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V. SMALL-DOLLAR LENDING: THE PERRENNIAL PROBLEM

The development of the modern American consumer economy has become a triumph in the modern world, and an important part of this triumph has been the development of market-based credit for consumers. Beginning over a century ago, retail sources, manufacturers, and financial institutions began to provide mechanisms for consumers to change the scheduling of large purchases that provide a future return to a preferred purchase pattern. Although changing the time of purchase might sound mostly mundane, development of consumer and housing credit has enabled consumers to acquire homes, transportation, other durable goods, college educations, and needed services that provide a return over time at an earlier period in their life cycles than would otherwise have been possible. Acquiring them early is when they are most valuable, rather than saving and acquiring them only later, a process that can be slow and costly since it requires substitutes during the process.

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The consumer-credit system has become intertwined with the growth of the American middle class and movement to the suburbs in the post-World War II era. Middle-class families today encounter a world of mainstream credit: bank loans, credit cards (largely replacing the retail installment sales and cash credit from retail stores and finance companies in earlier generations), automobile loans, student loans, and mortgage loans for housing. These mainstream credit products account for the overwhelming portion of credit for consumers in the United States today.

By contrast, many lower-income and other credit-constrained households encounter a different world. Although they often have access to mainstream credit products, that access can be more limited than for middle-class consumers. This fact sometimes leads them to supplemental credit suppliers at higher prices, as discussed by theorists/empiricists Juster and Shay and others. Yet they benefit from access to credit for the same reasons as middle-class consumers. They too use credit to purchase transportation to commute to jobs, for purchasing appliances like washing machines and refrigerators that provide a return over time, to manage the expensive challenges of children, and to mitigate emergency situations.

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The challenge of small-dollar credit arises from the reality for many consumers, especially younger families, that their demand for credit often exceeds the available supply at mainstream prices. As discussed in Chapter 3, early in their financial life-cycle consumers have many very high-value investment opportunities, including consumer durable goods that provide a regular return over time. They also have emergencies that occur and that necessitate access to additional resources. But at the same time that consumer demand for credit is highest, credit supply is at its lowest state. For most people, one's starting salary is as low as it ever will be. Further, younger people typically own few assets (such as cars or real estate), have modest savings and financial investments (if any), a largely unproven credit record, and minimal experience with financial products. Even many middle-class college graduates owe substantial amounts on student loans upon graduation and are technically insolvent from the moment they reach the other side of the graduation stage.

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In short, for millions of individuals, especially younger ones, their demand for credit is highest at the stage of their lives when their available supply of credit likely is lowest. As will be discussed, this means that many consumers are "rationed" in their credit access. As a result, many consumers are unable to meet all of their credit demand through mainstream financial providers, yet the demand remains. This dynamic is what gives rise to particular characteristics of the small-dollar loan market, which we explore in this chapter. The perennial problem of small-dollar credit has been enabling rationed consumers to gain access to needed credit at what is considered by observers to be a "reasonable" price instead of the price established through the free interplay of supply and demand. It is precisely this difficulty that has given rise to the recurrent experiences with interest-rate ceilings through history.

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After reviewing millennia of history, centuries of economic theory, and decades of empirical analysis, the Taskforce concludes that the problem of providing small-dollar credit to wage-earners at what others consider to be "reasonable" prices is not only a perennial problem but is probably also unsolvable. Either small-dollar credit can be provided at market prices that take into account its production costs, it can be provided by massive governmental intervention at a cost that has never yet been politically acceptable (and which still would have to contend with operating costs), or it will not be provided at all. Legislative or regulatory mandates to set different prices cannot change those realities. So Federal and state legislators are faced with a difficult choice.

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The Economics of Small-Dollar Lending

Small-dollar lending is a distinct market with some submarkets for different kinds of small-dollar loans (specific kinds and estimated amounts are discussed later). But this does not mean that its economics is unique. As noted earlier, there have been constraints on lenders throughout history (Chapter 2 above), but there still is demand for credit based upon its usefulness (Chapter 3), and supply is still determined by its costs (Chapter 4). Attempts to subvert these realities at various times have continuously led to unintended consequences: unmet needs, evasions, and calls for new regulation in an unending cycle. The difference in small-dollar lending arises from its special constraints on consumers and providers, not from its fundamental economics.

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The National Commission on Consumer Finance (NCCF) discussed in 1972 how all potential lending institutions face the restrictions on lending dictated by their cost structures, not just consumer finance companies whose costs are discussed at further length above in Chapter 4. Sometimes the view is heard that there was some time in the past that banks were better able to provide small-loan services than in more recent history when technological change has led them to providing smaller credit amounts only through their more restrictive credit-card programs. This is not the case. Writing before much of the growth in card programs that took place in the 1970s and 1980s, the Commission noted (p. 141):

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> The costs of commercial banks reflect the grade of credit risks acceptable under their established finance rates, which are typically below their rate ceilings. Often by choice and sometimes because of low rate ceilings, commercial banks generally serve a less risky and, therefore, less costly segment of the market than finance companies. There is not, however, a clear delineation between the markets. Commercial banks must perform the same basic services as other credit grantors, and the costs of many of these services are fixed, regardless of the amount of credit extended.

The Commission then went on to discuss further the cost structure of personal lending by commercial banks at the time using data available then. The Commission found banks' cost curves by loan size similar to those of consumer finance companies.

The idea that banks were not servicing the needs of small loan borrowers was not new with the Commission. For instance, writing about the experiences of railroad clerk John Doherty in 1910 as an example of conditions then, Anne Fleming noted, "For borrowers like John Doherty, in need of cash rather than credit to buy goods, there were a number of sources available. Banks were not among them, however. Commercial banks did not make small loans, particularly to low-income working-class borrowers." Writing about 1937, she added, "Personal finance companies and banks did not serve the same clientele, however. In the 1930s and 40s, bank borrowers usually had higher incomes than clients of personal finance companies, who were drawn from the 'lower middle income and lower income groups.'" [1]

The Fundamentals

In their economic analysis of credit-use decisions in 1964 (discussed here in Chapter 3 as part of the development of the economics of consumer credit), Juster and Shay explained the theoretical reasons why consumers are sometimes willing to borrow at high rates of interest. To summarize, rates of return for benefits of purchases made on credit can be quite high and under the circumstances households would be willing to borrow to make these purchases or mitigate emergencies.

But because income and accumulated savings of borrowers are often limited, primary lenders (low-rate lenders) limit the amount of credit they are willing to offer them. This means benefits from some additional consumer expenditure might exceed the borrowing cost from primary lenders but primary lenders are unwilling to lend more. Low-rate lenders may be unwilling to lend at all to some potential borrowers desiring credit. This is known as credit rationing and it is discussed further next. A continuum of specialized secondary lenders willing to lend small amounts might arise and relax the credit constraint and in many situations provide solutions to needs and problems, increasing overall consumer utility. But lending small amounts is costly due to operating costs and higher risks.

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Chapter 4 examined credit supply and showed where lending costs come from: Credit involves a production process called financial intermediation that provides services but also entails costs. There are production costs consisting of origination, processing, bad-debt, and

[1] Anne Fleming, *City of Debtors* (Cambridge, MA: Harvard University Press, 2018), p. 21 and p. 97, respectively.

capital costs. These production costs include more than simple forbearance cost that arises from giving up alternative uses of the funds by the lender (historically called "interest"). Production costs were understood even in medieval times when rate ceilings were part of religious law that prevailed in most of Europe then. The framers of the Truth in Lending Act understood this too, and they defined the cost of credit as the "finance charge" and not "interest."

Chapter 4 also looked at the economic reasons why supplying a small-dollar loan is more costly per loan dollar than supplying a mainstream loan: many *operating* costs of lending are fixed costs or close to fixed. Fixed operating costs then loom larger and larger per loan dollar as the loan size becomes smaller and smaller.

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In contrast and unlike operating costs, costs of loanable funds increase proportionally as loan size increases. For example, interest paid on the second million or billion dollars of loanable funds for a lender to use to make new-auto loans is going to be much the same as the interest paid on the first million or billion dollars of loanable funds. In other words, cost of obtaining the loanable funds is going to be much the same for each lendable dollar in a particular capital market, up to the limit of the lender to obtain those funds. This means that as loan size becomes smaller, total *funding costs* loom smaller compared to fixed operating costs on a smaller and smaller consumer loan until most of the loan cost on a tiny loan is due to operating cost. Conversely, total funding costs loom larger compared to operating costs as loans become larger, until most of the cost of the loan is funding cost on a very large loan. This has become obvious in the mortgage lending area where consumer rates on retail mortgage loans closely track the cost of loanable funds to the mortgage lender.

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Not surprisingly, these relationships produce a hierarchy of economic lending costs per loan dollar for consumer lending. Costs of making small loans are going to approximate the operating costs. Since, as shown in Chapter 4, the operating costs on a small loan are high per loan dollar, so is the total cost of the loan per loan dollar. In contrast, for large loans the operating costs per loan dollar almost disappear compared to the funding costs, and the funding costs dominate. For the small loans, operating costs dominate.

But even so, other things are still not equal: It is also reasonable to expect, and empirical information demonstrates, that small loans are also typically riskier for lenders than larger loans due to the circumstances of borrowers who need small loans. This adds to operating costs of lending smaller amounts. As discussed at greater length in Chapter 4, additional costs of managing risk and the possibility of losses can make producing small loans even absolutely more expensive than larger loans, and not just relatively per loan dollar. So, if small loans are more costly to make per loan per loan dollar than larger loans, finance charges per loan dollar and accompanying APRs will also have to be higher on small loans to cover costs and make lenders willing to lend.

Even though these ideas have been basically understood since at least the middle ages, this does not make them satisfactory, or even acceptable, to many observers. Consequently, attempts to change and subvert the basic economics of lending through price ceilings have existed throughout history. These attempts have enhanced the reality of credit rationing, the situation where credit supply falls short of demand at the market price.

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<u>The Realities of Credit Rationing</u>

In modern terms, those frozen out by the system become "rationed borrowers" in Juster and Shay's terminology.[2] If rate ceilings are set relatively low, all borrowers become restricted to "primary lenders" that make loans at low rates, which typically excludes small loans. If ceilings are somewhat higher, there can also be "secondary lenders" in the marketplace that expand the availability of legal credit. Even if there were no ceilings, however, lenders will limit the amount of credit of both kinds at some point. The economic theory of credit rationing predicts that lenders will restrict credit when risk and other costs exceed profit potential, and experience shows this is what happens.

Modern economic theory of credit rationing based upon statistical conceptions of risk has become another highly technical and mathematical area of economic theory, but, as indicated, the underlying economic concepts are clear enough and have been understood and discussed for centuries.

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Credit is like other goods and services in that revenues must cover operating and nonoperating costs or suppliers will not provide it. It is not like other goods and services, however, in that, as indicated, its providers are also subject to one more cost aspect that arises from its intertemporal nature: how the repayments are expected after or over a period of time. This aspect of lending generates uncertainty and risk about whether the future promised payments actually will be received, and this risk of nonpayment is potentially costly. Much of the art and science of consumer lending goes into managing this nonpayment (default) risk.

Modern economic theory of credit rationing shows that even in a lending market completely unconstrained by price ceilings lenders will not lend unlimited amounts, since as they lend default risk rises. At the time of development of modern economic theory in this area that included also the work of many others, Juster and Shay pointed out that at some point primary (low-rate) lenders would be unwilling to lend more, even if borrowers were willing to borrow more at the same rates. In these cases, individuals seeking more credit would need to turn to secondary (higher-rate) lenders.

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Due to default risk, at some point even the secondary lenders would be unwilling to lend more. In both cases, default risk produces a situation where there might not be normal supply-demand equilibrium through a market-clearing price because under conditions of increasing default risk lenders are unwilling to supply more credit. Although specifics of the complete theory are considerably more complicated than discussed here, the result is credit rationing.[3]

Juster and Shay's theoretical analysis produced two types of outcomes, an equilibrium outcome and a rationing outcome. They considered first a simple example in which there are two borrowing rates, a lower rate charged by primary lenders and a higher rate charged by supplemental lenders. Both sorts of lenders have an absolute limit on the amount that can be borrowed. The consumer undertakes household-related investments until the rate of return on

[2]See F. Thomas Juster and Robert P. Shay, *Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation* (New York: National Bureau of Economic Research Occasional Paper Number 88, 1964).

[3]For the classic modern discussion of credit rationing, see Dwight M. Jaffee and Franco Modigliani, "A Theory and Test of Credit Rationing," *American Economic Review*, December 1969, and Dwight M. Jaffee and Thomas Russell, "Imperfect Information, Uncertainty, and Credit Rationing," *Quarterly Journal of Economics*, November, 1976. Precise discussion of the neoclassical economics of credit rationing requires graphical and/or mathematical presentation using calculus. See Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy*, which provide discussion and graphs of these and other technical analyses of credit rationing in their Chapter 5 and its mathematical appendix.

investment equals the borrowing rate charged by primary lenders. In this case, the amount borrowed does not exceed the limit set by primary lenders.

Rationing outcomes occur when the consumer is unable to equate the rate of return and the borrowing rate because lenders are not willing to lend more even if the rate is acceptable to potential customers. There are two rationing situations. The first occurs when the consumer is willing to take on the debt at the rate available from primary lenders, but the absolute limit on the amount of credit available from primary lenders prevents a consumer from borrowing further at their lower rate (rationing). In this case, the return on investment for the borrower is not sufficiently high to justify borrowing at the next higher available rate and borrowing stops.

A second rationing outcome occurs when the consumer exhausts availability of credit at the lower rate charged by primary lenders and borrows at the higher rate of the next of a tier of secondary lenders. The borrower's rate of return and rate of time preference may be equal to the higher rate charged by supplemental lenders, but no loan will be forthcoming if the amount of borrowing exceeds the supplemental lenders' limit at this higher rate. Again, rationing takes place and can prevent the individual from taking advantage of an available opportunity (or satisfy a necessity or emergency).

