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Why Cap Small Loans at 36%?

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Policymakers and advocates around the United States are pushing to cap interest rates on small loans at 36% to counter the devastating impact that 300% loans have had on struggling families. In these debates, the question often arises: why 36%?

The History of the 36% Rate Dates Back 100 Years

The 36% rate goes back to the early 20th century. With legal usury rates then about 6%, too low to support small loans to consumers, a black market of "salary lenders" made loans repayable on the borrower's next payday at annual rates over 1,000%.

Reformers, especially the Russell Sage Foundation, promoted a Uniform Small Loan Law to give legitimate lenders the incentive to enter the market. From 1914 to 1943, 34 states adopted a version of the law, with rates from 3% to 3.5% per month (36% to 42% per year). The rate caps were a result of research, political compromise, and practical experience – hypotheses, bolstered by research studies and tested in real world arenas.

The reformers' efforts transformed the landscape for small dollar lending, which became widely available. Eventually, credit cards largely supplanted the small dollar loan market. But even after deregulation, credit card rates are nearly always below 36%.

The 36% Rate is Gaining Renewed Acceptance

Today, over 35 jurisdictions have rate caps of 36% or less within their statutory schemes for small-dollar installment loans by nonbank lenders. Though industry lobbying has led to carve-outs for payday loans in many of these statutes, the deregulatory tide has begun to turn. Since 2005, at least 8 states have contracted high cost lending. As of 2013, 16 jurisdictions either ban payday loans or subject them to an interest cap of 36% or less:

Table 1: States that Ban Payday Loans or Cap at 36% APR or Less

<table>
<tr><td>Arkansas</td><td>Dist. of Columbia</td><td>Massachusetts</td><td>New Jersey</td><td>Ohio</td><td rowspan="3">West Virginia</td></tr>
<tr><td>Arizona</td><td>Georgia</td><td>Montana</td><td>New York</td><td>Pennsylvania</td></tr>
<tr><td>Connecticut</td><td>Maryland</td><td>New Hampshire</td><td>North Carolina</td><td>Vermont</td></tr>
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Voters, when given the choice, overwhelmingly support a 36% rate. In 2010, by a 72% vote, Montana imposed a 36% rate cap on small loans. Previous Ohio and Arizona votes were similar despite massive payday industry spending.

Congress and federal agencies have endorsed a rate cap of 36% or lower:

- After a 2006 Defense Department report, Congress capped loans to the military at 36%. In 2012, Congress reaffirmed and strengthened that law.
- In 2007, the Federal Deposit Insurance Corporation adopted Small Dollar Loan Guidelines encouraging loans under 36%.

- The National Credit Union Administration chose a 28% rate in 2010 as the appropriate level for cost effective small loans that are appropriately constrained to meet "their purpose as an alternative to predatory credit products."

The 36% Rate Results in More Affordable Payments.

Most payday loans are rolled over repeatedly. Eventually, some borrowers will scrape together the money, often from sources that could have been used to avoid the loan. But half will default, after paying multiple finance charges. If instead a borrower took out a 90-day installment loan at 36%, the payments for a $300 loan would be nearly identical but would result in the loan being paid off:

Table 2: Repayment of Payday Loan and 36% Installment Loan

	Payday Loan (2-weeks @ $15 per $100)	Installment Loan (36% APR, 90-days)
Amount borrowed	$300	$300
Biweekly payments: weeks 2 to 13	$45	$48
Amount owed at end of week 13	$300	$0

The 36% Rate Encourages Longer, More Honest Terms and Better Underwriting

Payday loans are unaffordable not only because of their rate but also their short term and single, balloon-payment structure. Most payday borrowers cannot afford to pay off a $300 loan in two weeks even if the loan were free. A two-week loan is a dangerous and deceptive product that leads to churning and perpetual debt.

A 36% rate cap gives lenders the incentive to make more realistic and honest longer-term loans so that they can earn enough interest to cover their origination costs, without the incentive to generate loan flipping and new fees. Three-quarters of payday loans are churned loans: made to pay off a previous payday loan, not because of a new need for credit. With a 36% rate cap, lenders would instead offer longer installment loans that are better for both lender and borrower.

High defaults are a sign of predatory lending and bad underwriting, not a justification for higher rates. The 36% rate forces lenders to minimize write-offs and avoid bad loans.

For More Information

Lauren Saunders, NCLC, *Why 36? The History, Use, and Purpose of the 36% Interest Rate Cap* (April 2013) http://www.nclc.org/images/pdf/pr-reports/why36pct.pdf

Leah Plunkett & Ana Lucia Hurtado, *Small-Dollar Loans, Big Problems: How States Protect Consumers from Abuses and How the Federal Government Can Help*, 44 Suffolk U. L. Rev. 31, Appx. B (2011). http://suffolklawreview.org/plunkett-hurtado/

NCLC, CONSUMER CREDIT REGULATION (2012)

Consumer Federation of America, http://www.paydayloaninfo.org/state-information.