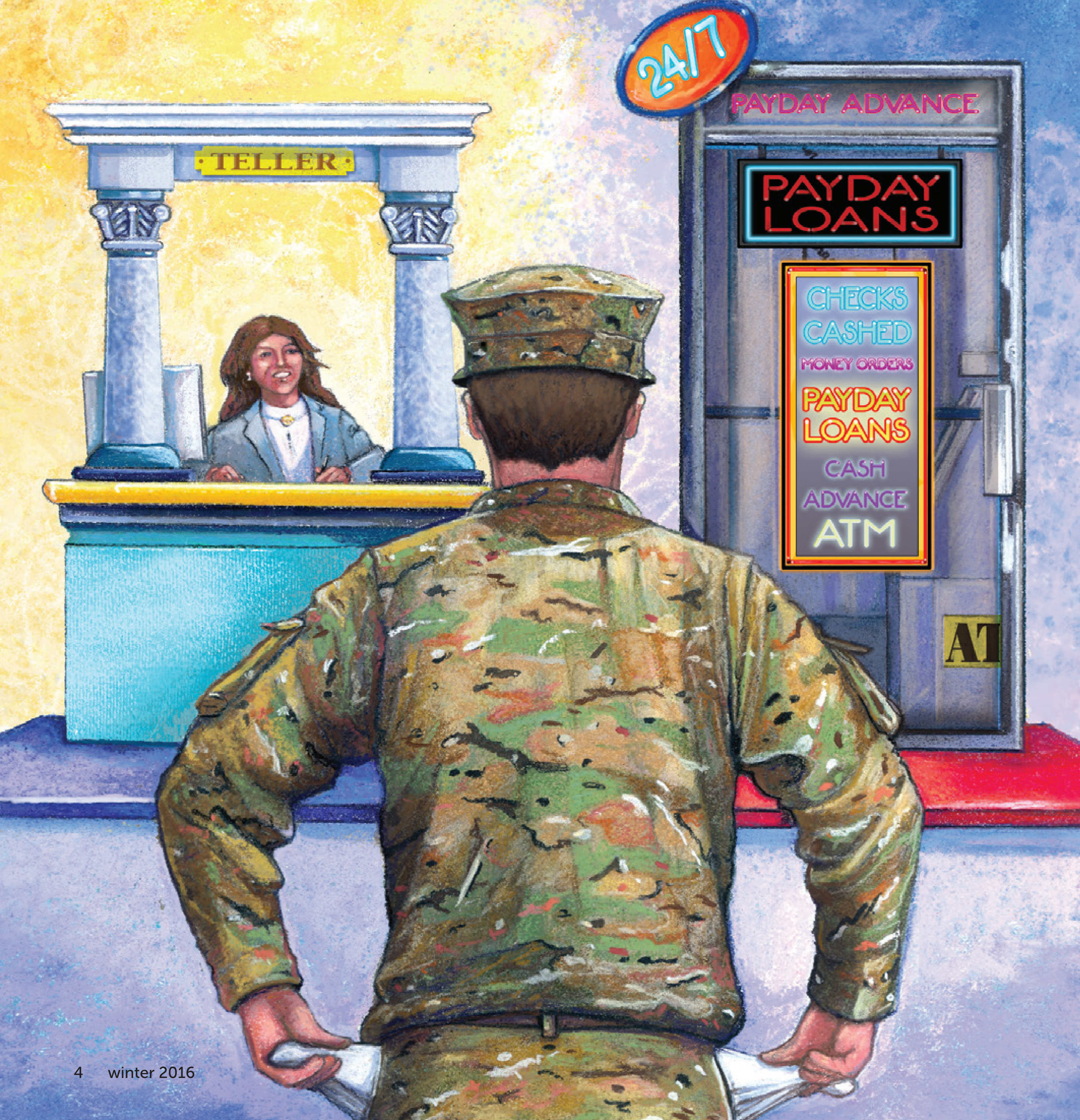
COVER STORY

The Military Lending Act

Do Fringe-Borrowing Policies Help?

Roman Galperin
JOHNS HOPKINS UNIVERSITY



A study of the effects of the Military Lending Act suggests that bans on fringe lending should be accompanied by increased access to mainstream credit products.

A 2012 Pew Research report estimates that every year about 5.5 percent of American adults take out payday loans, which carry 400 percent or higher annual percentage rate (APR).[1] Costly borrowing is even more prevalent if we include other alternative, or "fringe," credit products with high interest rates, such as auto-title and pawnshop loans.