These theoretical contentions are consistent with empirical evidence. It is well known that many good credit risks do not borrow the full amounts that primary (low-rate) lenders are willing to lend them (that is, their expected rate of return on additional credit use is less than the borrowing rate for them). This is not rationing but is choice based upon supply and demand. It is equally well known that lower-rate lenders limit borrowing at their normal rates of charge, however, even if borrowers are sometimes willing to borrow more at these rates. It is also well known that even secondary lenders are unwilling to lend unlimited amounts.

Although the complete theory of credit rationing allows for its existence even in the absence of some sort of external limitation on price, price limits established by governments have been the most common cause of credit rationing historically. As with any product, producers of consumer credit must cover their costs if they are to remain in business. For lending, expected default costs are part of the cost structure that lenders must consider and cover. As outlined briefly above in Chapter 2 above and at somewhat greater length by the NCCF in its Chapter 6, price ceilings established by government action have constrained lenders attempting to cover costs since ancient times.[4]

Theoretical development suggests that borrowers potentially rationed will tend to have relatively low or moderate current incomes and little discretionary income. Without credit, they would have to make large sacrifices in current consumption to pay for large or unexpected current expenses, making the purchases personally very costly. Because of moderate incomes and often younger age, these rationed borrowers generally would not have accumulated large amounts of liquid assets. At this stage in their life cycle, any liquid asset holdings for these individuals would have a high subjective yield anyway, because of precautionary needs, and they might well prefer not to use them.[5]

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[4] See also Sidney Homer and Richard Sylla, *A History of Interest Rates, 3rd ed.* (New Brunswick, NJ: Rutgers University Press, 1996).

[5] For discussion of importance of precautionary reserves to individuals, see George Katona *Psychological Economics* (New York: Elsevier Scientific, 1975, especially Chapter 16).

Available evidence shows that this theoretical profile does indeed describe users of small-dollar consumer credit. Surveys of small-dollar borrowers show that they are younger, lower-income, and more credit-constrained than non-users of these kinds of credit (Table 5-1). This means they will disproportionately include individuals with higher potential demand for credit use (greater returns) and lower potential credit supply. They are users of mainstream consumer credit when possible, but typically they have fewer sources when needed and more difficulty in obtaining mainstream credit.

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Consistent with Juster and Shay's theory of rationed consumers, the important characteristic of consumers who use alternative financial products is that they are constrained in their access to mainstream credit. For example, the overwhelming number of payday loan customers do not have access to credit cards or would exceed their credit limits if they tried to use them,[6] were recently denied access to credit,[7] or searched intensely for credit before accessing their first payday loan.[8] For auto title pawn loans, only about 20 percent of auto title loan customers had credit cards.[9] With respect to overdraft protection, one survey of frequent users of overdraft protection found that only 7 percent of respondents reported that they had "good" credit, compared to 32 percent who said they had "poor" credit.[10] Also, most studies of small-dollar lending find that consumers report that they use small-dollar lending products mostly to meet urgent and important financial obligations, such as rent, utilities, car repairs, and household necessities such as food, clothing, medicine, and gasoline.[11]

These survey findings are consistent with neoclassical economics that the major motivation for credit use involves situations where there is a positive return over time but rationing may affect some potential borrowers, in this case sending them to secondary lenders. There are, of course, also significant and well-known risks of unfortunate outcomes associated with any credit use, and these forms of supplementary credit are certainly not an exception.

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Short term credit products can also facilitate the accumulation of household assets for credit-constrained individuals even when they are not used directly to finance the actual household investment: Availability of short term credit when needed can reduce consumers'

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[6]Elliehausen found that only about half of payday loan customer had credit cards, 67% either had no credit card or would have exceeded their credit limit if they used the card, and 90% had either no cards or less than $300 in available credit card lines of credit). See Gregory Elliehausen, *An Analysis of Consumers' Use of Payday Loans*, (Washington: Georgetown University Credit Research Center Monograph No. 41, 2009).

[7]See Gregory Elliehausen, *An Analysis of Consumers' Use of Payday Loans*, op. cit. and Amanda Logan and Christian E. Weller, *Who Borrows from Payday Lenders? An Analysis of Newly Available Data* (Washington: Center for American Progress, 2009).

[8]See Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, "Payday Loan Choices and Consequences," *Journal of Money, Credit, and Banking*, March, 2015.

[9]See Jim Hawkins, "Credit on Wheels: The Law and Business of Auto-Title Lending," *Washington and Lee Law Review*, 2012.

[10]See Todd J. Zywicki, "The Economics and Regulation of Bank Overdraft Protection," *Washington and Lee Law Review*, 2012.

[11]See Gregory Elliehausen, *An Analysis of Consumers' Use of Payday Loans*, op. cit. Jim Hawkins, "Credit on Wheels: The Law and Business of Auto-Title Lending," op. cit., and G. Michael Flores and Todd J. Zywicki, "Commentary: CFPB Study of Overdraft Programs," Mercatus Center, George Mason University, 2013.

vulnerability to unexpected expenses or short-term fluctuations in income when they already have debts involving the financing of household investment. Although these short term credit products may be very costly per loan dollar, consumer losses resulting from illiquidity may be quite large as well. Even simple late payments of utility bills due to illiquidity, for example, can cause a consumer to incur late-payment fees, loss of deposits on monthly utility bills, and reconnect fees.

Those facing such circumstances typically are at the life-cycle stage where needs and returns can be high but resources often are limited. They then become potential small-dollar borrowers from secondary lenders. It also appears that many of them age out of this kind of credit as they establish themselves financially and graduate into greater access to mainstream credit, although some do not. Further, there is a pattern whereby some products are less desirable than others based on cost and features. Thus, if credit rationing by primary lenders affects access of individuals to preferred forms of credit (including more convenient forms like credit-card credit), they can still move down the order of preference to less desirable (and typically more expensive) kinds of credit. These various sorts of small-dollar products are discussed further below.

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Small Amounts of Credit in Recent History

Amounts of small-dollar credit in use today amount to only a small fraction of the approximately $4 trillion of consumer credit in use, but the numbers are certainly consequential. The Federal Reserve does not provide estimates of amounts specifically of small-dollar consumer credit within its aggregate amounts, but others have attempted this, using various sources of data.

One summary in an academic study published in 2020 provides some estimates of small-dollar credit use in 2016 and 2017 (Table 5-2).[12] Estimated totals for cash installment loans, pawn loans, vehicle title loans and payday loans were about $75 billion in these recent years, much less than other common forms of mainstream consumer lending. Amounts naturally are going to be smaller for "small-dollar" lending, but evidence also suggests that only a small fraction of the public uses these loans. According to the 2017 FDIC Unbanked-Underbanked Supplement to the Current Population Survey, 1.7 percent of households used payday loans, 1.4 percent used pawn loans, and 1.4 percent used automobile title loans. (This source does not report on traditional installment cash loans from finance companies.)

Table 5-2 goes here.

<u>Historical Review by the National Commission on Consumer Finance</u>

In 1972, the National Commission on Consumer Finance devoted a considerable portion of its attention to policy issues surrounding small-dollar consumer credit. Beyond merely pointing them out and referring to past reform efforts in the small-dollar lending area, the NCCF undertook and sponsored new empirical studies and encouraged more. Significantly, the NCCF argued for removing barriers to competition in financial markets in order to guarantee that charges for credit would be as low as possible in all areas of credit granting, including this one and its variations. Over the intervening years, regulators and institutions have implemented

[12] See J. Brandon Bolen, Gregory Ellihausen, and Thomas W. Miller, Jr., "Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research," *Economic Inquiry*, April, 2020, Table 1.

favorable competitive changes, but controversy over lending costs and necessary revenues for small-dollar loans remains.

The NCCF began its discussion of interest rates with its Chapter 6 titled "Rate Ceilings." The Commission described the two competing approaches over the millennia as "Free Rates" and "Decreed Rates." Both date to antiquity almost four thousand years ago. The Commission pointed out that interest-rate history shows that rates have always fluctuated with supply and demand, and so there is always going to be potential for conflict over interest rates between economic conditions and laws governing permissible rates.

Interest-rate history is also a history of violations of laws decreeing rates and subterfuges around various prohibitions. There were laws regulating loans and lenders in the ancient Babylon of Hammurabi, with penalties for violations (records are in the British Museum to this day). Lenders in the Roman Forum were faced by interest-rate limitations (often ignored) as were potential medieval lenders. The NCCF pointed out how charitable lending institutions for the poor in the form of public pawn shops existed specifically as a way around rate limitations for small loans by at least the fifteenth century. Apparently, small money-emergencies arose even before there was much of a money economy. Interest-rate ceilings continued to exist in the western European countries that sent colonists to North America in the seventeenth century, and settlers from England brought the experience of ceilings with them to the colonies and the early United States.

England repealed its rate ceilings in the 1850s, but during the NCCF's time all states except New Hampshire and Massachusetts still had general rate ceilings (still known as "usury laws" using the Biblical and medieval term). As outlined above in Chapter 2, by the early twentieth century, most states had also created various exceptions to their usury laws for various kinds of consumer credit but without eliminating the concept of ceilings. These exceptions consisted of special rate provisions according to institutional class and credit type: for small consumer cash loans at finance companies with state licenses (licensed lenders or small loan companies); for various kinds of loans (with or without deposits) at banks, credit unions, and industrial banking companies ("Morris Plan" banks); and at other regulated small-dollar lenders like pawn shops.

In the early twentieth century states also began to control "time-price differentials" on purchase of goods and services using credit from retail outlets and dealers that were another way around usury laws. Most states created the various clarifications and exceptions to their usury laws to facilitate the flow of consumer credit. The NCCF noted the extent and variety of these arrangements with examples and called the result a "hodgepodge." The Commission was quite evidently concerned whether the range of exceptions to legal requirements at the time was sufficiently broad to permit generation of needed credit availability under the competitive conditions it saw as desirable. It clearly was concerned that the "hodgepodge" had created gaps and limited markets into pockets where competition would be insufficient to generate the lowest possible prices consistent with production costs for all amounts of credit.[13]

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[13]Chapter 2 of this Taskforce report discusses a bit more about how rate ceilings and restrictions on other credit terms at this time differed by institutional class of the lender and often prevented lenders in one class from offering a set of terms offered by another class of lenders. The NCCF and others in its time also commented on how the variety of rate ceilings and loan size limitations in force could produce gaps in credit availability at different loan sizes and even situations where high-cost providers might be permitted to make loans of certain sizes while low-cost providers might be prevented from doing so. There is further interesting discussion of these possibilities with a graph that shows how they can happen in David H. Rogers, *Consumer Banking in New York* (New York: Columbia University Press, 1974, pp. 117-21).

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The Commission concluded its own historical review, seemingly indicating its frustration, by quoting from Sidney Homer's *History of Interest Rates* about how the controversy never seems to end (NCCF *Report*, p. 93):

> The controversy did not end with the Reformation and the modification of Church doctrine. It continued and continues. It is now couched largely in terms of justice and expediency, laissez faire or economic controls, controlled rates (supposed to be low) versus free rates (supposed to be higher). ... The rate of interest in the twentieth-century is often limited by law. It is still a subject of controversy, not only among economists, but equally among politicians and economic groups. Some like it high; some like it low.

The Commission then turned to discussion of purposes of rate ceilings on consumer credit commonly given. The Commission found four and discussed each at some length. In this discussion, the Commission contended that varieties of reasons were still advanced domestically, despite absence of governmental ceilings in most other countries it examined. Debate over the wisdom of price controls continued into the 1970s during the high-interest rates of those years that rendered usury ceilings even more disruptive than was usually the case in the past. These concerns seem generally less important today than in the NCCF's time as rates have subsided, except for disputes in the small-dollar area.

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The examination of usury ceilings was important to the Commission on account of its legislative charge to study and appraise "the adequacy of existing arrangements to provide consumer credit at reasonable rates" (Consumer Credit Protection Act 404(a)(1)). The Commission concluded that credit rationing arose from rate ceilings and also from insufficient competition in some parts of consumer credit markets caused by the inefficient system of interest-rate ceilings and various exceptions only for specific institutions.

The first possible purpose of ceilings discussed by the Commission was "to redress unequal bargaining power" (NCCF *Report*, p. 96). This was the idea that rates always rose to the ceiling and so ceilings were necessary to keep them from rising too far. The Commission showed this was not correct through its review of empirical evidence previously available and through extensive new rate surveys it undertook. Instead, the Commission found that rates generally did not rise to ceilings in mainstream consumer-credit markets "except when the price ceiling is set at or below the market rate for the particular form of credit placed under price control" (*Report*, p. 96). The latter area involved cash installment loans that were subject to relatively low rate ceilings relative to their production costs. These were the most important source of small-dollar loans at the time.

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There generally does not appear to be much request today for ceilings in other areas. Such other areas include mainstream mortgage lending, automobile, home improvement, and credit-card credit. Institutions establish rates based upon market conditions and competition in these areas. Rates on much of credit-card credit today also fluctuate with changes in an underlying market-rate index outside the institution's control. The Commission believed that Truth in Lending would continue to improve competitive conditions in these areas, which it appears to have done.

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The Commission indicated a second reason sometimes given for favoring ceilings as "to avoid overburdening consumers with excessive debts" (*Report*, p. 99). The Commission contended that "the theory is sustainable if it can be shown that consumers who would pay rates above ceilings are those who would become overindebted" (*Report*, p. 99). Even then the

Commission did not recommend the ceiling approach. Rather, ultimately it contended that it is the demand and supply for credit that determines the volume of debts, including the possibility of credit rationing by the suppliers.

The Commission maintained that it is not rate ceilings in some part of the market that accomplishes the task of limiting debts. Instead, excessive indebtedness springs from lending mistakes. To be sure, events subsequent to a loan can produce unfortunate outcomes to credit situations entered responsibly by both borrowers and lenders (that is, these intertemporal transactions are subject to risk of subsequent events). Sometimes other lending mistakes are made, but neither risk nor lending mistakes means that rate ceilings are necessary to prevent general overextensions of credit. The Commission contended that rate ceilings would instead merely produce a lowering of risk acceptance overall, with lowering of credit availability to riskier potential customers possibly in need of additional credit.

