Statement for the Record

On behalf of the

American Bankers Association

before the

Committee on Financial Services

of the

United States House of Representatives

February 5, 2020

"The concern for the consumer and for the less affluent is well taken. But often it has been expressed in a form that has done the consumer more harm than good. [Economists] have demonstrated that setting too low ceilings on small loan interest rates will result in drying up legitimate funds to the poor who need it most and will send them into the hands of the illegal loan sharks. History is replete with cases where loan sharks have lobbied in legislatures for unrealistic minimum rates knowing that such meaningless ceilings would permit them to charge much higher rates.

* * *

Finally let me speak to the legitimate concern of consumer groups. With the best intentions in the world some in that field cannot see the great harm which too low ceilings do to the equitable and efficient workings of the capital markets. This has been proved time and again in connection with deposit rate interest ceilings mortgage ceilings and so forth."

Testimony before the Massachusetts General Court[1]
Paul A. Samuelson
First American Nobel Prize Winner in Economics,
Advisor to Presidents John F. Kennedy and Lyndon B. Johnson

[1] *Statement by Dr. Paul A. Samuelson Before the Committee of the Judiciary of the General Court of Massachusetts in Support Of the Uniform Consumer Credit Code (January 29, 1969)*. As entered by Chairwoman Leonor K. Sullivan (D-Missouri) into the hearing record of the Subcommittee on Consumer Affairs, U.S. House of Representatives Committee on Banking and Currency: *Hearing on Consumer Credit Regulations (Session Part I of II)* February 26, 1969.

Introduction

The American Bankers Association[2] (ABA) appreciates the opportunity to submit a statement for the record for the hearing titled "Rent-A-Bank Schemes and New Debt Traps: Assessing Efforts to Evade State Consumer Protections and Interest Rate Caps."

Bank partnerships can protect consumers

We share your concern that consumers be protected when they apply for and are approved for credit. It is our belief that consumers are best protected when credit products are provided through channels associated with a chartered, regulated bank.

Some non-banks are using new platforms to essentially deceive and in extreme cases, defraud, consumers. We are also concerned about the potential emergence of standalone "big tech" providers of financial services who use regulatory arbitrage to achieve advantages over banks by neglecting to observe bank-level standards around data protection, privacy, consumer protections, and safety and soundness.

In contrast, bank partnerships allow other sectors, such as retailers, to serve their customers better. This is one of the reasons our Nation has maintained a longstanding doctrine of separating banking and commercial activities. The heavily-regulated banking industry can provide services to others in a manner that improves the condition of all parties. We believe that public policy risks are made more acute when lenders are *not* associated with a bank.

As recently as last week, ABA filed comments[3] with the Financial Technology Task Force of this Committee stating clear opposition to lightly-regulated non-banks gaining direct access to the Nation's core payment systems operated by the Federal Reserve. In the same comments, we provided current examples of regulatory hurdles such as the Durbin Amendment which prevent many underbanked Americans from accessing basic banking services from reputable financial services companies.

Interest rate caps harm consumers and freeze credit markets

But some overly-aggressive proposals to prevent abuses by non-banks would do more harm than good to current bank customers. Specifically, we know from years of accumulated observations of credit markets that when nearly-universally discredited restraints like price caps are imposed, consumers lose access to high-quality credit through the regulated financial system and are forced to seek the service of inferior, unregulated lenders on unconscionable terms.

Legislation to cap lending prices is not as advertised by some advocates: it is more than just "interest rate caps" and would undermine basic presumptions about how consumer credit markets operate. H.R. 5050 (the Veterans and Consumers Fair Credit Act), for instance, mandates an all-in ceiling that will impact loans

---

[2] The ABA is the voice of the nation's $17.9 trillion banking industry, which is comprised of small, midsized, regional and large financial institutions. Together, these institutions employ more than 2 million people, safeguard $14 trillion in deposits and extend more than $10 trillion in loans.

[3] Comments of the American Bankers Association for the House Financial Services Committee Financial Services Task Force hearing titled, "Is Cash Still King? Reviewing the Rise of Mobile Payments." January 30, 2020. https://www.aba.com/advocacy/policy-analysis/statement-fintech-task-force-mobile-payments-and-a-cashless-society

with interest rates *below the rate stated in the legislative text*. In addition to not containing an immediately transparent description of the loans affected, provisions in the bill also call into question the long-standing doctrine of preemption that has allowed banks to serve customers nationwide with innovative products.

