Minnesota House File 290 on Loan Interest Rate Caps: Bad for Consumers

What is the Issue?

Minnesota House File 290 was proposed as a bill in Minnesota on January 11, 2023 to cap interest rates at 36 percent on short-term, small-dollar loans.[1]

What are Short-Term, Small-Dollar Loans?

A short-term, small-dollar loan is a loan ranging from $50 to $1,000 with the average being $375.[2] Borrowers pay back the loan in full, plus the interest rate, usually within 14 days.

These types of loans are usually taken out by individuals who are short on cash and need money for an expense before their next paycheck—individuals who, without this credit, would otherwise be unable to afford an unexpected expense. Four in ten Americans lack the savings to cover an emergency expense of $400.[3] Some examples: a necessary car repair, a medical emergency, or a security deposit on a new apartment.

Who Uses Short-Term, Small-Dollar Loans?

- A young person with insufficient credit history to qualify for a traditional credit product.
- An otherwise creditworthy consumer with a sudden destabilizing financial experience.
- A recent immigrant who lacks a credit history.
- A person who has a history of being irresponsible with credit and who is thus unlikely to be approved for traditional credit products.
- A person who needs cash quickly and lacks the time to go through the process of obtaining a traditional credit product.
- A person with a strong history of paying for services that traditional lenders do not use in credit decisions.

Over 13% of African Americans do not have a bank account, relying instead on other, more costly types of credit.[4]

Women are more likely than men to be "underbanked" and therefore use alternative financial products that may carry higher fees.[5]

44% of active duty military members received a payday loan in 2017, 68% obtained a tax refund loan, 53% used a non-bank check-cashing service and 57% used a pawn shop, compared to less than 10% of all consumers who obtained each of those same alternative financial products.[6]

Why is a Loan Interest Rate Cap Bad for Consumers?

Innovation in the financial services sector provides competition for customers, and access provides comfort. Together, they provide inclusion. Inclusion is key to economic well-being, and inclusion relies on the freedom to borrow money, especially in an emergency or on a short-term basis to make ends meet. A rate cap at any level would result in the erosion of the freedom to borrow.

Many disadvantaged people have no bank account or face tenuous financial circumstances. They often rely on a safety net of innovative alternative, short-term forms of credit, which sometimes carry higher interest rates. Instituting a rate cap could run the risk of excluding many Minnesotans from the credit community and completely "unbanking" them.

Short-term, higher-cost, and single-payment loans can be an affordable and attractive form of credit for many Americans whose credit scores are sub-prime. Such loans are also superior to desperate alternatives like bouncing a check, bankruptcy, or piling up debt on a credit card and paying only the monthly minimum, or worse.

Fast Facts: America's Personal Finances

42% of Americans were denied a financial product because of their credit score in 2022.[7]

About **4 in 10 Americans** lack the savings to cover an emergency expense of $400.[8]

3 in 10 adults have income that varies from month to month.[9]

1 in 3 Americans have paid a bill late in the last six months.[10]

51 percent of Americans have less than three months' worth of savings.[11]

Loan Rate Cap Lesson from the Military Lending Act

To address financial concerns regarding military personnel and improve deployment readiness, in 2006 President Bush signed into law the Military Lending Act (MLA), which capped the fees banks and other businesses can charge when lending to service people and their spouses. The bill was updated in 2014 with the addition of further restrictions on military lending.

The intent of the MLA was to protect members of our armed services from predatory lenders by capping allowable loan interest rates at 36%. It has not worked as planned.

The number of short-term, small-dollar loans available for military families has dropped because lenders are prohibited from providing service members with these flexible, accommodating forms of credit. This has left many people in "credit deserts," without the credit options on which they formerly relied.

The Lesson from Illinois

In 2021, Illinois implemented an interest rate cap of 36%.[12] Researchers from Mississippi State University, Mississippi College, and the Federal Reserve reviewed credit bureau data and surveyed Illinoisans to better understand the impact of the rate cap. Here's what they found.

56%

of respondents were unable to borrow money at least once in the nine months after the imposition of the rate cap.[13]

39%

of respondents felt that their financial well-being was worse after the rate cap.[14]

79%

of respondents said they would like the option to return to their previous lenders from before the rate cap.[15]

45%

less loans originated for sub-prime borrowers.[16]

What Minnesota Should Do

When consumers need credit, the best policy prescriptions are ones that allow for the greatest innovation and access, not ones that eliminate options. Therefore, policymakers should make sure that potential negative impacts are identified and mitigated well before any consumer lending legislation is considered.

Policymakers should think creatively to address the plight of consumers who are financially on the margins. Bolstering and modernizing consumer financial protections, along with encouraging more consumer lending innovation, would be more effective at helping consumers.

The keys to good consumer financial policy are inclusion, access, innovation, and (strong) regulations, NOT restrictions. Short-term, small-dollar lending often serves as a vehicle for people with non-prime credit scores to establish or raise their credit scores—a benefit that provides longer-term dignity and goes beyond the short-term need to pay the bills.

Appendix

[1] Office of the Revisor of Statutes, "House File 290 as Introduced - 93rd Legislature (2023-2024)," https://www.revisor.mn.gov/bills/text.php?number=HF0290&version=latest&session=93&session_number=0&session_year=2023, accessed 13 January 2023.

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