# Federal Trade Commission

**Amending the Military Lending Act:**
**More Regulation, Less Consumer Welfare?**

**Remarks of Joshua D. Wright***
**Commissioner, Federal Trade Commission**

**at**

**American Financial Services Association's**
**2015 Installment Lending Summit**

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## Introduction

Good morning. I am pleased to be here today to discuss some of my thoughts on the Department of Defense's ("DoD") proposed amendments to its regulation implementing the Military Lending Act ("MLA"). As you are all aware, DoD published these proposed amendments for public comment in a September 2014 Notice of

* The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my advisor, Beth Delaney, and my legal intern, Elise Nelson, for their invaluable assistance in preparing these remarks.

Proposed Rulemaking ("NPRM").[1] In response to this NPRM, the staff of the Federal Trade Commission submitted a comment to DoD.[2] Although I support the "goals" behind DOD's efforts to implement strong consumer protections for service members, I didn't think FTC staff's comment adequately integrated the economic evidence exploring the impact of restricting access to consumer credit on consumers into its analysis of the proposed changes. Without tethering its comment to the available economic evidence, the FTC comment could not possibly shed light on the important issues and economic tradeoffs that lie at the heart of designing consumer protection policy in the market for consumer credit. Accordingly, I issued a separate comment to DoD on my own behalf, highlighting the substantial and pertinent research on the economic impact of regulations restricting the availability of consumer credit and setting forth my specific concerns with some of the suggested amendments in light of that research.[3]

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[1] John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. 109-364, as amended by the National Defense Authorization Act for Fiscal Year 2013, Pub. L. 112-239, codified in 10 U.S.C. § 987. The existing DoD regulation is at 32 C.F.R. Part 232 (hereinafter "existing regulation"); the proposed amendments are at 79 Fed. Reg. 58602 (Sept. 29, 2014) (to be codified at 32 C.F.R. Part 232) (hereinafter "proposed regulation").

[2] Comment of the Bureau of Consumer Protection & Bureau of Econ., Fed. Trade Comm'n, Before the Department of Defense, Docket No. DOD-2013-OS-0133 (Dec. 22, 2014), *available at* http://www.ftc.gov/policy/policy-actions/advocacy-filings/2014/12/ftc-staff-comment-department-defense-dod-proposed.

[3] Comment of Joshua D. Wright, Comm'r, Fed. Trade Comm'n, Before the Department of Defense, Docket No. DOD-2013-OS-0133 (Dec. 26, 2014), *available at* http://www.ftc.gov/public-statements/2014/12/comment-commissioner-joshua-d-wright-department-defenses-proposed.

This morning I will give an overview of the economic reasoning underpinning my comment to DoD and will provide a brief critique of the CFPB comment on the DoD proposal.

**Concerns about Proposed Changes to the MLA Regulation**

Changes to the MLA are likely to have a significant impact on credit availability for service members in terms of the quantity, quality, variety, and prices of consumer credit. Thus, it is important to consider the full economic costs and benefits of any such change before it is seriously considered for adoption. While economic theory and empirical evidence should inform any attempts to craft amendments to the MLA, in particular, I believe it is especially critical when examining whether or not to expand the existing regulation to cover a broader range of closed-end and open-end credit products.[4] While my comment was not intended to provide an exhaustive view of the relevant economic literature focusing upon the consequences to consumers of regulation restricting access to various forms of credit – and I will also spare you from a survey of the relevant literature at this early hour – suffice it to say my view is that the totality of the evidence strongly suggests that further restrictions upon access to consumer credit may cause serious harm to service members.

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[4] *See* proposed 32 C.F.R. § 232.3(f); *see also* 79 Fed. Reg. at 58602.

The economic consequences of regulation restricting access to consumer credit are well documented and have been the subject of rigorous research and investigation. Much of the economic literature focuses upon the economic consequences of usury laws and rate caps on specific consumer credit products, including credit cards. Other recent studies focus upon alternative credit products such payday loans, auto-title loans, and other products that might be covered under a broadened MLA. Any decision to restrict or to expand consumer access to credit, including alternative forms of credit, ought to fully consider both any potential benefits and costs to consumers of those changes.

The simplest and most common restriction on upon access to consumer credit is a usury law – that is, a rate cap imposed upon a specific credit product. Usury laws have been the subject of considerable research[5] and economists have documented several economic effects from usury regulations. First, there is no evidence that usury restrictions actually reduce the equilibrium price of consumer credit, which is set by the forces of supply and demand.[6] It is here the law of unintended consequences looms large and is often forgotten by proponents of tighter regulation of access to consumer credit. Restricting interest rates often, and as economic theory predicts, merely redirects changes in prices to other terms of the contract, such as down payments, up-front fees,

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[5] For a summary of research regarding the history and economic effects of usury regulations, *see* GREGORY ELLIEHAUSEN, THOMAS A. DURKIN, MICHAEL STATEN & TODD ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY 482-519 (2014).