If enacted, these kinds of restrictions would be a step backwards into what the late Nobel Laureate Paul A. Samuelson referred to (in 1969, at the advent of the modern era of finance) "the hodgepodge that has hitherto characterized our history."[4] As new data presented in these comments demonstrate, H.R. 5050 and similar bills to cap charges associated with consumer loans likely would significantly reduce access to good mainstream financial products such as credit cards. Supporters of this bill admitted as much when they suggested that the consequences of the bill could be ameliorated by consumers visiting pawn shops or borrowing money from friends. These proposals do not represent progress for consumers.

Furthermore, these bills were introduced without rigorous investigation into their effects on the consumer credit market, nor calculations about their impact on consumer welfare. In the absence of cost estimates or other forecasts, we urge caution about such dramatic one-size-fits-all proposals. Given that the consensus of economic science is that such proposals are harmful, caution is even more prudent. Fortunately, as embodied in decades of accumulated law, consumer protection is possible through means other than arbitrary price caps. Notably, landmark financial regulations of the modern era such as the Dodd-Frank Act eschewed the use of consumer credit price caps.

The unequal impact of interest caps

Consumers face a variety of credit choices in the formal and informal loan markets. The quality of these choices differs vastly. Consumers of substantial means are most likely to be able to finance their spending from their own savings and investments, and if they are not, they are also most likely to have access to funds from family, friends, or associates, lent on friendly terms. They are unlikely to be familiar with options such as payday loans, pawnshops, auto title loans, or even less attractive options in the black market.

For some Americans who may require the convenience of unsecured credit, a policy decision that effectively revokes their access to credit (without any compensating replacement) can cause a significant disruption to life. A family that does not qualify for the lowest interest rates or know someone willing to lend to them on short notice and good terms is left to make hard choices when the unexpected happens. A car that breaks down may go unfixed and a job unworked, or a home unheated when a boiler fails. When people in need cannot meet their credit needs through financial institutions, the need does not go away; instead, people are driven to "informal" sources.

---

[4]Samuelson, P. (1969) Testimony to Massachusetts General Court.

New Data: Interest Caps Significantly Reduce Access to Credit Cards

American consumers highly value their credit cards for a host of reasons, including the quick access to credit and ease of completing transactions. Most credit cards also offer rewards, which are particularly popular with consumers: more than 90% of all credit card spending is charged to rewards cards, and 96% of rewards cardholders consider these programs valuable.[5] Despite their popularity, however, there is growing interest for Congress to pass a bill that would fundamentally change the credit card market by capping the interest rate credit card companies (and other providers of short-term credit) can charge borrowers. Two such bills were introduced in the past year: H.R. 5050 (the Veterans and Consumers Fair Credit Act) and H.R. 2930 (the Loan Shark Prevention Act). A cap like the ones proposed in these bills would upend the credit card market in multiple ways, including by reducing credit access among borrowers with less-than-perfect credit histories. Specifically, nearly 95% of subprime borrowers would be at serious risk of losing access to credit cards under the 15% retail APR cap proposed in H.R. 2930.[6] A rate cap would also reduce the value and prevalence of rewards programs, which would affect consumers across the risk spectrum.

Interest rate cap would reduce credit card access

A cap on credit card interest rates is a price control. Wherever instituted, price controls lead to shortages and raise other costs to compensate for the lost sales resulting from operation of the cap. In this instance, the interest rate cap will lead to a shortage of credit for borrowers who credit card issuers consider to be higher-risk based on their credit history. In addition, while a rate cap would reduce interest rates for some credit card users, it would paradoxically *increase* the cost of credit for other borrowers.

An interest rate cap would likely be set below the rate issuers need to compensate them for the risk of issuing unsecured short-term loans to high-risk borrowers. Since issuers would not be able to charge these borrowers a rate that adequately compensates them for the risk of extending credit, they will most likely stop offering credit cards to these consumers. If issuers continued to offer these borrowers credit at rates below the cap, the issuers would soon be incurring losses that make these loans unsustainable.

