



REGULATED LENDERS
ASSOCIATION
OF MICHIGAN

APR DISTORTS FLAT FEE FOR SHORT-TERM, SMALL-DOLLAR LOANS

What a Short-Term, Small-Dollar Loan Really Costs

There's a lot of confusion about what a short-term, small-dollar loan costs, but customers would tell you that the answer is simple and straightforward: typically, \$15 to borrow \$100 until your next payday. Period.

There are no hidden fees, no compounding interest – just \$15. Whether a customer repays their loan in three days or 30, they will pay the same one-time fee.

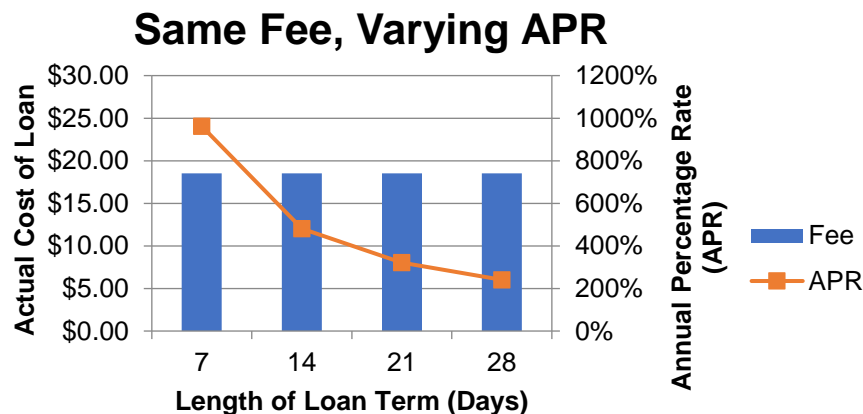
Annual Percentage Rate (APR): A Flawed Calculation

As required by the Truth in Lending Act (TILA), consumer credit providers always disclose the fee associated with services as both a dollar amount and an APR. But, due to the short-term nature of the loan, APR is not an appropriate value indicator.

The APR calculation disclosed by lenders represents the implied annual rate for a short-term, small-dollar loan, and assumes that a small-dollar loan is extended 26 times – or every two weeks – during a year, with the customer paying a new fee each time. This is a flawed assumption. Customers use this service for a relatively short period of time – weeks or months. Disclosing APR on a short-term loan would be equivalent to a grocery store displaying the price of hamburger meat by the ton, or if a parking meter listed the rate for a year's worth of parking.

\$15 Typical Loan Fee (per \$100 Borrowed) **X 26** # of Consecutive 14-day Cycles = **391%** Implied APR

What's more, the APR on a short-term, small-dollar loan changes depending on the loan's term, even though customers pay the same \$15 fee – there's no compounding interest. As the chart below illustrates, if a customer is paid monthly and thus repays their loan in four weeks, the APR is calculated as 195 percent. But if he or she is paid every two weeks, the \$15 fee has an APR of 391 percent.



Note: Chart based on typical fee of \$15 per \$100 borrowed.

Eliminating Credit through APR Caps

Despite these facts, a number of state legislatures have pursued misguided legislation that would impose an APR cap on small-dollar loans – amounting to an effective ban. In fact, the Center for Responsible Lending, which has led the campaign to prohibit small-dollar lending in various states, said that one state’s policymakers “fully understood that [an APR cap] would ban the product,” when the legislature passed an APR cap in 2008.

Several states and the District of Columbia have implemented APR caps, including Arkansas, Arizona, New Hampshire, Ohio and Oregon. These actions created an environment that was not economically viable for many lenders, as they were unable to cover basic operating costs, such as wages, rent and utilities.

For example:

- Under a 36 percent APR cap, a \$100 loan would yield a \$1.38 fee. No business – not a credit union, not a bank – can sustainably lend money to many customers for less than 10 cents a day without being subsidized.
- According to the Federal Reserve, a loan amount of \$2,530 is necessary to break even at 36 percent; that does not address consumers’ small-dollar needs.¹
- Recent research from Adam Levitin of Georgetown University Law Center confirms that a 36 percent APR cap for a two-week loan would not come close to covering a lender’s credit losses, costs of funds, other variable per loan costs, and other fixed overhead costs.²
- Lenders in these states were forced to close hundreds of centers, costing thousands of employees their jobs and leaving consumers with fewer credit options.
- Historically, price fixing of any kind almost always results in reduced consumer access to any product.

Interest rate caps harm consumers by eliminating a critical choice for thousands of people who need short-term, small-dollar credit, forcing them to choose costlier or less regulated options, such as overdraft loans or illegal loans.

¹ “The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board’s 2015 Survey of Finance Companies,” Board of Governors of the Federal Reserve System, August 2020, <https://www.federalreserve.gov/econres/notes/feds-notes/the-cost-structure-of-consumer-finance-companies-and-its-implications-for-interest-rates-20200812.html>

² “The Financial Inclusion Trilemma,” Yale Journal on Regulation, December 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4304357