

SHORT-TERM CONSUMER CASH LOANS:
LOOKING BACKWARDS AND FORWARDS

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The concept of borrowing and lending has been around as long as humans have been living communally and is indeed part of the social fabric of communities (Seabright, 2004). The manifestation of consumers' need to borrow cash for short periods of time came along somewhat later, but the idea of borrowing and lending is as old as the concept of community. Today's manifestation of that need is frequently found in the form of short-term cash consumer loans, also known as payday loans.

The payday lending industry has grown from practical non-existence in the early 1990's to widespread proliferation today. As of 2001, over 10,000 locations were open nationwide to provide payday loans (Caskey, 2001). From 1993 in Kansas alone, over 1,900 payday and title lender locations were licensed. According to reporting lenders in Kansas, over \$230 million in payday and title loans were made to Kansas consumers in 2005 (Office of the State Bank Commissioner, n.d.).

A payday loan transaction generally consists of a consumer writing a post-dated check to a lender and receiving a lesser amount of cash in return. This differential amounts to the cost of the loan for the proscribed period, usually two weeks. These loans are not inexpensive; a consumer who writes a check for \$300 to a lender can expect to receive \$240 in return (Callahan & Mierzwinski, 2005), which amounts to a 521% Annual Percentage Rate (APR). The loan is uncollateralized and closed ended. There is no asset pledged or lien applied. There is an effective payment schedule, as the consumer's check is cashed at the end of the two week period. If the customer does not repay the loan, it can be renewed for another two weeks for another \$60.

This does not seem to be a very good deal for consumers who have short-term cash needs. Yet, one intuitively understands that this is not a situation unique to 21st century Kansans.

How have short-term consumer cash transactions been handled in the past? What has been the role of institutions in regulating these transactions? And what can be done to protect consumers from unfair lending practices? This paper will explore these issues from both an historical and a policy perspective, and propose solutions for the benefit of consumers today and in the future.

Lending Policy and Legislation

Usury laws are the earliest and most common form of policy regulating consumer lending and may be considered the oldest form of financial regulation, dating back to the code of Hammurabi and transcending religious faiths (Bodenhorn, 2007; Benmelech & Moskowitz, 2007). Those with free-market inclinations will wonder why interest rates are not set by the market, with those who have the means to borrow funds doing so at a market-determined rate. However, the very nature of the need to borrow cash for a short-term basis somewhat contradicts the market's ability to supply funds.

The argument that the market will determine interest rates is predicated on each case for borrowing assuming a positive net present value (Chakravarty & Scott, 1999). Short-term consumer cash borrowing frequently cannot make this claim; in fact, short-term consumer cash borrowing may be a matter of starvation or not, particularly in historical cases. In these cases, the regulatory power of religious powers, be they Roman Catholic, Islamic or Indian Vedic, have grounds for intervention. The Roman Catholic Church's prohibition on usury, parts of which were in place until 1830, was the most pervasive on Western Europe and thus most influential on the development of consumer lending in this country (Reed & Bekar, 2003). However, the admonitions against usury are pervasive throughout other cultures as well.

Vedic texts of ancient India dating back nearly 4,000 years made class distinctions regarding usury; it was seen as an unfit practice for the upper castes. Over time, usury was only condemned in as much as it contradicted the current legal practice. The dilution of the admonition continued until it existed only in principle and only applied to practices that are outside the bounds of social convention (Visser & MacIntosh, 1998).

Biblical passages in the Judaic texts forbid the practice of usury. The sundry laws of Exodus include this passage from Chapter 22, verse 25, New American Standard version, "If you lend money to My people, to the poor among you, you are not to act as a creditor to him: you shall not charge him interest." However, Deuteronomy 23:20 clears the way for charging interest to foreigners.

Usury in Islamic economic life was criticized during the prophet Mohammed's lifetime and is mentioned in his writings. The principle of interest was an established prohibition during the reign of the Caliph Umar (634- 644). While different branches of Islam have different interpretations of the interest prohibition, particularly relating to the difference between commercial and consumption loans, there are currently interest-free financial institutions in Pakistan, Saudi Arabia, Switzerland and in North America (Visser & MacIntosh, 1998).

In Christianity, the lessons of the Old Testament were supplemented by those of the New. Specifically, Luke 6:34 is cited as a prohibition of usury: "And if you lend to those from whom you expect to receive, what credit is that to you? Even sinners lend to sinners, in order to receive back the same amount."

The Roman Catholic prohibition on usury has many economic interpretations; the church wished to be a net borrower and enforced a rent-seeking model (Ekelund, Hébert & Tollison,

1989), the church as a net lender who wished to operate as a monopoly (Reed & Bekar, 2003), the church as a provider of welfare with an interest in rationing credit (Posner, 1995) or smoothing consumption (Glaeser & Scheinkman, 1998), or the church as an institution that prospered by keeping as much of the population as possible alive, healthy, productive and tithing (Reed & Bekar, 2003).