Restrictions like the 15% interest rate cap proposed in H.R. 2930 and the 36% "all-in" cap in H.R. 5050 would have dramatic effects on credit access. Nearly 9 in 10 credit card accounts (and 95% of subprime accounts) have an annual percentage rate (APR) above 15%, while 6 in 10 accounts have an APR above 18%.[7] While accounts with rates that are slightly above the cap may see those rates adjust downward to the cap level, tens of millions of consumers would face a serious threat of losing access to credit cards under such a cap. Moreover, a fixed cap as proposed in the two bills would become even more problematic in the future if the Federal Reserve Board raises interest rates to tamp down inflation pressures. This is because most credit card APRs are variable and tied to the prime rate: when the prime rate shifts due to

---

[5]Phoenix Marketing International (2016), "2016 Credit Card Monitor Report."

[6]Based on ABA analysis of Verisk Financial | Argus data from June 2019. Sample excludes accounts with promotional interest rates.

[7] *ibid.*

Fed policy (or other factors), credit card APRs shift as well. Currently, the prime rate is low compared to its historical average, but when it rises, even more accounts will be affected by a rate cap.[8]

Academic research has confirmed that rate caps lead to lower credit access. Three recent studies examined the impacts of a 36% rate cap in Chile. They found that rate caps dramatically decrease access to credit, and one study observed an outsized negative impact on the youngest, poorest, and least-educated families.[9,10,11] In addition to this research, a 2010 study analyzing the effect on consumers of a regulatory change in Oregon found that rate caps caused deterioration in household financial conditions, while a historical study of British consumer credit published in 2008 found that rate caps distort credit markets and reduce consumer welfare.[12,13] Related research examining the effect of rate caps in the online lending and auto loan markets have come to the same conclusion.[14,15]

Such a reduction of credit card access occurred after the Federal Reserve finalized rules that regulated credit card contract terms in December 2008 — rules that were largely codified or superseded by the Credit Card Accountability Responsibility and Disclosure Act (CARD Act) of 2009. While the CARD Act did not impose an explicit cap on interest rates, it restricted several practices credit card issuers have used historically to manage risk, most notably the ability to increase interest rates on existing credit card balances. In response, card issuers predictably reduced credit access: subprime accounts declined by nearly 40% in the subsequent five-year period and remain 11% below 2008 levels — a loss of nearly 10 million subprime cardholders. Among new accounts (i.e., those opened over the preceding two years), the effect is even more stark: subprime account openings fell by nearly two-thirds over a five-year period and remain 17% below pre-regulatory levels.[16]

Interest rate cap would raise costs

Under a rate cap, banks would receive less revenue and incur losses if they continue to offer credit cards to higher-risk borrowers. To compensate, issuers may increase the fees they charge, such as for late payments and annual membership. Those fee increases may be applied to all credit card users and, if so, they would

---

[8]As of December 2019, the average prime rate among the top 25 lending banks is 4.25%, down from its 30-year historical average of 5.9%. Federal Reserve Bank of St. Louis (2020).

[9]Cuesta, J., and Sepúlveda, A. (2019), "Price Regulation in Credit markets: A Trade-off between Consumer Protection and Credit Access."

[10]Schmukler, S., Tessada, J., Vasquez, C., and Vera, M. (2019), "Winners and Losers from Interest Rate Ceilings: Quasi-experimental Evidence from Chile."

[11]Madeira, C. (2019), "The Impact of Interest Rate Ceilings on Households Credit Access: Evidence from a 2013 Chilean Legislation," Journal of Banking and Finance, 106:166-179.

[12]Zinman, J. (2010), "Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap," *Journal of Banking and Finance*, 34(3):546-556.

[13]Temin, P., and Voth, H.-J. (2008), "Interest Rate Restrictions in a Natural Experiment: Loan Allocation and the Change in the Usury Laws in 1714," *The Economic Journal*, 118(528):743-758.

[14]Rigbi, O. (2013), "The Effects of Usury Laws: Evidence from the Online Loan Market," Review of Economics and Statistics, 95(4):1238-1248.

[15]Melzer, B., and Schroeder, A. (2017), "Loan Contracting in the presence of Usury Limits: Evidence from Automobile Lending."