[6] *Id.* at 518.

or loan maturities.[7] Decades of economic research finds – once again as economic theory predicts – that an inevitable result of interest rate ceilings is to restrict access to legal credit for consumers, especially higher-risk borrowers.[8] On the other hand, restricting the supply of credit does not eliminate consumer demand for credit: thus, the predictable consequence of such regulation inducing consumers to substitute from the now-regulated form of consumer credit to substitutes that are also available to the consumer. The closest available substitute, especially for low-income or high-risk consumers, is often more costly and less desirable. So, for example, stricter interest rate ceilings imposed upon consumer credit have been associated with a growth of illegal loan sharking operations, often provided by organized crime. For example, a 1968 Senate Report concluded that loan-sharking was the second largest revenue source of the mafia at that time.[9] Finally, by segmenting credit markets and making product

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[7] *Id.* at 515-16.

[8] *See, e.g.*, Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate*, FDIC BANK TRENDS 98-05 (1988) (showing deregulation of credit card usury ceilings after 1978 produced a substantial increase in credit card availability); Daniel Villegas, *The Impact of Usury Ceilings on Consumer Credit*, 56 S. ECON. J. 126 (1989) (finding the quantity of consumer revolving and non-mortgage closed-end credit was significantly lower in states with usury ceilings during the year 1983); John Wolken & Frank Navratil, *The Economic Impact of the Federal Credit Union Usury Ceiling*, 36 J. FIN. 1157 (1981) (finding that loan growth in federally chartered credit unions was constrained by the imposition of usury ceilings during the late 1970s). *See also* Oren Rigbi, *The Effects of Usury Laws: Evidence from the Online Loan Market*, 95 REV. ECON. & STATS. 1238 (2013) (finding that an increase in the usury ceiling covering unsecured consumer installment loans between 2007 and 2008 expanded this type of credit, especially among risky borrowers).

[9] STAFF OF S. COMM. ON GOV'T OPERATIONS, 90TH CONG., REP. ON FEDERAL EFFORT AGAINST ORGANIZED CRIME (June 1968).

pricing more complex and less transparent, usury restrictions may actually lead to higher prices for consumers than would otherwise prevail.[10]

It is important to recognize the economic tradeoffs in play when discussing the design of consumer protection policy for credit markets. The fundamental policy question is relatively straightforward: are usury laws and other restrictions on access to consumer credit are good or bad for consumers? Economic analysis illuminates the key tradeoff at issue. In theory, usury laws could restrict access to credit, which would in turn prevent borrowers from alleviating hardships by managing consumption over time. That is, restrictions upon credit availability in the short-term might prevent a household that receives a negative shock to income to avoid adverse events like foregone health care, eviction, or delinquency on debt. Alternatively, if consumers systematically err weighing the costs and benefits of taking on additional debt today, it is possible that restricting consumer access to credit could improve consumer outcomes. Of course, as already mentioned, restricting access to one form of credit, or rationing its use, will also predictably result in those consumers turning to other, perhaps higher-risk, forms of credit. Fortunately for those designing policy in these areas, there is a substantial economic literature exploring the effects upon consumers of the many past regulatory experiments restricting access to consumer credit.

[10] ELLIEHAUSEN ET AL., *supra* note 5, at 515.

To skip ahead to the punchline: economic research has overwhelmingly concluded that usury ceilings generally harm those that they are intended to help. For example, one recent study evaluates these overall effects by examining the causes and consequences of usury laws in the United States during the 19th century.[11] The authors of that study find that usury laws not only lead to less credit, but also that a one percentage point lower rate ceiling results in approximately 4 to 6 percent less economic growth over the next decade. They also find that this reduction in economic growth comes largely at the expense of small firms; large firms are able to evade the restrictions and find alternative sources of credit.

This finding is consistent with evidence that the democratization of credit in the United States has generally resulted in large benefits for traditionally disadvantaged groups. For example, innovations that significantly reduced liquidity constraints have enabled greater numbers of Americans to borrow more and have helped increase credit availability dramatically for members of socially and economically disadvantaged groups. [12]

Alternatively, by drying up the supply of credit available to riskier (often lower-income borrowers) and redirecting supply to lower-risk borrowers, economists have

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[11] *See* Efraim Benmelech & Tobias J. Moskowitz, *The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century*, 65 J. FIN. 1029 (2010).

