GEORGETOWN LAW

Anne Fleming
Associate Professor of Law

August 2, 2018

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Comments on Notice of Proposed Rulemaking (PALs II), RIN 3133-AE84

Dear Mr. Poliquin:

I am an Associate Professor of Law at Georgetown University Law Center, where I teach courses on consumer debt, bankruptcy, commercial law, and contracts.[1] I recently published *City of Debtors: A Century of Fringe Finance* (Harvard University Press, 2018), which chronicles the history of the small-dollar lending industry in the United States and its regulation over past century. I have appended to this comment letter two additional pieces that I wrote on the history of small-sum lending and its present-day policy implications: a July 2018 piece for the American Historical Association's *Perspectives Daily* and a 2017 opinion piece that appeared in the *Washington Post*'s Made by History section.

I write to offer some historical context for the NCUA's proposed rulemaking.

In the United States, a major impetus for the formation of credit unions was the perceived need for facilities to lend to working-class households at reasonable rates. In the 1920s and 30s, the Credit Union National Extension Bureau, led by Roy Bergengren, worked to promote the formation of credit unions across the country by sponsoring legislation at the state and federal levels. In Bergengren's view, the credit union performed a "high and important public service," namely "to eliminate the wastes of high-rate money lending, turning into new buying power what interest overcharges working people have hitherto paid to high-rate money lenders." Bergengren opined that usury can "be stamped out only by the creation of normal credit resources for the masses of people."[2] In 1924, Bergengren also privately wrote that he believed

[1] I am writing to express my own views and not on behalf of Georgetown University.
[2] Roy F. Bergengren, *Coöperative Credit*, 191 THE ANNALS OF THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE 144–148 (1937).

600 New Jersey Avenue, NW, Washington, DC 20001-2075
PHONE 202-662-9391 FAX 202-662-9444
anne.fleming@law.georgetown.edu

"the credit union is the only solution in sight" for the "small loans problem if the wage worker is ever to be able to get credit at anything approaching bank rates."[3]

Thus, it is consistent with the founding principles of cooperative credit in the United States for NCUA to provide a regulatory framework that encourages credit unions to offer small loans on terms that are profitable for credit unions and fair to borrowers.

The existing PALs rules support this mission while also incorporating one of the key principles of small-sum lending reform movements over the past century: that spurring competition with existing lenders offers one of the best means to protect borrowers from loan sharks.

The PALs rules attempt to spur competition in the small-loan market by allowing credit unions to offer borrowers products that provide an alternative to payday loans. But the current regulatory limitations on loan amount and term and the minimum length of membership requirement all render PALs less useful to some potential borrowers. The proposed regulatory changes would make PALs more useful to borrowers in need of larger loans, which require a longer term to repay, and to those who have recently become credit union members and are in immediate need of small-dollar credit. The proposed changes will allow these borrowers to access credit from their credit union, rather than seek out payday loans.

The question of how to regulate the rate of charge for small-dollar loans has recurred over the course of the past century. It was an early source of debate between small-sum lenders and reformers from the Russell Sage Foundation when they jointly drafted a model state lending law, which became known as the Uniform Small Loan Law. That law, which was originally drafted in the 1910s and widely adopted by states over the course of the 1920s, allowed lenders to charge rates as high as 3.5 percent per month on loans of up to $500. As the Foundation explained, such rates were necessary to encourage "honest capital" to enter the small loan business. Reformers and industry leaders agreed that small loans could not be made profitably at rates of 6 or 7 percent per year, given the costs of originating and servicing these loans.

The same is true today. I do not offer a specific recommendation on what interest rate and fees NCUA should allow credit unions to charge for PALs. Rather, I note that if NCUA wishes to encourage credit unions to offer small-dollar loans, it must allow them to charge enough for these loans to be profitable.

At present, only a relatively small number of credit unions offer PALs and there is a large range between the rates that credit unions can charge and those offered by payday lenders. Although NCUA should not allow credit unions to charge the rates currently offered by payday lenders, a slightly higher rate of charge would grant credit unions a bit more revenue and might encourage a larger number to offer payday loan alternatives. This would, in turn, increase the options available to borrowers in need of small-dollar credit.

