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Dodd-Frank and the Return of the Loan Shark

In the name of consumer protection, Congress has pushed more Americans outside the traditional banking system.

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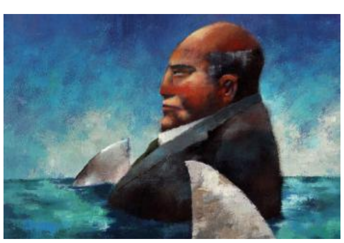
The least surprising event of 2010 was that, in the wake of new federal limits on how credit-card issuers can price risk and adjust interest rates, more Americans had to go to payday lenders, pawn shops and local loan sharks in order to get credit. It's simply the latest installment in the old story of regulators thinking they can wish away the unintended consequences of consumer credit regulation. Proponents of the 2009 Credit CARD (Card Accountability Responsibility and Disclosure) Act argued that it would protect Americans from exploitative credit-card companies by limiting penalty fees and interest-rate adjustments. For many Americans, though, the law meant higher interest rates, an increase in other fees, and reduced credit limits.

The impact was even worse for lower-income Americans, who have lost access to credit cards and were dumped in the laps of payday lenders that charge interest rates 10 times higher than credit-card companies. As the chief financial officer of a national payday-lending chain, Advance America, put it: "We believe that we're starting to see a benefit of a general reduction in consumer credit, particularly . . . subprime credit cards."

Regulators cannot wish away the need of low-income consumers for credit: If your car's transmission blows, you need $2,000 for repairs to get to work, whether or not you have it saved in the bank (and most low-income Americans don't). If you can't get a credit card, you're going to have to get that money from a payday lender, pawn shop or loan shark.

In a competitive market, regulation of consumer credit has three predictable types of unintended consequences. First, regulation of some terms of the credit contract will result in the repricing of other terms. Thus restrictions on the ability to raise interest rates in response to a change in a borrower's risk profile lead card issuers to raise interest rates on all cardholders, good and bad risks alike.



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Shark Infested

But even if card issuers reprice some terms, they may still be unable to price risk efficiently under the new rules. This gives rise to a second type of unintended consequence: product substitution. Card issuers can't price risk, so they issue fewer cards—pushing would-be customers to payday lenders and other nontraditional credit products.

Third, if issuers can't price risk effectively, they will ration lending. In order to make a loan, a lender must be able to price its risk efficiently or to reduce risk exposure by rationing credit. One way to do the latter is to lend less to existing borrowers, which is part of the reason why more than $1 trillion in credit-card lines have been slashed since the onset of the credit crunch.

Banks can also drop riskier borrowers completely. In his letter to shareholders last spring, Jamie Dimon of J.P. Morgan Chase reported that, "In the future, we no longer will be offering credit cards to approximately 15% of the customers to whom we currently offer them. This is mostly because we deem them too risky in light of new regulations restricting our ability to make adjustments over time as the client's risk profile changes." Meet the new payday loan customers.

And how will the market respond to the so-called Durbin Amendment to the Dodd-Frank banking reform law, which places price controls on debit-card interchange fees (which retailers pay for accepting cards)?

Pursuant to the law, the Federal Reserve announced before Christmas that it plans to slash the interchange rate to between 7 cents and 12 cents, a 90% cut from the current rate. While this will provide a major windfall to big-box retailers and other merchants, the impact on consumers will be devastating—and again low-income consumers will be the hardest hit.

Even before the Fed's announcement of its low price ceilings, some banks covered by the Durbin Amendment (any institution with over $10 billion in assets) had already announced that they would be cutting cardholder benefits and imposing new account maintenance fees. Customers who maintain large balances or use other bank services can avoid some such fees, but many low-income consumers cannot.

Many low-income Americans will be unable to qualify for free checking under the new fee regime, meaning they will have to pay higher fees or simply drop out of the banking system. Financial products that cater to unbanked consumers—check cashers, pawn shops, purveyors of nonbank prepaid cards—can expect to benefit from the Durbin Amendment, just as payday lenders have prospered as a result of credit-card regulations.

Nontraditional financial products serve an important role in the marketplace for the millions of consumers who count on them. Even pawn shops and loan sharks are more palatable and less expensive than the bounced checks and utility shut-offs that would result in their absence. Still, low-income consumers aren't better off when they have to rely on such lenders because paternalistic regulations have deprived them of a credit card. And just wait until the Consumer Financial

Protection Bureau comes on line, increasing costs and further restricting credit for low-income consumers.

Congress can pass all the laws it wants, but it can't repeal the law of supply and demand and the law of unintended consequences.

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