



STATEMENT BY

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BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

**SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT**

Washington, DC

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Chairman Capito, Ranking Member Maloney, and honorable members of this subcommittee, thank you for this opportunity to present testimony on behalf of my organization, the Competitive Enterprise Institute, on this hearing examining important concerns about access to credit and capital among consumers and small businesses, and both federal and state regulatory impediments to this access.

This hearing also shines light on one of the most untold stories on the workings of Congress. This story is that – believe it or not – members of Congress are working together and finding common ground on legislation that would pare down excessive regulations that block stable and transparent sources of credit and capital for both consumers and entrepreneurs. And they are doing so by getting together on bills that lower barriers for many sources that provide consumer and business financing: community banks, credit unions, and, as this hearing will explore, nonbank lenders or nondepository creditors.

First, there was the Jumpstart Our Business Startups (JOBS) Act, signed by President Obama in April after it passed this House overwhelmingly. The JOBS Act provides relief from some of the most onerous provisions of Sarbanes-Oxley and Dodd-Frank, provisions that make it especially difficult for smaller and emerging growth companies to raise capital and go public. It also greatly aided community banks by quadrupling the number of shareholders they may have without being subject to a multitude of rules from the Securities and Exchange Commission.

Then there is there is the Small Business Lending Enhancement Act (H.R. 1418) with cosponsors ranging from some of the most conservative Republicans to some of the most liberal Democrats, which would raise the cap on the business lending that credit unions can provide to their members.

And then there is the legislation that is the subject of this hearing, the Consumer Credit Access, Innovation, and Modernization Act (H.R. 6139), co-sponsored by Congressmen Blaine Luetkemeyer (R-Mo.) and Joe Baca (D-Calif.) This bill would give nonbank lenders, or nondepository creditors, the option of being chartered federally by Office of the Comptroller of the Currency (OCC), to allow them to make the same type of loans to consumers and entrepreneurs across state lines. Creating this option for these creditors – who lend every day without the guarantees of deposit insurance or other government backing -- would extend a healthy source of credit to underserved consumers and small businesses without putting a dime of taxpayer dollars at risk.

My organization, the Competitive Enterprise Institute, is a Washington-based free-market think tank that since its founding in 1984 has studied the effects of all types of regulations on job growth and economic well-being. As we have said before, we follow the regulatory state from “economy to ecology,” and propose ideas to “regulate the regulators” and hold them accountable so that innovation and job growth can flourish in all sectors.

Our theme on job growth has been “liberate to stimulate,” because as our Vice President Wayne Crews has observed, one doesn’t need to teach – or subsidize -- grass to grow. Rather, remove the rocks obstructing its growth, and it will grow wide and tall.

My title at CEI is senior fellow for finance and access to capital. And to increase access to credit and capital, CEI proposes a public policy strategy that can best be described with a phrase sometimes associated with energy exploration: “All of the above.” Banks, credit unions and nonbank lenders *all* have a role to play in expanding credit for responsible consumers and entrepreneurs. And all should be able to operate free of excessive regulation.

That’s why we supported the regulatory relief for community banks in the recently enacted JOBS Act. It’s why we support allowing credit unions to make more business loans to their members. And it’s why we support H.R. 6139’s giving nonbank lenders the same opportunity to offer financial services through a national charter that banks have had for 150 years.

CEI has long supported optional federal chartering as a part of our goal of what we call “competitive federalism.” As our chairman Michael Greve, who is also a fellow at the American Enterprise Institute,

puts it, “Real federalism aims to provide citizens with *choices* among different sovereigns [and] regulatory regimes.”¹

Neither states nor the federal government are perfect, and we believe the best system of regulation is fostered when they learn from each other by competing with each other, allowing consumers and entrepreneurs to help decide what system of regulation is the best. We’ve long supported expanding the system of optional federal chartering that has existed for banks to other financial services such as insurance.² The sponsors of H.R. 6139 have made a convincing case to us that optional federal chartering would work well for nonbank lenders as well.

After all, all this would basically do for unsubsidized nonbank lenders is to create the same system of optional federal chartering that has existed for banks for almost 150 years, and at the very same federal agency – the OCC. Under the Civil War-era National Bank Act, banks could apply for a national charter through the OCC. Many banks chose to stay with their state regulators, but competition from federally chartered banks lowered the cost of credit and capital for everyone.

One of the clearest examples of this is what happened in the market for credit cards when the Supreme Court clarified in its unanimous 1978 decision *Marquette National Bank of Minneapolis v. First of Omaha Service Corp* that federally chartered banks could offer credit cards to consumers across state lines. Over the next few years, not only did access to credit increase, but credit became overall cheaper. Companies slashed interest rates and fees, and many got rid of the annual fee that had previously made credit cards costly for middle class consumers. Some consumers used this access to credit irresponsibly, and some credit cards used deceptive marketing tactics, for which there should be swift punishment, but overall most American benefitted from access to credit at a much lower cost.³

A similar reduction in the cost of credit – and increase in access to credit -- could occur under a system of optional federal chartering for nonbank lenders. This would work to the benefit of lower income consumers – currently priced out of mainstream financial instruments such as credit and debit cards – as well as small entrepreneurs who can’t get traditional bank loans or venture capital investment.

