

# **An Assessment of Consumers' Use of High-Rate Credit Products**

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## **I. Introduction**

Despite a general acceptance of the view that credit used by consumers to finance the purchase of homes, education, automobiles, and other expensive household durables, a strong undercurrent of belief holds that consumer credit is not always a useful product, at least for some population segments. This belief holds especially for a variety of consumer credit products that have gained notoriety because of their high interest rates. The products include pawnbroker loans, some small personal loans, payday loans, automobile title loans, and refund anticipation loans. Interest rates for these products are indeed high. Finance charges are large relative to the loan amounts, and annual percentage rates of interest often exceed 100 percent.

Not surprisingly, triple-digit interest rates invite criticism. The critics of high-rate credit products contend that consumers would be better off without such borrowing opportunities. They see little or no benefit to using high-rate credit and assert that high-rate credit products have great potential to harm consumers. They assert further that consumers using such products often are uninformed or have been misled. The critics often support these views using anecdotal evidence. There clearly have been instances in which consumers have suffered harm and have been misled or were uninformed. However, systematic evidence on frequency of problems or the extent to which use of high-rate credit may be informed is very limited. That these products visibly remain in demand, and even seem to be gaining in popularity, suggests the usefulness of further analysis.

This paper examines available evidence on consumers' use of high-rate credit products within the context of their credit situation and decision process. Economists' model for inter-temporal consumption and investment decision and psychologists' cognitive model of the decision process provide the framework for the analysis. The economists' model helps answer the question whether actual users of high-rate credit fall into groups that the theory predicts might benefit from use of such credit. The psychologists' model of the decision process then provides criteria for assessing the extent to which these consumers' behavior is purposive and intelligent.

This paper is organized as follows: Section two briefly provides some historical background on consumer lending. Section three describes the different types of high-rate credit products that are available today. Sections four and five discuss the economic and cognitive models, which provide the theoretical framework for analysis, and presents the evidence on who uses high-rate credit products and assesses whether these users made informed decisions. Section six discusses several recent papers attempting to assess whether payday loans benefit or harm consumers who use them. A final section provides conclusions. To preview, the findings indicate that high-rate credit users generally are those whom economic theory predicts may benefit from such credit, and many of them are fully aware of what they are doing, even as some observers see their choices as outrageously shortsighted.

## **II. Historical Background**

Attitudes toward high-rate lending have their origins in antiquity. For much of human history, lending was considered a social obligation to help necessitous and unfortunate members of the community. The practice of taking interest for loans appears to have emerged as agriculture became established and productive land became privately owned (Robinson and Nugent 1935). A conflict between traditional

attitudes and the demand for credit to fund productive activities developed. Helping the poor and necessitous (sometimes expressed as protecting them from taking harmful actions) while providing credit for productive uses resulted in uncomfortable, often ineffective compromises. The compromises commonly involved various degrees of limits on maximum interest rates, exceptions to limits, and tolerance of violations but provided little credit to poor households. This situation existed in consumer lending for most of the history of the United States. Since the 1980s, however, greater acceptance of higher interest rates has expanded availability of small loans to poor and necessitous households, often at very high rates of interest. This section briefly outlines high-rate lending in several early societies and then discusses in greater detail the development of high rate lending in the United States.

### **A. Ancient Times**

The earliest records of interest rates are for Babylonia of about 4000 BC. They indicate that rates could be quite high, varying between 20 to 360 percent per annum depending on the nature of contract and the type of security. Social custom continued to regulate lending, limiting and sometimes prohibiting the charging of interest in times of distress. Later interest rate ceilings established in the Code of Hammurabi (1800 BC), which limited interest charges to 33 1/3 percent on loans of grain repayable in kind and 20 percent on loans of silver, incorporated customary restrictions on interest. The code waived interest in case of floods or draughts, for example. Charitable lending also existed. Temples sometimes provided interest-free loans to the poor (Homer 1963).

Babylon was not the only ancient society to condemn or restrict interest. Israel's law prohibited interest on loans to other Israelites (Exodus 22:24, Leviticus 25:35-38, Deuteronomy 23:19-20) but not on loans to Gentiles (Deuteronomy 23:19-20). This prohibition, developed during the period when Israel was a pastoral society wandering in the desert, aimed to protect the poor. The extent to which the law was kept is not known, but the need for the Old Testament's frequent reprobation of interest suggests that violations did occur (Gamoran 1971).

Among the Greeks lending at interest was common. Much of the lending supported commerce, but small personal loans at high rates of interest also existed. Athens apparently had some restrictions on interest rates. Among Solon's reforms was a removal of these restrictions (Homer 1963). Both Plato (*Laws*, Book V) and Aristotle (*Politics*, Book I, Part 10) condemned the practice, which they viewed as contrary to older ideals. Their condemnation had little effect on their contemporaries. However, the later rediscovery of Aristotle's works in twelfth century Europe strongly influenced the scholastic thought concerning economics and usury (Schumpeter 1954).

The Romans, whose attitudes reflected agrarian rather than commercial values, retained restrictions on interest, including limits on the maximum rate of interest. Rate restrictions were limited to Roman citizens and were evaded by lending through foreign agents. Loans were also structured to involve a risk or force a late payment, for which the law allowed extra charges (Robinson and Nugent 1935, Homer 1963).

### **B. Medieval Europe**

European attitudes were formed by the medieval Christian Church's stand against charging interest. The Old Testament restriction on taking interest and an interpretation of a New Testament exhortation to benevolence (Luke 6:34-35) led the Church first to condemn any loan repayment in excess of the original principal, effectively prohibiting payment of any interest at all, and later to condemn only the taking of

excessive interest. Interest prohibited by the Church is commonly called usury.<sup>1</sup> Civil prohibitions of usury accompanied the Church's condemnation. Charlemagne is believed to be the first prince to forbid usury (Homer 1963).

Lending occurred despite the Church's stand on usury. Jewish moneylenders, whose religion did not prevent them from charging interest on loans to Gentiles, were not deterred by the threat of excommunication and provided much of the credit needed for financing households, commerce, and civil authorities in the Middle Ages. Church restrictions on the taking of interest eventually were relaxed at least in part to meet the growing needs of commerce. Exceptions allowing charges for late payments and risk were permitted, and evasions involving cash discounts on credit sales or inflated foreign exchange fees were tolerated, for example (see DeRoover 1967). Illegal lending at high rates was also common.

Usury restrictions did not help poor and necessitous households obtain credit. Jewish lenders provided some short-term credit at a high rate of interest against pawn to the poor. However, most poor households did not have assets to pawn or incomes sufficient to repay interest and principal. Evidence suggests that Jewish moneylenders provided credit primarily to merchants and wealthier households for productive investments than to poor and necessitous households (Botticini 2000). The Church and civil authorities established charitable lending institutions known as *monti di pieta* to provide such credit. Even when moderate interest rates were allowed, small loan sizes made these loans unprofitable. The need for appropriations and solicitations to cover losses limited charitable lending institutions' ability to provide small loans to the poor. Some of these institutions avoided small loans, instead lending larger amounts to more prosperous households.<sup>2</sup>

### C. The United States

English law sanctioned the Church's prohibition of usury. The eventual change in views of usury from any interest to excessive interest and England's separation from the Catholic Church led to the establishment of England's first rate ceiling in 1545. The rate ceiling was repealed, reinstated, and then revised three times in the next 168 years (Robinson and Nugent 1935).

Britain's North American colonies inherited its extant usury ceiling, but by the time of the revolution all but one of the thirteen original colonies had adopted somewhat higher ceilings to attract capital from Britain. State usury ceilings largely remained in force after the revolution. The United States economy was largely agricultural at that time. Distrust of banking and commercial interests was strong, but eventually some states relaxed usury ceilings in response to strains caused by increases in market rates. A few states repealed their ceilings. That the first state to repeal its usury ceiling—Massachusetts in 1867—had strong industrial and commercial interests is probably not a coincidence.

Violations of usury laws were tolerated. In a study of borrowing by Massachusetts textile mills between 1840 and 1860, for example, Davis (1960) found that rates of interest tended to cluster around the legal limit (6 percent discount). In periods of tight credit, however, the textile mills borrowed at above ceiling rates from non-bank lenders (which paid less attention to legal limits than banks) and out of state lenders

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<sup>1</sup> The origin of "usury" is Middle English *usurie*, from Medieval Latin *usuria*, alteration of Latin *usura*, from *usus*, past participle of *uti* to use. Its first known use was in the 14th century (see <http://www.aolsvc.merriam-webster.aol.com/dictionary/usury?show=0&t=1290606525>). For a concise discussion of the Church's views, see the entry on usury in the *Catholic Encyclopedia* (<http://www.catholic.org/encyclopedia/view.php?id=11855>).

<sup>2</sup> For further discussion, see Robinson and Nugent (1935).

(which were subject to less restrictive laws).<sup>3</sup> An analysis of loans made between 1845 and 1859 by a New York bank (Bodenhorn 2007) found that a large share of the loans had interest rates that exceeded the statutory interest rate ceiling. That detailed records of usurious transactions exist suggests that such transactions were widely tolerated. Access to credit was apparently more important than short term gains from legal actions seeking relief from usurious loans.

There were also exceptions to usury limits. Two exceptions were important for the US. First, under the so called “time-price” legal doctrine, the courts exempted credit purchase arrangements from usury laws. The courts held that merchants may offer a good at different prices, a cash price and a time price. That the interest rate implied by the difference between the time and cash prices exceeded the usury ceiling was immaterial. The courts (if somewhat implausibly) deemed such an arrangement as a sale of a good at a higher price, not a loan at all. In contrast, usury laws regulated compensation for the use of money (Collins 1941, p. 58).<sup>4</sup> This doctrine allowed merchants and peddlers—both important sources of consumer credit in the nineteenth century—to finance households’ purchases of goods (see Calder 1999).

The other exception to usury restrictions involved “salary buying” agreements. Under salary buying agreements, the salary buyer purchased an employee’s next paycheck at a discount (paying, for example, \$22.50 for the worker’s \$25.00 paycheck). Courts held that usury ceilings did not affect the right to purchase the salary or wages of another (or sell one’s salary or wages to another) and the right to agree to a discount that exceeded the legislated ceiling. Similar to the reasoning regarding the time price doctrine, the courts did not consider the outright purchase of the worker’s salary an extension to for the use of money and hence not a loan subject to usury law (Collins 1941, p. 62). The salary loan industry, which provided small cash loans to borrowers with regular sources of income (discussed below), commonly invoked this exception to usury restrictions.

### 1. *Sources of Credit in the Nineteenth Century*

Merchants were the major source of credit for middle class consumers, but relatively conservative lending terms limited availability of such credit for the greater part of the nineteenth century. Working class consumers relied on peddlers. Peddlers arranged a line of credit with a wholesale or retail merchant to finance a stock of goods that they sold to door to door on an instalment basis. Peddlers tended to sell goods on lenient terms, collected weekly through visits to their customers, and relied on personal relationships to help collect debts. Peddlers were often immigrants who sold goods to others in their own immigrant communities (Calder 1999). Both merchants and peddlers invoked the time-price doctrine in providing credit to customers.

Pawnbrokers provided cash loans to the poor, but two types of small loan companies emerged to lend to a growing class of workers with regular salaries or wages. The small loan companies primarily offered one of two types of loans, salary loans or chattel loans.

Salary loans were commonly secured by wage assignments, contract terms that allow a lender to collect payments directly a borrower’s employer in the event of default. Loans were small, typically between \$10 and \$35 (Wassam 1908). As the loan was presented as a loan sale and collected by wage assignment in the event of default, loan size was limited by the amount of the borrower’s weekly or monthly income.

