Rate Caps: the Only Proven Cure for Payday Loan Debt

By Dory Rand
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"The only proven way for state policymakers to protect their citizens from predatory small loans is to enforce a comprehensive small loan law with an interest rate cap at or around 36 percent," concludes the Center for Responsible Lending (CRL) in a report released Dec. 13, 2007. See www.responsiblelending.org.

The report, entitled "Springing the Debt Trap: Rate caps are only proven payday lending reform," reaches that conclusion after evaluating the effectiveness of three types of payday loan policies: little or no restriction; an interest rate cap; and a middle ground where payday lenders can charge triple-digit interest rates with certain restrictions. The vast majority of payday borrowers are trapped in long-term debt. CRL finds that the debt trap persists even in states that have attempted to reform payday practices using the middle ground approach including the following measures:

- Renewal bans/cooling off periods
- Limits on number of loans outstanding at any one time
- Payment plans
- Loan amount caps based on borrower's income
- Databases which enforce ineffective provisions
- Regulations that narrowly target payday loans

On the other hand, CRL finds that states that enforce a comprehensive interest rate cap at or around 36 percent have solved the debt trap problem and saved their constituents $1.5 billion.

The report singles out Illinois as an example of how narrowly targeted laws are ineffective. The payday loan law enacted in Illinois in 2005 only covers loans with over 36 percent interest rates and terms of less than 120 days. "To avoid complying with these provisions….payday lenders changed their product to a longer-term 'payday installment loan' of at least 121 days," the report states.

As advocates and policymakers return to state legislatures this year, they should heed CRL's recommendations:

1. Cap all interest rates on small loans at or near 36 percent.
2. Cap the number of loans that a borrower can receive annually. To be effective, a loan cap must extend to all members of a household and be tracked through a statewide database. Ensure that customers may not be indebt for over three months in any 12-month period.
3. Ban the use of the bank account access as collateral.
4. Increase incentives for small loans. For example, make linked deposits of state funds in financial institutions that agree to make small installment loans at no more than 36 percent APR.
5. Encourage accumulation of emergency savings.

For information on efforts to reform payday lending in Illinois, contact Dory Rand at the Shriver Center at 312.368.2007 or doryrand@povertylaw.org or the Msgr. John Egan Campaign for Payday Loan Reform at http://www.citizenaction-il.org/issues/predatorylending/predatorylending.html.