[12] *See* David S. Evans & Joshua D. Wright, *The Effect of the Consumer Financial Protection Act of 2009 on Consumer Credit*, 22 LOY. CONSUMER L. REV. 288 (2010).

found that usury regulations can benefit higher-income consumers at the expense of lower-income consumers.[13]

More recently, a large and growing empirical literature is developing focusing upon the effects on consumers of regulation restricting access to what might be considered alternative or high-risk credit. The evidence here is somewhat mixed. For example, several studies have found that access to payday loans and other forms of alternative lending exacerbate financial distress for at least some consumers.[14] However, there is also ample evidence that restrictions on access to consumer credit – including payday loans and other alternative lending products – can have serious negative consequences for consumers. For example, studies find that, on average, access to payday loans and other products help consumers smooth negative expenditure shocks, avoid more onerous forms of credit, alleviate financial distress, and increase job retention.[15] The evidence also suggests that some consumers will face

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[13] ELLIEHAUSEN ET AL., *supra* note 5, at 533-36.

[14] Dennis Campbell, F. Asis Martinez-Jerez & Peter Tufano, *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures*, 36 J. BANKING & FIN. 1224, 1232-33 (2012); Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* (Vanderbilt Law & Economics, Research Paper No. 11-13) (Nov. 9, 2009); Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, 126 Q. J. ECON. 517 (2011).

[15] Scott Carrell & Jonathan Zinman, *In Harm's Way? Payday Loan Access and Military Personnel Performance*, REV. FIN. STUD. (2014); Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap*, 34 J. BANKING & FIN. 546 (2010); Dean Karlan & Jonathan Zinman, *Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts*, 23 REV. FIN. STUD. 433 (2010); Bart J. Wilson, David W. Findlay, James W. Meehan, Charissa P. Wellford & Karl Schurter, *An Experimental Analysis of the Demand for Payday Loans*, 10 B.E. J. ECON. ANALYSIS AND POL'Y (2010); Adair Morse, *Payday Lenders: Heroes or Villains?*, 102 J. FIN. ECON. 28 (2011); Donald P. Morgan & Michael R.

adverse consequences if these forms of credit are restricted.[16] Policymakers must carefully weigh the costs and benefits of further restrictions before implementing them in order to ensure that the costs to consumers, service members in this instance, do not outweigh any benefits.

In light of this body of economic evidence, the DoD's proposed rule is especially susceptible to result in a consumer protection policy that does more harm to service members than good. For example, the DoD proposal notably excludes bank overdraft protection from its regulatory scope, yet researchers have consistently found that overdraft protection is a close substitute for payday lending for consumers.[17] An obvious economic consequence of increasing the price of access to payday loans is consumer substitution toward overdraft protection. Similarly, eliminating access to payday lending also leads consumers to substitute to late bill payments or to bounce more checks.[18] Yet, while payday lending is obviously expensive, both overdraft

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Strain, *Payday Holiday: How Households Fare After Payday Credit Bans* (Fed. Res. Bank of N.Y., Staff Report No. 309) (November 2007, revised February 2008).

[16] Kelly D. Edmiston, *Could Restrictions on Payday Lending Hurt Consumers?*, FED. RES. BANK KAN. CITY ECON. REV. 31, 51 (2011) (describing costs that restrictions upon payday lending are likely to have for consumers in low-income counties or consumers with lower credit standing who are forced to substitute to more costly sources of credit).

[17] *See* Robert L. Clarke & Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 REV. BANKING & FIN. L. 235 (2013).

[18] *See* Donald P. Morgan, Michael R. Strain & Ihab Seblani, *How Payday Credit Access Affects Overdrafts and Other Outcomes*, 44 J. MONEY, CREDIT & BANKING 519 (2012) (finding that prohibiting payday lending leads to increased bounced check revenues at banks); Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap*, 34 J. BANKING & FIN. 546 (2010)

protection and bounced check fees often exceed the cost to consumers of payday loans.[19] Here, basic principles of economic theory, informed by economic evidence and past experience, make clear that the most likely impact of the DoD proposal is to provide incentives to substitute to inferior forms of consumer credit, resulting in substantial consumer harm. In fact, a recent *Wall Street Journal* article identified several banks located near military bases as deriving an unusually large amount of their revenues from overdraft and other fees and specifically identified the effects of the MLA as driving an increase in the use of overdraft protection by service members.[20] Unfortunately, these economic consequences for service member-consumers are quite predictable, and thus avoidable, in light of basic economic theory and publicly available empirical evidence.

**CFPB Report on the Extension of High-Cost Credit to Service Members**

Let me now turn to the comments offered, as part of the rulemaking process, by the Consumer Financial Protection Board ("CFPB") to the DoD. As you might imagine,

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(finding elimination of payday lending led consumers to greater use of overdraft protection and late bill payments).

[19] *See* Brian T. Melzer & Donald P. Morgan, Competition and Adverse Selection in a Consumer Loan Market: The Curious Case of Overdraft vs. Payday Credit (Dec. 2, 2009) (unpublished manuscript), *available at* http://www.clevelandfed.org/research/conferences/2010/9-9-2010_household-finance/melzer_morgan_2_16_2010.pdf.