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<sup>3</sup> Rates charged by non-bank and out of state lenders approached six percent between 1840 and 1846, which suggests that the ceiling rate may have been about equal to the market rate during this period. Somewhat later, when the usury law began to break down, textile mills reported paying more than legal rates also on loans from Massachusetts banks.

<sup>4</sup> The leading US case involving the time price doctrine is *Hogg v. Ruffner*, 66 US (1 Black) 115 (1861).

Normally, the loan was repaid in small periodic instalments. A salary loan of \$25 dollars, for example, would be repayable in 14 weekly payments of \$2.50. The finance charge is \$10, the \$35 sum of payments less the \$25 loan amount. The annual percentage rate is 252.43 percent, which is the 4.84 percent weekly interest rate multiplied by 52.14 weekly periods in a year.

Chattel loans were secured by household goods that remained in borrowers' possession. Chattel loans ranged between \$10 and \$300, with by far most being less than \$50 (Ham 1909). The loans were to be repaid in weekly or monthly instalments, commonly over a period of three to twelve months. A \$25 chattel loan, for example, might be repayable in 7 monthly payments of \$5.40. The finance charge would be \$12.80, the sum of payments \$37.80 less the \$25 loan amount. The annual percentage rate for this loan is 138.60 percent (11.55 percent per month multiplied by 12 months per year).

The small loan companies operated largely outside the law. For this reason alone, they provided little information about the transaction and did not give borrowers copies of loan documents. Lenders did not want to provide any information that could be used to prosecute them. Their rates were high, not only because of relatively high operating costs of making small loans, but also because of the legal risks and social opprobrium. That notwithstanding, both contemporary accounts (Wassum 1908, Robinson and Nugent 1935) and recent studies (Calder 1999) have pointed out that some small loan companies were honest business. Secrecy and illegality, however, provided opportunities for disreputable companies to deceive and intimidate borrowers. Lenders sometimes required borrowers to sign blank forms or did not inform borrowers of the true nature of the transaction. Salary lenders commonly required guarantors on some loans. Some salary lenders did not inform guarantors of their obligations, telling guarantors that they were only making a recommendation for the borrower.<sup>5</sup> It was not uncommon for lenders to harass delinquent borrowers. In such cases, dun letters with the name of the lender the purpose of the letter prominently displayed might be sent to a borrower's home and place of employment. Collectors might go in person to borrower's homes or place of employment and loudly threaten actions or shout abuse at him. Some lenders seemed to make it difficult for borrowers to avoid problems. For instance, one salary lender operating in New York City required payment at an office in a different city (Providence, Rhode Island), apparently in order to generate additional revenue from late fees. This lender employed a collection agency that contacted borrowers the day after a late payment and demanded immediate payment of the amount due and late fees. These companies were not alone in such practices.

## 2. *Consumer Credit Reform*

High rates of interest, abusive collection practices, and a perception that these cash lenders preyed on the poor gave rise to calls for stricter laws and more vigorous reform in the 1880s. Most of the states that had earlier repealed usury laws reinstated them over the next two decades. Many states prohibited or restricted wage assignments and use of household goods as collateral, which the small loan companies used to enforce their debt contracts.<sup>6</sup> Generally, these reform efforts were ineffective and counterproductive. Lenders often changed the details of the transaction to place it outside the purview of the law; and borrowers, unwilling to

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<sup>5</sup> Salary lenders would lend readily to consumers whose employers were known discharge employees who make wage assignments. The threat of notifying a borrower's employer of a wage assignment was a very effective incentive enforcing repayment of the loan. However, in situations in which an employer's attitude toward wage assignments was unknown or the lender had other reasons to question the security of a borrower's wage assignment, salary lenders typically required a borrower to provide one to three guarantors.

<sup>6</sup> See Gallert, Hilborn, and May (1932) for an extensive discussion of efforts to reform the small loan business. Michelman (1966) and Calder also provide good discussions of reform efforts.

risk losing access to credit, were often reluctant to complain to enforcement authorities (Robinson and Nugent 1935, Horack 1941, Rogers 1974).

The ineffectiveness of restrictive laws in curbing illegal lending gradually led to an acceptance of the view that laws should regulate but not prohibit cash loans, either explicitly or through restrictions that make small, relatively short term unsecured loans economically infeasible. Around the turn of the century, states began passing specific legislation to create such opportunities. Among the earliest initiatives was legislation authorizing semi philanthropic lending institutions known as remedial loan societies in the last decade of the nineteenth century. Remedial loan societies were established primarily to provide credit to working class borrowers at lower rates than those charged by small loan companies. The legislation authorized higher charges than those allowed under usury laws, but rates and fees allowed remedial loan societies were limited. Remedial loan societies were not wholly philanthropic in that suppliers of funds risked loss of principal; nor were they wholly commercial because return on investment was limited, with any surplus being returned to borrowers through lower interest rates.

The Russell Sage Foundation developed a third approach to reform consumer lending. The foundation chose credit reform as a major focus of its activities. Through its research, investigations, publicity campaigns, legal activities, and lobbying, the Russell Sage Foundation played a central role in efforts to reform consumer lending. Over time, the foundation concluded that semi philanthropic and cooperative lending institutions would never be able to attract sufficient capital to satisfy the demand for small loans. Recognizing the relatively high cost of making small loans, the foundation believed that allowed interest rates had to be high enough to allow lenders to earn a competitive return on invested capital. In exchange for high interest rates, the foundation believed that the loan terms should be transparent to the borrower and that lenders should be licensed and regulated (see, for example, Ham 1912). Between 1910 and 1916, the Russell Sage Foundation worked with legislatures in several states to enact legislation to establish a small loan industry based on these beliefs. Lenders licensed to operate under new small loan laws formed state associations to promote their interests, and in 1916 the state associations formed the American Association of Small Loan Brokers (AASLB). The AASLB cooperated with the Russell Sage Foundation in 1916 to develop a model small loan act known as the Uniform Small Loan Law. The Uniform Small Loan Law became the basis for future state legislation authorizing small cash loans for consumers. By 1932, twenty five states had adopted a version of the Uniform Small Loan Law.

State small loan laws based on the Uniform Small Loan Law and enacted during this period enabled the emergence of the consumer finance company industry. The laws authorized a fixed percentage finance charge per month for loans not exceeding a specified limit, required lenders to be licensed by the state, included provisions for supervision and enforcement of the laws, and required lenders provide borrowers a record of the transaction. Many states adopted the ceiling specified in the uniform law—a finance charge of 3½ percent on unpaid balances without fees or additional charges for loans up to \$300.<sup>7,8</sup> Licensed lending grew rapidly

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<sup>7</sup> In order to be effective, the ceiling rate must not be effective over the range of loan sizes that the regulation is intended to permit. The uniform law's choice of 3½ percent rate was made with this intent and based on the studies of cost and experience of remedial loan companies and other small loan lenders. See (Clark 1931, pp. 46-7), Robinson and Nugent (1935, pp. 115-7), Carruthers, Guinnane, and Lee (2009, p.13).

<sup>8</sup> The Russell Sage Foundation recognized that most lending costs are fixed, so that a 3½ percent ceiling made a \$100 loan less profitable than a \$300 loan. The foundation's position on transparency prevented it from supporting any remedy for this problem, such as allowing the lender to charge a higher percentage finance charge for smaller loans or fixed fee per loan (see Carruthers, Guinnane, and Lee 2009) See chapter 5 for a discussion of costs of consumer lending. Graduated rate ceilings, which allow higher

but did not entirely eliminate illegal lending by unlicensed small loan companies. Small loan companies taking chattel mortgages on household goods were more receptive to the 3½ percent ceiling and licensing than companies making loans secured by wage assignments. This outcome was probably because the larger size of loans made by chattel mortgage lenders—\$10 to \$300 compared to \$5 to \$50 for wage assignment lenders (Nugent 1941)—made licensed lending more profitable for these lenders. Clark (1931) reported that about 90 percent of licensed lending was done on a chattel mortgage basis. Some states enacted rate ceilings lower than the 3½ percent ceiling or later reduced ceilings below that level. In these states, licensed lending was inhibited, and illegal lenders were not displaced or regained their market presence (Clark 1931, Robinson and Nugent 1935, Hubachek 1941, p. 126; Nugent 1941, p. 12).

The Russell Sage Foundation collected data to support its advocacy, and state supervisors required licensees to report statistics on small loan lending. These data provide considerable information on the effects of the small loan laws. The 3½ rate ceiling made larger secured loans profitable but was not sufficiently high to cover the cost and return on capital required for smaller unsecured loans. Few unsecured lenders licensed their local offices when small loan laws were passed. Unsecured lenders shifted capital from regulated states (that is, states with small loan laws) to unregulated states. Those unsecured lenders that remained in regulated states reduced the number of their offices by consolidations.

The Russell Sage Foundation recognized that wage assignment lending was unprofitable under the code's rate ceilings. However, the foundation was unwilling to modify its recommendations. Robinson and Nugent (1935) listed six reasons for the foundation's unwillingness:

1. It believed that the greater part of small loan demand could be satisfied at the code's rate ceilings and that providing collateral was in borrowers' best interest.
2. The burden of rates above the ceiling rate would cause more hardship than the inability to borrow.
3. Providing higher rates for smaller loans would create an incentive for lenders to split loans (that is, offer two smaller loans in place of a larger loan).
4. Providing exceptions to the general regulatory character of the code would undermine its legitimacy.
5. It believed that salary lenders had caused sufficient harm in that past to bring the entire industry into disrepute.
6. The ease with which salary loans were negotiated encouraged thoughtless and perhaps unnecessary borrowing.

Note that these reasons are largely beliefs, not empirical findings. Robinson and Nugent conceded that salary lending had never been adequately studied. They added that the persistence and extent of salary lending suggested that a distinct demand for small dollar amount loan products existed.

### 3. *State "Experiments" with Rate Ceiling Reductions*

The consequences of rate ceilings lower than those recommended by the Russell Sage Foundation were demonstrated in several states that subsequently reduced rate ceilings amended their small loan laws (see Nugent 1933, Nugent and Robinson 1935). In 1929, four states—Maine, Missouri, West Virginia, and New Jersey—reduced their maximum rates. Maine reduced its maximum rate from 3½ to 3 percent. The number of licensees declined from 47 in 1929 to 33 (a 30 percent decline in the number of licensees) in 1933, but the change in volume of loans outstanding was similar to changes in states in which no rate reduction occurred.

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rates on smaller loans, became a common feature in state small loan laws. Graduated rate ceilings are discussed later in this chapter.



Missouri reduced its maximum rate from 3½ to 2½ percent. The number of offices declined 49 percent from 174 to 89 at the end of 1932. Growth in loan volume stopped abruptly. Lenders specializing in larger loans secured by household goods continued to increase their lending. Most other licensed lenders stopped making smaller loans or took steps to liquidate their business. Unlicensed lenders stepped in to provide smaller sized loans, which were no longer available from licensed lenders.

Larger rate reductions in West Virginia and New Jersey had more serious consequences. West Virginia reduced its maximum rate from 3½ to 2 percent. The number of offices declined 65 percent from 62 to 22 at the end of 1933. Loan volume decreased 75 percent between 1929 and 1932.<sup>9</sup> New Jersey reduced its maximum rate from 3 to 1½ percent. The number of offices in New Jersey decreased 81 percent from 437 to 83 (and all but 19 of the 83 were liquidating) in 1932. Loan volume declined 73 percent in the first year the rate reduction was effective.

In both West Virginia and New Jersey, the remaining licensed lenders offered only larger size secured loans. As in Missouri, unlicensed lenders entered the market to provide smaller sized loans at rates that were considerably higher than were permitted before rate reductions. Ultimately, the consequences of these legislated rate ceiling reductions were deemed undesirable. The New Jersey legislature increased the maximum rate ceiling to 2½ percent in 1932, and the West Virginia legislature increased the maximum rate ceiling to 3½ in 1933.

