

Consumer Finance Monitor (Season 6, Episode 7): A Close Look at the Recent Study of the Effects of Illinois' 36% “All-In” Interest Rate Cap on Small-Dollar Credit Availability, with Special Guest Tom Miller, Professor of Finance, Mississippi State University, and Study Co-Author

Speakers: Alan Kaplinsky and Tom Miller

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor Podcast, where we explore important new developments in the world of consumer financial services and what those developments mean for your business, your customers, and the industry.

This is a weekly podcast show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm. I'm your host, Alan Kaplinsky, former practice group leader for 25 years, and now senior counsel of the Consumer Financial Services Group at Ballard Spahr. I am very pleased to be moderating today's program.

For those of you who want even more information about the subject that we're covering today or literally about any subject in the world of consumer financial services, don't forget about our blog, consumerfinancemonitor.com. Goes by the same name as our podcast show. We've hosted our blog since 2011 when the CFPB became operational, so there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry.

To subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com. If you like our podcast, please let us know. Leave us a review on Apple Podcasts, Google, Spotify, or wherever you get your podcasts. Also, please let us know if you have any ideas for other topics that we should consider covering or speakers that we should consider as guests for our show.

Today I am joined by Tom Miller. Tom Miller is a professor of finance and inaugural holder of the Jack R. Lee Chair of Financial Institutions and Consumer Finance at Mississippi State University. He's also a senior research Fellow at Consumers' Research in Washington, DC. Professor Miller received his PhD in finance from the University of Washington in Seattle and his Bachelor's and Master's degrees in applied economics from Montana State University. He's taught at the University of Washington, the University of Missouri-Columbia, Washington University in St. Louis, and St. Louis University. His current research includes projects on various aspects of consumer credit and specifically small-dollar installment loans. Professor Miller also maintains an active research interest in derivative securities. He's the author of *How Do Small-Dollar, Nonbank Loans Work?* And a co-author of *Fundamentals of Investments: valuations and Management*. Professor Miller's interests include American saddlebred horses and playing jazz and blues on his tenor saxophone. I wish I could play jazz and blues on a tenor saxophone, but we do share a common interest in jazz. So Tom, a very warm welcome to our show today.

Tom Miller:

Thank you, Alan. It's good to be back. I'm a real fan of the show, and I'm honored to be a guest.

Alan Kaplinsky:

Well, thank you very much. That's kind of you. Let me first tell our audience why I invited you back to our show because you are a, I guess you could say a recidivist. You've been on our show before. Tom, along with J. Brandon Bolen of Mississippi College and Gregory Ellichhausen of the ... I hope I pronounced that right ... Of the Board of Governors of the Federal

Reserve System, have done a study entitled, The Effects of Illinois's 36% Interest Rate Cap on Small-Dollar Credit Availability and Financial Well-being. This was done in the aftermath of Illinois enacting a statute not too long ago that put a 36% rate cap on certain types of loans. Tom will explain and give you more background on the origin of the study and why he did it in just a couple of minutes.

Let me jump into the fray here, Tom. I've got a lot of questions for you. As I just indicated, your research investigates the effects of the Predatory Loan Prevention Act that was passed in Illinois in 2021. Tell us, first of all, what is the Illinois Predatory Loan Prevention Act?

Tom Miller:

Well, this act went into effect in March of 2021, and it caps interest rates. It's called an all-in APR, so any fees or whatever rolled into the installment payment. Any consumer loan product under \$40,000 puts a cap of 36%. The Act exempts banks and credit unions, but it does apply to any other entities, including online lenders who lend to consumers in Illinois. One thing about this act, it wasn't a long time coming. People weren't really prepared. There's no way to prepare for it. It just kind of boiled up and went into law in March of 2021, which basically is pretty close to the end of the first quarter of 2021.

Alan Kaplinsky:

Once this act was enacted, how did it arise that you and your colleagues decided it was worthwhile to do a study of the impact of the statute? How did that happen?

Tom Miller:

Well, I've had a long-standing interest in studying a very particular type of loan product called an unsecured installment loan, which is typically offered by finance companies, and that loan product is an interesting thing. It came into existence through a collaboration between activists and capitalists in the early teens. That's not 20-teen, it's 19. So the Uniform Small Loan law of 1916 said, "Here's some ways for us to avoid illegal lenders and provide safe, affordable credit for people." That product was interesting because the activists and the capitalists came together in a very cordial way to figure out how can the industry provide loans? They said, "Well, what we'll do is we'll set the rate about six times higher than the current usury loss," which was 6%. So they moved it to 36%, where it's basically remained to this day even though costs and wages and whatnot have gone up.