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The Commission also cited a third reason sometimes advanced for ceilings, "to administer credit grantors as public utilities" (*Report*, p. 102). Not much is heard about this idea today, but it certainly is not dead. The Commission continued: "This approach recognizes that if consumers are to be served, rate ceilings must be high enough to permit credit grantors to earn an adequate rate of return on their invested capital" (p. 102). In other words, this approach would allow lenders to be able to operate on a "cost plus" basis. The Commission noted that this requires knowledge of production costs to generate cost-plus legal pricing, but that its real impact would be segmentation by risk class chosen making this approach "a self-fulling result of the risk class served" (p. 102).

The Commission pointed out that this approach would require "a rate commission that would have to specify in some manner the highest risk class of consumers that could and *should* (emphasis in original) be served by each credit grantor" (p. 102):

> Unless the rate commission were then prepared to examine the validity of credit turndowns for each franchisee, credit grantors operating under a fixed rate ceiling could improve their profit margin by denying credit to riskier consumers and by not offering costly forms of credit, such as small short-term loans. The establishment of credit standards; and appropriate prices for multifaceted credit arrangements and the enforcement of requirements that credit grantors meet any "justified" demands by consumers of widely varying credit standings pose dire problems for a ratemaking-commission governing franchised consumer credit grantors.

It seems that this concern would still exist if this approach were advanced today, but the NCCF also discussed some further "practical difficulties." One was cost measurement for multiproduct financial institutions like banks and proper allocation of joint costs. Another was the existence of extensive availability of retail-store and dealer credit at the time where charges for credit could easily be buried in the cost of goods. A further one was the highly mobile nature of lending assets. Mispricing by public rate authorities would not immediately eliminate the availability of electrical service while the electric utility company struggled for profitability. The nature of the fixed assets in electricity generation (generating plants and distribution infrastructure) could not easily be employed in different uses. This would not be true of highly-mobile lending assets that would quickly move to other uses.

The NCCF also discussed a fourth argument sometimes advanced as favoring rate ceilings and the "most compelling problem to be considered," namely "to assure that consumers pay fair rates for credit" (p. 103). Following its analysis, the Commission again concluded that this issue amounted to another label for the same problem: fair for whom? Again, the outcome (and societal value judgement) would depend on which *risk classes* of consumers the system would allow to obtain legal credit. Higher risk classes would simply be more costly to serve, and this was the crux of the problem. Charging them higher prices than others was offensive to some, but rate ceilings would preclude their obtaining credit. How to manage this dilemma becomes a societal problem.

The Commission recommended that governments reconsider the need for interest-rate ceilings and take available steps to improve competition in consumer credit markets generally. As also indicated in Chapter 2 above, many states made changes to their interest-rate regimes during and following the extremely high interest rate period surrounding the year 1980, and consumer-credit granting institutions are generally much more competitive today. These changes and the broad decline of interest rates since the early 1980s have tended to make interest-rate ceilings much less contentious in recent decades, except in the case of small-dollar credit.

On balance, the Commission appeared to favor permitting existence of smaller-dollar credit from commercial sources, as long as regulatory conditions provided a competitive marketplace (p. 149):

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> The Commission recommends that each state evaluate the competitiveness of its markets before considering raising or lowering rate ceilings from present levels. Policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed.

Evidence shows that even this hedged recommendation was controversial at the time, even within the Commission itself (see the exchange between commissioners Senator William Proxmire (pp. 220-30 and 263-4) and Professor Robert W. Johnson (pp. 243-62)). As indicated already in this Taskforce report, allowable rates on small amounts of credit remain controversial today, in at least the fifth millennium of this debate.

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Recent Developments

The NCCF discussed at some length the main kinds of small-dollar lenders in existence then, notably traditional cash installment lenders (then known as licensed lenders or small loan companies) and retail outlets. There also were pawn lenders that the Commission did not discuss. These credit sources still exist, but today there also are other small-dollar lenders, including whole new industries such as payday and automobile-title lenders. There is also a related depository-institution product referred to as overdraft protection or sometimes as "bounce protection." Further, there also are rent-to-own outlets. Taken together, these lenders have arisen on account of credit rationing by low-rate lenders and they cater to a range of risks. All of them must contend with the fixed costs of lending that loom large per loan dollar on small amounts of risky credit extensions.

It seems that much of the criticism of small-dollar lending and lenders from ancient times to the delivery of the NCCF's Report and beyond reflects the view that charges for credit use reflect in large part the attempt by lenders to take advantage of borrowers. In economic terms a situation of this sort would be called a "market failure" in that markets are not providing for the needs (demand) in the marketplace at the minimum price that covers costs and allows for exchange. In effect, some observers through history from the Bible through ancient credit codes and up to the NCCF and the present time have suggested that much of high-rate lending results from the present-bias of borrowers that allows for price gouging by unscrupulous lenders.

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As discussed here in Chapters 3, 4, and this chapter, economic theory and empirical evidence have shown there is more to the story. Most credit use by individuals today arises from opportunities that provide benefits over time including a preferred consumption time pattern. Economic theory also suggests that small-dollar lending will arise in situations where willing borrowers are constrained by credit rationing of low-cost lenders to limit risk. Higher-rate lenders will emerge, but if small amounts of credit are involved, production costs per loan dollar are high. This means that prices at which market exchanges (lending) takes place will also be high.

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Available empirical evidence is consistent with this theory, but some observers apparently still maintain the market-failure contention. For instance, in its 2017 rulemaking concerning "payday" lending, the Consumer Financial Protection Bureau suggested that the desperate condition of payday borrowers indicated they would pay almost any price and that biases toward considering only the present prevented them from fully understanding the costs of payday loans, views supported by many commentators.

Existence of large numbers of small-dollar credit sources where allowed, however, does not suggest existence of a comprehensive market failure like monopoly power conditions that allow price gouging. Lending does not require large fixed investments such as electric power generating stations that permit scale economies and discourage market entry by others. There also are no patents or secret processes in lending. Barriers to entry are low, except in states that create regulatory barriers to entry. Available empirical evidence indicates that although the price charged for small-dollar loans is high in APR terms, those prices appear to be the result of high operating costs including high loss rates per loan dollar on small-dollar lending (see Chapter 4). As discussed further below in Chapter 8, there is no evidence of supranormal profits or rates of return for businesses operating in the small-dollar loan market. Rather, it seems that where regulation permits market entry, lenders are readily willing and able to enter markets to equate demand with cost-based supply.

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Likewise, evidence to be discussed suggests that there does not seem to be market failure due to absence of necessary consumer understanding or knowledge. To be sure, consumers do not necessarily know nor understand everything about lending institutions or loans perfectly. But they also do not necessarily need to know or understand everything about lending for most of them to act in their own interests, even if some do not. Further, Truth in Lending in effect since 1969 provides ready access to information on prices. Individuals also learn from their experiences and can also pass information on to family members and others. Information will be discussed further in the next section and in Chapter 7.

That credit sources are willing sometimes to compete on a non-price basis like preferred hours or greater convenience likewise does not imply market failure. Institutions may try to attract customers by many means, but this does not mean customers are unaware of cost differences. The National Commission on Consumer Finance showed that consumers were aware of differences among credit-providing institutions and the credit-cost alternatives that the market provides. The Commission called this "institutional knowledge" and discussed it on pp. 177-80 of the Commission's *Report*. The Commission found that institutional knowledge

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extended well beyond knowledge only of the new Truth-in-Lending disclosures.[14] The NCCF also stressed the importance of expanding competition in the small-dollar area, and the landscape is much more competitive today. This enables institutions to compete in a variety of ways and borrowers to choose the ones they prefer. There is no evidence of a market failure on this basis either.

Further, although human nature seems like it has always been able to provide a supply of willing producers of sharp practices (for instance, evidence also suggests that need for codification of moral codes like the Ten Commandments and others also extend well into antiquity), there does not seem to be a failure of consumer protection in the lending area either. Consumer protection laws in the financial area are quite comprehensive at both state and Federal levels. Some individuals may violate the laws, but this does not seem to be the norm. There also is substantial public enforcement. Rather than turning to shady lenders willing to evade or break laws, it is more likely today that constrained potential borrowers will simply move down the list of lenders to a less preferred (higher-cost) credit source if necessary.

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But some observers still do not like laws that permit small-dollar credit with its high costs per loan dollar. Their opponents hold the opinion that overly-restrictive consumer-protection laws can have the unintended consequences of preventing consumers from doing what they want and need or even acting in their own best interest. Ultimately, this is at heart a difference of opinion on the proper role of government in society, also discussed further below. With all this background in mind, it is worth looking at evidence on modern small-dollar lending more closely.

Common Methods of Providing Small-Dollar Credit Today

Juster and Shay wrote about “primary” and “secondary” consumer lenders, but there actually are many kinds of consumer lenders in what amounts to a continuum in the risk acceptance and pricing dimensions rather than a simple dichotomy. On the low-risk, low-cost end of the lending spectrum, there are prime mortgage lenders, new-auto lenders, and premium credit-card issuers. There even are lenders to highly credit-worthy wealthy individuals purchasing expensive cars, boats, aircraft, and even country club memberships, art, and antiques who prefer not to liquidate other assets to purchase such luxuries.

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Credit cards move a bit further out on the risk continuum. Many credit-card purchasers use card services merely for convenience in making payments, even large ones, and repay the amounts quickly upon presentation of the bill at the end of the billing cycle. Other card holders use them as a credit source for purchases of appliances, home furnishings, and home and auto repairs and do not necessarily pay the balance in full when the monthly bill arrives. Some individuals have two or more cards, one for facilitating routine transactions and one or more others used as source of revolving credit.

There even are subprime credit cards used by individuals with poor credit records. Some of them remain poor credit risks but there also are others who use the subprime cards to generate improvements in their credit records with the hope of moving more into the mainstream. And so credit cards are a transitional form on the risk/cost scale. There are many low-risk, mainstream users of credit cards but also some riskier and more costly users. Some

[14] See also Thomas A. Durkin and Gregory E. Elliehausen, *The 1977 Consumer Credit Survey* (Washington: Board of Governors of the Federal Reserve System, 1978), Chapter 3.

users of higher-risk cards graduate to lower-risk credit sources while others do not or even move the other way.[15]

More recent evidence further shows, however, that card holding has fallen from a peak of about three quarters of households in 2001 (see Table 2-2 in Chapter 2), suggesting the possibility of unserved demand in this credit area. Beyond most credit-card credit on the risk scale are the true secondary lenders in the Juster-Shay sense, the high-risk, small-dollar lenders. Discussion of these other sorts of small-dollar credit has been widespread enough recently that today there are many existing descriptions of them ranging from journalistic reports to academic analyses.[16]

Basically, there are four main approaches to non-credit-card, small-dollar lending widely found today and a few others that should also be mentioned. Arrayed from lowest charge per loan dollar to the highest, the four main approaches are: traditional installment cash lending by finance companies at the lower-rate end, and then higher-rate, single payment pawn loans, auto-title loans, and "payday" loans. Some individuals also use forms of "overdraft protection" on deposit accounts for small-dollar credit needs, a source of short-term cash in some aspects like payday loans. These are the lenders and forms of lending that have caused much of the concern among some observers about consumer-credit use in recent years.

Two more credit sources on this end of the risk spectrum are the rent-to-own store and the buy-here-pay-here auto sales outlet. Very little about these latter sources is written in the economics literature. Even beyond them are the illegal lenders, typically still called "loan sharks," that continue to exist according to news reports. They can range from small individual "entrepreneurs" to organized criminal enterprises, the latter especially not a favored research area among the academic community.

Academic and policy interest in other small-dollar lending in recent years means that a list of questions about such lending has developed. Some questions involve research matters and some are more oriented toward policy questions. Research questions include what is the evidence on outcomes of small-dollar loans and whether these borrowers seem to know what they are doing. Research in these areas is ongoing and quite apparently is not going to decide policy debates, but maybe it can inform them. Among the policy questions is concern over the proper role of government in making decisions for individuals. This is discussed in the next section of this chapter.

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[15]Research following implementation of the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the "CARD Act") showed that about seven in ten individuals in the bottom quartile of credit bureau scores held bank credit cards in 2001, but that the proportion had declined to about half after by the time the CARD Act became effective in 2010 (also following the sharp recession of 2008-9). The research also showed an accompanying increase in cash loans at finance companies among nonprime consumers in states where rate ceilings permitted credit availability from this source. These findings show the apparent substitutability between credit card credit and traditional finance company loans (the latter at higher rates) as credit card credit became less widely available to subprime customers following implementation of the CARD Act and the recession. See Gregory Elliehausen and Simona M. Hannon, "The Credit Card Act and Consumer Finance Company Lending," *Journal of Financial Intermediation*, April, 2018.

[16]For lengthier academic descriptions of these institutions and kinds of credit, see Thomas W. Miller, Jr., *How Do Small-Dollar Nonbank Loans Work*? (Arlington, VA: George Mason University Mercatus Center (2019) and J. Brandon Bolen, Gregory Ellihausen, and Thomas W. Miller, Jr., "Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research," op. cit. See also Durkin, et al., *Consumer Credit and the American Economy, op. cit.,* Chapter 8.

Looking first at the outcomes issue, Professor John P. Caskey of Swarthmore College articulated his "Big Question" concerning whether small-dollar loans "on net exacerbate or relieve customers' financial difficulties."[17] Most of the recent studies of small-dollar lending focus on payday lending and the payday results have been mixed on this question for them (discussed further below). This is partly due to differences in the specific questions analyzed by the payday studies but also to data and methodology differences (for instance, using aggregate statewide economic data versus surveys of individuals or findings from experimental designs). Ultimately underlying the research results is the inherent variability of outcomes from credit use (its risks), especially where high risk, high rate, single payment loans like payday loans to lower-income consumers are involved. Therefore, research findings do not reveal clear conclusions on Caskey's "Big Question" for all cases or allow easy generalizations.[18]

Overall, research findings on small-dollar lending show that having small amounts of credit available can mitigate costly contingencies ranging from overdraft fees, bounced-check fees, and late fees on unpaid rent and other bills to needs like emergency car repairs and unexpected medical bills. The correct underlying interpretation of the need for a short-term loan is illiquidity that has developed possibly for a combination of reasons.

