Predatory Lending

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TO : Illinois State Treasurer's Policy Department
FROM : 12231546
SUBJECT : Policy response to predatory lending

The financial health of Illinoisans is of paramount importance to government and business alike. To help citizens avoid the crippling pitfalls of unaffordable loans, the State Treasurer's Office should establish a fund (or use part of the Illinois Fund) to provide short term liquidity to distressed borrowers. A public option for short term finance would be easier to regulate than payday lenders and could be designed to incorporate insights from behavioral science to mitigate negative outcomes for borrowers.

What is Predatory Lending?

The best way to distinguish predatory lending from other types of finance by understanding how people process information. Economists have historically considered people as rational actors seeking to maximize utility. Under this assumption, we should expect people to receive and process information related to economic outcomes in a rational way. We now know, based on contemporary behavioral science research, that this 'reasonable person model' is inaccurate. People seek to increase pleasure and diminish pain, and economic behavior is an extension of those priorities. Predatory lenders manipulate borrowers' innate fears to bind them to contracts overloaded with fees, unsustainable interest rates, and heavy penalties. Lending in such a manner negates a borrower's agency, and therefore, is a predatory practice.

Behavioral Principles

1. Most poor people have a mental model of finance based on survival. When the poor are thinking about money, it's in the context of survival, not long term economic outcomes. Payday loans are usually thought of as financial products designed specifically to cover one-off emergencies. Yet, nearly seventy percent of borrowers use short term loans to pay for common expenses like utility bills, rent, and food[1]. Measuring the implications of borrowing alongside one's ability to repay, requires a borrower to add extra layers of sophistication onto their current mental model or construct a new one from scratch.

2. People in financial distress have diminished capacity for complex thought. Folks seeking payday loans are, by definition, short on cash and lack better options. Digesting the jargon and nuance in financial contracts requires effortful attention for non-experts. The daily stresses of poverty already put people at a disadvantage in terms of mental resources. Walking through the doors of a payday lender puts someone in a uniquely vulnerable position while further taxing

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[1] https://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why

their mental resources. When taking into account the ambient anxiety of poverty and the acute stress associated with taking out a short term loan, payday borrowers are operating at suboptimal mental capacity that severely reduces their chances of accurately assessing the economic outcomes of a financial contract.

3. People are intrinsically motivated to exit states of confusion and boredom while seeking states of comfort and pleasure. Filling out a loan application is both boring and confusing for most folks. At the same time, the material scarcity that brings someone to sign on the dotted line portends immediate and severe consequences. The prospect of alleviating both chronic and acute stressors at the same leads borrowers to narrowly focus on the inevitable reward of capital infusion. Performing time series calculations of one's income relative to compounding interest rates is no small mental task under perfect circumstances. When people are facing potential eviction, hunger, or inability to fill a prescription, the task overwhelms their cognitive load. Borrowers in financial distress are likely not making financially motivated decisions, but responding to the push/pull of negative and positive stimuli.

Recommendation

The Illinois State Treasurer's Office should create a fund (or use part of the Illinois Fund) to provide citizens with short term financing at affordable interest rates. Bringing such a service in-house would allow us to design a system built on the insights of behavioral science. Approval for loans could be dependent on a completion of a brief but comprehensive financial literacy quiz delivered through the Treasurer's Office website. Design features will be critical to this program's success, and should be primarily focused on presenting new information in a non-threatening and easy to digest format. The State has the capital and infrastructure to implement such a program, and keeping people from financial ruin will allow them to continue paying taxes. Moreover, we can increase basic human welfare perspective by providing an alternative to predatory lenders.