[16]Verisk Financial | Argus (2020). Note: based on data from 2018Q4.

hurt borrowers at all risk profiles. Issuers also may pare back consumer rewards, such as points at certain retailers or cash back. Issuers might also raise interest rates for lower-risk borrowers with currently low APRs under the cap, causing those borrowers' costs to rise if they carry balances despite having a strong credit history.

H.R. 5050 also imposes a cap on the fees that lenders may charge on a loan. If enacted, this may lead card issuers to increase fees that are not covered by the cap or deny credit card access to more borrowers (or both). Though there is uncertainty regarding what fees would be included in the 36% "all-in" cap proposed in H.R. 5050 and the precise effect of the law is thus difficult to quantify, if an all-in rate cap were equivalent to a 27% retail APR cap, this would translate to 13.8 million subprime borrowers (or 20% of subprime accounts and 4% of all accounts) who may lose credit access. Similarly, if an all-in rate cap were equivalent to a 27.5% retail APR cap, 6.9 million subprime borrowers (or 10% of subprime accounts and 2% of all accounts) would be directly impacted and may lose credit access.[17,18]

The minority of consumers whose accounts carry rates that are currently just above the cap level may find that issuers remain willing to extend them credit at the cap level (though potentially at a reduced credit line) and, as such, would be the main beneficiaries of a cap. However, based on real-world examples, this group of consumers would be far smaller than the group who would face higher rates and fees under a cap, or who would lose access to credit altogether. Research published in 2019 that examined a rate cap in Chile found that only 16% of consumers benefited from lower fees, while 82% were harmed through reduced credit access.[19] Moreover, higher-risk borrowers — who were presumably the intended beneficiaries of the rate cap — were disproportionately harmed by the Chilean rate cap regulation: loans to higher-risk borrowers declined 24% following the regulation.[20]

Loss of credit cards unfair to those who would repay

The loss of credit card access would be an additional hurdle to many borrowers who have imperfect credit histories due to financial stress related to unexpected medical expenses, job loss, and/or the 2008-09 recession, but who are now financially better-positioned and ready to rebuild their credit rating. Using a credit card and staying current on monthly payments is a great way for them to raise their credit score and demonstrate their credit-worthiness to prospective lenders, enabling them to purchase a home, car, or other essentials, or to take out a loan to start and grow a small business. A rate cap would make it more difficult for card issuers to extend credit to individuals who may have fallen on hard times during the aftermath of the Great Recession but are now back on their feet and deserving of a second chance.

In addition, for young consumers with no credit history, opening a credit card is often the best way to build up their credit rating, putting them in a better position to secure housing, employment, transport, and other necessities later in life. With a rate cap in place, card issuers may not be able to offset the risk

---

[17]Based on ABA analysis of Verisk Financial | Argus data from June 2019. Sample excludes accounts with promotional interest rates.

[18]ABA is currently working with Verisk Financial | Argus to determine with more precision which fees would be covered under H.R. 5050 and, by extension, what the equivalent retail APR cap would be under the law.

[19]Cuesta, J., and Sepúlveda, A. (2019).

[20]*ibid*.

associated with lending to consumers with no credit history, thereby limiting young consumers' abilities to take out a mortgage or qualify for other loans and impairing their path toward financial independence.

Lack of credit access would harm those that need it most

Consumers who lose their credit cards because of the cap will suffer because they will lack quick access to credit in a pinch. These borrowers often rely on their credit card as a last resort when needed. If they face an unexpected bill for healthcare, car repair, or other financial emergency, they will still need to find a way to pay for these expenses. That means they may turn to payday lenders or other providers of short-term credit — whose loans typically carry higher interest rates than credit cards.

However, most interest rate and fee cap proposals — including H.R. 5050 and H.R. 2930 — would also apply to non-credit card lenders (e.g., payday lenders). As a result, millions of borrowers who currently rely on credit cards may be forced to turn to pawnshops and other less-attractive options. Further, research demonstrates that when consumers lose access to credit, they often reduce spending on essentials such as healthcare, education, and food, and are more likely to fall behind on bill, mortgage, and rent payments.[21] Other borrowers will find the funds they need, but they will end up paying much more interest than they would have had they still had their credit cards.

