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Current Approach to Short-Term Credit Doesn't Cut It

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We live in a changing world where outdated rules and assumptions prevent needed innovations. This is particularly true in the case of consumer credit.

Back in the "good old days," the U.S.'s thriving middle class had stable and increasing household income and high savings. Not long ago, banks were the main provider of consumer credit and most Americans could expect to be approved if they needed a loan from a bank.

Now, as average household income drops (by another 8% since 2007) and destabilizes as a result of the "gig economy," our hollowed-out middle class buckles under widespread financial pressures. According to the Federal Reserve, nearly 50% of Americans cannot cover an emergency expense of $400. Furthermore, over half of Americans' credit scores have dropped below 700 while banks have eliminated nearly $150 billion in revolving credit (e.g. credit cards) to non-prime consumers. Unsurprisingly, nonbank lenders such as payday, pawn, title and installment lenders have grown rapidly.

In addition to the looming Consumer Financial Protection Bureau proposal to rein in short-term lenders, the government has also responded with programs to "bank the unbanked." However, these programs haven't been profitable and haven't scaled due to their interest-rate caps. Even Google has taken a position on the situation by recently blocking paid ads from payday lenders. But does this help consumers or is it an example of how the elite have become out of touch with mainstream America?

I argue that the problem with American credit is not nonbank lenders; it's the fundamental change in the economic status of average Americans and the failure of banks, regulators and consumer groups to recognize it.

We need to adopt a nuanced view of credit that considers not only the cost of credit, but also the cost of default and the cost of having no credit.

To illustrate the decisions facing millions of Americans, let's introduce Jane. Jane is a single mom working as a part-time nurse supplementing her income driving for Uber. Last year she went through a contentious divorce and defaulted on her credit card debt. Jane prides herself on being a responsible example for her daughter, but it's hard to build savings.

Unfortunately, the brakes on Jane's car failed and the mechanic estimates it will cost $1000 to fix. What should Jane do? She could: a) Get a two-week payday loan with a finance charge of $170 (or 440% APR); b) pledge the title of her car for a loan with an 80% APR; c) get a home equity line of credit at 10% APR; d) borrow the money from friends and family; or e) get a bank installment loan at 14%?

It's a trick question: her friends and family don't have $1000 and she isn't eligible for a bank installment loan because her credit score is below 700. Jane is worried that her hours as a nurse may be cut again, so she chooses the most expensive option - the payday loan - to avoid the risk of losing her car or house if she cannot make her loan payments.

Most traditional credit is provided with a relatively low APR on the assumption that customers will repay

the loan. To guarantee repayment, lenders typically can sue the customer, add punitive fees and seize the borrower's property (like a car) for collateral. Prime consumers with high savings, stable income and financial support from friends and family can ignore these risks, but for non-prime consumers with a higher likelihood of default, this is a ticking financial time bomb.

One solution is to institute a strict rate cap on credit which would limit credit to only consumers with the highest credit quality. However, the need for credit is even more critical for non-prime consumers. Fifty percent of Americans are like Jane: access to credit improves their quality of life, helping pay for car repairs, bills and medical emergencies. For people like Jane, the most expensive form of credit is often no credit at all.

There is an answer, albeit a counterintuitive one. Instead of traditional prime credit with low rates but drastic financial downsides for nonpayment, non-prime credit should be priced to the risk of each customer. And there should be no default costs if people are unable to repay their loans.

So, will consumers stop repaying their loans? No. Our experience suggests that consumers repay their loans because they are responsible and desire future access to credit.

New data and analytical techniques like machine learning are constantly improving the accuracy of credit scoring. Lenders can determine default risk more accurately than ever and price loans to that risk to achieve target returns without penalizing borrowers. The customer who repays their loan may pay more money, but it's controllable, well-disclosed, and contains no financial downside risk to consumers.

I remain convinced that improved federal regulations governing non-prime credit are essential to protect consumers from abusive practices and to promote needed innovation. I support the CFPB's efforts to create rules for non-prime and nonbank lenders. However, in my opinion the bureau (along with banks and consumer groups) remains too focused on the cost of credit rather than the cost of default and the cost of no credit at all.

We need to foster a new breed of no-harm consumer credit products that support the financial realities of the new middle class rather than letting obsolete views and naïve assumptions constrain access to the emergency credit that is essential to the well-being of millions of Americans.

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