Surveys show that consumers acknowledge a variety of immediate reasons needing immediate attention. For instance, surveys on payday-loan borrowers reported by the Pew Charitable Trusts found that 69 percent of payday loan users used such loans "to cover recurring expense, such as utilities, credit card bills, rent or mortgage payments, or food; 16 percent dealt with unexpected expenses, such as a car repair, or emergency medical expense."[19] Studies also show that there also appear to be some individuals who exhibit behaviors involving small-dollar credit consistent with present-focused behavioral biases or time-inconsistent discounting of future incomes and spending. These also are hypothesized and sometimes identified by academic behavioral researchers using student subjects, but this is not the overarching reason for small-dollar credit use.

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It also turns out that consumer decisions for many small-dollar loans do not require some sort of difficult financial mathematics for users to make informed decisions about potential outcomes. Reasons for using the credit typically are very immediate and clear: some sort of illiquidity. For instance, few things are clearer than emergency conditions or an immediate need with little or no cash available. The emergency is obvious and the cost of a loan is readily available and easy to ascertain. Further and significantly, Truth-in-Lending requirements mandate cost disclosures both in dollars ("finance charges" in TIL terms) and as an Annual Percentage Rate. Even the skills of a certified financial analyst would not lead to different decision parameters in these situations: Often the short time period means that discounting the cash flows is little different from undiscounted cash flows. Even at high rates,

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[17]John P. Caskey, "Payday Lending: New Research and the Big Question," in Philip Jefferson, ed. *Oxford Handbook of the Economics of Poverty* (Oxford: Oxford University Press, 2012).

[18]Interestingly, evidence shows that low income and high risk on the basis of credit score are by no means perfectly correlated (see Rachael Beer, Felicia Ienescu, and Geng Li, "Are Income and Credit Scores Highly Correlated?" *FEDS Notes*, August 13, 2018). They are correlated to a degree, however, and even low-income individuals with high credit scores are going to exhaust their credit capacity more quickly than higher-income individuals with high scores, making them riskier for substantial amounts of mainstream credit from primary lenders.

[19]Pew Charitable Trusts, Payday Lending in America: *Who Borrows, Where They Borrow, and Why* (Pew Charitable Trusts, 2012).

entering calculations of time value of money as a financial analyst might do would cause few analytical reversals of benefit/cost criteria or require sophisticated financial review.[20]

Survey evidence also shows that many users are aware of the main features of the loan products. For instance, evidence from a variety of surveys shows that borrowers typically understand the dollar-cost of the loans, also discussed further below. This means that users are easily aware of both the benefits and the cost and provides the context for use of the credit and its potential outcome. Unfortunately, looking closely at choices and outcomes for large numbers of specific individuals by researchers is generally not easily possible due to lack of much survey information on outcomes at the individual level. Research findings are discussed further in the following subsections on individual products.

Traditional Installment Cash Lenders

Beginning with the lowest-rate source for small-dollar credit, one type of small-dollar lender still somewhat common today in some states is the traditional cash installment lender. This sort of lending is considerably older than payday and auto-title lending industries and has its own approach and heritage. Notably, the traditional small-loan industry makes loans with repayment over multiple months with repayment designed to fit into monthly budgets more smoothly than lump-sum repayment.

As indicated earlier in Chapter 2, small cash loans to individuals for household purposes became common in the United States in the years after the Civil War, mostly illegally at first. By the 1910s, abuses produced a public reform effort led by the Russell Sage Foundation and it conceived the regulated small-loan industry. In the past, these companies were known as licensed lenders, small loan companies, or consumer finance companies. In the states where it still exists, this industry today typically is called the traditional installment cash-loan industry to differentiate it from the other small-dollar lenders.

These lenders make relatively small cash loans to individuals for periods usually from six months to about two years with interest rate ceilings specified in state lending laws. Because of the unsecured nature of these loans and their longer maturities and slower payment schedules, the lenders evaluate the employment and budget condition of potential borrowers more carefully than the other small-dollar lenders (called "underwriting" the loans).

Typically, the allowed rate within states varies somewhat by loan size, with higher rates allowed on smaller loans in some states. Because the National Commission on Consumer Finance discussed them at length and since lending-cost data on these lenders exist, Chapter 4 of this Taskforce report examined cost aspects of their lending in more detail. Rate requirements on the smallest loan sizes for short terms and annualized under TIL rules can exceed 100 percent APR, but more typical are somewhat larger loans at considerably lower rates.

Traditional small cash installment loans occupy a middle ground between mainstream installment credit from banks and other primary lenders including credit cards and small single-payment loans like pawn and payday transactions. Traditional small installment loans are not

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[20]Textbooks on finance discuss the concept of time value of money and the role and methods of financial analysis in more detail. For discussion in the context of payday loans see Gregory Elliehausen and Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand*, op. cit., also summarized in Durkin, et al., *Consumer Credit and the American Economy*, op. cit., Chapter 8, pp. 370-4.

the same as the other forms of small-dollar credit, despite how they are sometimes lumped together. Payday loans arose from the check-cashing industry as a "payday advance" procedure requiring single-payment payoff redemption. Pawn loans and title pawns have different heritages, but also have reflected the plan of a single-payment payoff within a short period of time. Evidence suggests that where laws still allow small-dollar versions of traditional installment cash loans to exist, lenders also supply them and demand finds them.

As indicated in Chapter 2 and here, traditional installment lending industry arose from the ultimate background of the reforms sponsored by the Russel Sage Foundation in the 1910s. At the time, the reforms allowed for exceptions to prevalent state rate ceilings on loans of $300 and less that permitted small loans to be made with repayment in installments. Allowed rates varied according to state, but reached 42 percent on the smallest sizes in an early version from the Sage Foundation. Today, traditional installment cash lenders typically make small cash loans at the sorts of rates suggested as necessary by the NCCF in 1972 (see discussion in Chapter 4 above).

Statistical review in the previous chapter suggests that a ceiling of 42 percent today would not allow these lenders to engage in making such loans smaller than about $2000 and still cover all costs (see Table IV-2 in the previous chapter). Thus, finance company installment loans at the larger end of the size spectrum are going to be more prevalent in states allowing rates at the lower end of the rate spectrum, as they were at the time when the Sage Foundation was lobbying its reforms. Today some states allow for sufficient rates on smaller loan sizes to permit lenders to make smaller loans, but lending laws that once encouraged this reform have atrophied in many places. This happens if limits on loan amounts permissible special (higher) rates do not keep pace with inflation.

An extreme hypothetical example can clarify this point: If in some state the loan size ceiling of $300 at a 42 percent rate had not been raised above this size limit since 1916, there would be no loans in this state today under this law. As the table in Chapter 4 shows, lenders would not be willing to make loans in this market below a size of about $2000, but the legal size limit would not permit loans larger than $300. Thus, there would be no lenders (and no loans) at the atrophied legal limits of $300 and 42 percent in this state. Filling in a larger loan size limit in the example up to about $2000 would produce the same result.

There has been only limited research on the traditional installment cash lending industry in recent years, mostly, like with other forms of small-dollar lending, because of lack of data such as surveys of borrowers. There is only limited information even about where such traditional installment lending takes place and in what volumes. At the time of the NCCF, much more information was available from state regulators. Some studies at the time used this available statewide data, and the NCCF undertook additional data gathering and research studies on this industry.[21]

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[21]A selection of economic, historical, and statistical studies of the installment cash lending industry available to the National Commission in 1971-2 included, among others: Arthur Ham, *The Campaign Against the Loan Shark* (New York: Russell Sage Foundation, 1912; Rolf Nugent, "Three Experiments with Small Loan Interest Rates," *Harvard Business Review* (October, 1933); Louis N. Robinson and Rolf Nugent, *The Regulation of the Small Loan Business* (New York: Russell Sage Foundation, 1935); Thomas G. Gies, Cedric V. Fricke, and Martha Seger, *Consumer Finance Companies in Michigan* (Ann Arbor, MI: Bureau of Business Research, University of Michigan, 1961); Paul F. Smith, "Recent Trends in the Financial Position of Nine Major Consumer Finance Companies," in *The Consumer Finance Industry: Its Costs and Regulation,* eds. John M. Chapman and Robert P. Shay (New York: Columbia University Press, 1967), updating Paul F. Smith, *Consumer Credit Costs 1949–1959* (Princeton, NJ: Princeton University Press for the National Bureau of Economic Research, 1964); Irving S. Michelman, *Consumer Finance: A Case History in American Business* (New York: Augustus M. Kelley, 1970); John M. Chapman and Robert P. Shay, *Licensed Lending*

More recently, Durkin, Elliehausen, and Hwang used information from a survey of traditional installment cash lenders undertaken by the American Financial Services Association to report characteristics of more than 3.1 million small-dollar traditional installment loans made in the second half of 2013.[22] They reported many of the key findings about these surveyed loans in a summary attached to their paper. Discussion included how these loans are found in states where rate ceilings on smaller loan sizes are similar to those the National Commission on Consumer Finance calculated in 1972 were necessary before such loans would be available. Few loans were found in states with lower ceilings (see their summary, pp. 2-3):

> Findings from the AFSA survey of installment lenders are consistent with hypotheses developed many years ago from the economic theory of credit rationing. These hypotheses suggest that users of small dollar amounts of installment credit from secondary credit sources are "rationed" borrowers in an economic sense, those borrowers unable to obtain as much credit as they need or want from primary lenders at low rates. Specific findings include:
>
> Most loans (more than 85 percent) clearly are subprime on the basis of credit scores. (Sixty-eight percent had credit scores below 620 and 24 percent were below 551).
>
> These installment loans are both small and short term. Almost 75 percent of the surveyed loans are made for $2000 or less and 77 percent for two years or less. These are precisely the loans the federal study commission [the NCCF] determined would require high rates.
>
> High APRs are due to both small size and high risk.
>
> Loans are made with low payments to satisfy both demand among rationed borrowers for small payments and supply by lenders who also are interested in easy repayment. Almost 40 percent of the loans have payments of $100 or less monthly and almost 75 percent $150 or less. ...

Durkin, Elliehausen, and Hwang also found that frequency of this lending varied sharply among states. States with low ceilings have few loans, larger average loan size, and longer maturities. The finding that states with low ceilings have larger average loan size is consistent with the hypothesis that where permitted rates are lower, borrowers and lenders will work toward adjusting terms. Adjustments tend to increase the principal amount borrowed in order to reduce the Annual Percentage Rate of the loan to come in under the legal rate ceiling. To keep payments manageable on larger loans, maturities could be lengthened, but these changes would result in higher costs (total finance charges) for the consumers, even at a lower APR. Durkin Elliehausen, and Hwang offer examples of these adjustments in their paper. Such larger and longer loans also would likely only be available to the better credit risks.

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in New York (New York: Columbia University Press, 1971); and Thomas A. Durkin, *A High Rate Market for Consumer Loans: The Small Small Loan Industry in Texas* (Washington: Technical Studies of the National Commission on Consumer Finance, Volume II, Number 3, Government Printing Office, 1973).

[22]Thomas A. Durkin, Gregory Elliehausen, and Min Hwang, "Rate Ceilings and the Distribution of Small-Dollar Installment Loans from Consumer Finance Companies: Results of a New Survey of Small-Dollar Cash Lenders" (2014, available on Social Science Research Network). Before discussing their statistical findings about these loans, the authors further reviewed Juster and Shay's analysis of how credit rationing would likely involve lower income and younger consumers most often.

As previously discussed (with examples) in Chapter 4, such adjustments that rate ceilings cause can be harmful to consumers desiring smaller loan amounts of credit. First, some higher-risk consumers who could qualify for a loan at a smaller principal amount will not be able to qualify at the larger minimum loan size. Second, adjusting to larger loans for a longer period can force higher total finance charges than if they were permitted to borrow only the amounts they needed. The National Commission on Consumer Finance and the Russell Sage Foundation before it understood this.

Durkin, Elliehausen, and Hwang provided examples. The found that in Pennsylvania, which has a low maximum permissible rate, there were few installment loans — just 1.5 per 1000 population. Moreover, there are almost no loans for less than $500 and only 1 percent of loans for under $1000. Fifty-seven percent of loans had maturity lengths greater than two years. As a result of these larger loan amounts, 55 percent of loans had monthly payments in excess of $150 per month.

The authors compared experience in Pennsylvania to Texas, which allows higher APRs on small installment loans. In Texas, there are many more loans — 23.9 per 1000 population. Forty-two percent of loans were for under $500 and 70 percent were under $1000. Finally, 99 percent of loans had maturity periods shorter than two years. Because of the smaller loan sizes, only 16 percent of borrowers had payment obligations of greater than $150 per month. And smaller loans for shorter intervals reduce finance charges.

The authors also found that the delinquency rate in the survey of installment loans was high, with the highest slow-pay experience on the smallest loans sizes. Delinquency there ranged up to more than 25 percent, although undoubtedly many of these loans paid off, even if slowly and only after costly and time consuming reminders. Borrowers with the lowest credit scores qualified for only the smallest loans.

In recent years, online installment lending of "payday-type" loans has also grown rapidly and should not be confused with "traditional" installment loans.[23] Although there is little systematic research of these newer payday-installment loans, available information suggests that these online installment loans are, on average, larger in size than those made by traditional storefront payday lenders, and have substantially higher rates of fraud and chargeoffs than such traditional storefront payday loans. Online borrowers also appear to have higher incomes than traditional storefront payday borrowers, consistent with the finding that they are also more likely to borrow larger sums.[24]

Pawn Lenders

The oldest of the small-dollar lenders is the pawn lender, dating at least to the ancient Greek city states. In a pawn transaction, the borrower brings an item to the lender and leaves it there for a fixed length of time in exchange for current cash (the loan amount). Simultaneously, the borrower agrees to repay the loan in full with interest in a set amount of time (redeem the pawn), usually in a month, at which time the borrower receives back the pawned item. There is no true obligation actually to repay the loan and redeem the item, however. Instead, the borrower may simply walk away, in which case the pawn broker may sell the pawned item (or sometimes auction it if required by state law).

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[23]See Howard Beales and Armand Goel, Small-Dollar Installment Loans: An Empirical Analysis, Working paper, 2015, available SSRN: https://ssrn.com/abstract=2581667.