[20] Mark Maremont & Tom McGinty, *Hefty Fees Waylay Soldiers: Banks that Market to Military are Among Top Collectors of Fees*, WALL ST. J. (Jan. 15, 2011), http://www.wsj.com/news/articles/SB10001424052702304887104579306770984874320.

the CFPB came out strongly in favor of the amendments, in particular the proposal to expand the definition of "consumer credit." In support of their position, and of particular import for our discussion today, the CFPB appended to their comment a December 2014 analysis of the extension of high-cost credit (so-called deposit advance products) to service members and their families.[21]

In its report, the CFPB discusses the use of deposit advance products ("DAPs") – lines of credit offered by some depository institutions as a feature of an existing depository account. The report has two ostensible purposes: first, to better understand service member use of a particular high-cost credit product, and second, to assess and describe the ways that consumer credit products available on the market today fall outside the scope of the MLA.

With respect to the first part of the analysis, the report notes that of those eligible to take a DAP at some time during the 12-month study period, 22% of service member accounts obtained at least one advance, while in the full sample of accounts (including service members and the general population), nearly 16% used DAPs. As explained in a footnote, although this difference is statistically significant, some or all of the difference could be explained by differences in the two underlying populations. The report acknowledges it does not provide evidence that being a service member makes a

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[21] CFPB, THE EXTENSION OF HIGH-COST CREDIT TO SERVICEMEMBERS AND THEIR FAMILIES 6 (Dec. 29, 2014), *available at* http://www.consumerfinance.gov/newsroom/cfpb-report-finds-loopholes-in-military-lending-act-rules-rack-up-costs-for-servicemembers/.

person more likely to use DAPs.[22] Instead, this calculation seems only to have been derived in order to establish that service members use DAPs. The logic appears to be that because service members use DAPs, and there are fees associated with the product, the MLA should be extended to cover it.

However, neither the CFPB comment, nor its attached report, actually provides any sort of economic analysis that justifies broadening the scope of credit products covered by the MLA. The CFPB report ignores the fundamental economic question: will further restricting access to consumer credit by regulating DAPs help or harm consumers? The report recommends that the MLA be extended to cover these products without addressing or even considering whether or not there are benefits or merits to the use of DAPs, or what other alternatives might be available to service members to yield similar benefits if the MLA is extended cover such financial products. The economic evidence I've discussed today exploring the same question in the context of other financial products strongly suggests the CFPB approach is not harmless error for consumers. Instead, the comment and the analysis merely point to evidence of borrowing behavior and other anecdotes as evidence that the MLA regulations are being circumvented. The implicit premise of the CFPB's case for regulation is that service-member access to high-cost credit products is presumptively harmful to them. Without tethering its approach to economic analysis, the report cannot help but miss

[22] *Id.* at 6, n.11.

the consequence well understood in the economic literature – that is, consumers will respond to the restriction of access to one form of consumer credit by substituting to other, often more costly and lower quality, credit products. The report instead takes the simplistic approach that more regulation of consumer credit is always better, and thus any attempt to circumvent the MLA should be prevented.[23]

This analysis falls far short of the work attempted by DoD in its initial promulgation of the final rule in 2007. There, DoD arguably tried to tailor the scope of the MLA's coverage with the economic consequences of regulation restricting the availability of consumer credit in mind, and acknowledged the potential for more broadly applicable regulation to "adversely affect credit availability." [24] DoD also noted "the intent of the statute is clearly to restrict or limit credit practices that have a negative impact on service members without impeding the availability of credit that is benign or beneficial to Service members and their families." Hopefully, in the current rulemaking, DoD will remain sensitive to the potential unintended consequences and unknown impact of broader restrictions upon the availability of consumer credit. At the very least, in its NPRM, it states its interest in obtaining and analyzing additional data regarding the nature, scope, and prevalence of credit products offered or extended

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[23] CFPB, *supra* note 21, at 10 ("These examples underscore the assessment that there are a number of ways that consumer credit products can be structured to fall outside of the scope of the Military Lending Act, as it is currently implemented.").

[24] 72 Fed. Reg. at 50580, 50584.

to service members and their families, as well as the consumer impact of those proposed changes.[25]

Economic analysis provides a proven and powerful lens for understanding the likely impact of regulation of this sort on consumers. I am hopeful that DoD's stated interest in analyzing the likely impact upon service members from these proposed changes to the MLA will lead to the design of consumer protection policy in this area informed by the best available economic theory and evidence. I am also hopeful FTC staff will take advantage of the wealth of economic expertise available to it and embrace the important task of injecting more economic analysis into modern debates concerning the regulation of consumer credit.

Thank you for your time. I am happy to take your questions.

[25] *See* 79 Fed. Reg. at 58606, 58631.