressional hearing that the United Kingdom enacted a similar interest-rate cap on payday loans. He said research found the number of borrowers dropped 53% within 18 months of the cap being introduced, more than double the 21% regulators predicted.

"Given that regulators' forecasts aimed for the 'optimal' amount of payday borrowing, this miscalibration of the interest cap's impact almost surely left hundreds of thousands of borrowers worse off," he told the committee.

But consumer advocates say capping payday loan rates will not significantly impact consumers' ability to get cash. Many states already impose interest-rate restrictions, and consumers have found other ways to address financial shortfalls, says Diane Standaert, director of state policy at the Center for Responsible Lending.

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Ohio, which previously had the highest payday interest rates in the nation, implemented legislation this year that capped annual interest of these loans at 28%. The Record-Courier, a newspaper based on Kent, Ohio, reported that nine companies, including three of the largest

short-term lenders in the U.S., registered to lend under the new guidelines within days of the new rules.

There’s no guarantee any of the legislation proposed by Democrats will get turned into national law, but Rep. Gregory Meeks (D-NY) said these are important issues for lawmakers to consider: “Ensuring access to fair and affordable financial products and protecting consumers from debt traps is, and should be, a priority.”

And in the meantime, states like California are picking up the slack.