[24]See G. Michael Flores, "The State of Short-Term, Online Lending," Bretton Woods, Inc., 2015

Explained this way, a pawn arrangement is a single transaction, a secured loan for one month. But it is also closely akin to and can be structured as two transactions: first a sale of the good by the individual to the pawn broker with agreement by the individual to buy it back later in a second transaction for a higher price. This sort of "lending" was done in the middle ages when true lending with interest was prohibited. The repurchase later at a higher price takes the place of returning the loan principal with interest. Robinson and Nugent (1935) reported that this sort of transaction was common in the "loan shark" period of domestic consumer credit before about 1910. At the time, a succession of such one month "loans" could extend the transaction for much longer than a month.[25]

Because this second possibility could potentially produce abusive situations even amounting to extortion by lenders holding on to the goods instead of allowing their timely return, state laws typically require that pawn-shop transactions be structured clearly. They must be either loans with specified terms, conditions, and requirements, including the lending period and maximum amount of finance charge, or true sales. Because pawned items often are not redeemed, however, ordinary pawn loans also often become sales to the lender (or auctions) to recover the loan amount and interest. In fact, a good way of thinking about a pawn loan is to think of it really as a sale for cash now (by the "borrower") with the option to cancel the sale next month and get the item back by repaying the "loan." Described this way it should not be surprising that "defaults" are relatively common: the "borrower" simply decides later to go through with the sale.

Because in some large sense pawn transactions are not really loans, pawn "lenders" rely on the value of the pawned item for security and do not investigate income or credit status of the "borrower." Goods that are easily transportable, like jewelry, musical instruments, and electronic items, are common pawn offerings today. Typical maturity is one month with a common fee of twenty percent of the loan amount (annualized by Truth in Lending requirements as an Annual Percentage Rate (APR) of 240 percent). The pawn charge includes interest but also fees for secure storage of pawned pledges, since the pawnbroker is liable for damaged items and must provide storage space and facilities. There also are special regulatory requirements including records for law enforcement to prevent pawning or sale of stolen goods.

There is not much recent research information on pawn lending, but there is some.[26] Concerning pawn borrowers, survey information suggests they are probably the weakest borrowers financially (Table 5-1). Casual industry commentary suggests that pawn lending frequently involves customers that would often not be of interest even to payday lenders due to risk. Bolen, Elliehausen, and Miller report much the same:[27]

> Pawn borrowers are often in worse financial condition than those who use vehicle title loans or payday loans. They have lower incomes, more difficulty paying bills, and

[25]See Louis N. Robinson and Rolf Nugent, *The Regulation of the Small Loan Business,* op. cit.

[26]See Robert W. Johnson and Dixie P. Johnson, *Pawnbroking in the US: A Profile of Customers*, Georgetown University Credit Research Center, Monograph Number 34, 1998, Robert B. Avery and Katheryn A. Samolyk, "Payday Loans Versus Pawn Shops: The Effects of Loan Fee Limits on Household Use," Social Science Research Network Working Paper, 2011, and Marieke Bos, Susan Payne Carter, and Paige Marta Skiba, "The Pawn Industry and Its Customers: The United States and Europe," Law and Economics Working Paper 12-26, Vanderbilt University Law School, 2012.

[27]J. Brandon Bolen, Gregory Ellihausen, and Thomas W. Miller, Jr., "Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research," op. cit., p. 13.

higher spending relative to income than vehicle title and payday borrowers. Pawn borrowers are also less likely to use auto loans, student loans, and credit cards than vehicle title and payday borrowers.

This worse financial condition than even other small-dollar credit users probably accounts for their use of pawn: As indicated, the pawn loan often amounts to the conditional sale of an asset owned by the borrower with a short-term *option* to buy it back in a month or so (presumably if conditions improve), by redeeming the item through paying off the pawn loan. Evidence also suggests that rate ceilings on pawn lending restrict the number of pawn shops and the amounts that lenders are willing to advance on pawn loans, although demographics are also important.

For many consumers, pawnbrokers are among the least-attractive options. In addition to being forced to pledge some item of personal property, the average size of pawn loans is much smaller than for other types of alternative lending, reflecting the reality that many of the items pawned are used consumer goods with modest resale value. Studies have found that the average size of a pawn transaction is only about $70-$80, a size of limited utility for meeting most financial obligations. Pawnbrokers are often patronized by consumers who do not have bank accounts, because many other types of small-dollar loans (such as payday loans and bank overdraft protection) require a bank account.

<u>Automobile Title Lenders</u>

The third kind of small-dollar lending common today is the automobile title loan, sometimes called a "title pawn." It actually is a new variation of pawn lending in recent decades. In this transaction, the borrower brings the legal title of an automobile or truck to the lender and receives a short-term loan based on it. Necessity of holding clear title suggests that most title pawns are mostly going to involve older vehicles with no other loans and liens.

A few differences from the traditional pawn loan are evident: First, the borrower keeps possession of the vehicle and leaves only the ownership document with the lender. Second, this difference in possession makes the transaction more akin to a secured loan for the lender but with the physical item of security not in the lender's possession and highly mobile. This enhances lending risk, since in case of default the security is not readily available for sale or auction without a repossession-like undertaking. Rates of twenty percent per month (240 percent APR) also are common in title pawns, but typically involving larger loan amounts than traditional pawns.

Like other pawns, most title pawns are made for one month, with payment of principal and interest at the end of the month (renewals for an additional month or months often occur). Some loans are made allowing for a succession of payments until full repayment is achieved (known as "vehicle-title installment loans," and again not to be confused with traditional cash installment loans from finance companies). Multi-month loans at title-pawn rates are going to be more costly for the individual than a single-month loan of the same amount.

Like normal pawns of smaller items left with the pawn broker, it is possible to think of a title pawn as a conditional sale of the vehicle by the "borrower" with a monthly option to reclaim the sold vehicle for the sale price (the loan amount) plus an option fee (legally, the pawn interest). Again it is not too hard to imagine that "defaults" are going to be common: the "borrower" simply goes through with the sale by walking away from the transaction (i.e. "defaults").

Empirical evidence suggests that "defaults" are common on title pawns. Undoubtedly, some occur because the borrower would like the car back but cannot make the payment. Others likely occur because the borrower prefers to keep the sale price (loan amount) rather than keep the old car, especially if it needs repairs. This conveniently puts the burden of getting rid of an unwanted car onto the lender. In some cases the vehicle is not even worth repossessing for the lender and it becomes a complete loss to both "borrower" and "lender."

Title pawns tend to be larger than pawn loans or payday loans due to the motor vehicle used as collateral. In 2016 the CFPB reported from a large sample that median size was about $700 with mean $959 due to some loans being much larger.[28] Nonetheless, Hawkins found that 57 percent of title pawn customers do not have banking relationships.[29] Industry sources report informally that many might be recent immigrants.

Some evidence suggests that a portion of title pawn lending involves short-term business loans. In a 2010 study Zywicki assigned title pawn borrowers to three classes: small business owners like landscapers who use their vehicles as a source of short-term working capital, moderate-income borrowers with poor credit histories, and low-income consumers with needs and credit problems.[30] Others examining other locations and circumstances have found borrowers with lower incomes and less evidence of business-related borrowing purposes. The nationally representative survey in 2015 referred to earlier in Table 5-1 found title pawn customers to be somewhat higher-income than payday and pawn customers with somewhat more use of mainstream consumer credit, but many still within the demographic categories where credit rationing is more likely (see Table 5-1 and sources).

Historically, both pawns and title pawns share the difficulty of payday loans that they are inherently single-payment loans, making full repayment after a short time period inherently difficult in some cases. This means that full repayment may sometimes take a while, leading to a sequence of monthly renewals for this while. Defaults also are common in both short and longer title lending, but, as indicated, some defaults and even automobile repossessions on title pawns really amount to sale of the pledged item to the lender after time to consider this possibility further. As indicated and like other pawns, a title pawn can act like a conditional sale to the title lender for the loan amount, with a (renewable) option to repurchase the car by paying off the loan later. It seems possible that the borrower would be more likely to let the car go and end the sequence of monthly options when a pawned vehicle suddenly needs some new (expensive) repair or attached equipment like tires.

Most cars that are pledged as collateral for a title loan are old; Hawkins found that the average car pledged was approximately 11.4 years old and had over 90,000 miles. He also reported that the majority of auto title loan customers own more than one car and virtually all title pawn customers have access to alternative transportation if they lose their car as part of the loan.[31] Owing to their age and condition, many defaults on auto title loans result from a major

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[28]Consumer Financial Protection Bureau, "Single-Payment Vehicle Title Lending" (May 2016), p. 6.

[29]See Jim Hawkins, "Credit on Wheels: The Law and Business of Auto-Title Lending," op. cit.

[30]Todd J. Zywicki, "Consumer Use and Government Regulation of Title Pledge Lending," *Loyola Consumer Law Review*, No. 4, 2010.

[31]See Jim Hawkins, "Credit on Wheels: The Law and Business of Auto-Title Lending," op. cit. Interestingly, almost 9 percent of auto title loan borrowers in the survey reported that if they lost their car they would simply buy another one.

mechanical failure or major accident to the car. In fact, only about half of defaults result in repossession of the vehicle because following a major incident its value can be less than the cost of repossessing and reselling it.[32] According to one survey, 8.5 percent of title pawn customers report that they would be forced to sell the car if they were unable to obtain an auto title loan. That figure exceeds the percentage of borrowers who lose their vehicle to repossession for failure to pay, but those forced to sell their cars lose possession immediately and with certainty.[33]

Apparently to combat this rollover element of such lending that has been objectionable to some observers, and, presumably, in anticipation of a proposed CFPB rule with the potential effect of limiting short-term single-payment loans, the industry trend has been toward loans with multiple payments (title installment loans). Greater prevalence of loans repayable in multiple payments does not make such loans similar to traditional cash installment loans, however, since the payday, pawn, and title-pawn multiple-payment loans are made at much higher APRs. From the "lender's" perspective, pawn and title pawn "loans" are not even dependent upon the income or cash flow of the borrower, but rather depend upon the value of the pawned item.

There has been a small amount of survey research on the experiences of title-loan customers, focusing especially on aspects of the decision process such as overconfidence about repayment ability with the planned time and time preference itself.[34] Because of data limitations it was not possible for the authors to provide definitive conclusions, but (like findings in the payday area examined next) they found evidence that many borrowers could make reasonable estimates of potential time to full payoff but with some evidence of present bias and a range of outcomes. They also found some evidence of learning about repayment times through experience. They found that about a fifth of borrowers were overtly present-biased in their estimation, but by no means everyone or even close to a majority.

Payday Lenders

"Payday" loans are the fourth kind of small-dollar loan widely available and the newest basic type other than title pawns that really are a variation of older pawn lending. Payday lenders grew in recent decades out of the check-cashing industry. Check cashers developed to cash paychecks, for a fee, for workers who for one reason or another had no bank relationship for deposits or check cashing (or for whom common banking hours were inconvenient). It was only a small step to start "cashing" paychecks early for a somewhat larger fee. Due to a variety of regulations including Truth in Lending, such actions amounted to lending under state and federal laws. This would be controversial enough by itself, but annualizing these fees as required by TIL and then extending longer terms and providing rollover possibilities made them even more so. A fee of fifteen percent on a loan of two weeks is common (annualized under TIL rules as 391 percent APR).

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[32]See Todd J. Zywicki, "Consumer Use and Government Regulation of Title Pledge Lending," op. cit.

[33]The Consumer Financial Protection Bureau reported a 3 percent repossession rate and Hawkins 4-6 percent.

[34]See Kathryn Fritzdixon, Jim Hawkins, and Paige Marta Skiba, "Dude, Where's My Car Title: The Law, Behavior, and Economics of Title Lending Markets," *University of Illinois Law Review*, 2014.

Evidence shows that payday borrowers are overwhelmingly subprime with an average credit score of 520.[35] As discussed above, they lack current access to credit-card credit and many have searched extensively for credit elsewhere. Most do not have liquid savings available.

Recent tendencies in the payday loan industry include payday loans with repayments made in installments over time. While superficially such loans appear similar to traditional installment loans, installment payday loans are made under provisions of payday lending laws, at much higher TIL percentage rates and finance charges than traditional installment cash loans of the same size and maturity. Another more recent trend is toward making payday loans online over the Internet instead of only at storefronts. This approach contemplates making payday loans across state lines as well as locally. Available evidence suggests that online payday loans are the riskiest and highest-cost form of institutional consumer lending.

As indicated, most of the studies on outcomes of small-dollar credit in recent years involve payday lending. Using datasets not necessarily always originally designed to address questions on the impact of payday lending directly, studies over the past fifteen years have found usefulness of payday lending in reducing bounced checks and costly overdraft fees, Chapter 7 and 13 bankruptcy filings, and debt-collector harassment. One study found increases in Chapter 13 filings with payday lending but the authors also recognized that filings "depend on difficult-to-estimate parameters like private and social net costs of bankruptcy filings." [36]

Some studies found favorable impact of availability of payday lending on other aspects of financial well-being defined in a variety of ways at the state level and other studies found little impact. There also are differences in findings concerning impact of payday lending on military preparedness using different definitions of preparedness and different data. The most recent study, using better data, concludes there is no evidence of a favorable impact on military preparedness of the ban on payday lending to the members of the military.[37] Some studies indicate that payday loans are a response to financial difficulties and not the proximate cause. Various studies have shown that payday borrowers typically do not have other credit available at the time of the loan.[38]

By themselves, these findings on balance appear to support the usefulness of payday lending in many situations, but they do not satisfactorily answer Caskey's Big Question: Even if findings were generalizable, there still is a significant range of possible outcomes at the individual level from highly favorable to highly unfavorable. This simply outlines the nature of the problem that financial regulators and legislators face, "a difficult trade-off between the benefits of regulation to households that make mistakes, and the costs of regulation to other financial market participants."[39]

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[35]See Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, "Payday Loan Choices and Consequences," op. cit.