Those that no longer have a credit card will also lose out on the ease and convenience of paying for everyday items. Those who have fluctuating incomes will lose the ability to delay payment temporarily until income is received. Lack of a credit card would also likely reduce their consumption of higher-priced items like furniture and clothing. Stores that sell such goods no longer provide store credit like they once did. Without a credit card, these consumers will not be able to buy high-cost necessities.

Noting the decrease in credit access brought on by rate caps, some policymakers have suggested instituting postal banking or another public banking option to expand credit to riskier borrowers who would be otherwise priced out of the lending market.[22] While such policies could address credit access if carefully designed and implemented, they would also lead to a consolidation of high-risk borrowers at below-market rates, effectively subsidizing their loans with taxpayer money.

Credit card interest rates should be determined by market forces

While it is true that credit card interest rates are typically higher than rates for other forms of credit, and that riskier borrowers typically face higher rates than low-risk borrowers, these realities reflect the fundamental nature of credit markets and are not evidence of unfairness. Credit card lending is inherently riskier to lenders than other forms of credit, particularly for subprime accountholders. For example:

- Credit card lending is unsecured, making it riskier to the lender than other types of loans. Unlike a loan for a home mortgage or a car loan, for instance, a credit card issuer does not have a physical item to repossess to help recoup their cost if the borrower defaults.
- A credit card is a revolving line of credit; that is, the borrower is only required to pay off a certain amount of the card balance each month. Revolving credit accounts pose additional risk to the lender because their cost of funds could increase — or the borrower's risk could rise (e.g., if the borrower loses their job or has a sudden increase in living expenses) — while the account carries a balance,

[21]Cuesta, J., and Sepúlveda, A. (2019).

[22]See Bernie Sanders' and Elizabeth Warren's proposals on financial regulation.

thereby changing the risk profile of the loan. Moreover, higher-risk borrowers are more likely to hold balances on their cards, and for longer periods.

- All else equal, subprime borrowers are more likely to default on a loan than prime or super-prime borrowers. Like most lenders, credit card issuers offset this additional risk by charging a higher interest rate for amount borrowed.

In order to extend credit to cardholders, credit card issuers need to be compensated for all these risks, in part by charging a higher interest rate. To the extent a rate cap prevents issuers from charging a rate that is commensurate with the risk imposed by subprime borrowers, issuers will be less willing — or unwilling — to offer them credit.

Differential rates help borrowers

Setting different interest rates based on borrowers' risk profile is a relatively new innovation in the credit card market. In the not-too-distant past, credit card issuers lacked the tools or technology to vary rates in this way; instead, issuers set one (usually high) rate for all accounts. This was suboptimal for consumers in several ways:

- Lower-risk borrowers paid higher rates than their risk required, effectively subsidizing higher-risk borrowers.
- The high rates priced many would-be credit card users out of the market (even if they imposed very little risk to issuers' lending portfolios).
- Some higher-risk would-be borrowers were denied access to credit cards because issuers could not adequately identify them in advance and charge them a higher-than-average rate to offset the additional risk they posed.

Innovation has allowed credit card issuers to charge users interest rates that reflect their varying risks, helping both low-risk and high-risk borrowers. Higher-risk users now have access to credit cards they lacked before and the convenience that cards convey. Lower-risk users now pay lower rates, which has increased usage among this group. An interest rate cap would restrict issuers' ability to efficiently price risk, thereby reversing these beneficial advances.

Conclusion

The research is clear: interest rate caps hurt consumers and have disproportionate negative effects on high-risk borrowers, the exact population they are intended to help. Card issuers currently set credit card interest at appropriate rates given a borrower's risk level. If issuers were required to keep rates artificially low, many consumers would lose access to credit, which myriad studies have shown has real, damaging effects on households. Moreover, many consumers who maintain credit access under a rate cap would still feel the negative impact through the loss of rewards. Interest rate caps, including those proposed in current legislation, would fundamentally change the current credit card market and leave most consumers worse off. By restricting credit available through regulated institutions where your policymaking can have an impact, such proposals would drive consumers to less-regulated or unregulated alternatives, including those in the informal economy.

We urge the Committee to approach consumer protection in ways that are proven to provide real improvement to the lives of Americans, which would conclusively exclude the adoption of discredited price caps. It would be avoiding the consistent lessons of history to do otherwise.