Opinion **Capital markets**

How government can guide small borrowers

Dean Karlan and Jonathan Zinman APRIL 29, 2009

The US government and the Federal Reserve are spending billions of dollars to jump-start credit markets and restore access to liquidity for businesses and households.

Yet at the same time, Congress is considering four different bills that would restrict access to liquidity for many households by capping interest rates on short-term consumer loans at a 36 per cent annual rate or thereabouts. The main targets are payday lenders, which tend to charge $15 per $100 for two-week loans, producing triple-digit annual percentage rates. Many states have capped what payday lenders can charge and lenders have responded by shuttering their doors.

Does it make sense to jump-start some credit markets and pull the plug on others? Only if some types of loans help people and other types harm them. In theory, it can go either way.

Under traditional economic models, more choice is better. Indeed, this logic underpins the worldwide movement to fight poverty by increasing access to (often expensive) credit. Our research in other countries is consistent with these models.

But research at the intersection of economics and psychology theorises that some people may have trouble handling expensive credit. They may be too impulsive, too optimistic, or too apt to believe that serial borrowing at high rates is cheaper than it appears.

In practice, the evidence is mixed. There are studies finding that access to expensive loans helps consumers. It seems that many financially stressed borrowers use the loans to make stabilising "investments" in retaining their jobs, residences, utilities or family health. In this case, an APR can be misleading. The dollar benefit to a consumer of overcoming an income interruption or unexpected expense – a "shock" in economic terms – frequently outweighs high borrowing costs.

But there are other studies finding that access to expensive credit exacerbates, rather than alleviates, financial distress for consumers. These studies find that the cost/benefit calculus does not work out for many payday borrowers and may impose social costs.

So what should policymakers do? The evidence suggests that they should approach the problem by improving the consumer decision-making environment – the "decision architecture" – rather than by bringing in the wrecking ball of an interest-rate cap that would in effect drive payday lenders out of business.

First, a cap would surely deprive sensible but distressed consumers of the ability to make productive "investments" in job retention and family stability. Second, a cap will almost as surely have unintended consequences. For example, in a recent study one of us found evidence that borrowers shut out of the payday loan market in Oregon turned to alternative sources of liquidity that can be even more expensive (such as bank overdrafts and paying bills late).

Restricting supply does not restrict demand. While the wrecking ball may hit payday lenders, history suggests that other credit providers – from banks to utilities to loan sharks – will emerge from the destruction with ways to provide even more expensive loans.

Our approach starts with an entirely different question. It asks not whether we should shut markets down, but how we can make them work better. How do we create an environment that

allows those who would benefit to borrow, and leads those who would be harmed to avoid expensive debt traps? Recent research offers some guidance.

Existing loan products can be bundled with financial counselling. Building financial literacy may be overly ambitious when there are fires to put out, but giving distressed borrowers some simple guidelines could lead many out of trouble.

New products can make it easier for consumers to shift from borrowing to saving. Millions of Americans have participated in programmes that help increase future savings with automatic payroll withdrawals. Similar policies could work to help people get out of debt – gradually and voluntarily.

Disclosures can reveal the true costs of borrowing in terms that consumers can understand. They can also highlight typical borrower experiences to give the overly optimistic a reality check. Short waiting periods or simple licensing criteria for consumers can be used to discourage the impulsive. Voluntary commitment contracts can help people to restrict their own borrowing.

Such "nudges" represent a more nuanced, more scientific and more effective approach than caps and shutdowns. Identifying and implementing the right measures will take creativity and flexibility. It will require the co-operation of regulators, lenders, non-profit organisations and researchers.

But our distressed families and distressed markets deserve nothing less. The potential pay-off from finding ways to make subprime credit markets work better for all has never been higher.

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