[36]Paige Marta Skiba and Jeremy Tobacman, "Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default," Vanderbilt Law and Economics Research Paper 08-33, 2008, p. 26. One problem with trying to determine the relationship of payday loans with financial distress is that it is not always clear whether high-cost loans are a cause or effect of distress. For instance, do they push a borrower into bankruptcy or are they the last resort in trying to avoid bankruptcy which is likely to occur anyway as a result of other conditions.

[37]Susan Payne Carter and William Skimmyhorn, "Much Ado about Nothing? New Evidence on the Effects of Payday Lending on Military Members," *Review of Economics and Statistics*, October, 2017.

[38]For lengthier summary of these studies and detailed references, see Bolen, et al. (2020, pp. 23-6) and Durkin, et al. op. cit., Chapter 8, pp. 386-94.

Another line of investigation of payday lending has involved the implications of payday-lending heritage as single-payment loans payable a short period of time after the loan is made. This naturally raises the question how an individual who cannot pay for some emergency today is going to be able to make the payment a short while later, this time with an extra fee to cover the charges on the payday loan. An intervening paycheck is the answer, but what if that entire paycheck is already earmarked for other necessary expenditures (including payment of non-payday debts or other payday loans) or it is smaller than expected due to variations in employment hours of hourly workers, or even unavailable?

Analysts at the Consumer Financial Protection Bureau and elsewhere have examined this question and have attributed the frequency of renewals on payday loans as evidence of users' frequent inability to repay in full in single payments a short time later.[40] This is undoubtedly true in some cases, but some borrowers also do not extend their loans and many do appear to have understood this likelihood in advance.

Available evidence suggests many payday borrowers are aware of important information for making decisions. For instance, Elliehausen and Lawrence (2001) found that up to 98 percent of surveyed payday borrowers reported dollar costs of their loans that could be deemed accurate (precise measurement of accuracy would require availability of the loan documents, which the authors did not have). In contrast, they reported that only 20 percent of borrowers could report an accurate APR, although they indicated that most borrowers recalled receiving information on the APR. They concluded that borrowers considered the finance charge as the important indicator of the cost of the credit. In a study using an experimental design, Bertrand and Morse reached a similar conclusion in 2011.[41] This is not surprising since these loans are simple products with one price, a single finance charge at the outset (or at a rollover) compared to other loans that might have multiple components and fees.

The finding that the finance charge in dollars is an important concept to small-dollar borrowers actually considerably predates the beginnings of the payday loan industry. In other contexts, Due (1955), Juster and Shay (1964), and Durkin (1973) noted similar empirical findings.[42] These results suggest, reasonably, that the APR is not the only credit-price information that consumers may need or use to make credit decisions (also discussed here in

[39]John Y. Campbell, "Restoring Rational Choice: The Challenge of Consumer Financial Regulation," *American Economic Review*, May, 2016, p. 25. Immediately following this quotation is Campbell's concluding sentence: "The task for economists is to confront this trade-off explicitly, bringing to bear the highest quality evidence that modern applied microeconomics can make available." Reviewing available earlier studies on payday lending Allcott, et al. raise the same point as Campbell in a new working paper in 2020 discussed further below: "Such analyses are difficult to use for welfare evaluation because it is not clear how to trade off effects on different outcomes or include other unmeasured welfare-relevant outcomes" (Alcott, et al., p. 5).

[40]See Consumer Financial Protection Bureau, "Payday Loans and Deposit Advance Products," April 24, 2013; "Consumer Financial Protection Bureau, CFPB Data Point: Payday Lending," March 2014; Pew Charitable Trusts, "Payday Lending in America, 2013 (three reports); Center for Responsible Lending, "The State of Lending: Payday Loans," 2013.

[41]See Gregory Elliehausen and Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand*, op. cit. and Marianne Bertrand and Adair Morse, "Information Disclosure, Cognitive Biases, and Payday Borrowing," *Journal of Finance*, November, 2011.

[42]Jean Mann Due, "Consumer Knowledge of Installment Credit Charges," *Journal of Marketing*, October, 1955; Juster and Shay, *Consumer Sensitivity to Finance Rates*, op. cit.; Durkin, *A High Rate Market for Consumer Loans: The Small Small Loan Industry in Texas*, 1973, op. cit.

Chapter 4). Congress understood this when it passed Truth in Lending in 1968, mandating disclosure of both the finance charge in dollars and the APR.

Before Truth in Lending, Wallace Mors (1965) had assessed the usefulness of various types of financial information and charges in a study for the National Bureau of Economic Research. He proposed that ideally consumers needed the dollar amount of finance charge, the size and number of monthly payments, and the annual effective finance rate (in TIL now known as the APR, functionally the annual unit price). He examined the use of these items in evaluating loan contracts having different loan amounts and terms to maturity. He concluded that none of the items can serve effectively as a single criterion, because each applies only to some aspect of the credit decision.[43]

Regarding small, short-term loans, he noted that annual finance rates are very high even when the dollar finance charges are nominal. As discussed here above in Chapter 4, this happens because largely fixed costs of acquisition and servicing are spread over a small amount of credit for a short maturity period. He further pointed out, as had Juster and Shay, that for evaluating loans of the same amount and maturity, finance charge, monthly payment, and APR are perfectly correlated. This means that in evaluating credit arrangements between and among lenders, focusing on the finance charge or the monthly payment amount also provides important information for comparisons in many cases.

Chapter 4 of this *Report* also noted briefly that on small-dollar loans the finance charge is also useful for another important comparative reason. Namely, when considering a short-term loan for a current need, the need or emergency is normally going to be very immediate and obvious. By examining the finance charge instead of the APR, the cost/benefit comparison of whether or not to employ the credit quickly becomes apparent as well. Hence, there is no surprise that those seeking such loans tend to focus more on the finance charge than the APR. This discussion is by no means intended to denigrate the importance of the APR but rather merely to refer back to Mors who pointed out before TIL that no single disclosure provides all the information about a credit arrangement. The finance charge, monthly payment, and APR serve different needs, but all are now required disclosures under TIL.[44]

Turning to another aspect of payday lending/borrowing, an interesting new paper by Allcott, et al. explored, among other things, whether payday loan borrowers correctly predict the amount of time it will take them to repay their payday loans, the rollover problem noted by the

[43]Wallace Mors, *Consumer Credit Finance Charges* (New York: National Bureau of Economic Research, 1965). Mors also considered computational rates (used in mathematical computational formulas) in his analysis, but even before Truth in Lending using some kinds of underlying computational rates for disclosures was generally not legal unless they were also effective rates or specifically allowed by state law.

[44]For a complete discussion of evaluating investments that provide benefits for the future including the theoretically correct way of using APRs to calculate net present values, see the well-known text on financial analysis by Bierman and Smidt (2006). Fortunately, since virtually all consumers will not find net present values either intuitive or easy to compute, APRs may also be used for unit-price comparisons of similar credit arrangements among creditors. Bierman and Smidt also note at the outset of their ninth edition that complex analyses are unnecessary for choices in which benefits are received in a short period: "If benefits are likely to accrue reasonably soon after the expenditure is made, and if both the expenditure and benefits can be measured in dollars, the analysis of the problem is more simple than if the expected benefits accrue over many years and there is considerable uncertainty as to the amount of these benefits" (Harold Bierman, Jr. and Seymour Smidt, *The Capital Budgeting Decision: Economic Analysis of Investment Decisions*, 9th ed. (New York: Routledge, 2006, p. 2)).

For extended discussion of uses of APRs and finance charges on different sorts of consumer credit but especially short-term small-dollar loans see Thomas A. Durkin and Gregory Elliehausen, "Assessing the Price of Short-Term Credit," 2017, available on Social Science Research Network.

CFPB.[45] This is an important question for both consumer welfare and regulatory policy. If borrowers make accurate predictions of their repayment prospects (for instance, knowing that they will not be able to repay in full on the initial due date of the loan necessitating one or more renewals before repayment), then they can better estimate the complete costs and benefits of their payday loan than otherwise. If, in turn, they do not understand or predict the likelihood of renewals, then inability to repay and a cycle of unintended renewals can force borrowers into unexpected "debt traps" that, in addition to high APRs, are among the main complaints about the payday industry by advocates and various political figures.

In designing their study, Allcott, et al. had the advantage of reviewing and understanding earlier studies and how gaps in understanding this market had developed for lack of data and other reasons. For instance, they easily recognized that findings about whether borrowers understood what they wanted to do did not necessarily mean they *should* want to do it in the eyes of advocates and regulators. This encouraged a sophisticated research design by Allcott, et al. that connected such considerations as theory of life-cycle spending patterns, time value of money, risk aversion, and the potential bias of present focus or not of individual borrowers. They also surveyed and studied the relation of borrower experiences to the predictions of experts.

Data were specifically gathered for this project and involved a careful control-group experimental design (with a meaningful rewards component and size sufficient for statistical statements). As indicated, there were surveys of both borrowers and outside experts. Participation of a large payday lender allowed comparisons of experimental results with actual borrowing experience. The authors acknowledged that participation of only one lender could produce the complaint that customers might not be representative of all lenders and situations, but the project seems large enough to be importantly indicative, using forty-one separate payday storefronts.

Significantly, findings showed that borrowers predicted quite well the likelihood of reborrowing within a short period of time. This echoed the findings of Ronald Mann in a less-sophisticated and smaller pioneer study in this area some years earlier. Mann also found that most borrowers expected to extend the loan after the first period and predicted the final repayment date with some accuracy. He also found that errors made were in both directions and not just indicative of underestimating.[46]

Further, Allcott, et al. found that borrowers appeared to learn with experience, predicting better after previous experience, "more experienced borrowers predict exactly correctly on average" (p. 3). The authors argued that this experience component in prediction may suggest the reason why other, purely-experimental research designs, have found poorer predictive ability. They also reported that their panel of experts (including both academics and payday lenders) predicted considerably worse performance by borrowers in forecasting their payday loan payment patterns than predictions by payday borrowers themselves.

Although not the main focus of their work, the authors suggested that findings have implications for policy in this area. After not finding that behavioral biases of payday borrowers

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[45]Hunt Allcott, Joshua Kim, Dmitry Taubinsky, and Jonathan Zinman, "Are High-Interest Loans Predatory? Theory and Evidence from Payday Lending" (March 9, 2020).

[46]Ronald Mann, "Assessing the Optimism of Payday Loan Borrowers," *Supreme Court Economic Review*, 2013.

make them unable to predict future borrowing, the authors contended that outlawing payday lending lessens consumer welfare (p. 3):

> We first provide theoretical propositions that give qualitative intuition for optimal policy. A payday loan ban can only harm time-consistent or sophisticated borrowers, as they correctly predict their future repayment when initially deciding how much to borrow. However, with limited uncertainty in repayment cost shocks, a ban benefits *persistently* naive borrowers, as they fall into "debt traps" where they continually reborrow because they falsely believe they will repay in the next period. If borrowers are *temporarily* naive and become sophisticated, as in our empirical estimates, the losses from overborrowing are tightly bounded, and a ban is again likely to be harmful [emphases in original].

As indicated, the authors noted that their results contrasted sharply with the prior beliefs of their panel of experts that contended that borrowers would be much more naive than they actually were.

Overdraft Protection

Overdraft protection on depository accounts is a service similar in some ways to payday loans. Like payday loans, overdraft protection provides small amounts of credit for a short time to individuals with liquidity difficulties. Unlike payday loans, the individuals must be current customers of the specific bank or other depository institution that provides the overdraft protection, suggesting customers are not drawn from the very poor. Overdraft protection is provided by depository institutions like banks that hold the customers' transaction accounts, but otherwise banks have never provided much small-dollar credit (except through credit cards), largely for cost, reputation, and regulatory reasons.

Under common overdraft protection plans, the bank or other depository agrees to cover overdrafts with a transfer of funds from another deposit account owned by the customer (like a savings account) or from a prearranged line of credit. There may be a fee for the transfer service.

But many potential users of overdraft protection do not have a savings account and also would not qualify for a line of credit and these options are not a practical possibility. Even in the absence of such prearrangements involving a transfer from another account or a line of credit, however, the depository and customer may arrange that the depository will honor debits from a debit card or ATM that cause an overdraft up to a certain amount, provided that the customer "opts in" to the arrangement.

Most users of this service view payday loans as the closest alternative product.[47] Both overdraft protection and payday loans are attractive to consumers with impaired credit and little or no further access to credit card or other loans but who have some urgent need for cash. Overdraft protection may be especially useful for point of sale transactions as it is far more convenient to access overdraft protection than a payday loan. Melzer and Morgan have found find that in choosing between payday loans and bank overdraft protection, most consumers

[47]See Robert L. Clarke and Todd J. Zywicki, "Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau," *Review of Banking and Financial Law*, 2013-2014.

choose rationally, typically choosing the product that minimizes their overall costs of acquiring credit.[48]

In the situation of an overdraft that the depository covers, the fee for advancing funds for a time makes the arrangement look much like a short-term loan for a fee, but current rules make this sort of arrangement part of the deposit agreement and not a loan subject to Truth in Lending. Like payday loans and other forms of small-dollar credit noted above, overdraft protection can mitigate or obviate fees from illiquidity that can arise in other ways, including delinquency and late-payment fees on various bills and non-sufficient-funds (NSF) fees from dishonored overdrafts.

Much of the criticism of overdraft protection arises from the assessment of fees for covering shortages in deposit accounts. In recent experience, a fixed fee of around $35 for covering a debit card or ATM overdraft is common. Unlike a payday or other loan with a specific loan amount for a fixed amount of time set by contract and where an APR can be calculated and disclosed in advance, an analogous APR for a specific overdraft-coverage event can only be calculated after the fact: As with a mainstream line of credit (including credit cards), the amount and timing are unknown in advance, making impossible the calculation of an APR conceptually the same as the APR on a closed-end loan like a payday loan.

Using assumed examples and experiences recorded on actual accounts, the CFPB and others, however, have calculated post-hoc APRs for these arrangements that exceed those on common payday loans. While such calculations are easy enough to make after the fact, it seems unlikely for the reasons discussed above that such APRs are as interesting or important to users as the actual charge of $35. Even in individual cases where such charges are not fully contemplated or understood in advance, they probably are understood and remembered after the initial actual encounter. This undoubtedly helps explain recent growth of low-balance electronic alert services provided by the institutions using text messages. Nonetheless, "opt in" arrangements to overdraft protection are commonly offered by depositories and often used. That individuals and institutions have made such "opt in" arrangements is consistent with underlying neoclassical economic theory that debt use comes about from opportunities and necessities that provide net benefits to informed credit users.