Anyway, when we saw this law go into existence, I thought, "Well, if we could get some data from credit bureaus and compare what happened in Illinois where the law went into effect versus what happened in a state where there was no law that went into effect, what could we see?" Because it's kind of a natural difference-in-difference kind of an experiment that we could run.

We chose Missouri because Missouri has no rate cap other than what the market sets for interest rates on installment loans. So we just felt it was a natural experiment to do and approached someone at the AFSA and asked if they could get us data. We have no paid relationship with the folks at the American Financial Services Association, but know them well enough to approach and say, "Hey, can you give us this data?" They agreed, and we put a stipulation on them that we can publish whatever we find, and they agreed that they will not influence the study in any way, shape or form. So it's a legitimate academic study, and we're very happy that they were able to collect data from a credit bureau. I'm really not sure which one, one of the big three, on the size and number of unsecured installment loans.

Alan Kaplinsky:

What kinds of loans, Tom, are charging more than 36% that were affected by the law? You're talking about installment loans, not payday loans?

Tom Miller:

Well, payday loans would certainly fall under the law. We didn't study payday loans, but it's my belief that a 36% interest rate cap will render any lump sum payday loan unprofitable. It's a mistake to take the interest that's paid back on a two-week installment loan and annualize that to a year. It's like living in a hotel room for a whole year. Nobody does that.

Anyway, but under the law, an annualized rate will force out payday for sure. Pawn loans, pawn is an interesting product because it's really not a loan. There's no recourse from the pawn broker if you don't pay back the loan. They just keep your moose head or whatever you've pawned. But they still operate in the State of Illinois.

Alan Kaplinsky:

I assume on the pawn loans the interest rate effective yield is above 36%.

Tom Miller:

That's right. I mean, I don't believe pawn brokers were affected by this legislation. Typically, in a pawn transaction, the typical rate is \$25/100 for a month, so 25x12 would be the annual percentage rate, which is, see if I can do this in my head, 300%. But again, nobody holds an item in pawn for a whole year. You hold it for a month and then you have the option to walk away. Pawn loans are kind of an interesting product and have existed since time in memorial really.

Alan Kaplinsky:

Who, among the universe of borrowers in Illinois, who uses unsecured installment loans and for what purpose do they borrow?

Tom Miller:

Well, we're really not sure of the purpose because people can say they're using the installment loan to go pay bills or go Christmas shopping, but money's fungible so any money that people have can be used for whatever purpose.

But I was surprised when we did our study that we asked ... One of the things I wanted to do was to see how different credit scores, like Vantage credit scores, how they were affected or even how they were distributed across the landscape. What we found out, or what I thought was kind of surprising is that the finance companies or what's called other companies from the credit unions, they operate all the way from credit scores 300 to 500 all the way up to 850. The banks and credit unions have much smaller numbers, but they're skewed toward the higher-end credit scores. But I was surprised to see that banks and credit unions offer a few loans in the low credit score, the subprime area; whereas the finance companies tend to be centered around say, 575, 600, somewhere like that. People all across credit scores, which I think is an interesting finding of this paper, take out these small-dollar cash unsecured loans, installment loans.

Alan Kaplinsky:

When you started your study, what did you expect to find? Then we'll get into a little later what you actually found.

Tom Miller:

Well, what we expected to find is an interest rate cap is just a rent control or a control on the price of money, and so any rate cap you have or any price cap will create shortages, it'll reduce transactions or gains from trade, and it'll impose search costs on people to fulfill their product or their product need. But interest rate caps have an additional thing is that theory says that interest rate caps will reduce credit availability to high-risk borrowers. The lenders will shift money away from high-risk borrowers to low-risk borrowers.

Alan Kaplinsky:

Okay. What are the data sets that you used to study the effects of the cap on unsecured installment loans?

Tom Miller:

Well, as I said, we asked to get credit bureau data, and we have four quarters of credit bureau data stemming from the fourth quarter of 2020 through the third quarter of 2021, so four consecutive quarters. We have Missouri and Illinois data by county, the number of loans by VantageScore buckets, the average size of the loan and data by three providers: banks, credit unions,

and other companies. We put those VantageScores into different buckets, subprime less than 600, near-prime 600 to 649, prime greater than 650.

The other dataset we had is a survey that the results of which were provided to us by the Online Lenders Alliance. So we actually had the results of a survey that they did of customers whose online lenders left the state. That survey was done nine months or so after the imposition of the act.