#### *4. Summary*

The disposition to be charitable to those who suffer misfortune or are in need is at least as long as human history. This disposition has produced an aversion to high interest rates, which authorities have sought to restrict through regulation. Efforts to provide low interest credit for such purposes on a charitable basis have not been successful. Some lenders operating outside the law have been willing to provide small loans at high interest rates. These transactions have not always been transparent. Sometimes the loans contained harsh terms, or the lenders used abusive collection practices. Passage of Uniform Small Loan Laws early in the twentieth century by many states created conditions favorable of the emergence of a small loan industry. These laws contained rate ceilings that were sufficiently high to make such lending profitable. However, the rate ceilings were still insufficient for very small loan amounts. Reformers at that time were aware very small loan amounts were unprofitable but believed that such loans probably would not benefit most potential borrowers. They had little evidence to support this belief.

Since the emergence of new high-rate credit products late in the twentieth century, data have become available to assess these products' effects on consumers. The remainder of this paper will describe the different high-rate credit products and assess the evidence on their use.

### **III. High-Rate Products Described**

High price rate products actually are quite diverse. Many are small single-payment loans with relatively short terms to maturity, but a few involve larger amounts and installment payments over a year and sometimes longer. The characteristic that makes all of these types of loans distinctive, other than their

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<sup>9</sup> Clark (1931, 198-9) reported effects of West Virginia's 1929 reduction in the interest rate ceiling for small loans from 3½ percent to 2 percent. At the time of the rate reduction, 38 licensed lenders were doing business. Within six months, 17 companies had gone out of business, and nine companies were in the process of liquidating. All of the remaining companies were small. They adjusted their business model by taking only the best credit risks, making only larger loans, requiring additional security, and imposing strict collection methods.

relatively high price, is their availability to consumers who have difficulty qualifying for many other types of credit. The diversity of the products at least in part reflects efforts of various lenders to find ways of making credit available to such consumers. This characteristic of these markets also differentiates high rate loans from the mainstream credit products, which are the ones more familiar to most consumers.

## A. Pawnbroker Loans

Pawnbroker loans are among the oldest forms of credit, stretching back to antiquity.<sup>10</sup> In a pawn transaction, the borrower brings an item that secures the loan to the pawnshop. The most frequently used security in a pawnbroker loan today is jewelry, but consumer electronic equipment, guns, tools, and musical instruments also often serve as security for pawn loans. A pawnshop employee inspects the item and estimates its value.<sup>11</sup> Based on the estimated value, a loan amount will be determined. The borrower leaves the item with the pawnbroker, and at the end of the term of the loan, commonly one month, the borrower may repay the loan amount plus a finance charge to redeem the item. The borrower may also extend the loan for an additional month or two, paying additional finance charges for extensions. If the borrower does not redeem the item at the end of the term, the item is forfeited to the pawnbroker/lender or, in some places, to the state, for resale.

Pawnbroker loans generally are quite small. In 1997, pawn loans typically ranged from \$35 to \$260, with an average size of about \$70 (see Johnson and Johnson 1998).<sup>12</sup> The finance charge consists of interest and a storage and security charge for the pawned property. The finance charge on a \$70 loan, for example, might be \$9.40, with \$1.40 (2 percent per month) in interest and an \$8.00 charge for storage and security. The Annual Percentage Rate for this example is  $(\$9.40 \div \$70) \times 12 = 161.14$  percent.

A pawnbroker loan is based on the value of the item pledged as security and, perhaps, for a repeat customer, the borrower's history of previous redemptions. The loan does not depend on the borrower's income or credit history. The borrower's performance on a pawnbroker loan is not sent to a credit reporting agency (credit bureau).

Because the pawnbroker takes physical possession of the security item, the pawnbroker must protect pawned items. The pawnbroker is liable for replacement value of any pawned item that is lost, stolen, or damaged. In years past, this fact sometimes encouraged consumers to pawn seasonal items such as expensive fur coats (where larger loan size also meant lower rates), as a means of acquiring out of season secured storage. Pawnbroker personnel must be knowledgeable about jewelry, appliances and equipment, electronics, firearms, musical instruments, tools, and many other segments of the used goods market to assess the market value of a wide variety of items. Since a borrower is unlikely to redeem an item worth less than the loan amount, a pawnbroker lending too much on an item then faces the likelihood of a loss on the transaction when it is not redeemed. Pawnbrokers also need to be able to identify and note defects in pawned items, distinguish genuine items from imitations, register items with the local police as needed to prevent fencing of stolen property, and be watchful that the customer does not substitute an item of lesser value for one that is inspected. All of this makes pawn lending an expensive form of credit for the pawnbroker to engage in, especially considering the generally small amounts usually borrowed.

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<sup>10</sup> Exodus 22:25-26 and Deuteronomy 24:12-13, for example, state that a lender who held a garment in pledge should restore it to the borrower at night so that the borrower would have protection from the cold. Finley (1981) pointed to the operation of pawnbrokers in ancient Greece. And Yang (1950) noted that in China pawnbrokers can be traced back to the fifth century.

<sup>11</sup> The inspection may include a request for the borrower to demonstrate how an item works. The purpose of the demonstration is twofold. The demonstration shows whether the item indeed works but also whether the borrower knows how the item works. Not knowing how an item works raises a question whether the borrower actually owns the item. One of the costs of modern pawnbroking is the necessity of complying with rules in various jurisdictions designed to prevent sale by criminals of the items they have stolen (usually called "fencing").

<sup>12</sup> The National Pawnbrokers Association, the trade organization for the industry in the US, reported an average loan amount of \$100 in 2009 ([www.nationalpawnbrokers.org/2010/year-in-the-life-of-a-pawnshop/](http://www.nationalpawnbrokers.org/2010/year-in-the-life-of-a-pawnshop/)).

## B. Small Consumer Finance Installment Loans

The consumer finance industry emerged early in the twentieth century after states enacted laws establishing special interest rate ceilings for relatively small loans to consumers (see Michelman 1966, Chapman and Shay 1967, Rogers 1974, and Calder 1999).<sup>13</sup> With the goal of promoting public relief from illegal lenders (which were commonly called loan sharks), these laws required lenders operating under the special rate ceilings to obtain a license from the state. The laws established rate ceilings that were high enough to enable licensed lenders to lend small amounts profitably. The interest rate ceilings in these laws were graduated by size of loan, with higher rates being allowed for smaller loans. The laws also often regulated other loan terms, such as maximum loan sizes and time to maturity. They gave rise to the regulated small loan company or consumer finance company industry. The small consumer loans from these companies are typically repaid in monthly instalments. The loans are amortized, with a part of each payment repaying principle so that the loan is paid in full by the last scheduled payment. The loans are often unsecured.

The Texas Finance Code Chapter 342-E (subchapter 201) is an example of a law with a graduated interest rate ceiling and limits on term to maturity and maximum loan size. The maximum interest rate is 18 percent per year (add on) for loan amounts up to \$1,800 and 8 percent per year (add on) for loan amounts from \$1,800 to \$15,000.<sup>14,15</sup> The maximum term to maturity is 37 months for loans of \$1,500 or less, 49 months for loans from \$1,501 to \$3,000, and 60 months for loans over \$3,000. The rate ceiling can be converted into an Annual Percentage Rate in Truth in Lending terms when loan size and term to maturity are specified. For example, the rate ceiling for a 12-month \$1,000 loan is 31.71 percent per annum, and the rate ceiling for a 24-month \$3,000 loan is 23.40 percent per annum.

The Texas Consumer Finance Code is of particular interest because it specifies in Chapter 301-F (subchapter 252) special interest rate ceilings for very small loans, defined in the code as loans of \$520 or less. Rate ceilings in this loan size range are considerably higher than the ceilings for the larger small loans:

- Loans under \$30 have a maximum finance charge of \$1 per \$5 borrowed;
- loans between \$30 and \$35 have a maximum finance charge of 10 percent of the loan amount plus \$3.00 per month;
- loan between \$35.01 and \$70 have a maximum finance charge of 10 percent plus \$3.50 per month;
- loans between \$70.01 and \$100 have a maximum finance charge of 10 percent plus \$4.00 per month, and
- loans between \$100.01 and from \$101 to \$520 have a maximum charge of \$10 plus \$4.00 per \$100 per month.

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<sup>13</sup> See chapter 11, "State Regulation of Consumer Credit," for further discussion of the emergence of the modern consumer finance industry.

<sup>14</sup> An add-on rate is a rate applied to an initial credit balance, multiplied by the number of years (or fractions of a year as needed), with the product then added to the initial balance to determine the total of the payments expected over time. Division of this total by the number of months produces the monthly payment. When the credit is repaid in installment payments, however, the average effective credit balance outstanding is about half the beginning balance, and so the add on rate is about half the effective Annual Percentage Rate required for Truth in Lending disclosures. Add on rates were popular in the past when calculators and computers were expensive or unknown because of the ease of doing the calculations with pencil and paper, and for this reason they often became enshrined in state laws. Today, add on rates are still found in some state rate laws and they sometimes are still used for calculations, typically with a computer, but they may not be used in disclosures to consumers. Consumer rate disclosure must be the Annual Percentage Rate defined in Truth in Lending.

<sup>15</sup> The graduated rate ceiling reflects loan size bracket adjustments in the Texas Office of Consumer Credit Commissioner, *Texas Credit Letter*, 28 (March 10, 2009).

The maximum term to maturity is one month for each \$10 up to a maximum of 6 months for loans of \$100 or less and one month for each \$20 up to a maximum of 12 months for loans of \$101 to \$440. Annual percentage rates corresponding to these ceilings are between 109 and 240 percent per annum, depending on loan size and term to maturity. The average size of Chapter 342-F loans was \$546 in 2009, far less than the average loan size of \$7,578 for regular Chapter 342-E loans.<sup>16</sup>

Consumer finance companies generally serve consumers whose income or past debt payment performance prevents them from qualifying for prime credit, although the main consideration in making the loan remains the consumer's ability to make the payments, unlike pawn loans where the main concern is the value of the collateral. Lenders look for a reliable source of income for the borrower and attempt to arrange a loan with a relatively low monthly payment, which the borrower can afford to pay with ease. Thus, the term to maturity tends to be at the maximum allowed term, and loan amounts may be limited to keep monthly payments low. A history of previous payment problems does not necessarily disqualify a consumer in this market, but previous problems at the same lender may preclude further borrowing there.

The Texas Chapter 342-E rate ceilings are similar in structure to rate ceilings in many other states, although the level of ceilings in some other states may be somewhat higher. The Texas Chapter 342-E and many other state rate ceilings are not sufficiently high to allow lenders to make the very smallest loans profitably, leading to the special provision in Texas and in a few other states. In contrast, the Texas Chapter 342-F rate ceilings are among the highest rate ceilings for consumer finance installment loans. Rates in this loan size range are competitive with rates pawnbroker and payday loan companies offer, but the loans are installment loans payable over a longer time than a few weeks or a single month.

### **C. Payday Loans**

While pawn loans date back to antiquity, and small cash installment loans existed at least in the nineteenth century and legally since about 1910-20 in many states, the payday loan industry developed only during the 1990s. A payday loan is a small, short term, single payment consumer loan. The part of this lending approach that is new is that the customer writes a personal check for the sum of the loan amount and finance charge and leaves it with the lender at the time of receiving the cash. The payday loan company agrees in writing to defer presentment of the check until the customer's next payday, which is often 10 to 30 days later.<sup>17</sup> At the next payday, the customer may redeem the check by paying the loan amount and the finance charge, or the payday loan company may deposit the check in its account. In some states, the customer may extend the payday loan by paying only the finance charge and writing a new check. Most state laws that allow such extensions or renewals limit the number of renewals during the year. Payday loan companies may offer an extended payment plan, which allows the borrower to repay the loan in a small number of instalments. A few states require payday loan companies to offer extended payment plans.