Payday borrowers all already have checking accounts at banks and credit unions, which puts these institutions in a good position to meet borrowers' needs for small-dollar loans. NCUA can

[3] Notes on Letter from Roy Bergengren to L.N. Robinson, 9/9/24, Folder 200: Remedial Loans Division, 1920-1932, Box 26, Russell Sage Foundation Records, Rockefeller Center Archive.

provide credit unions with the guidance and flexibility necessary to meet those needs, while also ensuring adequate protections are in place for borrowers.

Sincerely,

/s
Anne Fleming
Associate Professor of Law
Georgetown University

Appendix

Anne Fleming, *Fishing for Loan Sharks: Small-Sum Lending Reform over Time*, AHA PERSPECTIVES DAILY (July 12, 2018)

Available at: https://www.historians.org/publications-and-directories/perspectives-on-history/summer-2018/fishing-for-loan-sharks-small-sum-lending-reform-over-time

"I was looking to borrow $500, so I filled out the online forms," explained Walter Archer, a truck driver and father of four who was featured in the 2018 Netflix documentary series *Dirty Money*. Archer had borrowed from an internet-based lender called One Click Cash based on his understanding that he would pay a fee of $150 for $500 borrowed. "I knew $150 was a little bit on the high scale," he said, "but I wasn't too terribly worried about paying it back." It was only later that Archer discovered that he had taken out a "payday loan" and that the lender would charge him a new fee every two weeks until the loan was repaid. The cost of the loan, measured as an annual percentage rate (APR), was 782.14 percent.

Over the past several weeks, policymakers have proposed a range of schemes to put payday lenders like One Click Cash out of business, or at least diminish the demand for their products. Payday loans are a controversial form of small-dollar, short-term borrowing that typically cost customers around $15 for every $100 borrowed, equivalent to an APR of more than 300 percent for a two-week loan. Some have compared payday lending to legalized loansharking.

In response, federal officials recently unveiled several proposals to reduce households' reliance on payday loans. The National Credit Union Administration, which supervises credit unions, announced plans in early June to expand the variety of "payday loan alternatives" that federal credit unions are allowed to offer. The Office of the Comptroller of the Currency, which supervises national banks, proclaimed in late May 2018 that it would encourage banks to offer short-term, small-dollar loans. Finally, in late April, US Senator Kirsten Gillibrand proposed new legislation to create a Postal Bank that would offer basic financial services, including small-dollar loans, in every post office location across the nation. "Millions of Americans are being forced into payday lending schemes that only exacerbate their money problems," Gillibrand explained. The Postal Bank aims to "wipe out these predatory practices."

Concerns about high-rate, small-dollar loans are not new. Over a century ago, in the early 1900s, urban reformers launched the first campaigns against the "loan shark evil," targeting cash lenders that charged up to 500 percent interest per year for small loans to working-class borrowers. To

be sure, this history does not tell us how to tackle the modern problem of payday lending. But it can provide necessary context for policymakers and everyday people to understand the current fight for lending reform, revealing what is truly novel about our present moment and what is merely an echo of the past.

All three federal proposals to reform the short-term, small-dollar lending marketplace rest on two old ideas: first, that tighter regulation cannot wipe out the demand for small-dollar loans and, second, that spurring competition with existing lenders offers the best means to protect borrowers from loan sharks. Both principles date back to the earliest campaigns against high-rate small-dollar lending. The Russell Sage Foundation, established in 1907, spearheaded early efforts designed to harness the power of competition to rid American cities of loan sharks. The foundation championed "remedial" lending by semi-philanthropic private societies, which raised capital to lend from wealthy investors and, in exchange, paid them a small, fixed dividend on their contributions.

Together with representatives of industry, the foundation also drafted a model state lending law that would encourage "honest capital" to enter the small loan business by raising interest rate caps for small-dollar loans. The foundation lobbied for passage of the law, known as the Uniform Small Loan Law, in states across the nation. When lawmakers recoiled at the idea of allowing lenders to charge rates as high as 3.5 percent per month, the foundation explained that lower rate caps of 6 or 7 percent per year merely drove the small-sum lending business underground. They did not cause the business to cease operations or lessen the demand for loans.

The foundation opined that the shortfall between workers' wages and their cost of living, along with "enforced idleness, unexpected illness and similar emergencies," made borrowing a necessity. These conditions "cannot be eliminated without the entire remodeling of our whole social and economic system," it explained. Unwilling to scrap capitalism, early 20th-century reformers seized upon regulated competition as the next best option. And thanks to the Sage Foundation's campaign, the Uniform Small Loan Law was widely adopted over the course of the 1920s. By 1930, at least 25 states had the law, or a similar measure, on their books.

