High-Cost Credit Better than No Credit? Not Necessarily

By Todd H. Baker

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A recent opinion piece in The Wall Street Journal by Robert J. Jackson Jr., a Columbia law professor, discusses an interesting research study about the short-term impact on poor-credit borrowers of the usury caseMadden v. Midland Funding LLC.

The study, which Jackson wrote with Columbia business professor Colleen Honigsberg and Fordham law professor Richard Squire, concludes that the decision by the Second Circuit Court of Appeals in New York "significantly" impaired the availability of credit from marketplace lenders for riskier borrowers, those with FICO scores below 625. The ruling said a bank's ability to charge rates above state usury limits did not extend to debt buyers, but the case is seen as harming marketplace lenders that have thus far steered clear of state-by-state usury laws. (The Supreme Court is weighing whether to hear the case.)

The result of the appeals court decision, Jackson's op-ed tells us, is unequivocally a bad thing for borrowers. But his conclusions are based on industry talking points and assumptions that don't stand up to real-world scrutiny. Access to marketplace loans may in fact be useful for a subset of poor-credit borrowers shut out by state usury limits, but the study in question doesn't show it.

It is certainly true that marketplace lending to borrowers with low credit scores has been curtailed by the Madden decision. That's no surprise, as state usury limits are often far lower than the interest rates charged on the marketplace loans analyzed in the study; rates on those loans ranged from 5% to 66% with a mean rate of 18%. Let's not kid ourselves: With rates many thousands of basis points over Treasuries, the unmade personal loans we're talking about would be "subprime" — loans to borrowers with poor credit histories who would have paid through the nose for the privilege of borrowing from a marketplace lender.

Why is Jackson so sure that fewer high-cost subprime loans are a bad thing? He argues the reason is economic inefficiency. As he explains in the op-ed, "The study's result vindicates the teachings of Economics 101: A price cap reduces the quantity of goods supplied to consumers. Lenders unable to charge an interest rate that compensates them for borrowers' risk, we show, will simply exit the market."

Indeed, some lenders may exit the market. But who actually would be hurt by that exit? Professor Jackson says that reducing high-cost marketplace lending to borrowers with poor credit "may well mean sacrificing credit for millions of Americans struggling to make ends meet" and "choke[s] off the supply of marketplace credit to borrowers who need it most."

Really? Perhaps these loans will help borrowers "make ends meet" for a month, maybe. But what about longer-term? What about two months? A year? How many of these borrowers would end up in a better financial position after — as many of them do — struggling and frequently failing to pay off a high-cost loan? Ten percent? Twenty percent? Thirty? What about the borrowers who default?

Jackson doesn't weigh the potential benefits of *not* getting a high-cost loan that you can't pay off. Instead, he uncritically repeats the subprime lending industry's favorite talking point: Making high-cost credit more available to "those who need it most" is both a social and economic good for the borrowers and a positive for the larger U.S. economy. He seems to honestly believe that charging a market-clearing interest rate for a loan — even if the rate is 66% and the chances of default are one in two — is economically efficient, and therefore the socially and morally proper thing to do.

A talking point is just that — talk — and not evidence of anything. If there is a factual basis for the claim that access to high-cost credit generally creates positive change in the lives of financially stressed consumers — whose loans are the most expensive and who have the least ability to repay — or leads to sustainable economic growth, I have not seen it.

On the other hand, there is a lot of historical and economic data which suggests that lending to the financially stressed at high rates is fundamentally wrongheaded social policy, and that the vast majority of the benefit from high-cost credit extensions accrues to lenders and their capital providers. Just take a look at recent studies from the Pew Charitable Trusts to see the devastating impact that high-cost debt has on the actual lives of the borrowers who "need it most." Those unlucky individuals are frequently driven out of the financial system by the consequences of borrowing and rarely, if ever, can pull themselves back in.

As to the larger economic impact, the 2008 crisis showed us that economic expansion driven by high-risk credit is a fool's game. While the rapid growth of mortgage and unsecured credit to poor-credit borrowers during the early 2000s did stimulate economic expansion in the U.S. for a few years, all that leverage-fueled growth, and more, was reversed when the borrowers with access to high-cost loans actually had to pay off the loans. The price of this Potemkin economic growth was a severe recession and the human misery of defaulting mortgage borrowers.