This last theory of consumption smoothing as a benefit to the church meets several moral and economic points. At the height of the Church's usury prohibition in the 13th through 16th centuries, there is little correlation between poor harvests and mortality, suggesting that a means of consumption smoothing existed. Reed and Bekar (2003) suggest that the Church served as that instrument of pooling resources, of collecting during prosperous times and disbursing during lean times. The Church benefited from the tithe and from land income. If there was not a healthy population to produce the tithe and to work the land for the Church, these benefits dissipated. Therefore, the Church worked to balance the income from the land and the tithe with the almsgiving necessary to maintain a working population. The poor were excluded from borrowing because of the prohibition against usury, complicated by the fact that they had no collateral. The wealthy had collateral and the merchant class found it necessary to borrow for trade. So the Church was the sole source of charity for the distressed poor through formal pooling of resources. By channeling the private capital markets away from consumption loans and into trade, the Church secured the loyalty of its subjects by meeting their consumption needs during bleak times.

Benmelech and Moskowitz (2007) discuss another historical case where institutional entities, in this case wealthy industrial interests, utilize usury laws to "help" the poor while at the

same time maintaining a working class and stifling competition. During the first financial crisis in the United States, the Panic of 1819, up to 10% of the population of New York City was receiving relief in the form of public assistance, private charity and “stay” laws to postpone property foreclosures. Debt relief legislation was proposed and passed in many states. However, in no case was the usury law in a state relaxed, allowing the co-existence of policies designed to protect the poor and limit entry into the marketplace by marginal contenders. Moreover, in those states where debtors had more political power, usury laws were more relaxed than in states where they were strictly enforced.

Consumer v. commercial lending

It should be noted, however, that the Church made a distinction between consumption (consumer) loans and commercial lending, and applied leverage to the pawnbrokers, not the bankers. Punishments for usury included exclusion from rites of the church, such as confession, absolutions and Christian burial, and excommunication for those rulers of communities that profited from the practice of usury (Reed & Bekar, 2003).

The exchange of views between Adam Smith and his student Jeremy Bentham on the eve of the industrial revolution provides insight into the distinction between commercial or merchant lending and that for consumption. Philosophers such as Francis Bacon and John Locke had considered the issue, going as far as to propose interest rates suitable for each occasion. However, Smith, the father of modern economics, “for all his faith in natural liberty, proved unwilling to let the interest rate float” (Persky, 2007, p. 228).

In the United States, knowledge about the business of pawnbroking pales in comparison to that of the banking industry. While providing less than 0.1% of consumer loans in the mid-

1980's, there were more than twice the retail outlets for pawnshops than for savings and loan institutions, which are more targeted to the consumer market than are commercial banks (Caskey, 1991). Pawnshops provide an outlet for consumer loans for those who do not have sufficient collateral to make use of commercial banking or community savings institutions, and for those who participate in the economy using cash only. Their regulation varies from state to state and variances in usury laws can at least partially explain this difference. Many payday lending locations are collocated with pawnshops, and indeed, payday lending may in some ways be seen as an extension of pawnshop services and check cashing businesses (Stegman & Faris, 2003).

Truth in Lending

The passage of the Truth In Lending Act in 1968 was a watershed event in the history of consumer credit policy. Prior to this legislation, prospective creditors were not required to adhere to standard methods of presenting the terms of credit arrangements to consumers. This standardization was manifested in the use of the Annual Percentage Rate, or APR.

Prior to standardization on the APR, creditors could express interest rates in simple terms, compound terms, in terms of dollars only or by translating a fixed price into a series of monthly payments. In testimony in front of a Congressional committee, Dr. Richard L. D. Morse from Kansas State University stated that consumers had a need for comparable facts about alternatives in consumer financing decisions, and that these included four parts of a consumer finance charge quotation:

1. Amount of down payment and monthly payments
2. Number of months

3. Total finance charge
4. Annual percentage rate

Dr. Morse felt that providing consumers with fully disclosed information would increase consumer confidence in the use of credit. He was also keenly aware of the imbalance of power in consumer credit situations; the creditor does this as his daily course of business, but for the consumer, these are infrequently made decisions. Therefore, it is in the best interest of all parties to protect the consumer and maintain his or her faith in the business practices of vendors.

Payday lending practices

The rise of payday lending can be attributed to several factors, including the need for check-cashing businesses to find new services to offer as direct deposit services have replaced their core business and an increase in the number of consumers whose credit limitations force them to seek alternative sources for short-term cash loans (Stegman & Faris, 2003). A payday loan is a quick and simple transaction and can be accomplished at a growing number of locations that are strategically placed to allow for convenience and avoid competition (Burkey & Simkins, 2004). Payday loan consumers are also familiar with other forms of credit. According to Elliehausen and Lawrence (2001), payday loan consumers are three times more likely than other U.S. adults are seriously debt burdened and four times more likely to have filed for bankruptcy.