Even if such overdraft-protection advances are more expensive on an APR basis than payday loans, their convenience may still make them attractive to some people for managing liquidity shortages. Such circumstances include potential returned-check situations at merchants where a fee and possible ill will could be involved, or some other sort of emergency. The convenience of prearrangement compared to a payday loan would tend to make them competitive with payday loans, even if the cost is somewhat higher than a small payday loan. Neither of these sources of small-dollar credit is available to those without a depository account (the "unbanked") who would still be restricted to credit sources like pawn lenders, specialized retail outlets, and individuals.

Rent-to-Own Programs

Before concluding this section, it is worth also mentioning rent-to-own programs. Strictly speaking, rent-to-own transactions are not credit, but they serve as credit substitutes in some cases, and critics sometimes lump them together with small-dollar credit products. Rent-to-own transactions are actually rentals of household durable goods like furniture and

[48]Brian T. Melzer and Donald P. Morgan, "Competition in a Consumer Loan Market: Payday Loans and Overdraft Credit," *Journal of Financial Intermediation*, January, 2015.

appliances on a week-to-week or monthly basis but with automatic renewal until stopped. They sometimes are combined with small-dollar credit products because at some point the rental provider has received enough in payment and the property has aged and depreciated enough that it does not have much remaining resale value anyway. At this point, the renter simply hands over ownership to the lessee, hence, "rent-to-own" that providers heavily advertise as a possibility.

The arrangement differs from an installment purchase of the product, however, because the provider bears the ownership risks and costs during the rental period. These include delivery, set-up, repair, loaner service, refurbishing, and eventual re-rental or sale. The renter can return the product at the end of any rental period without early termination fee or further charge, except for damages. This avoids difficulties or costs associated with resale or disposal that might occur for owners.

With survey research in 2000, Lacko, McKernan, and Hastak found in a report for the Federal Trade Commission that about two thirds of rent-to-own users intended to purchase the item and about 70 percent actually did so.[49] Leaving aside the issue of how the costs of use (delivery, set-up, extended warrantee, etc.) are not strictly comparable between rent-to-own and installment purchase, calculating an APR on a typical transaction as if it were the same as an installment purchase reveals a high APR. A high APR on a relatively small transaction is why rent-to-own becomes lumped with small-dollar lending in many discussions.[50]

Lacko, McKernan, and Hastak also reported that three quarters of the survey respondents said they were satisfied with the transaction. They did not question respondents about costs, but responses to questions about satisfaction indicated that "many respondents were aware that the price was high." Satisfied customers typically reported characteristics of the item being rented or services provided by the rent-to-own company as a reason for satisfaction. Few customers gave inadequate cost information as a reason for a poor evaluation.

Customer characteristics suggest that limited credit availability from other sources likely played a role in their decision to use rent-to-own. Available information suggests that rent-to-own users are comparable to pawn borrowers and are on average younger and lower income even than payday or auto-title borrowers and much younger and lower income than the population as a whole.[51]

<u>Illegal Lenders</u>

For the obvious reason that too much inquisitiveness can be dangerous to health, academic researchers have tended to stay away from studying the illegal loan-shark industry, although on occasion research reports have arisen.[52] Much of what is known about illegal

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[49]James M. Lacko, Signe-Mary McKernan, and Manoj Hastak, Survey of Rent-to-Own Customers (Washington: Federal Trade Commission, 2000).

[50]Durkin, et al., *Consumer Credit and the American Economy*, op. cit. provide some APR calculations on their pages 366-7.

[51]Information on rent-to own customers is not available from the sources used in Table 5-1. Somewhat earlier comparative information, including from Lacko, McKernan, and Hastak for rent-to-own, is in Durkin, et al., *Consumer Credit and the American Economy*, op. cit., Table 8.3, p. 375.

[52]See John M. Seidel, "Let's Compete with Loan Sharks," *Harvard Business Review*, May-June, 1970; Ronald Goldstock and Dan T. Coenen, "Controlling the Contemporary Loanshark," The Law of Illicit Lending and the

lending arises instead from criminal investigations that take place from time to time.[53] The worst aspect of illegal lending is how criminal enterprises have been known to engage in violence as part of collection activity, although the general belief among lenders apparently has been that too much violence is counterproductive by driving away potential customers from this market. News reports suggest it still exists, however.[54] It has even invaded popular culture through the movies.[55] It seems unlikely that most individuals, even those down on their luck and without other available credit, would approach known criminal loan sharks today, but there have been many instances of doing so since at least the time of the Roman Empire.

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In sum, it seems reasonable that more research findings on how individuals actually use small-dollar loans (or overdraft protection and rent-to-own) could help inform debate in the small-dollar area. Such research is expensive and uncommon, however, and even if undertaken more frequently seem destined not to settle in any sense the policy debate over small-dollar credit anyway.

For policy conclusions in the area of small-dollar loans, there still are tradeoffs to address. Economic theory and considerable empirical evidence suggests the usefulness of small-dollar loans, but not everyone agrees this is sufficient. For instance predictions by consumers of timing of full repayments of payday loans that are "exactly correctly on average" (Allcott, et al., p. 3) is a significant finding but not exactly the same as "exactly correct always." The latter is, of course, an impossible standard, given contingencies, but this is not the same as saying it is not popular or wished for.

Further, findings show that some people are uninformed or are "present focused." Also, risks unknown at the outset of a transaction sometimes can cause bad outcomes, even among the informed and rational. And small-dollar is the area of the highest cost (per loan dollar) and riskiest consumer credit. Finally, there is still also a contingent of observers who approve of wisdom perceived in Senator Proxmire's contention in 1972 in the *Report* of the National Commission on Consumer Finance: "State governments have traditionally sought to protect consumers from the consequences of their own folly by limiting rates of interest" (p. 229). It seems he has not been the only observer with this view.

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So, findings once again highlight the conundrum for legislators and regulators in this area: How to manage the tradeoff of denying availability of products like high-rate small-dollar loans that can help many users in appropriate situations but are high cost relative to loan dollars and some kinds may be difficult to repay in a short period of time. They also can sometimes harm individuals in situations of present bias. Such situations are less useful for enhancing

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Problem of Witness Fear," *Cornell Law Review*, January, 1980; and David Baker and MacKenzie Breitenstein, "History Repeats Itself: Why Interest Rate Caps Pave the Way for the Return of the Loan Sharks, *Banking Law Journal*, 2010.

[53]See, for example, New York State Commission of Investigations, *The Loan Shark Racket*, 1965.

[54]See, for example, Associated Press, "22 Held in Staten Island Betting and Loan Sharking Raids," November 81, 2009; Dave Warner, "Authorities Accuse 13 in Philadelphia of Mob Charges," Reuters, May 13, 2011; J. Roebuck, "In Court 'Frankie the Fixer' Describes Collecting Loan-Sharking Debts," McClatchey Tribune Information Services, January 2, 2014. According to news reports, loan sharking is apparently of concern in parts of Europe, Asia, and Africa.

[55]For instance in the early part of the original "Rocky" movie that won the 1976 academy award as Best Picture, the Rocky character played by Sylvester Stallone is employed as a loan shark collector/enforcer in Philadelphia. An actual convicted New York loan-sharking leader named Anthony Salerno was a main character in the 2019 movie "The Irishman."

welfare, and there are also the cases where credit simply does not work out well because of unfortunate contingencies that develop after the loan is made in good faith by both parties.

The Big Question

As noted at the outset of this chapter, small-dollar lending is a distinct market with some submarkets for different kinds of small-dollar loans, but discussion here shows that its economics is not unique. What is different about small-dollar lending concern the special conditions and constraints on consumers and providers in these markets, not their fundamental economics. There have been constraints on lenders throughout history (Chapter 2 above), but there still is demand for credit based upon its usefulness (Chapter 3), and supply is still determined by its costs (Chapter 4), even where the amounts are small.

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As the foregoing shows, the basic characteristics of the small-dollar lending market are consistent with the predictions of neoclassical economics of consumer finance usage. Consumers who use small-dollar loans do so for the same reasons as consumers in mainstream credit markets: to take advantage of investment opportunities and mitigate costs of emergencies while changing the timing of the purchases to a preferred one.

But they do so under the distinctive condition of being *rationed* in credit availability. Many of them seek such credit at the state in their life cycle when demand for credit is highest but supply is lowest causing an imbalance. As a result, rationed consumers are unable to acquire all of the credit they demand from mainstream lenders and turn to secondary (higher cost) lenders, sometimes referred to as "fringe" lenders, to meet that demand. The prediction is that many borrowers using small-dollar lenders would be younger and more credit-constrained than those who use mainstream credit. This turns out to be an accurate prediction.

As shown in Chapter 4, the underlying cost structure of small-dollar loans suggests that the costs of making small dollar loans is expensive in both absolute and relative terms. This is inherent in the reality of relatively-fixed production costs: the cost of making loans does not scale proportionally with the size of the loan. Thus, the costs of small amounts of credit are high per loan dollar.

This interaction of supply and demand suggests that the equilibrium price per loan dollar for small-dollar loans will also be high. Moreover, there appears to be little reason to conclude that the actual prices that we see in the market are distorted by competitive issues or insufficient consumer protection. As history confirms, it is simply not possible simultaneously to control the price of small-dollar loans and still provide a supply that meets consumer demand. This is not a market failure but rather the perennial problem of how to provide small-dollar loans to wage earners at a price below that required by the market.

This reality has been long understood. So then why do we see repeated cycles of regulation and efforts to control prices and the supply and demand of small-dollar loan products? Apparently the answer is that while many acknowledge these equilibrium conditions, they are also uncomfortable with this outcome.

For the Taskforce, this gives rise to something we characterize as our own "Big Question": whether society believes consumer credit availability for everyone is a good idea or not.[56] Chapter 3 discussed the ageless economic motivations for the widespread phenomenon of consumer credit use today, how it provides the wherewithal to change spending timing and make large purchases and mitigate short-term emergencies that do not fit into family budgets. This mostly involves the kinds of purchases today that provide a return over time through vehicles, appliances, recreation and hobby items, repairs, modernization, and management of emergencies. The return comes about through acquiring the services they provide sooner than would otherwise be possible, avoiding purchasing less desirable (and often costly) substitutes in the meantime or doing without (and even "frittering away" the money). Such favorable outcomes can result from using mainstream forms of credit but also from employing less traditional smaller amounts. Nonetheless, there are difficulties here and all of this has remained a divisive area for centuries.

It seems that all observers some of the time and some observers all of the time today agree that credit availability is good for many individuals and should not be restricted from those who show evidence of ability to use it well. But some observers some or all of the time maintain that credit use is often too expensive (and possibly too dangerous) for at least some individuals. Some go farther still and recommend legal restrictions. Recently, it seems that at least some of the latter group have seized upon a developing new branch of economics referred to as "Behavioral Economics" that they believe supports this more-restrictive view. Many economists, including behavioral economists, disagree with this contention, as discussed further in the second half of Chapter 3. Instead, they contend that the motivations and evidence about using credit are much more fundamental than some behavioral biases identified by experimental researchers using student subjects in unreal settings that are not robust empirically with most consumer-credit uses.

But the Taskforce concludes that at its deepest level, whether or when to restrict credit use is not only a dispute in theoretical economics or about the worth of available empirical evidence. Evidence clearly shows that credit use is beneficial to most individuals in a wide range of situations, although undoubtedly with risks and sometimes with unfortunate outcomes. In this context it should not be surprising that studies of small-dollar credit use (in recent years, mostly concerning "payday" loans) find somewhat mixed results on questions of impact on overall consumer welfare. Sometimes these unfortunate outcomes are simply correlated with financial struggles, not the cause, as many of these products are last efforts to find a financial lifeline to stave off a descent into bankruptcy. Outcomes from credit use always vary among individuals, and probably vary most of all where small-dollar credit is involved due to the difficult financial circumstances of the users. Even mortgages, credit cards, and other mainstream financial products have risks for consumers.

Certainly, differences in outcomes are going to exist. Economic theory and widespread empirical evidence clearly shows the advantages that can result from consumer-credit use, but difficulties that can develop are also well known. They include nonpayment, lawsuits, repossessions, and unfortunate, stressful collections at the worst possible time. These sorts of difficulties with credit can sometimes be seen clearly (with hindsight) when enough repayment ability was clearly not there, but they are mostly unforeseen for individuals at the outset of a credit transaction, developing only after unfortunate later contingencies. There also may occasionally be overreaching by certain institutional providers that can give consumer credit and

[56]The term "the big question" is certainly generic and could be used in many ways to illustrate many things. As indicated above, Professor John P. Caskey of Swarthmore College used it to characterize the closely-related question whether small-dollar loans, particularly payday loans, "on net exacerbate or relieve customers' financial difficulties." The Taskforce's use of the term to mean whether "society believes consumer credit availability for everyone is a good idea or not" is broader than Caskey's usage.

its other providers a bad reputation. Some people may also be shortsighted. But the crux of the dispute goes deeper and does not seem resolvable by economic theories or empirical evidence about outcomes. Rather, it depends both on how observers evaluate the underlying tradeoff between potential rewards and risks of credit use and how they interpret their relationship to those caught up in this tradeoff, especially lower-income consumers.

In 1972, the National Commission on Consumer Finance addressed this tradeoff and came down on the side of encouraging credit availability by relaxing legal rate ceilings on small-dollar lending and promoting competition and consumer empowerment through information instead of imposing legal caps on prices. After discussing historical sources and reviewing studies and statistics, the NCCF wrote in its *Report* (p. 136):

> The implications of these findings for public policy seem obvious: the only truly effective way of gaining ample supplies of personal loan credit for consumers *and* reasonable rates too, is to increase competition while simultaneously relaxing inordinately restrictive rate ceilings.