Payday loans typically range from \$100 to \$500, although some states permit payday loans up to \$1,000 (see Elliehausen 2009). Finance charges are typically between \$15 and \$20 per \$100 of the loan amount. The calculation of the cost of a payday loan is straightforward. For example, a customer borrowing \$200 for 14 days, where the finance charge is assessed at a rate of \$15 per \$100 borrowed would owe a

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<sup>16</sup> Texas Office of Consumer Credit Commissioner, Calendar Year 2009 Regulated Lender Consolidated Lender Report. (Available at [http://www.occc.state.tx.us/pages/publications/consolidated\\_reports/RegulatedLender2009ConsolidatedReport.pdf](http://www.occc.state.tx.us/pages/publications/consolidated_reports/RegulatedLender2009ConsolidatedReport.pdf), accessed 20 May 2011).

<sup>17</sup> Payday loan companies may provide only payday loans, or they may provide payday loans and other services such as check cashing, pawnbroker loans, and wire transfers.

finance charge of \$30 (2 times \$15 = \$30). The Annual Percentage Rate for this transaction is 391.07 percent, which is the periodic rate ( $\$15 \div \$100 = 15.00$  percent) multiplied by 26.07, the number of 14-day periods in a year.

The underwriting process for payday loans consists primarily of verifying the applicant's income and the existence of a bank account. Payday loan companies typically request that applicants provide their last bank statement and pay stub, identification (for example, social security number and driving license), and sometimes proof of residence. Companies generally limit the maximum amount of the loan to a specified percentage of the customer's take-home pay. Unlike mainstream lenders, payday loan companies do not obtain a credit bureau report, but some companies do subscribe to a risk assessment service that provides information on recent payday loan use by the applicant.

Taking a postdated check helps reduce the costs of collection for the payday loan company.<sup>18</sup> If the consumer fails to redeem the check, the payday loan company has a relatively low-cost method of collection: the company can deposit the check to obtain payment of the loan amount and finance charge. Depositing the check does not ensure payment, of course, since the customer may not have sufficient funds in the account. But not having sufficient funds in the account subjects the customer to overdraft fees, which makes failure to repay the payday loan more costly to the customer. Thus, the postdated check provides an incentive to repay the payday loan, thereby reducing the probability of default and the expected value of collection costs.

#### **D. Subprime Credit Cards**

Subprime credit cards are credit cards intended for consumers who have serious delinquencies or other credit problems in their credit histories. Subprime credit cards have low initial credit limits, \$300 to \$500 (Andriotis 2011) to limit losses from delinquencies and defaults. Annual Percentage Rates for subprime credit cards (on average, about 20 percent) are substantially higher than the industry average but do not reach the triple digit levels of other small loan products. The notable feature of subprime credit cards is that their annual fees are quite large, \$39 on average, relative to credit limits. They may also charge an initial account processing fee and a monthly fee. These fees are deducted from the credit line, leaving the customer initially with little available credit. For example, initial available credit on a \$300 credit line on an account with a \$19 processing fee and a \$75 annual fee would be \$232.<sup>19</sup> These fees, which are not included in Annual Percentage Rates, make subprime credit cards costly relative to the amount of the credit line.<sup>20</sup>

The low credit line and fee structure for subprime credit cards can be explained by customer risk. Large percentages of customers default within two years of account opening or are chronically delinquent, but a significant percentage of customers are able to improve their credit bureau scores and qualify for prime credit after a short period of time. The low credit limits limit losses from defaults.<sup>21</sup> The one time initial

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<sup>18</sup> For further discussion of fees, costs, and profitability of payday lending, see Flannery and Samolyk (2005).

<sup>19</sup> Fees for subprime credit cards were much higher before the Credit Card Accountability, Responsibility, and Disclosure Act (CARD Act) of 2009 limited initial fees to 25 percent of the credit limit granted. This restriction made many subprime credit card programs unprofitable. Subprime credit card issuers responded by discontinuing programs or substantially raising minimum credit standards.

<sup>20</sup> Because credit card balances can fluctuate rapidly and unpredictably and sometimes equal zero, factoring such fees into the APR is not practical. Such APRs would be highly volatile and sometimes even infinite. Moreover, such APRs could only be calculated retroactively, because future charges and payments are unknowable. For discussion, see chapter 6 in Durkin and Elliehausen (2011).

<sup>21</sup> Pre CARD Act data on subprime credit card performance are available. One subprime credit card issuer indicated that about half of subprime accounts had one or more 90+ day delinquencies in the first 24 months after account opening, and 30 percent charge off all or part of balances owed (Beacom 2008). This performance resulted despite screening that rejected about two thirds of applicants. The company also reported that 23 percent of its customers improved their credit bureau scores and obtained higher limit (near prime or prime) credit card accounts within 24 months. Turner and Walker (2008) examined 2007 data from three issuers

processing fee helps provides revenue to cover origination expenses and losses on accounts that default. Recurring annual and monthly fees help compensate for collection costs for chronically delinquent accounts. The amount of interest income generated on these low balance accounts is insufficient to cover costs of default and delinquency. Sharply higher rates than the rates actually charged likely would still be insufficient to cover the costs.

#### **E. Automobile Title Loans**

Automobile title loans, sometimes called title pawns, typically are one month loan contracts secured by a first lien on the borrower's automobile. The borrower gives the lender the title to the car as collateral for the loan. The borrower also gives the lender a copy of the keys or allows the lender to install a device to disable the car's ignition, which facilitates seizure of the collateral in the event of default. The entire balance of the loan plus finance charge is due at the end of the month. The borrower may extend the loan by paying the finance charge at the end of the month. Borrowers commonly extend loans by paying the finance charge and a percentage of the amount borrowed, often for three to five months. Automobile title loans range from \$100 to a few thousand dollars, but the typical loan size is from \$400 to \$600. A typical monthly finance charge would be \$25 per \$100 borrowed. In that case, the Annual Percentage Rate would be 300 percent.

Automobile title loan lenders typically require applicants to provide information on the automobile, income, proof of employment (such as a pay stub), proof of residence, and information on the title and insurance. Loan evaluation consists of an examination of the condition of the automobile, determination of its value, and evaluation of the borrower's ability to repay. Lenders may verify employment and obtain a credit report. However, some automobile title loan lenders will lend even to consumers who are not employed or have a bad credit history.

Cars used as collateral for automobile title loans tend to be older vehicles, as the borrower must have clear title to the car. About 14 percent to 17 percent of automobile title loans default, but only a fraction of these defaults lead to repossession. The need for expensive repairs on older vehicles or accidents often triggers default. In many such cases, lenders do not reposes the vehicle pledged as collateral. Title loans generally are nonrecourse loans, so the lender cannot sue the borrower for the difference between the amount owed and the value of the vehicle.<sup>22</sup>

#### **F. Income Tax Refund Anticipation Loans**

A tax refund anticipation loan is a short term loan to a consumer that is based on the amount of the consumer's expected income tax refund. The consumer receives the loan amount up to the expected refund due less the loan fee. The proceeds of the refund anticipation loan may be paid to the consumer by check, deposited in a bank account, or disbursed through a prepaid cash card, within one to three days of filing the tax return. The refund anticipation loan and fee are normally repaid by the tax refund. The loan functions like an acceleration of receipt of the tax refund due, but because there is an advance of funds to the consumer, it is also a loan of money and must be booked under a variety of laws as an advance of consumer credit.

Tax refund anticipation loans are typically arranged through a tax preparation service such as H&R Block, Jackson Hewitt, and a large number of smaller tax preparers, which act as middlemen between

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and reported that defaulting borrowers used virtually all of the available credit (98 percent) and defaulted early (about three fourths of charged off accounts were delinquent within the first three months).

<sup>22</sup> See Zywicki (2010) for further discussion.

borrowers and the lenders. The lender makes the credit decision and funds the loan through the services of the tax preparer. A small number of banks provide the loans in conjunction with tax preparers.

Tax refund anticipation loans typically range from \$200 to \$7,000, but most are greater than \$2,000 (see Elliehausen 2005). Lenders may make loans up to the amount of the claimed refund, but some lenders limit the loan amount regardless of the size of the refund or lend only up to a specific percentage of the refund amount if they have had no previous experience with the customer. The refund anticipation loan fee ranges from \$10 to \$100 depending on the size of the loan.<sup>23</sup>

The term of the loan depends on the time the Internal Revenue Service takes to process the refund claim, generally between ten and fourteen days. Annual Percentage Rates for tax refund anticipation loans are relatively high. For example, a \$2,000 tax refund anticipation loan might have a loan fee of \$89, which is 4.45 percent of the loan amount. If the loan is outstanding for 10 days, the Annual Percentage Rate would be 4.45 percent multiplied by  $365/10 = 36.5$  periods per year, or 162.43 percent.

Making a tax refund anticipation loan is not risk free for the lender. The borrower is obligated to repay a refund anticipation loan but may not actually receive all or part of the anticipated refund expected to repay the loan. The Internal Revenue Service may reduce a request for a refund for any number of errors or omissions in the borrower's tax return, or may also apply funds from a refund to offset unpaid federal income tax obligations from previous years, student loans, other federal agency debts, state taxes, or child support.<sup>24</sup>

The lender collects or may collect information on applicants' name, address, telephone number, and social security number; amount of income, deductions, and refund from the tax return; debts or liens owed to the government; other debts and assets; previous refund anticipation loans; employment, and credit history. Most applications for a tax refund anticipation loan are accepted. Some lenders advertise that they accept nearly 90 percent of applications. As indicated, many refund anticipation loans are for the full amount of the refund less the amount of fees deducted, although, in some situations, lenders may limit loan amounts to control risk. Lenders may limit the dollar amount of a refund anticipation loan or the percentage of the refund financed if the customer had no previous refund anticipation loan or a refund anticipation loan from another lender. Lenders may also limit the amount or percentage of the refund anticipation loan covered by an earned income tax credit or limit loans that rely on income from federal Form 1040 Schedule C (sole proprietorships). And lenders may limit or refuse applications if the consumer owes delinquent child support or government debts or liens.

## **G. Illegal Loans**

With passage of small loan laws in the early twentieth century, many of the firms that previously made small loans illegally (that is, at interest rates well above usury ceilings) became licensed and constituted a large part of the new consumer finance industry. The small loan laws did not eliminate unmet demand for small loans, however. Not all jurisdictions passed small loan enabling legislation at the same time, and the ceilings

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<sup>23</sup> Other fees such as electronic filing and deposit account setup fees may be charged in conjunction with a refund anticipation loan. Whether or not such fees are included in the finance charge and Annual Percentage Rate under Truth in Lending rules depends on whether the charge would be incurred in comparable cash transactions.

<sup>24</sup> In the early 1990s, the Internal Revenue Service provided notice of the existence of an offset (but not the amount of the offset) on the acknowledgement of the electronic tax submission transmission. The IRS discontinued the notice in 1994 due to concerns about fraud in electronic filings with refund anticipation loans but reinstated the notice in 2000 in order to encourage electronic filings. The IRS has again decided to discontinue the notice for the 2011 tax season because it believes that the notice is no longer needed to promote electronic filing. See Theodos et al. (2010).



were not generally high enough to allow lenders profitably to extend very small sized loans.<sup>25</sup> Illegal lenders continued to operate in states that had not passed legislation. Most firms that specialized in making very small loans changed their business plan and made larger loans under the new ceilings or exited the state (Robinson and Nugent 1935, Haller and Alviti 1977).