State and federal lawmakers and regulators are considering—and some have implemented—laws and regulations that ban such lending. But without understanding why fringe lenders have proliferated and why there is demand for their services, the policies may be ineffective, even misguided.

Last Straw or Life Raft?

Prohibiting fringe loans could deprive households in dire straits of the only available source of credit, escalating small adverse events like a car breakdown into major crises like losing a job requiring transportation. However, if fringe borrowers are misled about true costs, or if they take out loans without any justifying need, a ban on fringe lending could reduce the likelihood of falling into a cycle of debt.

The Military Lending Act of 2007 (MLA) followed a Department of Defense report that concluded fringe lenders target US military bases because young servicemen and women are generally inexperienced with personal finances, have relatively low wages, little credit history, and a virtually guaranteed income. The report found that expensive loans hurt the finances and morale of servicemen and women. The MLA prohibited making expensive loans to members of the military and their dependents.

Military Lending Act Study: Key Findings

- On average, there was no change in credit standing (measured with credit score), but an increase in credit access (measured with cumulative credit limit across all credit cards) by about 13 percent.
- Although there was also no increase in searches for new credit on average, fringe borrowers applied for more credit when severely constrained—that is, when cumulative available credit fell below $300. After the passage of the MLA, the number of credit applications during such times increased by about 13 percent for those who lost access to fringe loans. The number of applications during less constrained times dropped after the passage of the MLA, which explains no average increase.
- The credit-constrained calendar quarters tended to occur in connected spells. It took over nine months, on average, for fringe borrowers to get out of a spell of extremely tight credit. After the passage of the MLA, the spells got shorter by about two weeks for those who lost access to fringe loans.

Eight years later, the Department of Defense, the Consumer Financial Protection Bureau (CFPB), and the White House issued statements saying that the MLA was a step in the right direction but that a stricter law is required to completely stem fringe lending in the military.

But was the MLA good policy? Did it help borrowers? Curiously, none of the statements in support of expanding it refer to any systematic assessment of its effectiveness.

Proposing any policy based on assumptions and anecdotal evidence is, to say the least, problematic. But with fringe lending, the situation is worse, since it is not even clear what the appropriate assumptions for such laws should be.

Contradictory Findings

Deciphering the effects of recent regulation could provide a window into the behavioral mechanisms behind the demand for fringe products. But such studies are rare and their conclusions contradictory, making regulation little more than a shot in the dark.

Several studies of state-level bans on payday lending find that having access to payday loans helps households that have few options. After state bans on payday lending, such households bounce more checks and are more likely to file for bankruptcy, overdraw their checking accounts, be late on utility bills, and suffer foreclosure on their homes after a natural disaster.[2] Those findings imply that households make rational decisions to take out payday loans and a ban would make them worse off.

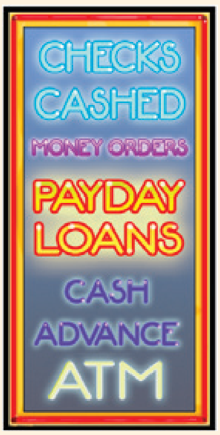
Other studies seem to contradict the assumption of a strategic borrower, indicating that access to payday loans is associated with higher likelihood of involuntary checking account closure, delayed health care, and difficulty paying bills.[3] Those results imply that fringe borrowers launch a cycle of debt and are likely misinformed, undisciplined, or both. Such conclusions are in line with the assumptions behind expanding the MLA.

Yet another set of findings questions whether the updated MLA will have any effect at all. Two Federal Reserve Board studies report that taking out payday loans has no effect on the borrower's subsequent credit standing, measured with a credit score and the likelihood of future delinquencies.[4]

What to make of such contradictions in light of the proposed MLA expansion?

Addressing the Conundrum

After considering the problem, Kaili Mauricio and I began to systematically assess the MLA's effects on the financial health of the military's likely fringe borrowers.[5] Improving on previous studies, we measured borrowers' financial health on multiple dimensions—changes in credit standing, access, and need (measured with the intensity of seeking more credit). The results suggest that, although the MLA may have done some good, like increasing would-be fringe borrowers' access to less expensive credit products, its effects were uneven. Moreover, our approach resolved many of the contradictions from the previous studies: on some dimensions the law had no effect; on others, it improved borrowers' situation, albeit the improvements were painful in a way fringe borrowing was not.