Research on entrepreneurship from the Kauffman Foundation and other respected sources, as well as some prominent specific examples, shows that there is much less of a gulf between personal credit and business credit than some policy makers may believe. Sergey Brin, for instance, started what is now Google Inc. as a college student using his personal credit card. Now-Famous filmmakers such as Spike

¹ Michael S. Greve, *Real Federalism: Why It Matters, How It Could Happen*, AEI Press, Washington, D.C., 1999

² Jennifer Smith-Bozek, “Pros and Cons of Optional Federal Chartering for Insurers,” Competitive Enterprise Institute, *WebMemo* No. 1, January 15, 2008, <http://cei.org/sites/default/files/Jennifer%20Smith-Bozek%20-%20Pros%20and%20Cons%20of%20Optional%20Federal%20Chartering%20for%20Insurers.pdf>.

³ Todd J. Zywicki, “The Economics of Credit Cards,” *Chapman Law Review*, Vol. 3:79, 2000
<http://www.globaleconomicsgroup.com/publication/the-economics-of-credit-cards/>

Lee maxed out their credit cards to make their first films.⁴ And the Kauffman Foundation finds that nearly half of all entrepreneurs use personal credit cards.⁵

There is also evidence that entrepreneurs utilize nonbank lenders more typically associated with consumer borrowing. Former Federal Reserve senior economist Thomas Durkin has written: “Small businesses sometimes use consumer credit products that might be considered fringe financial products. For instance, small independent businesses such as landscaping, plumbing, and handyman services may use auto title loans as a source of short-term working capital.”⁶

Durkin further explains: “An independent landscaping company may need several hundred dollars to purchase sod and bushes for a job, or for temporary cash to meet payroll while finishing a job, or awaiting payment. In these cases, the proprietor may pledge his pick-up truck to obtain the necessary capital to buy the supplies to complete the job. Then when the job is complete—often only days later—payment is made and the owner can redeem the collateral.”⁷

H.R. 6139 would broaden these options and lift barriers to loan innovations specifically suited to small entrepreneurs. And it also would move away from the flawed reliance on the annual percentage rate as a measure of a short-term loan’s fairness and effectiveness. As I point out in my recent study, “The 400 Percent Loan, the \$36,000 Hotel Room, and the Unicorn”, if “the financing costs of other goods and services were measured on an annual basis, it would be easy to lob ‘predatory pricing’ charges against their producers as well.”⁸ As the distinguished economist Thomas Sowell points out, “Using this kind of reasoning — or lack of reasoning — you could ... say a hotel room rents for \$36,000 a year, [but] few people stay in a hotel room all year”⁹

Closer to home, if common bank fees – such as late payment and overdraft charges were subject to the APR measurements – they would have astronomical interest rates, much higher than the nonbank short-term loans that come under such controversy. Kelly Edmiston, senior economist at the Federal Reserve Bank of Kansas City, points out in his study published in that Fed branch’s *Economic Review*, that the “median interest rate” for bounced check fees — if they were measured as interest payments — would be “well in excess of 4,000 percent, or up to 20 times that of payday loans”

⁴ “Does Credit Card Debt Harm Small Business?” Index Credit Cards, April 19, 2010
<http://www.indexcreditcards.com/creditcardnews/does-credit-card-debt-harm-small-businesses/>

⁵ “The Kauffman Firm Survey,” Kaufman Foundation, March 2008,
http://www.kauffman.org/uploadedFiles/kfs_08.pdf

⁶ Thomas A. Durkin, “The Impact of the Consumer Financial Protection Agency on Small Business, U.S. Chamber of Commerce, p. 18, <http://www.uschamber.com/sites/default/files/reports/090923cfpastudy.pdf>

⁷ Ibid

⁸ John Berlau, “The 400 Percent Loan, the \$36,000 Hotel Room, and the Unicorn,” Competitive Enterprise Institute, *WebMemo* No. 176, Feb. 6, 2012, <http://cei.org/sites/default/files/John%20Berlau-The%20400%20Percent%20Loan.pdf>

⁹ Kelly D. Edmiston, “Could Restrictions on Payday Lending Hurt Consumers,” *Economic Review*, First Quarter 2011, <http://www.kansascityfed.org/publicat/econrev/pdf/11q1Edmiston.pdf>.

Now, I don't believe we should ban or put ceilings on overdraft fees or put any thicket of new regulations on banks and credit unions. As I noted previously, CEI supports an all-of-the-above strategy for access to credit and promotes consumer choice and consumer responsibility with true disclosure. But I do believe that some non-bank short-term loans – be they for weeks or for months – could be a better alternative for many consumers than overdraft fees. In deciding whether to put restrictions on credit, we need to look at what consumers would use as alternatives for emergency cash were the law to deny them choices in legitimate credit.