In the 1920s, a new source of illegal lending emerged in New York (which did not pass small loan legislation until 1932). Criminal organizations entered the loan business, first lending to gamblers and local businesses and then by the early 1930s to consumers who previously had been served by salary lenders. By the 1950s, consumer lending was a standard business activity of criminal organizations operating in many major metropolitan areas across the US (Haller and Alviti 1977). Racketeer loan sharking still exists today despite the growth of legal high APR credit alternatives since the 1990s.<sup>26</sup>

Unlike the firms that made illegal loans before small loan laws, the racketeer lenders (which were also called loan sharks) operated informally, relying on personal acquaintance and local connections at the workplace or in the local community. Because of the informal nature of the illegal loan market, few reliable statistics on these the nature or the extent of these loan transactions exist. Available evidence from the mid 1960s suggests that typical illegal loans ranged in size from \$50 to \$1,000, with an average probably between \$150 and \$400 (Seidl 1968, 1970). The customary interest rate was 20 percent per week, which amounts to 1,040 percent per annum. Interest charges were due each week as long as the principal was outstanding. Principal could be reduced only in lump sum, or sometimes, half lump sum payments.<sup>27</sup> Loan sharks typically used the threat of force or violence to enforce payment. Instances of actual violence tended to be limited, however. Violence discourages new or continued borrowing by making customers more apprehensive, and some forms of violence (murder, for an obvious example) make it difficult for the borrower to repay and the lender to recover his loan principal.<sup>28</sup>

Illegal lenders often operate in low income neighborhoods (Venkatesh 2006) or immigrant communities (Filkins 2001). It is likely that not all illegal lenders are associated with organized crime, and some rely on repossessing assets (business equipment, cars, electronic equipment, or household goods, for example) rather than threats or violence to collect loans (Venkatesh 2006). Available evidence suggests that these illegal lenders charge high rates of interest similar to those charged by racketeer lenders.

Illegal lending probably accounts for a small part of high price lending today. Most consumers with unmet demand for small loans likely would not turn to illegal lenders if legal high cost loans were not

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<sup>25</sup> At that time, two types of firms supplied illegal loans: chattel lenders, which took security interest in household goods; and salary lenders, which included wage assignment provisions authorizing payments to the lender directly from a borrower's employer in the event of default. The chattel lenders made larger loans than the salary lenders and could operate profitably under rate ceilings established by the new small loan laws. The smaller loans extended by salary lenders, however, generally were not profitable. Robinson and Nugent (1935) reported that state regulatory agencies and the Russell Sage Foundation knew that salary lenders' were unable to make small loans at ceiling rates but made no effort to do anything about the problem despite recognition that a demand for such small loans existed.

<sup>26</sup> For recent instances, see, for example, "22 Held in Staten Island Betting and Loan Sharking Raids" (Associated Press 2009) or "Authorities Accuse 13 in Philadelphia of Mob Charges" (Warner 2011).

<sup>27</sup> Seidl reported some variation in rates across markets. In several markets, the rate was 20 percent add on for a six or ten week period, with interest and principal paid in equal weekly instalments. Interest rates would be 284.53 percent and 179.93 per annum, respectively.

<sup>28</sup> Seidl identified three market segments in addition to the small consumer loans. They are small businesses needing working capital, speculators seeking venture capital, and individuals needing funds to satisfy spending habits (gambling or drug consumption, for example) or finance illegal business activities. Loan terms in these other market segments differ from those in the small consumer loan segment.

available.<sup>29</sup> Nevertheless, illegal lending is worth mentioning because its existence is a reminder that there are sources willing to provide high price credit even if the provision of such credit is illegal.<sup>30</sup>

#### **H. Bank Payday Advance Products and the FDIC's Small Dollar Amount Loan Pilot Project**

A few banks offer a payday advance product. To be eligible for this product, the customer must have a direct deposit of a paycheck or other recurring payment (Social Security, for example) in a checking account. The credit limit on this type of account is based on the size of the direct deposit and commonly has a maximum between \$500 and \$750. The customer initiates the advance by telephone, at an ATM, or through the Internet. The advance is repaid from the next direct deposit. These automated procedures likely make the operating cost of the bank payday advance product less than that of the standard payday loan.

The finance charge for the advance is 10 percent of the advance amount, regardless of the time the loan is outstanding. Thus, the finance charge on a \$300 advance would be \$30. The Annual Percentage Rate depends on when the advance is obtained. If the loan is obtained two weeks before the was taken, for example, the number of two week periods in a year would be 26, and the Annual Percentage Rate would be  $10 \text{ percent} \times 26 = 240 \text{ percent}$ .

The banks offering this product market the product as short term credit. To enforce the short term intent, the banks limit the number of consecutive checking account statement periods in which an advance can be obtained. Limits range from six to 12 statement periods. After reaching the limit, the customer is ineligible for advances for a specified period of time, or the bank reduces the credit limit until it reaches zero.<sup>31</sup>

Noting the demand for payday loans and use of fee based check overdraft programs but critical of their cost, the Federal Deposit Insurance Corporation initiated in 2008 a pilot project to stimulate development of low APR small dollar loan products at banks (Miller et al. 2010). For the pilot project, the FDIC specified certain guidelines for product designs:

- Loan amounts of up to \$1,000
- Payment periods that extend beyond a single paycheck cycle
- Annual percentage rates below 36 percent
- Low or no origination fees
- No prepayment penalties
- Streamlined underwriting
- Prompt loan application processing
- Automatic savings component
- Access to financial education

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<sup>29</sup> Even if legal alternatives are available, some consumers might turn to illegal lenders because of they ask few questions of the borrower, are willing to provide credit immediately, and are often also available outside of normal office hours.

<sup>30</sup> In a study of credit market regulation in the UK, Germany, and France, Policis (2006) found that borrowers in Germany and France, where low rate ceilings restrict credit availability, were much more likely to turn to illegal lenders than borrowers in the UK, where high rate credit is readily available from a variety of different sources. See Chapter 10 for further discussion of rate ceilings and illegal lending.

<sup>31</sup> Many more banks offer lines of credit on checking accounts, but most of these accounts are similar to credit card accounts. Results of a recent survey of Federal Deposit Insurance Corporation supervised banks indicated that the median credit limit of checking account lines of credit was \$5,000, and the median Annual Percentage Rate was 18 percent (Federal Deposit Insurance Corporation 2008).

As the pilot project was intended to encourage experimentation, the guidelines were rigid requirements for participation in the pilot project. The FDIC required that the products be designed to be profitable and not be contrary to bank safety and soundness.<sup>32</sup>

One of the preliminary results was that some banks relied on somewhat larger loans to make their profitable. These banks reported that some customers qualified for larger loans and that the larger loans provided greater revenue for the same operating cost as the smaller (\$1,000 or less) loans.<sup>33</sup> This result caused the FDIC to expand the loan the pilot to track larger loans of \$1,001 to \$2,500 (nearly small dollar loans).

Twenty eight banks participated in pilot program at its completion at the end of 2009. All of the pilot project products were closed end loans. The average size of small dollar loans (\$1,000 or less) was \$724, and the lowest loan size was \$445. The average nearly small dollar loan (\$1,001 to \$2,500) was \$1,727. The average term to maturity was 12 months for small dollar amount loans and 15 months for nearly small dollar amount loans.

The most common interest rate charged for both loan size categories was 18 percent. About half of the banks also charged upfront fees, which were larger for nearly small dollar amount loans (\$46 on average) than for small dollar amount loans (\$31). Annual Percentage Rates, which include both fees and interest, for all products were less than 36 percent, as specified in the initial guidelines.

Thirty day delinquency rates for both small dollar amount loans (9 to 11 percent, depending on quarter) and nearly small dollar amount loans (6 to 11 percent) at least three times higher than for similar types of unsecured loans (2 to 3 percent) in 2009. In contrast, charge off rates for pilot project products were in line with industry averages. The cumulative charge off rate was 6 percent for small dollar amount loans and 9 percent for near small dollar amount loans. These compare to charge-off ratios of 5 percent for unsecured loans to individuals and 9 percent for credit cards in the fourth quarter of 2009.

As the small dollar amount products are not established products, some comment on their commercial viability seems appropriate. The FDIC did not have reliable data on the profitability of the pilot project small dollar amount products but was able to report qualitative information provided by the banks participating in the program. The banks indicated that the costs of launching and marketing small dollar loan amount programs and originating and servicing the loans were similar to those of other consumer loans. However, because of their small size, the interest and fees from these loans were not always sufficient to achieve robust short term profitability. Most pilot bankers said that they sought to generate long-term profitability through volume and by using small-dollar loans to cross-sell additional products.

The FDIC envisaged the products developed in the pilot program as possible alternatives to payday loans.<sup>34</sup> Whether or not the small dollar amount products are indeed substitutes for payday loans is not clear. The smallest small dollar amount loan (\$445) was larger than by far most payday loans. Elliehausen (2009) reported that only about a quarter of payday loans were greater than \$400. The larger loan sizes of the small

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<sup>32</sup> A press release announcing the pilot project can be found on the FDIC website at [www.fdic.gov/news/news/press/2007/pr07052a.html](http://www.fdic.gov/news/news/press/2007/pr07052a.html). The press release explains the purpose of the pilot project and discusses the guidelines for product designs.

<sup>33</sup> This finding is consistent with relationships between costs and loan size discussed in the Report of the National Commission on Consumer Finance (1972) historical experience in regulating small loans (for example, see Robinson and Nugent 1935).

<sup>34</sup> Based on the experience gained from the pilot project, the FDIC proposed the following template for bank small loan amount lending products: (1) a maximum loan size of \$2,500; (2) a minimum term to maturity of 90 days; (3) interest rate and fees not exceeding 36 percent; and (4) a streamlined underwriting process in which proof of identity and residence are required, loan amount is based on income verification and an assessment of ability to pay, and credit reports are obtained.

dollar amount loans may reflect borrowers' greater ability to service debts due to lower interest and longer time to repay or simply different loan demand. That most banks used credit reports in underwriting suggests that a significant number of payday loan customers might have difficulty qualifying for one of these bank loans, so different (although perhaps partly overlapping) market segments for the bank and payday products seem plausible. Moreover, the marginal profitability of these bank small dollar amount products suggests that they are unlikely to displace the payday loan industry.

### **I. Rent to Own Transactions**

Rent to own transactions are short term rentals, not credit.<sup>35</sup> However, consumers often obtain items—either intentionally or unintentionally—using rent to own transactions; and rent to own companies make heavy use of the purchase option to market their products. The implicit APR of the rental purchase justifies their inclusion in this discussion.

The rent to own industry consists of dealers who rent furniture, appliances, home electronics, and jewelry to consumers on a week to week or month to month basis. Rent to own companies do not check credit reports, but they do require verification of applicants' identity, residence, and employment. In a typical rent to own transaction, the customer enters into a self renewing weekly or monthly lease for the item. The customer is not obligated to continue payments beyond the current weekly or monthly period. At the end of the period the customer can continue to rent by paying for an additional period or can return the item. The rental agreement provides an option to purchase the item. The customer can accomplish purchase by continuing to pay rent for a specified period of time, by paying a specified percentage of the rental payments that remain to be paid before the item is purchased, or by some other formula that depends on factors such as the number of payments made and value of the item.

The rent to own transaction differs from transactions involving an installment purchase or a multi-period financial lease in that the rent to own company, not the consumer, bears the risk of ownership. The rent to own company incurs the costs of delivery, setup, repair, loaner services, pickup, refurbishing, and re-rental. Installment sellers generally do not deliver and set up items without charging for the services. Sellers also do not normally repair items or provide a loaner during the repair period, although they may for an additional charge sell a customer a service package. The rent to own customer can return the item without penalty at the end of the week or month if he or she is dissatisfied, no longer needs the item, or has difficulty making payments. A consumer who purchases an item would have to seek a buyer in the second hand market or otherwise dispose of an unwanted item, and a consumer who uses a financial lease normally would pay an early termination fee. These features make rent to own purchases more costly to the provider than an installment purchase or a multi-period financial lease.