Alan Kaplinsky:

Okay. Let's get to what you were able to document after taking all that data and running it through whatever process you used. What was the end result?

Tom Miller:

Well, yeah. First we used Vantage Credit Scores to sort borrowers into bins. Borrowers with Vantage Credit Scores up to 600 are subprime borrowers, and those with Vantage Credit Scores over 650 are prime borrowers. Recall that we had four consecutive quarters of data, two before the act and two after. Using our estimation method, we found that the number of loans that sub-prime borrowers would have received, had the law not been passed, fell by about 34,000 loans. Roughly a 44% decrease. By contrast, prime borrowers, those who had abundant credit options, saw an increase of about 19,000 loans over the same period. About a 20% increase. In addition, the average loan size for subprime borrowers increased by about \$700 after the imposition of the rate cap. Finally, we did not see much of an increase in the supply of loans by banks and credit unions, even though they're exempt from the act.

Alan Kaplinsky:

How can you conclude from that, that that's not a good thing for borrowers? I assume the people, the proponents of the legislation, felt that borrowers were over extended and were in a cycle of debt that they couldn't escape from, and the government felt they had to impose a rate cap because those people shouldn't be borrowing to begin with. How do you know that's not a good result?

Tom Miller:

Well, actually we're in the business of supplying the results, and we let the regulators and legislatures decide what to do with the results. My thinking personally is people are better off when they have more options, and if they have options to run their lives, that's a better thing. Simply because people don't have a lot of money doesn't mean they necessarily make bad credit decisions or bad financial decisions. I think bad financial decisions are equally dispersed. They're dispersed throughout the range of income and credit soundness or the credit scores.

Alan Kaplinsky:

I guess, as I'm thinking about it, the universe of people in Illinois who were directly impacted by the legislation, I suppose there are other ways in which they could borrow money. They could go on the internet and borrow from some offshore source who might be willing to lend illegally into Illinois because they know that Illinois can't go after them. Or it could be a Native American tribe they could be borrowing from. I mean, a lot of different ways in which they could borrow. It's a lot more inconvenient for people, but doesn't mean necessarily they no longer can get money that they need to live, to take care of medical bills, to repair their car, et cetera.

Tom Miller:

Yeah, and that's a really hard question to answer. Where do people go when this particular loan product is choked off? One of the things people might do is just try to scrimp and cut expenses, not repair their car, not repair their house, not buy school supplies for their children, however people finance their shortfall just by trying to match expenditures. The common refrain that I hear is, "Well, people should just go to their friends and family to borrow." But that's a kind of tricky thing. I mean, it's

hard to borrow money from your friends and family really. I suppose you could try, but really you can't do it for size. I mean, an arm's-length transaction is better.

The legal online lenders left Illinois because they were subject to the law, and they could be prosecuted. Now, I really don't know much about offshore online lending. There's lots of different lending options out there, and I think the more I study the small-dollar loan space, just the more complicated it seems to be. I mean, there's really no clearcut type of answers. Where do people go? What products are available, and et cetera?

Alan Kaplinsky:

Right, right. So there have been some critics of the work that you've done. I saw Professor Adam Levitin posted something on the Consumer Law Blog. What are the critics saying, and how do you respond to them, Tom?

Tom Miller:

Well, our paper is a working paper, and it is posted on the Social Science Research Network or the SSRN, and it will be submitted through a peer-reviewed process. Really the critics that we pay attention to are those that are in the process of getting it posted.

I think one of the criticisms of Professor Levitin was that we don't study the whole subprime lending market, and that's true. We don't. We say upfront we are studying one particular loan product. So good research then should just focus and say, "Here's the product we're studying, here's the time period, here's what we find." That's one piece of a mosaic that other researchers and legislators can build a picture and say, "What does it really look like in this space?"

As a result, as you were saying, there's all these different sources of loans and who knows where people go, but that's not what we do in our study. We focus specifically on unsecured traditional installment loans. Another perhaps criticism is that, gee, all we find is that the number of loans to subprime borrowers fell, and at the same time we saw the number of dollars, the loan amount, went up to subprime borrowers. That's exactly the point of our study though, is that's what we found.

Alan Kaplinsky:

I'm going to drill down a little bit on what you just said. Those subprime borrowers who were able to continue to borrow had to borrow more money than they wanted to borrow? Is that to get above certain thresholds where there was no rate cap?