Payday loans can be rolled over as quickly and simply as they can be originated. When the original loan is due, the consumer can either write a new check for the amount of the loan and the new fee, or pay the fee only. This practice can effectively evolve into an interest-only loan where regular payments are made, but the principal is never reduced (Stegman & Faris, 2003). A national survey indicated that 40% of consumers of payday loans renewed at least six

loans in the previous 12 months and 10% rolled over loans 14 or more times (Ellichausen & Lawrence, 2001). States can pass legislation designed to limit the number and frequency of rollovers, however the payday lending companies will soon discover another loophole or new innovation to facilitate this highly profitable business segment. A simple and obvious alternative is for the consumer to simply go another payday lender to obtain a loan to cover the first obligation (Stegman & Faris, 2003).

Proposed solutions

Traditionally, the regulation of banks and other financial institutions has been delegated to the individual states. As a result, legislation regarding payday and title lending institutions varies widely. According to the Consumer Federation of America, twelve states prohibit payday loans through the use of small loan laws or usury caps, although there are some loopholes in the laws. In 37 states, payday loans are authorized by either payday loan laws or licensed lender laws. Only New Mexico appears to be completely unregulated. In addition, the variety of laws and loopholes available in most states means that lenders can keep one step ahead of the next legislative session when operating in many states. For example, lenders in Texas took advantage of a loophole in 2000 legislation that allowed them to partner with out-of-state financial institutions and charge higher rates of interest (Texas Public Interest Research Group (n.d.)).

In order to protect the most vulnerable consumers, comprehensive federal legislation is required to bring all fees and charges associated with short term consumer cash loans by banks and fringe financial institutions under a set of uniform regulations. In lieu of federal action, a model framework for short-term cash lending should be designed and the individual states encouraged to enact conforming legislation. This framework should be developed by consumer

advocates, industry groups and governmental entities; for any effort to be successful, all parties must be involved.

Enforcement is the other substantial challenge in the regulatory segment. Because of the proliferation of payday lending locations, state regulatory bodies are faced with an increased demand for their services, and the effort of keeping up with changing regulations. In addition, consumers who have issues with payday lenders may feel embarrassed or intimidated by asking for assistance from a governmental entity. The dollar amount of the transactions involved is not large, therefore consumers may assume that their complaints will not be given priority by the regulating agency. In contrast, state securities regulators are usually dealing with larger, more significant transactions and a more sophisticated consumer base. It would be an interesting research project to compare the size of state regulatory enforcement agencies in terms of personnel associated with securities, banking and payday/title lending fraud.

According to the website of the Division of Consumer and Mortgage Lending in the Kansas Office of the State Bank Commissioner, 10 field examiners are employed to regulate the activities of approximately 2,000 lenders. The Office of the Securities Commissioner has a similar sized staff and their investigations resulted in 31 actions in 2006. They also have department devoted to Investor Education which is funded by fines from violators.

Policy Implications

Providing comprehensive financial education through public schools and workplaces would lessen demand for payday and title lending services. Consumers with knowledge about financial issues and the costs and risks associated with entering various financial transactions are more equipped to make sound decisions. This skill set allows them to avoid the situations that

lead to the need for payday lending and to provide for contingencies associated with credit card lending, home buying and other financial transactions related to daily life.

Financial products that can compete with payday and title loans could significantly impact the demand for these services. By increasing the use of conventional, regulated financial institutions in low-income and minority areas, or “banking the unbanked”, demand will be created for banks, credit unions and thrifts to operate in areas that serve those with low incomes, particularly race/ethnic minorities. The advantages to low-income and minority families include financial security and access to low cost transactions. Financial security appears in the form of insured accounts and regulated costs for services. Low cost transactions occur through the leveraged use of technology; Automated Teller Machine (ATM) and on-line transactions are available to consumers at a fraction of the cost of traditional person-to-person transactions (Smith, 2005). In other words, it is less expensive to pay one’s utilities with an ATM card than it is to travel to a location that accepts utility payments, stand in line and enact a physical transaction. Community organizations working with established financial institutions through frameworks such as the Community Reinvestment Act can create critical masses of consumers in underserved areas to demand the types of services these institutions offer.

Regulation could have the most substantial impact on payday lending, but it is also the avenue most fraught with challenges in the form of bureaucracy, political complexity and conflicting interests. Enforcement as a branch of regulation holds promise and must be examined in the light of consumer protection. Governmental entities have the most compelling interest in protecting the rights of minority populations. Political power must be brought to bear on those who can protect and serve.

Conclusion

If society accepts the concept that no one should have to pay 521% APR to borrow \$500 for two weeks and that a family should not lose the only asset that it has to make a utility payment, then action should be taken to regulate payday and title lenders. Local enforcement at the state level can have an immediate impact by aggressively investigating and fining violators and using those funds for a public service campaign to educate vulnerable investors. This can be modeled on the campaign run by the Kansas Office of the Securities Commissioner to prevent investor fraud. Long-term help will hopefully come in the form of financial education in our schools.

Creating a demand for fairly priced financial services by encouraging the use of the banking system is a way of providing alternatives to payday loans. By offering services in underserved communities, conventional financial institutions can increase market share and add to profits. Opportunities exist for community organizations and conventional financial institutions to work together and create these opportunities.

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