The terms of a rent to own transaction can be illustrated by considering the rental of a 50-inch high definition plasma television with the following terms: The rental cost for the television is \$99.99 per month and the customer owns the television after 24 months. If the customer wants to purchase the television earlier than 24 months, he or she would have to pay the difference between the rent to own company's specified cash price of \$1,329.99 and a percentage of the sum of rental payments made. The customer can also purchase the television by paying the company's cash price within the first 90 days of the rental.

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<sup>35</sup> Rent to own transactions are not covered by the federal Truth in Lending Act (Regulation Z) or Consumer Leasing Act (Regulation M). Forty seven states have state laws that define rent to own as a lease and regulate the terms of rent to own transactions (Association of Progressive Rental Organizations, <http://www.rtohq.org/>, accessed 8 June 2011).

Determining the cost of credit when a product is purchased jointly with financing and also possibly with other services is not always straightforward. The calculated cost of credit depends on the allocation of costs among the items purchased jointly; but the allocation of costs may be arbitrary if the product and other services are not also sold separately for cash, which is normally the case for parts of rent to own transactions.<sup>36</sup>

For example, it is possible to use the retail price for the same television to attempt to measure the credit cost. Suppose the same television has a list price of \$849.95 and retails for \$528.00. The seller does not calculate and collect sales tax for items ordered through the Internet. The shipping cost is \$102.85. A three year, extended warranty may be obtained for \$139.99. Adding these additional costs to yields a cash purchase price of \$770.84. The periodic rate which equates this purchase price and the 24 payments of \$99.99 is 7.30 percent, which is 145.71 percent on an annual basis.<sup>37</sup>

The 145.71 percent annual rate for this transaction would not include setup, however, nor, more importantly, does it include the value of the option to return the item at any time nor the repair and loaner features available in the rent to own situation. Presumably, the value of these features would be included in the rent to own company's cash price of \$1,329.99, although there is no assurance that this aspect of the price would be a market price. Equating the company's cash price and the 24 payments of \$99.99 yields a period rate of 5.38 percent, or 64.57 percent annually.<sup>38</sup> Regardless of the choice of product price, this example suggests that rent to own is a much more costly method for financing the purchase of a consumer durable than instalment credit.

#### **IV. High Rate Credit and the Economic Model of Consumer Credit Use**

Most consumer credit is used to finance the acquisition of consumer durables. Consequently, Fisher's (1907 and 1930) consumption and investment model provides an appropriate framework for analysis of consumers' credit decisions. Seligman (1927), a founder of the American Economic Association, adopted the model for his study of instalment credit. Hirschleifer (1958) extended Fisher's model to accommodate cases in which lending and borrowing rates differ and the increases in borrowing can only take place at higher interest rates, and Juster and Shay (1964) addressed further institutional features of credit markets in the model.

##### **A. Juster and Shay's Analysis**

In their economic analyses of the consumer's credit decision, Juster and Shay (1964) explained why consumers are sometimes willing to borrow at high rates of interest. Like Seligman before them, Juster and Shay argued that many products purchased using consumer credit provide benefits over a period of time. Such benefits imply a rate of return are compared with the cost of acquiring the product, and acquisitions that produce rates of return greater than costs are utility increasing. Limited empirical evidence suggests that the return on durable assets can be quite large for many households (Poapst and Waters 1964; Dunkelberg and Stephenson 1975, for example).

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<sup>36</sup> See Durkin and Elliehausen (2011) for discussion of the difficulties of determining annual percentage rates in joint purchases.

<sup>37</sup> These terms were available from a vendor on Amazon.com in early June 2011. The vendor did not calculate or collect sales tax. The item shipped within two days of the order. Faster shipping was not available. The warranty was for 36 months.

<sup>38</sup> The rent to own company also offers a contract with weekly payments of \$24.99. The customer owns the television after 104 payments. The annual percentage rate for this contract would be 161.59 percent at the retail price and 76.17 percent at the rent to own company's cash price.

Juster and Shay (1964) examined circumstances that cause consumers' marginal cost of borrowing to differ from the loan interest rate and extended analyses to certain institutional features of consumer credit markets—specifically, marginal borrowing rates increasing with increasing amounts of debt and absolute limits to further lending. The later extensions account for the unwillingness of many consumer lenders (primary) to finance the entire cost of consumer durables and the existence of specialized lenders (secondary lenders) offering unsecured credit at relatively high interest rates.<sup>39</sup>

Juster and Shay's analyses produced two types of outcomes, an equilibrium outcome and a rationing outcome. Consider a simple example in which there are two borrowing rates, a lower rate charged by primary lenders and a higher rate charged by secondary lenders. Both lenders have an absolute limit on the amount that can be borrowed. The consumer invests in durables until the rate of return on investment is equated with the discount rate, which in a situation involving borrowing is the rate charged by primary lenders. The amount borrowed does not exceed the limit set by primary lenders, and the rate of return on investment, discount rate, and rate of time preference are equal.

Rationing outcomes occur when the consumer is unable to equate the rate of return on investment, discount rate (which in the case of borrowing is the borrowing rate), and rate of time preference. In a first rationing outcome, the consumer is able to equate the rate of return on investment and the rate of time preference. However, discontinuities in market opportunities for borrowing prevent the consumer from taking advantage of potentially utility increasing investments. Rationing prevents a consumer from borrowing further at a lower rate, and the return on investment is not sufficiently high to justify borrowing at the next higher available rate.

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. In this case the rate of return on investment is less than the consumer's rate of time preference. The rate of time preference may be equal to the higher rate charged by secondary lenders or greater than the higher rate if the amount of borrowing exceeds the secondary lenders' limit. Again, rationing prevents the individual from taking advantage of potentially utility increasing investments.

### *1. Consumer Characteristics Associated with Credit Rationing*

Users of high APR credit products would be expected to have characteristics of rationed borrowers. Unrationed borrowers generally would not find high APR credit products attractive. A large, disproportionate percentage of unrationed borrowers using high APR credit products would raise a question whether their use is rational, as marginal borrowing rates for unrationed borrowers are normally relatively low. Within this theoretical context, Juster and Shay identified characteristics that distinguish rationed and unrationed borrowers. This distinction is useful in assessing consumers' use of high APR credit products.

Reviewing the discussion from Chapter 2, rationed borrowers are typically in early family life cycle stages. For them, rates of return on household investment tend to be high. They tend to have relatively low or moderate current incomes and little discretionary income, making the sacrifices in current consumption acquire to pay for large expenses costly. And because of their moderate incomes and young age, rationed borrowers generally would not have accumulated large amounts of liquid assets. At this stage in the life cycle, their liquid asset holdings have a high subjective yield due to precautionary savings motives.<sup>40</sup> The high rates

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<sup>39</sup> For theoretical analyses of equity and collateral requirements in loan contracts, see Barro (1976) or Benjamin (1978).

<sup>40</sup> Subjective yields on liquid asset holdings are higher than nominal yields for many consumers because they strong precautionary motives for savings. Many consumers use liquid assets grudgingly even when events occur that impair their earning potential or

of time preference and high subjective yields on liquid assets cause equity requirements to be expensive for rationed borrowers, making them willing to pay high interest rates to obtain more credit.

Unrationed borrowers, in contrast, typically are in later family life cycle stages or have relatively high incomes. Unrationed borrowers in later life cycle stages may have relatively few high-return household investment opportunities. For them, high income may provide discretionary amounts that allow unrationed borrowers for large expenses without costly reductions in current consumption. Moreover, their age and income may allow unrationed borrowers to accumulate some savings. Consequently, subjective yields on liquid assets are often substantially lower for unrationed borrowers than for rationed borrowers. Availability of low-cost discretionary income and liquid assets for acquisition of durables would make unrationed borrowers generally unwilling to pay high interest rates for additional credit.

## 2. *New High Cost Borrowing Opportunities for Rationed Consumers*

Consumer credit markets have changed considerably since Juster and Shay's study. Advances in information availability and in the technology to manage and analyze large amounts of information have improved lenders' ability to assess risk. Credit reporting through credit reporting agencies (credit bureaus) is now close to comprehensive. Credit reports thus reflect a consumer's complete credit history, making information in credit reports more useful for predicting future payment performance. In addition, the development of credit bureau scores has made statistical credit evaluation available to all lenders.

Such changes have loosened the credit limits of primary lenders. Equity requirements have also relaxed, as terms to maturity have lengthened for most closed end installment credit, and down payment requirements have also been reduced. Furthermore, home equity lines of credit and cash out refinancing of mortgage loans have developed to allow consumers to finance acquisition of durables using savings from equity in their homes. Thus, today many consumers are more able to finance a greater proportion of their household investment through primary lenders.

Nonetheless, higher cost credit products from secondary lenders have also proliferated. Unsecured credit is now widely available through bank credit cards, and many borrowers today use bank credit cards in much the same way as Juster and Shay described borrowers using unsecured personal loans (see Bizer and DeMarzo 1992, Brito and Hartley 1995). Competition has extended availability of bank credit cards to many consumers who previously would have had difficulty qualifying for them. As a result, unsecured credit is now available to more consumers at a lower cost than in the past. There also are various "subprime" versions of credit cards, automobile financing, and mortgages. As this term suggests, such products are mostly used by those who exhibit greater amounts of credit risk than mainstream consumers. These subprime products allow consumers to finance a larger share of the value of household durable goods and services, borrow more heavily against future income, and obtain credit despite previous problems repaying debts. The financial crisis of 2008-2009 has disrupted subprime credit markets; but, after necessary reevaluation and restructuring, they are unlikely to go away.

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require large expenditures. Their reluctance to use liquid assets stems from a belief that the worse the current situation, the greater is the need to maintain reserves for future emergencies (Katona 1975). As a consequence, subjective yields on liquid assets are often substantially greater than nominal yields. This characteristic of consumers' financial behavior may explain consumers' simultaneous holding of consumer debt and relatively large amounts of liquid assets. The weighted average Annual Percentage Rate on the outstanding consumer credit is greater than the nominal yield but less than the subjective yield on the liquid assets. Since many consumers who have relatively high cost personal loans from finance companies or credit card debt also hold liquid assets is, the subjective yield on liquid assets is likely to be quite high for some consumers.

As outlined earlier in this paper, there also are new short term credit products to go with the small loan industry that has existed for decades and the pawn lenders prevalent for centuries. The payday lending industry allows consumers to obtain an advance on their next paycheck, automobile title lenders offer small loans secured by consumers' automobiles, and income tax refund anticipation loans enable consumers to obtain an advance on expected tax refunds. Short term credit products may facilitate the accumulation of household assets even when they are not used directly to finance household investment. The availability of short term credit may reduce consumers' vulnerability to unexpected expenses or reductions in income when consumers use relatively large amounts of debt to finance household investment. Although these short term credit products may be very costly, consumer losses resulting from a lack of liquidity may be quite large. Thus, short term products may also have expanded the opportunities for rationed consumers to finance household investment.

### B. The Short Term Credit Decision

It is possible to look at this common consumer problem with the standard tools of financial economics. The net present value rule for evaluating investments is theoretical core of modern financial analysis and consistent with the work of Juster and Shay, the rule holds for consumer investment decisions as well as for corporate finance. Net present value (NPV) is calculated as follows:

$$NPV = -C + \sum_{t=1}^n \frac{S_t}{(1+r)^t} \quad (8.1)$$

where  $C$  is the cost of an expenditure,  $S_t$  is a periodic saving for  $n$  periods from an making an expenditure, and  $r$  is the periodic discount rate. An expenditure is utility increasing when the present value of its benefits exceeds its cost. As noted by Juster and Shay, the benefits from durable acquisitions can often be measured in dollars as saved costs. The benefits of using a short term loan may also be expressed in terms of the costs of some market alternative. For example, a short term loan may be used avoid a late payment, take advantage of a one-time sale, or avoid some other costly outcome.