Measuring the effects of fringe-lending regulation is difficult because systematic data are lacking. The industry was effectively without a regulator until CFPB took on the role in 2011. And since fringe loans are not reported to mainstream credit agencies, private data on the national level are unavailable. Yet we knew that about 60 percent of fringe borrowers also use traditional credit products like credit cards, even if in a limited way. Since many therefore have credit histories, we could establish the MLA's effects on credit health. We decided to measure changes in would-be fringe borrowers' financial health using data about credit history from a sample of US adults provided by Equifax and the New York Fed.

We also understood that the assignment of military personnel to different locations turns MLA implementation into a quasi-experiment: the average characteristics of the military population match across states, but some states did not allow fringe loans even before the MLA. This means that only service members where there was no previous prohibition would lose access to fringe loans, while those in strict states would remain unaffected. By comparing changes in service members' credit standing, access, and credit search across strict and lax states, we could assess the MLA's effects. (See "Military Lending Act Study: Key Findings.")

Our findings suggest that borrowers were forced to replace fringe loans with mainstream credit, which is 10 times less expensive. However, they were increasing their access to mainstream credit in an inefficient way, applying for credit when least creditworthy.

* * *

Making policy on the basis of a simple (and somewhat patronizing) assumption that all, or even most, borrowers need to be saved from predatory lenders may not be optimal. We should shift focus from what fringe borrowers are doing (borrowing from predatory lenders) to what they are not doing (maximizing access to less expensive credit options like credit cards).

Bans on fringe loans may be most effective and least harmful when complemented with increased opportunities for borrowers who have poor credit. Moreover, such borrowers should be encouraged to apply while doing better financially, to avoid inefficient searches during tough times.

Given concerns about American households' growing debt, encouraging low-income borrowers to get more credit cards may sound counterintuitive. But we all need credit to weather tough periods, and reducing the cost of borrowing tenfold or more has to be a good thing.

Roman Galperin, PhD, *is an assistant professor of management at Johns Hopkins Carey Business School and a visiting scholar at the Federal Reserve Bank of Boston. Contact him at galperin@jhu.edu.*

Acknowledgment

This research was conducted with Kaili Mauricio, a senior policy analyst at the Federal Reserve Bank of Boston.

Endnotes

1 "Who Borrows, Where They Borrow, and Why" (report, Pew Center on the States, Pew Charitable Trusts, Philadelphia, 2012), http://www.pewstates.org/research/reports/who-borrows-where-they-borrow-and-why-85899405043.

2 D.P. Morgan, M.R. Strain, and I. Seblani, "How Payday Credit Access Affects Overdrafts and Other Outcomes," *Journal of Money, Credit and Banking* 44, no. 2–3 (2012): 519–531, http://doi.org/10.1111/j.1538-4616.2011.00499.x; A. Morse, "Payday Lenders: Heroes or Villains?" *Journal of Financial Economics* 102, no. 1 (2011): 28–44, http://doi.org/10.1016/j.jfineco.2011.03.022; and J. Zinman, "Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap," *Journal of Banking & Finance* 34, no. 3 (2010): 546–556, http://doi.org/10.1016/j.jbankfin.2009.08.024.

3 D. Campbell, A.F. Martínez-Jerez, and P. Tufano, "Bouncing out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures," *Journal of Banking & Finance* 36 no. 4 (2012): 1224–1235, http://doi.org/10.1016/j.jbankfin.2011.11.014; and B.T. Melzer, "The Real Costs of Credit Access: Evidence from the Payday Lending Market," *Quarterly Journal of Economics* 126 no. 1 (2011): 517–555, http://doi.org/10.1093/qje/qjq009.

4 N. Bhutta, "Payday Loans and Consumer Financial Health," *Journal of Banking & Finance* 47 (2014): 230–242, http://doi.org/10.1016/j.jbankfin.2014.04.024; and N. Bhutta, P.M. Skiba, and J. Tobacman, "Payday Loan Choices and Consequences" (white paper, Social Science Research Network, Rochester, New York, 2012), http://papers.ssrn.com/abstract=2160947.

5 For more early results of our investigation, see Roman V. Galperin and Kaili Mauricio, "Tough Times Borrowing: Effects of Fringe Lending Regulation on Credit Standing, Search, and Access" (Community Development Discussion Paper no. 2015-3, Federal Reserve Bank of Boston, 2015), http://www.bostonfed.org/commdev/pcadp/2015/cddp1503.htm.