Not all present trends are rooted in the past, however. Comparing the 1910s and the 2010s can create a sense of déjà vu, but some aspects of recent policy changes do represent a profound departure from past practices. For example, although the Office of the Comptroller of the Currency's guidance describes banks as having "withdrawn" from the short-term, small-dollar loan market, banks have never been a reliable source of credit for working-class households. Prior to 2013, some banks did offer "deposit advance products" that allowed customers with recurring direct deposits to borrow against some portion of their next regular deposit for a set fee. But for most of the past century, banks have not catered to those in need of small-dollar, short-term loans.

As I explain in my recent book, *City of Debtors*, banks did not begin offering small personal loans until the 1920s, at the urging of consumer advocates who sought to cultivate lower-cost sources of small loans. Once banks entered this market though, they served mostly white-collar, higher-income borrowers, while finance companies helped those of more modest means. If banks do begin offering small loans to the working-class households who now borrow from payday lenders, this will represent a new era in banking lending, rather than a return to form.

The same is true of postal banking. Postal savings is an old idea, but postal lending would be entirely new in the United States. The postal savings banks of yesteryear did not offer loans. Rather, they provided small depositors with a safe place to store their savings, albeit at the below-market interest rate of 2 percent per year. They also granted additional stores of capital to local commercial banks, where the post office ultimately deposited most of the aggregated savings of its customers. As US Senator Thomas H. Carter, the chief sponsor of the original postal banking legislation, noted in January 1910, lawmakers hoped that postal savings would inculcate "habits of industry, frugality, and thrift" among the citizenry and "bring into circulation millions upon millions of money now dormant and in hiding." Postal lending represents an innovation, not a reversion to an old practice.

As history shows, fixing the small-sum loan market has proved enormously challenging. Those who tried in the 1910s would not be surprised that problems remain in the 2010s. The shortfall between workers' wages and their cost of living, along with unexpected emergencies, still drives demand. Warriors of the earliest reform campaigns would recognize much of their thinking in modern attempts to tinker with the available supply of small loans. But the latest round of reform proposals also quietly introduces some novel tactics and offers hope that maybe this time, things will be different.

Anne Fleming, *Federal Regulation of Payday Loans Is Actually a Win for States' Rights*, WASHINGTON POST, Made By History (Oct. 9, 2017)

Available at: https://www.washingtonpost.com/news/made-by-history/wp/2017/10/09/federal-regulation-of-payday-loans-is-actually-a-win-for-states-rights/?utm_term=.51fabfe2bb0e

Back in 2014, during the first season of his hit HBO show "Last Week Tonight," John Oliver took on the payday loan industry. Boggled by loans that carried up to a 1,900 annual percentage rate (APR), Oliver offered up a revised version of the "Lion King" theme song. "It's the circle of debt!" he sang. "And it screws us all." Oliver explained that the outrages of the payday loan industry couldn't be stopped because "they are incredibly good at avoiding regulation."

Not anymore. The Consumer Financial Protection Bureau (CFPB), the agency charged with implementing and enforcing federal consumer law, just unveiled a new rule establishing, for the first time, uniform nationwide standards for payday loans and similar forms of credit. Under the rule, lenders will be required to verify a borrower's ability to repay before making a loan.

Critics of the CFPB rule, such as House Financial Services Committee Chairman Jeb Hensarling (R-Tex.), argue that federal regulation of these loans infringes on state sovereignty. But the current system of state-level regulation, without any federal floor, imposes its burdens on states that seek to protect their residents from payday loans. Lenders often operate across state lines, lending from states where payday loans are permitted to borrowers in states where such loans are illegal. This makes it incredibly difficult for these "restrictive" states to protect their residents from being saddled with unaffordable debts.

If strengthening states' rights is the goal, federal rules can actually empower states that want to protect their residents from predatory lending by halting the flow of unregulated payday loans

from out-of-state lenders and ensuring that any credit extended across state lines meets minimum standards for consumer protection.