#### 1. Payday Loan Example

Elliehausen and Lawrence (2001) provide an example of a net present value calculation of the kind familiar in economic and financial analysis but evaluating use of a payday advance to repair an automobile. In their example, a consumer needs \$200 to repair the automobile. The consumer can obtain a \$200 payday loan for a \$30 fee due on the next payday in two weeks or take public transportation until next payday and obtain repairs then.

Their example is based on commuting from a Washington, DC suburb to the city. They used US government mileage rate for calculating automobile fuel and depreciation cost. Opportunity cost for extra time for commuting by public transportation was calculated for a \$10.00 per hour wage rate. Parking was provided by the employer and so use or not did not affect the consumer's cost. The upper panel of Table 8.1 summarizes the calculation of the daily cost of using by public transportation as an alternative means of commuting.



**Table 8.1**  
**Cash Flows for Using a Payday Loan to Repair an Automobile**

*A. Daily cost of public transportation*

|  |        |
|--|--------|
| Bus and subway fare (2×\$3.50)                                       | \$7.00 |
| Less: Automobile mileage (2×12 miles×\$0.31 per mile)                | \$7.40 |
| Plus: Opportunity cost for commuting<br>(2×0.25 hours×\$10 per hour) | \$5.00 |
| Equals: Daily cost   | \$4.56 |

*B. Cash flows*

| <u>Day</u>                             | <u>Undiscounted<br/>cash flow<br/>(dollars)</u> | <u>Discounted<br/>cash flow<br/>(dollars)</u> |
|--|---|---|
| 0 Tuesday (repair car)                 | -200.00   | -200.00                                       |
| 1 Wednesday (daily cost)               | 4.56  | 4.51  |
| 2 Thursday                             | 4.56  | 4.46  |
| 3 Friday                               | 4.56  | 4.42  |
| 4 Saturday                             | 0.00  | 0.00  |
| 5 Sunday                               | 0.00  | 0.00  |
| 6 Monday                               | 4.56  | 4.28  |
| 7 Tuesday                              | 4.56  | 4.23  |
| 8 Wednesday                            | 4.56  | 4.19  |
| 9 Thursday                             | 4.56  | 4.14  |
| 10 Friday                              | 4.56  | 4.10  |
| 11 Saturday                            | 4.56  | 0.00  |
| 12 Sunday                              | 4.56  | 0.00  |
| 13 Monday                              | 4.56  | 3.97  |
| 14 Tuesday (daily cost and car repair) | 204.56  | 176.24  |
| <i>Sum of cash flows</i>               | 45.60   | 14.55   |

Source: Elliehausen and Lawrence (2001).

Elliehausen and Lawrence further assumed that the automobile was used only for commuting between the consumer's residence and place of employment and not for additional useful or pleasurable purposes. The second panel of Table 8.1 summarizes the cash flows and calculates the net present value of using a payday

loan to pay for the repair. The cost of the repair  $C$  is the net cash flow on day 0. The cost of public transportation is the periodic savings,  $S_t$ , which are \$4.56 per day on weekdays and \$0.00 on weekends. In addition the consumer would incur the cost of repairing the automobile at the end of two weeks.

The column on the right provides the discounted value of the cash flow. The periodic discount rate is 1.07 percent per day, which is the finance charge of \$15 per \$100 borrowed divided by the 14 days (the term of the payday loan). The net present value is the sum of discounted cash flows \$14.55. The positive net present value indicates that borrowing at 1.07 percent per day, a 309.00 percent Annual Percentage Rate, is wealth increasing.

It is worth noting that the undiscounted net value of using the payday loan is the \$45.60 sum of net cash flows from the table less the \$30 finance charge for the payday loan or \$15.60. That result, \$15.60, is not much different from the \$14.55 discounted net present value. Despite the high discount rate, the effect of discounting is small because of the very short term to maturity. The short term to maturity for many of the high price credit products simplifies the consumer's decision. There is not any great need to think in terms of discounting cash flows, even in theory, because the time is so short that the undiscounted cost serves as a good proxy for the discounted costs, even if the discounting rate is very high. This would not be the case for a long term loan, of course. Extended use of this sort of credit is where it becomes most highly controversial.

This example is obviously hypothetical. Different assumptions might lead to different decisions. A more costly repair or daily parking fees would reduce net present value and might produce negative net present values. Additional trips using public transportation or a higher opportunity cost rate would increase net present value and might produce a positive net present value even for a more costly repair or including daily parking fees. Data that permit calculation of net present values for actual payday loan decisions are not available. Nevertheless, the example illustrates that there are plausible situations in which use of high price credit is rational.

## 2. *Income Tax Refund Anticipation Loan Example.*

Elliehausen (2005) calculated the net present value of using an income tax refund anticipation loan to obtain a benefit a short time in the future by loan size and amount of benefit. This type of transaction might involve using the proceeds of the refund anticipation loan to pay bills now rather than paying bills late plus late payment fees for failure to make timely payment. A more positive example might be buying an item on sale now rather than paying full price later. Because a refund anticipation loan is a single payment loan, equation 8.1 simplifies to

$$NPV = -C + \frac{F}{1+r} \quad (8.2)$$

where  $C$  is the current cost (the amount of the bill or the sale price),  $F$  is the future cost (the amount of the bill plus avoided late payment fee or the regular price of the item), and  $r$  is the discount rate. Net present values are calculated for selected undiscounted benefit (that is, avoided fees or regular price) amounts ranging from \$25 to \$125. The discount rate, which is based on an actual refund anticipation fee schedule at the time of the study, calculated by dividing the refund anticipation loan fee by the loan amount.<sup>41</sup> A positive net present value indicates that the benefit exceeds the cost of the transaction.

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<sup>41</sup> The 4.50 percent rate for 10 days implies an annual percentage rate of 164.25 percent (4.50 percent per 10 day period × 365/10 periods per year).

As an example, Elliehausen considered a consumer who has a choice between purchasing an appliance for \$2,000 in a limited time-period sale and waiting ten days or longer (until receipt of a tax refund) to purchase the appliance at the regular price of \$2,100. The net present value of using a refund anticipation loan to take advantage of the sale is obtained by subtracting the sale price from the full price discounted at the periodic 4.50 percent rate for a \$2,000 refund anticipation loan. That is,

$$NPV = -\$2,000 + \frac{\$2,100}{1+0.0450} = \$10.53 \quad (8.3)$$

This result means that using a refund anticipation loan to purchase the appliance on sale is less costly than waiting for a tax refund and paying the regular price.<sup>42</sup>

**Table 8.2**  
**Net Present Value and Undiscounted Net Value of Refund Anticipation Loan, By Size of Refund Anticipation Loan and Amount of Savings or Avoided Loss**

| <u>RAL amount</u>                          | <u>RAL fee</u> | <u>Periodic rate</u> | <u>Benefit (savings or avoided loss)</u> |             |             |              |              |
|--|----------------|----------------------|--|-------------|-------------|--------------|--------------|
|  |                |                      | <u>\$25</u>                              | <u>\$50</u> | <u>\$75</u> | <u>\$100</u> | <u>\$125</u> |
| <i>A. Net present value (dollars)</i>      |                |                      |  |             |             |              |              |
| \$300                                      | \$34           | 11.3%                | -8.08                                    | 14.37       | 36.83       | 59.28        | 81.74        |
| \$750                                      | \$49           | 6.5%                 | -22.53                                   | 0.94        | 24.41       | 47.87        | 71.34        |
| \$1,250                                    | \$59           | 4.7%                 | -32.47                                   | -8.59       | 15.28       | 39.15        | 63.03        |
| \$1,750                                    | \$74           | 4.2%                 | -47.01                                   | -23.03      | 0.96        | 24.95        | 48.93        |
| \$2,000                                    | \$89           | 4.5%                 | -61.27                                   | -37.34      | -13.40      | 10.53        | 34.47        |
| \$4,000                                    | \$89           | 2.2%                 | -62.61                                   | -38.15      | -13.70      | 10.76        | 35.22        |
| <i>B. Undiscounted net value (dollars)</i> |                |                      |  |             |             |              |              |
| \$300                                      | \$34           | 11.30%               | -9.00                                    | 16.00       | 41.00       | 66.00        | 91.00        |
| \$750                                      | \$49           | 6.50%                | -24.00                                   | 1.00        | 26.00       | 51.00        | 76.00        |
| \$1,250                                    | \$59           | 4.70%                | -34.00                                   | -9.00       | 16.00       | 41.00        | 66.00        |
| \$1,750                                    | \$74           | 4.20%                | -49.00                                   | -24.00      | 1.00        | 26.00        | 51.00        |
| \$2,000                                    | \$89           | 4.50%                | -64.00                                   | -39.00      | -14.00      | 11.00        | 36.00        |
| \$4,000                                    | \$89           | 2.20%                | -64.00                                   | -39.00      | -14.00      | 11.00        | 36.00        |

Source: Elliehausen (2005).

<sup>42</sup> Table 8.2 does not include any flow of services from the purchase during the time interval, nor does the table consider any non-pecuniary benefits such as convenience or reputation.

Other situations would produce different results. Panel A of Table 8.2 shows net present value calculated for different loan sizes benefits. In the example just discussed the net present value of the \$2,000 refund anticipation loan to obtain the item with a regular price of \$2,100 (\$100 saving) is found in the second from last row of the \$100 column. If the savings from purchasing the appliance on sale were only \$75, a negative net present value, -\$13.40, would be obtained (second from last row of the \$75 column). In this case, the consumer would be better off waiting for the tax refund and paying the regular price than using a refund anticipation loan to purchase the appliance on sale.

As in the payday loan example, the effect of discounting is very small, even at discount rates that are relatively high when stated on an annual basis. For the refund anticipation loan example shown in equation 8.3, the undiscounted net value is the \$100 savings from purchasing at the sale price less the \$89 refund anticipation loan fee. The undiscounted net value of \$11 is just \$0.47 greater than the net present value of \$10.53.

Over a broad range of plausible values of loan amount and savings the difference between the net present values and undiscounted net values are small. Panel B of Table 8.2 provides undiscounted net values for the refund anticipation loan amounts and savings amounts from Panel A. In nearly all cases, the undiscounted present value is within a few dollars of the net present value. In no case, would the undiscounted net value rule lead to a different decision than the net present value rule. This example suggests that an undiscounted net value heuristic would probably perform about as well as the optimizing net present value rule in evaluating choices involving short term credit.

### **C. High-Rate Credit Customers**

The economic model of consumer credit predicts that users of high price credit products would be consumers in early family life cycle stages who have limited discretionary income for servicing debt and face constraints to additional credit use. An examination of demographic characteristics of high price credit users suggests they generally have the characteristics that economic theory predicts.

#### *1. Age and Life Cycle Stage*

Consistent with the predictions of the economic model, users of high price credit products generally are young. Over half of pawnbroker loan, rent to own, and refund anticipation loan customers are under 35 years of age, and more than 36 percent of payday loan customers are less than 35 years of age (Table 8.3, panel A).<sup>43</sup> These percentages are considerably higher than the 28.6 percent of householders less than 35 years of age across all households.

