



Encouraging Responsible Credit for Financially Vulnerable Consumers

By Joe Valenti July 10, 2014

Center for American Progress



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Introduction and summary

Millions of Americans are financially vulnerable. Yet the credit options available to borrowers in some cases reduce their financial security even more.

The story of Susan Fronczak, a 60-year-old Arizona woman, demonstrates how expensive and risky consumer credit can be. She borrowed \$2,000 from an auto title lender—a company that makes loans pledged by a car title and a spare set of keys—at a 182 percent annual interest rate, under an agreement that would cost her at least \$3,860 to pay back the \$2,000 loan.¹ Ultimately, she could not afford the monthly payments, and her car was repossessed. By the time she was able to get her car back, she had paid more than \$5,000 to the lender.

Unfortunately, many Americans could easily end up in Fronczak’s shoes. Twenty-seven percent of Americans report that they have no emergency savings at all.² Roughly two out of every five American families indicate that they would “probably not” or “certainly not” be able to come up with \$2,000 in 30 days to deal with an emergency, according to the 2012 National Financial Capability Study.³ For Latinos, African Americans, and young people ages 18 to 34, this rises to half of all families. Of families in the bottom third of the income distribution, 68 percent said they would be unable to come up with the money in an emergency.⁴

At the same time, deceptive advertising abounds for easy cash through loans with “no credit check needed” and “same day approval.”⁵ Perhaps not surprisingly, many people turn to these high-cost, short-term loans—such as payday and auto title loans—in response to financial setbacks. These loans are pledged against a future paycheck or the keys to one’s car and are infamous for high fees and predatory practices.

These high-cost forms of lending have virtually disappeared from mainstream banks in recent years. Nudged by financial regulators such as the Federal Deposit Insurance Corporation, or FDIC, and the Office of the Comptroller of the Currency, banks that offer high-cost deposit-advance loans have largely left the market of making cash advances secured by a borrower's future income. These two bank regulators adopted new, common-sense guidance in November 2013 that requires banks to consider borrowers' ability to repay short-term, small-dollar loans based on their banking history over the past six months and to impose a "cooling off" period that would prevent consumers from getting trapped in a cycle of debt.⁶ Even several banks that are not subject to actions by these two regulators announced in January that they would voluntarily end their deposit-advance programs as well.⁷

While banks' departure from this predatory market is a step forward, financially vulnerable consumers are still targets of predatory lenders that generally offer false promises of financial help to deal with financial emergencies. Storefront payday lenders that enable consumers to receive cash upfront in exchange for an agreement to repay principal, interest, and fees in the near future—sometimes as quickly as the next payday—remain legal in 36 states.⁸ And in 21 states, auto title loans—or pledging a car's title and spare set of car keys in exchange for quick cash—are another option.⁹ If the loan is not promptly repaid, the borrower's car can be repossessed. Internet lenders have also entered the marketplace, some of which are situated offshore or on Native American tribal lands in order to evade state and federal laws, even as states have sought to regulate them.¹⁰

Regulators and policymakers have increasingly paid attention to the needs of financially vulnerable borrowers and are taking action both by protecting consumers from bad products and by supporting lower-cost alternatives. The 2007 Military Lending Act greatly curbed predatory payday, car title, and refund anticipation loans to active-duty military service members by capping interest rates on loans made to military borrowers and their families.¹¹ The FDIC has led banks to experiment with affordable small-dollar-loan programs with some success, and some credit unions and nonprofit organizations offer affordable loans as well. Employers have also established financial fitness programs that include short-term credit options, though it is unclear whether these loans will ultimately be a help or a hindrance to consumers.

But regulators and policymakers need to go further to protect consumers:

- Congress should extend to all Americans the 36 percent annual interest rate cap that currently applies to military families, and the Consumer Financial Protection Bureau should ensure that small-dollar loans truly take into account the borrower's ability to repay.
- State governments should pass and enforce 36 percent annual interest rate caps inclusive of all fees, and local governments should use their zoning powers to restrict the growth of high-cost predatory lenders.
- State and federal agencies should continue to use various enforcement mechanisms to target illegal lending activity.
- Congress and the financial regulators should encourage lenders to develop and market affordable alternatives for financially vulnerable consumers.

This report addresses why existing payday and auto title loan options are often harmful. It then outlines existing alternatives and the future steps that can be taken to better protect consumers.