The final benefit to H.R. 6139 is that as we expand the universe of small-loan options and providers, America's financial system becomes that much less reliant on large financial institutions deemed by some as "too big to fail." Former Federal Deposit Insurance Corporation Chairman William Isaac is respected by both parties for his advice on reducing systemic risk through reforming accounting and capital rules. Isaac now says in a written statement submitted for the record of this hearing (a statement I have also included as an Exhibit for this testimony), under the legislation, "these federally chartered and regulated short-term lenders will be required to raise their capital and funding entirely from private sector sources without the benefit of any federal guarantee." He notes that the safety and soundness "record of non-bank short-term lenders over recent decades has been impressive in good times and bad."

I'd like to end with the optimistic note that I believe this Congress can once again prove the media wrong and pass a bipartisan piece of legislation that "liberates to stimulate" by lifting the regulatory barrier that blocks access to credit for responsible consumers and entrepreneurs. Thank you again for inviting me to testify, and I look forward to answering your questions.

Exhibit 1
STATEMENT of
WILLIAM M. ISAAC
Former Chairman, Federal Deposit Insurance Corporation,
July 24, 2012

I commend the subcommittee for conducting this hearing on the important issue of access to credit for cash-strapped consumers and small businesses. I wish I were able to participate in the hearing in person and would appreciate my written statement being made part of the record.

I am former Chairman of the Federal Deposit Insurance Corporation; Senior Managing Director & Global Head of Financial Institutions for FTI Consulting; and Chairman of Fifth Third Bancorp. The opinions I express are my own and do not necessarily reflect the views of these organizations.

I appreciate Congressmen Luetkemeyer and Baca taking the time to fashion an innovative approach to increasing the flow of small loans to individuals and businesses. As reported in the “findings” of their bipartisan bill, studies by the FDIC and others “have shown that roughly half of all American families . . . are literally living paycheck-to-paycheck.” I think we can all agree that we need more education in financial literacy, and we need more stable sources of credit.

I believe the proposed Consumer Credit Access, Innovation, and Modernization Act’s creation of optional federal chartering for non-bank lenders is an innovative approach that could yield many benefits. It’s difficult for me to see a downside to the bill.

The legislation would create an optional federal charter for non-depository lenders at the Office of the Comptroller of the Currency, which has chartered national banks for 150 years. The legislation instructs the Comptroller to focus on the “true cost” of the loan product rather than the annual percentage rate (APR) and facilitates the offering of short-term lending products best suited to the needs of borrowers, beyond payday lending.

I have long been critical of interest-rate ceilings that restrict or effectively prohibit short-term personal loans from banks and non-bank lenders. While the APR provides useful information to consumers when comparison shopping for loans, it is inappropriate to use it to cap interest rates on short-term lending.

Hearing about a 390% APR for a payday loan, for example, is at first blush jarring. But after thinking about it more carefully, one recognizes the value proposition. The APR on a payday loan is much lower than the APR on a typical fee for a bounced check or for a late mortgage or credit card payment, or the fee for getting your electricity turned back on after it has been cut off due to late payments. The loan fee is definitely much less than the lost income when you can’t get to work because you can’t afford to get your car repaired. These are typical of the choices facing customers who take out a short-term loan.

The plain truth is that tens of millions of people from all walks of life decide their best option is to do business with non-bank, short-term lenders. The terms are very easy to understand – you borrow \$200 and you pay back \$230 two weeks later. Critics claim this amounts to predatory lending, a charge I don't understand. The loans are unsecured and if you default, there is not much the lender can do except not grant another loan. The lender cannot evict you from your house or take your car. It's not economic for the lender to even file a collection suit.

The legislation addresses directly the criticism that payday loans are never really repaid – just renewed over and over. I believe this criticism is blown out of proportion, particularly in comparison to other types of borrowing. The high APRs and short maturities on payday loans make it impossible to keep the rollover game going for very long, in contrast to credit card and other revolving debt.

In any event, to the extent rollover loans are a problem, it is largely because state regulatory barriers effectively prohibit lenders from offering borrowers more suitable options, such as installment loans, which most lenders would very much like to do. As John Berlau of the Competitive Enterprise Institute noted in a recent paper, "In California, a nonbank lender can make a payday loan in the maximum amount of \$300 or an installment loan in the minimum of \$2,500. This leaves a big gap in the middle."

The Luetkemeyer-Baca legislation will help bridge this gap by allowing safe, regulated and innovative loans to flow across state lines and benefit consumers and small businesses. It will do so without exposing taxpayers to any risk, as these federally chartered and regulated, short-term lenders will be required to raise their capital and funding entirely from private sector sources without the benefit of any federal guarantee.

The financial record of non-bank short-term lenders over recent decades has been impressive in good times and bad. Short-term lending is relatively risky, but the risks are ameliorated due to diversification in the portfolio, and the risks are priced into the fee structure. It is quite feasible to maintain high loan loss reserves and strong capital against short-term loans and achieve good returns if the short-term lender is an efficient operator.

Reducing unnecessary regulatory barriers will increase competition for bank and non-bank lenders and will foster sustainable sources of credit for consumers and small businesses. This will in turn stimulate economic growth and job creation. The Luetkemeyer-Baca bill appears to be an important step in the right direction and deserves a fair hearing and serious consideration.