But bad ideas are hard to eradicate. Too many university economists and legal scholars continue to favor the views that poverty can be eliminated by encouraging risky lending to the poor while severely punishing default, and that economic efficiency is the best guide for policy.

Jackson seeks to further buttress his case with the observation that for poor-credit "households, the ability to pay down costly credit card debt with cheaper marketplace loans can be the difference between financial freedom and personal economic ruin." If this were true, it would be a powerful argument in favor of unrestrained lending. Unfortunately, there is no evidence that the borrowers in question actually use the proceeds of alternative loans to "pay down high rate credit" or that their financial situation is improved through borrowing. While alternative lenders report what borrowers say they will do with loan proceeds when they apply, they have no idea what borrowers actually do with the money. Marketplace lenders don't control or even track how loan proceeds are used — it could be anything from paying bills to taking a vacation to buying an appliance. (Oddly, many marketplace lenders don't even report the loans they make to credit reporting agencies because of competitive concerns.)

Even when the marketplace loan actually is used to pay down credit card debt, the next step for a borrower is often to use the newly freed-up credit line on the credit card for more purchases, which effectively doubles down already unsustainable consumer leverage. Recent reports that both bank-issued credit cards and credit card balances are about to surpass 2008 levels suggest that doubling down on card debt is a more likely scenario than the rosy one painted by Jackson.

The U.S Treasury Department's recent study on online marketplace lending similarly seems to fall for the same assumption that all marketplace loan proceeds are being used for the financially positive purposes reflected in loan applications. To be fair, many marketplace lenders serve small-business borrowers, rather than consumers, and some lenders have also targeted higher-earning millennials. And perhaps we can forgive both the Treasury's paper and the study by Jackson, Honigsberg and Squire, for relying on the lenders' thin application data as there is little else to go on.

But until there is clear evidence from long-term studies of borrower behavior that shows that high-cost marketplace consumer loans really are being used to reduce overall leverage and improve family financial stability, it is foolish to assume that they are playing a positive role for low-income borrowers. It would be even more foolish for the industry and regulatory bodies (or the courts) to make important policy and legal decisions about the personal and economic benefit of credit extensions to poor-credit consumers without hard facts about real results.

Restricting access to high-cost credit could certainly hurt some potential borrowers with well-thought-out financial plans. And limiting subprime lending would be a lost profit opportunity for lenders and investors, while any regulatory scheme is sure to have unintended consequences. But fewer high-cost loans could be a hidden boon to many other consumers who will be forced to seek other far less damaging ways of dealing with cash flow problems.

Where do we draw the line? A proper balance would require factual research on long-term borrower outcomes and a willingness to confront hard issues that we know will be difficult to resolve politically and legally.

The questions that need to be addressed are abundant. Should lending operate as a free market where everyone can get a loan at any price, even if the price almost guarantees a bad outcome for the borrower? Should we ban high-cost loans entirely? Is it right to have a system that encourages lending but disproportionately punishes default? Can we design and impose standards that separate the "good" high-cost loans from the ones least likely to have a positive borrower outcome? How paternalistic or libertarian should those standards be? Should we subsidize "good" borrowers when risk-based pricing would undermine the value of a loan to the borrower? What happens to borrowers who are forced into the underground financial system because they can't get credit? And if we limit some high-cost loans but not all, how can we minimize the unintended consequences for potentially "good" borrowers?

Finally, we need to be willing to look outside the lending box and ask what alternatives to borrowing are available to low-income individuals struggling with cash-flow issues. Future low-income consumers may benefit more from access to real-time payments, mobile cash management tools and inexpensive new fintech products like Even — which smooth lumpy paychecks to ensure that regular bills can be paid — than they would from even the best lending product.

These are the complex policy challenges that industry, legislative, regulatory and academic players need to confront head on if we want a financial system which works for consumers, lenders and the country as a whole.

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