Tom Miller:

Yes. Well, we don't know if they borrowed more than they want to borrow. They did borrow more, and the economics of the loan space, Greg Elliehausen, who just recently retired from the Federal Reserve by the way, but he had done a study with one of his colleagues there to figure out what's a breakeven loan size. Because if you make a big enough loan, you can just think, a great big loan throws off a lot of interest at any interest rate. But what Greg and his co-author found is that a breakeven loan size who approached 2,500, 2,600 3,000 in that area. If you wanted to borrow \$1,000, the lenders say, "Look, that loan is just not profitable for me to make."

So what we found is yes, the size of the loans did go up for subprime lenders from up to \$600 higher, like \$2,700, so approaching that breakeven point to subprime borrowers from the lenders. We'll have to drill down on that more and see how that fits into previous research on the breakeven loan size. But it's not a surprise that the loan size went up because you put on the cap, you have to make a bigger loan to cover costs, which includes default costs, which are big in this space.

Alan Kaplinsky:

So Illinois is not alone in enacting legislation creating a 36% all-in rate cap. Am I right? Several other states have already done that. I think my recollection is correct. New Mexico for one, I think has done it, but there may be a half a dozen that have done it. Right now I'm sure there are many other states that are considering doing the same thing. I'm wondering, can you extrapolate from your study of Illinois what the impact is going to be in these other states? Or are all the circumstances unique in each state?

Tom Miller:

Well, that's a really good question. I would say that we would predict that would see a decline in the number of loans to subprime borrowers wherever an interest rate cap is placed. That's a prediction. Then we should test it to see what happened in a particular state, like say New Mexico as compared to states without interest rate caps like Missouri, for example and I think Utah perhaps. I think we can make predictions about what we see, but we can't say it will happen for sure until you go test it with data and find out.

Alan Kaplinsky:

The Federal Government also, from time to time legislation has been introduced to create a national usury ceiling on all-in rate cap of 36%. Hasn't gone anywhere, hasn't gained any traction. I would guess that's the reason why the advocates of a 36% all-in rate cap have decided to turn to the states to try to go state by state to enact this kind of a cap. Do you agree with that?

Tom Miller:

Well, I think we've seen a lot of momentum on a 36% rate cap. I would just like to remind anyone who's in favor of that is to think that that rate cap or that price has been in effect for over 100 years. So if you think of any other prices since the early teens have gone up with inflation or what have you, and so the way that if you put on a 36% interest rate cap, what you'll see are bigger loans. So people who need \$1,000 and can pay it back over 12 monthly payments, just are shut out of that particular product and have to search elsewhere. You're right in that there has been a big push for the Federal Government to impose a 36% interest rate cap. The Military Lending Act, for example, is one of them. Congress can certainly do what Congress wants to do. The CFPB is prohibited by statute from Dodd-Frank from setting a rate cap themselves.

Alan Kaplinsky:

They've sort of figured ways around that haven't they, Tom?

Tom Miller:

Yeah. Yeah. I mean, they can lobby Congress or talk to Congress and advocate for a rate cap. I'm not against legislation. I'm just against bad legislation or legislation that has consequences that can harm people. I'm not in favor of rate caps. I think the market itself can set the price of loans, just like it can set the price of sofas. So we set the price of sofas by the supply and demand for sofas, then we're going to go finance the sofa. Well, there's a rate cap on what we can charge. Anyway, it's just a fascinating area to study, and I think there will be continued pressure as we go forward for imposition of more rate caps around the country.

Alan Kaplinsky:

Yeah, sure. Okay. We've drawn to the end of our program today. I want to thank you very much, Tom, for taking the time to join us, being very, very generous with your time and want to commend you on the fine work that you're doing. I'm sure at some future date we'll have you back because either you'll be doing some other study or something else that pertains to the consumer finance industry.

Tom Miller:

Yes, we sure will. Again, I just want to say I'm honored to appear, and it's always a pleasure to talk to you about these issues. I actually just want to say once again that the market is the best advocate for consumers. The market, free choice, really matters for people.

Alan Kaplinsky:

Yeah. Yeah. So to make sure that you don't miss any of our future episodes, subscribe to our show on your favorite podcast platform, be it Apple Podcasts, Google, Spotify, or wherever you listen. Don't forget to check out our blog,

consumerfinancemonitor.com for daily insights of the financial services industry. We very recently did a blog about the very topic that we're talking about today on our show.

If you have any questions or suggestions for our show, please email us at podcast@ballardspahr.com. Stay tuned each Thursday for a new episode. I want to thank all of our listeners today for downloading our program. I hope you continue to listen each week as we produce another show that is likely to be pertinent to your interest in the consumer finance industry. Thank you for listening, and have a good day.