Payday loans — short-term loans that grant borrowers access to a few hundred dollars in quick cash — are controversial products because of their high cost per dollar borrowed and potential to trap users in a cycle of debt. A typical two-week loan costs $15 for every $100 borrowed, equivalent to an APR of more than 300 percent.

In practice, many borrowers are unable to repay their initial loan in full within two weeks, and so they pay only the fees owed and roll over the balance into another payday loan, incurring another round of fees.

Payday loans are primarily used by low-to-moderate-income earners with limited access to other sources of credit, often to pay basic living expenses or to cover an unexpected financial emergency. As household financial fragility has spread, so too has consumer demand for payday loans and other forms of short-term, high-cost credit.

In practice, the current system of state-level regulation imposes significant costs on states that seek to control payday lending to their residents. These restrictive states must expend resources to monitor attempts by out-of-state lenders, particularly the growing number of online lenders, to extend loans to their residents in violation of state law. Online lenders have a long reach, straining the law enforcement resources of restrictive states.

This problem is not new. Restrictive states have battled exploitative lending across state lines for over a century. In the early twentieth century, some small-dollar lenders employed what they called "the Portland device," named after Portland, Maine, to shift the legal locus of the companies' loans from the borrower's restrictive home state to a more permissive jurisdiction such as Maine, where high-rate lending was legal. Restrictive states, such as New York, responded with laws that raised new hurdles for lenders when they attempted to collect these debts.

To reduce these legal conflicts between states and stanch the supply of unregulated high-rate loans, reformers tried to establish a common regulatory framework by drafting a uniform law to govern small loans. The first draft of the law, known as the Uniform Small Loan Law, appeared in the late 1910s and allowed licensed lenders to make loans of up to $300 (more than $4,000 in today's dollars) and to charge fees and interest of no more than 3.5 percent per month. The law, drafted by the Russell Sage Foundation and members of the trade association for small-sum lenders, aimed to legitimize the business by drawing in "honest capital," meaning lenders who were "reputable men" and would charge no more than the maximum rate.

Rather than pushing for a federal law, reformers campaigned for the uniform law's adoption on a state-by-state basis. The law never achieved universal acceptance but a growing list of states adopted it over the course of the 1920s, with at least 25 states having a version of the law or a similar measure on their books by 1930. Without a federal rule, however, small-sum lenders have continued to find ways around state-level restrictions.

In the early 2000s, a version of the Portland device reappeared: payday lenders began extending credit to borrowers in restrictive states by partnering with banks, which are generally exempt

from compliance with state usury laws. The scheme worked, until federal regulators halted these so-called “rent-a-bank” arrangements.

Now, regulators are trying something new: a nationwide set of minimum protections established by federal law.

While this move marks a new approach in the regulation of small-sum lending, such national floors are common in the governance of other activities that easily cross state borders. The Clean Water Act, for example, set a nationwide floor for pollution standards, while allowing states to impose more stringent requirements on polluters by ratcheting up state standards above the federal floor.

For payday loans, the CFPB rule will likewise set minimum standards for lenders, while allowing states to impose more stringent requirements. Lenders in permissive states may continue to lend to borrowers in restrictive states in violation of state law. But the federal rule will mitigate the worst effects of this practice, ensuring that borrowers in restrictive states receive a minimum level of consumer protection when out-of-state lenders reach across state lines.

Going forward, lenders nationwide will need to determine that a consumer has the ability to repay a payday loan before issuing it and must also provide advance notice to borrowers before trying to withdraw funds from their bank accounts.

The strongest argument against a federal regulatory floor is that it will stifle state-level innovation in regulating small-dollar loans. States have traditionally been innovators in the governance of small loans, devising and testing new rules that other states or federal authorities have later adopted. Preserving this state function is a laudable goal.

But even this argument has serious weaknesses. The federal rules, as proposed, do not prevent state innovation. Rather, they push innovation into the space above the federal floor. Permissive states will remain free to experiment so long as they do not contradict federal standards. Meanwhile, restrictive states may rest easier knowing that out-of-state loans made to their residents will meet minimum standards for borrower protection.

All this debate, though, does little to reckon with the desperation that drives consumers to seek out payday loans. Federal regulation can provide a backstop for states that seek to protect their residents from what they view as predatory loans, setting a nationwide regulatory floor backed by federal enforcement resources. But until the government addresses the causes of household financial fragility that fuel demand for payday loans, the best it can do is to regulate the supply.