Not everyone agreed then (or now). Among many examples from many sources of the opposing view at the time, the opposing view is also found in the Commission's own *Report* especially in the "Separate Statement" of Commissioner and Senator William Proxmire, already quoted in part (NCCF *Report*, p. 229):

> What the Report fails to recognize is that consumers are not nearly as sovereign as economic textbook theory would have us believe. ... The real choice is not between paternalism and no paternalism as the Commission report assumes. It is between business paternalism that is largely unaccountable to the public and responsible government policies. State governments have traditionally sought to protect consumers from the consequences of their own folly by limiting rates of interest.

Thus, whether credit use for all based upon their own judgements, and particularly small-dollar credit use, becomes a philosophical or value-judgement dispute over the propriety (and effectiveness) of government action in allowing sometimes costly or risky individual behaviors in a free society. Users of small amounts of credit potentially can benefit like anyone else but there are special costs and risks involved too. Small-dollar loans produce difficult examples for society of the potential benefits-cost-risk tradeoff inherent in any credit use.

This Taskforce realizes that it can provide, review, and update evidence on questions of the value of small-dollar credit use and its costs and problems (and even how some problems might be addressed). It also can recommend more research, but it cannot satisfactorily ever answer this Big Question: whether society believes that credit availability is a good idea or not for all competent adults, including those who want or need small amounts and only can qualify for small amounts. The hope is that its work will be helpful in clarifying these tradeoffs and debates, at least until the next commission or taskforce must address the same unending issues once again in some future decade. The ineluctable conclusion of centuries of historical and legal analysis is that small-dollar credit can be provided to higher-risk borrowers only at high cost or not at all.

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Concerns over credit use today clearly are greatest in the area of small-dollar lending. For illustration, this is the last remaining bastion of domestic interest rate ceilings today and the one often suggested as in need of further extension.

By its nature, small dollar lending is going to involve individuals without much money, that is, without much discretionary income or liquid assets. Such individuals are not necessarily poor, but many are poor and down on their luck. Middle- and upper-income individuals are less likely to need small-dollar financing at all and if they do occasionally for convenience they can pull out their purses and wallets with their credit cards. And so the debate is going to center on these poorer and illiquid individuals down on their luck.

Another underlying problem here is that by their nature, small-dollar loans at low rates do not generate much revenue for the lender to go with its costs, as discussed in the previous chapter. Application of the same interest rate to a smaller and smaller balance for the same length of time produces less and less revenue as the loan size shrinks. At some loan size, the revenue does not cover the costs of lending; and, in a capitalistic economy, below some breakeven loan size no (legal) lender from the private sector will make smaller loans.

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One way out of the problem of credit availability for those in need of small-dollar amounts is to raise the interest rate or allow fees that amount to more interest on legal small loans. This was the approach favored by the progressive reformers of the Russell Sage Foundation in the 1910s to drive out the loan sharks. In 1972, the National Commission on Consumer Finance again explored the viability of this approach. Because it increases lending revenue and encourages legal lenders to be willing to lend, the NCCF concluded it would improve credit availability usefully.

But many people since at least Biblical times (including Senator Proxmire in 1972, as noted twice above) have objected to this approach to lending over the decades and centuries. The reasoning is that the higher interest rate on small loans is perceived as taking advantage of the poor and those down on their luck and making repayment more difficult.[57] The NCCF wrestled with this question especially in Chapters 6-8 of its *Report* and we have to do so too (Chapter 4 and the present chapter). But we are fearful that this is not solely an economic or legal analytical question and that there is no satisfactory solution or recommendation that will satisfy everyone.

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Poor and illiquid individuals' needing to pay higher rates for credit than middle-income and wealthier individuals who use larger amounts of credit has been unacceptable to many members of society for a long time. The result in many times and places has been governmental institution of rate ceilings on credit (called "usury" laws since the middle ages and actually much older). The outcome of these laws, in turn, has been unavailability of legally-allowed credit to affected individuals in many times and places since antiquity, notably in recent years domestically at the smaller loan sizes that do not generate much revenue. Sometimes charitable efforts or new institutions for government lending are offered as potential solutions. Others argue that insufficiency of charity and the general inefficiency of government compared to the private sector in any likely governmental approach to solving this problem weigh against these potential solutions. Even if this question is resolved, charitable or governmental lenders still must deal with the reality of operating costs, as do other worthy public ventures ranging from education to national parks.

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Credit for everyone and especially for individuals with limited current resources involves the questions how significant is household credit use in the economy and why households might want to use credit in the first place (Chapters 2 and 3 of this report). Clearly it also involves costs

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[57]The cost of making small loans to consumers is discussed in Chapter 4. Since small loans typically are also of short maturity, they may actually not be as costly in dollars as larger loans made at lower rates, but they certainly can appear more costly on a rate basis, as also discussed in Chapter 4.

of credit availability and how rationing can develop (Chapters 4 and 5). It also involves proper disclosures and competition (Chapters 7 and 8). But, as indicated, this discussion raises difficult questions that go beyond economics, law, and the institutions of lending that are the subjects of this Taskforce's efforts in any of these chapters. We note two components that society must resolve to answer the Big Question whether credit should be available for all and especially for those with limited means who need small amounts:

1. Is it proper for the government to decide who can obtain credit or not when there is a range of potential outcomes from good to bad, a subpart of the question what is the proper role of government in a free society? Although beyond the scope of any Commission or Taskforce on financial regulatory laws, this question naturally constantly impinges upon this Taskforce's efforts.

2. How can society solve the problem of poverty that raises most of the small-dollar lending concerns in the first place? This seems be an even more serious and difficult question that has vexed human history since its beginning.

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The National Commission on Consumer Finance was not oblivious to these concerns either and discussed them at some length in a mostly overlooked part of its *Report*. It is worth quoting at some length from this passage now (in its somewhat archaic original rendition) since this Taskforce recognizes the same issue (NCCF *Report*, Chapter 1, p. 2):

> As Congress recognized, such an appraisal must begin (and end) with the issue of whether the industry provides adequate consumer credit to those who want it at reasonable rates. *Unfortunately, the Commission has been able to devise no empirical method for determining who should get credit, how much credit, what kind of credit, and at what price* [emphasis added].
>
> It is questionable whether legislators want to begin making the intricate social judgements involved in designing laws to spell out who should get credit, how much, and at what rate. Most legislators attempt at all times to represent the best interests of their constituents. But their expertise is in the field of laws and statutes, not in rulemaking and regulations required to specify what part of a family's income could safely be devoted to monthly payments on credit obligations – given such variables as size of family, age of wage earners, nature of employment, and so on. This is the kind of activity the industry itself is constantly working on and attempting to improve by means of its credit scoring systems. The profit motive should be strong enough in our economy to assure that credit grantors will try to make as much credit available at "fair" prices and that if one creditor's "blind spot" keeps him from extending credit to a creditworthy individual, another creditor will probably jump at the chance.
>
> This does not mean that there is no role for the legislator in the area of consumer credit. There are critical functions – namely: (1) to promote and assure the maintenance of what the Commission deems to be the key ingredient of a finance industry capable of providing an adequate supply of credit at reasonable rates – competition among numerous alternative sources of credit; (2) to assure access *by all* [emphasis in original] to those alternative sources of credit; and (3) to prevent excesses which the system may provoke against the borrower.

Not specifically mentioned by the Commission, but certainly present in its overall tone, is the recognition that not everyone is going to agree with the worth of outcomes that the market system provides by itself in individual situations subject to risk. This Taskforce can agree, or not, with the findings and wisdom of the Russell Sage Foundation or the earlier Commission, but no financial study group can empirically satisfy remaining disagreements about the role of government in society and the solution to the problems of poverty. Neither, it seems, can it design legislative recommendations in these financial areas that satisfy all observers all of the time.

Conclusion: Insolubility of the Big Question

And so, what is the answer? In the previous section we asked the "Big Question," ultimately, whether society believes that consumer credit availability for everyone is a good idea or not. Since the beginning of recorded history and probably much longer, individuals have faced situations where more current resources would be useful, particularly in early life-cycle stages where demand for assets is high and available resources often low. Theory and evidence shows there are benefits to using credit in mainstream situations. These occur when acquiring assets that provide a positive return over time in the form of housing, transportation, education and better employment prospects, preferred recreational possibilities such as with boats and motor homes, and periodic mitigation of emergencies. Some credit use may indicate profligacy and impatience, but evidence suggests this aspect of credit use is less important than sometimes believed. All credit use is subject to risks of variable outcomes, including unfortunate ones not foreseeable in advance.

Some borrowers face additional difficulties due to lower or more variable incomes, more credit already outstanding relative to ability to repay, limited liquid assets, and underlying greater risks. Often such individuals are rationed, in that they are unable to obtain as much credit as they would otherwise prefer at the lending rates of primary (low-rate) lenders. Thus, they face the additional problem of needing small amounts of credit that operating costs and risks make more expensive on a rate basis.

This leaves stark tradeoffs in the marketplace and also among policy makers. Most observers believe today that availability of mainstream consumer credit is worth the risks that it entails, but the policy tradeoff problem is greatest where small dollars of credit are involved. There is little doubt that such lending is more costly per loan dollar than mainstream consumer credit.

All this then raises the issue of the role of government in society where these tradeoffs are concerned. Should government in a free society allow small-dollar loans or prevent them? Specifically, how can markets satisfy everyone that small-dollar credit is properly available to those who need it while not charging them more per credit dollar for the costs and risks involved? More generally, how can their needs for small amounts of credit be eliminated? Ultimately, such needs are poverty-based. History shows that no government favors poverty and also that none has been able to eliminate it, regardless of political choices or system. And so, the role of government on more-limited issues like small-dollar lending remains unsettled.

The Russel Sage Foundation and the National Commission on Consumer Finance proposed possible answers in this area (actually the same answer). Both were controversial in their times. There is no gain for this Taskforce to propose the same, or any other, solution to this question and to proclaim it now as the Big Answer, although it should be reexamined and we think the discussion here can help.

There always are, and always going to be, tradeoffs of potential gains and losses to be considered concerning credit use by individuals, the ongoing conundrum for legislators and regulators in this area. It seems, unfortunately, that any proposal or potential answer is going to be controversial in the same old ways. The Taskforce urges more rational and fact-based discussion. And, like the National Commission on Consumer Finance before it, this Taskforce recommends and urges further research and discussion of facts to characterize the debate. This would be much more useful than merely further recycling of the tired old arguments and slogans of the past (like knee-jerk characterizing all small-dollar lending as either "beneficial" or "predatory" without reviewing and understanding the facts). Complaints and arguments have ranged from religious prohibitions to value-judgement musings, some of them now well into at least the fourth millennium of their time. Now is the time for something new, like reasonable discussion of tradeoffs and the possibility of reasonable compromise on an important policy question.

Table 5-1. Demographic Information on Small-Dollar Borrowers in 2015

	Pawn Loan	Vehicle Title	Payday Loan	Non Users
Approximate Annual Household Income ($thousands):				
Less than $15	21	9	13	10
15-24	19	11	14	10
25-34	16	14	15	10
35-49	16	15	16	14
50-74	16	23	21	21
$75 or more	12	29	22	36
Total	100	100	100	100
Age				
18-24 years old	14	15	14	9
25-35	26	33	31	15
35-44	22	22	23	15
45-54	20	15	16	19
55-64	13	9	11	19
65 or older	5	6	6	22
Total	100	100	100	100
Life Cycle Stage				
<45, Married, has children	33	45	40	22
<45, Married, no children	1	1	1	1
<45, Not married, no children	3	3	3	2
>45, Married, has children	10	11	9	17
>45, Married, no children	8	10	8	33
>45, Not married, no children	14	8	11	15
Any age, not married, has children	31	22	29	11
Total	100	100	100	100

Note: Recent demographic information on borrowers at traditional cash installment lenders is not available.

Source of Table: Data from the 2015 National Financial Capability Study, Financial Industry Regulatory Authority (FINRA) with the US Department of the Treasury and the President's Advisory Council on Financial Capability, as calculated and reported by J. Brandon Bolen, Gregory Elliehausen, and Thomas W. Miller, Jr., "Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research," *Economic Inquiry*, April, 2020, Table 2.

Columns many not add to totals because of rounding.

Table 5-2. Estimated Dollars Borrowed in Small-Dollar Loans 2016 and 2017

Dollars Borrowed (Billions)	2016	2017
Installment cash loans	18	20
Pawn transactions	14	14
Vehicle title loans	6	7
Payday loans (storefront)	20	18
Payday loans (online)	15	15
Total Small Dollar	74	73
For Comparison:		
Credit card lending	415	406
Automobile lending	591	595
Student loans	130	135

Source: Center for Financial Services Innovation (CFSI), December 2017 as reported by J. Brandon Bolen, Gregory Elliehausen, and Thomas W. Miller, Jr., "Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research," *Economic Inquiry*, April, 2020, Table 1. CFSI cites data from "Alternative Financial Services: Innovating to Meet Customer Needs in an Evolving Regulatory Framework" by John Hecht, Stephens, Inc. 2014, and statements by John Hecht for Jefferies, Inc., 2015–2016. In addition, for pawn, payday, and installment loans, CFSI estimates are based on publicly traded industry leaders' annual and quarterly report data (2009–2017), market share data, and figures reported by the National Pawn Brokers Association. For payday, rollovers are counted as discrete volume. For Title lending CFSI estimates are based on state-specific title loan incidence, volume, and revenue data reported by regulatory agencies in CA, IL, NM, TN, TX, and VA (2009–2016 as available); 2016 Revenue Data from the Center for Responsible Lending "Payday and Car Title Lenders Drain $8 Billion in fees Every Year," (2017), footprint of auto title lending locations and proportion of states offering installment and single-payment models for all states where the practice is legal sourced from "Driven to Disaster: Car Title Lending and Its Impact on Consumers," Center for Responsible Lending (2013); additional data on proportional use of installment and single-payment auto title sourced from "Payday and Auto Title Lending in Texas, Market Overview and Trends 2012–2015," Texas Appleseed (2016). Rollovers counted as discrete volume. Data for credit card debt, automobile debt, and student loan debt is available from the Consumer Financial Protection Bureau at https://www.consumerfinance.gov/data-research/consumer-credit-trends/.