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<sup>43</sup> The surveys for demographic information on high rate credit users in this table were conducted between 1998 and 2005. The statistics are from the following sources: Pawnbroker loans, Johnson and Johnson (1998); payday loans, Elliehausen and Lawrence (2001); rent to own transactions, Lacko, McKernan, and Hastik, (2000); income tax refund anticipation loans, Elliehausen (2005); and automobile title loans, Verant (2000). Statistics for bank credit card revolving credit users are from the University of Michigan Survey Research Center's January 2000 Survey of Consumers. The comparative statistics for all households are from an omnibus telephone survey of adults conducted in 2004 (Elliehausen 2005).

**Table 8.3**  
**Demographic characteristics of high-rate credit customers**  
(Percentage distribution)

|                            | Pawnbroker<br><u>loan</u> | Payday<br><u>loan</u> | Rent to<br><u>own</u> | <u>RAL</u> | Auto title<br><u>loan</u> | All<br><u>households</u> |
|----------------------------|---------------------------|-----------------------|-----------------------|------------|---------------------------|--------------------------|
| <i>A. Age of customer</i>  |                           |                       |                       |            |                           |                          |
| Less than 35 years         | 53.1                      | 36.4                  | 50.8                  | 61.0       | 28.6                      | 28.6                     |
| 35-44 years                | 31.1                      | 31.9                  | 28.6                  | 25.4       | 39.2                      | 21.3                     |
| 45-54 years                | 11.6                      | 21.7                  | 15.9                  | 10.4       | 17.1                      | 18.4                     |
| 55 years or older          | 4.3                       | 10.1                  | 4.5                   | 3.3        | 15.1                      | 31.7                     |
| <i>Total</i>               | 100.0                     | 100.0                 | 100.0                 | 100.0      | 100.0                     | 100.0                    |
| <i>B. Life-cycle stage</i> |                           |                       |                       |            |                           |                          |
| Less than age 45           |                           |                       |                       |            |                           |                          |
| Unmarried,<br>no children  | 11.1                      | 8.1                   | n.a.                  | n.a.       | n.a.                      | 13.7                     |
| Married,<br>no children    | 7.2                       | 4.8                   | n.a.                  | n.a.       | n.a.                      | 8.0                      |
| Married,<br>Children       | 35.2                      | 47.2                  | n.a.                  | n.a.       | n.a.                      | 19.2                     |
| Age 45 or older            |                           |                       |                       |            |                           |                          |
| Married,<br>children       | 5.0                       | 2.0                   | n.a.                  | n.a.       | n.a.                      | 5.1                      |
| Married,<br>no children    | 9.4                       | 4.2                   | n.a.                  | n.a.       | n.a.                      | 20.2                     |
| Unmarried,<br>no children  | 8.9                       | 5.4                   | n.a.                  | n.a.       | n.a.                      | 22.3                     |
| Any age                    |                           |                       |                       |            |                           |                          |
| Unmarried,<br>Children     | 23.3                      | 28.3                  | n.a.                  | n.a.       | n.a.                      | 11.5                     |
| <i>Total</i>               | 100.0                     | 100.0                 | n.a.                  | n.a.       | n.a.                      | 100.0                    |
| <i>C. Family income</i>    |                           |                       |                       |            |                           |                          |
| Less than \$15,000         | 38.5                      | 7.3                   | 27.0                  | 18.6       | 11.9                      | 19.3                     |
| \$15,000-24,999            | 26.4                      | 17.0                  | 33.5                  | 27.9       | 17.4                      | 15.1                     |
| \$25,000-49,999            | 29.1                      | 50.5                  | 33.2                  | 38.8       | 40.8                      | 30.6                     |
| \$50,000 or more           | 7.1                       | 25.2                  | 6.3                   | 14.8       | 30.2                      | 34.9                     |
| <i>Total</i>               | 100.0                     | 100.0                 | 100.0                 | 100.0      | 100.0                     | 100.0                    |

n.a. Not available

The 35-44 years age group also shows greater than proportionate percentages of pawnbroker loan, payday loan, rent to own, and refund anticipation loan customers. Although the percentage of automobile title loan customers who are under 35 is the same as in the whole population, the percentage of automobile title loan customers who are 35-44 years is nearly twice the percentage of the population in that age group. Older consumers generally have less demand for credit than younger consumers, and so older consumers also would be less likely than younger consumers to be in situations in which mainstream credit would not be available.

Elliehausen and Lawrence (2001) and Elliehausen (2005) also provide information on life cycle stage of high price credit customers; life cycle stage involves consideration also of marital status and children as well as age. These studies find that both payday loan and refund anticipation loan customers are concentrated in two life cycle groups: less than 45 years of age, married, and with children; and any age, unmarried, and with children (Table 8.3, panel B).

It is notable that these two life cycle groups are also more likely than households overall to be credit card revolvers, another source for borrowing small amounts for short periods of time. Such families are the ones that Juster and Shay hypothesized would be most likely to turn to high price credit to finance additional household investment, in large part because they have not yet accumulated substantial stocks of household durable goods and because their families are growing. This would mean that the return on additional durable goods and services could be quite high leading both to credit use and to concerns over liquidity.

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## 2. *Household Income*

High rate credit customers are also disproportionately drawn from low or moderate income segments of the population. These individuals are more likely than those with higher incomes to have limited discretionary income after necessities and to be more vulnerable to unexpected expenses (part 3 of Table 8.2). This characteristic of high price credit customers suggests both greater likelihood of being rationed and that liquidity sources may be important to them.

Differences in the income distributions across high rate credit products argues that the sub markets within high rate credit products may be somewhat segmented. For example, most pawnbroker and rent to own customers are drawn from the lowest income groups (less than \$15,000 and \$15,000-24,999). Only small percentages of pawnbroker and rent to own customers are in the highest income group. In contrast, most tax refund anticipation loan customers are in lower, but not the lowest income groups (\$15,000-24,999 and \$25,000-49,999). The majority of payday loan customers and almost two fifths of automobile title loan customers are in the moderate income group (\$25,000-49,999). Only small percentages of payday loan and

automobile title loan customers are in the lowest income group, but a quarter of payday loan customers and 30.2 percent of automobile title loan customers are in the highest income group in the table.

### 3. Credit Experiences

High price credit customers are less likely to have a credit card than households generally (Table 8.4, panel A). Only fifty-seven percent of payday advance customers have a bank credit card and 61.6 percent have any credit card, compared to 68.0 percent of all households having a bank card and 73.0 percent with any credit card. Other high price credit customers are even less likely than payday loan customers to have credit cards. Fewer than half of pawnbroker, rent to own, and refund anticipation loan customers have credit cards. Thus, many high rate credit customers are unable to turn to open end credit for short term borrowing.

**Table 8.4**  
**Financial characteristics of high-rate credit customers**  
 (Percent)

|  | Pawnbroker<br><u>loan</u> | Payday<br><u>loan</u> | Rent to<br><u>own</u> | <u>RAL</u> | Auto title<br><u>loan</u> | All<br><u>households</u> |
|--|---------------------------|-----------------------|-----------------------|------------|---------------------------|--------------------------|
| <i>A. Use of selected credit types</i>                             |                           |                       |                       |            |                           |                          |
| Any credit card  | 41.5                      | 61.6                  | 43.6                  | 43.1       | n.a.                      | 73.0                     |
| Bank card  | n.a.                      | 56.5                  | n.a.                  | 39.0       | n.a.                      | 68.8                     |
| Retail card  | 29.7                      | 21.5                  | n.a.                  | 15.0       | n.a.                      | 50.0                     |
| Automobile loan  | n.a.                      | 52.9                  | n.a.                  | 40.8       | n.a.                      | 33.5                     |
| Other closed-<br>end loan  | n.a.                      | 36.6                  | n.a.                  | 28.1       | n.a.                      | 21.4                     |
| <i>B. Ownership of bank accounts</i>                               |                           |                       |                       |            |                           |                          |
| Any bank account   | 63.6                      | 100.0                 | n.a.                  | 75.3       | n.a.                      | 90.9                     |
| Checking account   | 47.4                      | 100.0                 | 63.7                  | 66.9       | n.a.                      | 87.3                     |
| <i>C. Perceptions of credit availability over last 5 years</i>     |                           |                       |                       |            |                           |                          |
| Refused or limited<br>Did not apply<br>because refusal<br>expected | n.a.                      | 73.0                  | n.a.                  | 46.5       | n.a.                      | 21.8                     |
|  | n.a.                      | 67.7                  | n.a.                  | 48.2       | n.a.                      | 14.3                     |

n.a. Not available

Information on closed end credit use is also available for payday loan and refund anticipation loan customers. In contrast to open end credit, both payday loan and refund anticipation loan customers are more likely than all households to owe automobile and other closed end credit. Moreover, when they owe debt (regardless whether closed or open end), payday loan and refund anticipation loan customers are apt to have higher monthly debt service payments compared to income than all households (not in table). These findings are consistent with these customers being predominately in early life cycle stages, where heavy debt use is more prevalent, than in later life cycle stages.

Many high rate credit customers exhibit characteristics that make qualifying for additional credit difficult. Pawnbroker, payday loan, and refund anticipation loan borrowers are more than several times more likely than all families to have had a recent bankruptcy or serious delinquency (data not in table). Twelve percent of pawnshop borrowers had filed for bankruptcy in the last 10 years. More than a quarter of payday loan customers were 60 days or more past due on a payment sometime in the last year, and 15.4 percent had filed for bankruptcy in the last five years. Twenty-six percent of tax refund anticipation loan customers were 60 or more days past due sometime in the in the last year. In contrast, over all households, just 5.8 percent were 60 or more days past due sometime in the last year, and had 3.7 filed for bankruptcy in the last five years.

Further, large percentages of pawnbroker, rent to own, and refund anticipation loan customers do not have a checking or any bank account (Table 8.4, panel B). Over half of pawnbroker customers and a third or more of rent to own and refund anticipation loan customers do not have a checking account. Payday loan customers are the exception, since having a checking account is a requirement for obtaining a payday loan. It is notable that the use of mainstream credit products by income tax refund anticipation loan customers with bank accounts is similar to that of payday loan customers. They are more likely than all families to owe closed end credit (not in table). In contrast, tax refund anticipation loan customers with no bank account are less likely than all families to owe closed end credit.

Consistent with relatively high debt use, credit payment problems, and the frequent lack of a banking relationship, many high price credit customers experienced or perceived limitations in credit availability. Of the 32.2 percent of pawn loan customers who applied for other credit in the previous 12 months, 50.2 percent experienced a turn down. Seventy-three percent of payday advance customers and 46.5 percent of refund anticipation loan customers were turned down or limited in the last five years (Table 8.4, panel C). Almost half of payday loan customers and three-fourths of refund anticipation loan customers said that during the last year they thought about applying for credit but did not because they thought that they would be turned down.

Further evidence of credit constraints is available for payday loan and refund anticipation loan customers with bank credit cards, which consumers might use for short term borrowing of small amounts. Sixty-one percent of payday loan customers with a bank card and a third of refund anticipation loan customers with a bank card reported that they refrained from using a bank card in the last year because they would have exceeded their credit limit.

In sum, consumers using different types of high rate loans tend to be in life cycle and income groups that are associated with strong demand for credit and are often rationed: They are relatively young, and in early family life cycle stages. They also have lower or moderate incomes, depending on the product. Some (payday loan and tax refund anticipation loan customers with bank accounts) are more likely to use closed end credit than all families and apt to have higher debt burdens than families with debt generally. Others (pawnbroker, tax refund anticipation loan customers without bank accounts, and rent to own customers) are less likely than all families to use mainstream credit products. Regardless of their use of mainstream credit products, many high rate credit customers have characteristics that limit their access to credit, and most have experienced turndowns or perceive that they are constrained. Thus, the consumers that use high rate loans are the ones that economic theory predicts might benefit from relaxation of credit constraints.

That consumers using high rate credit products tended to have demographic and economic characteristics that are associated with credit rationing and rational use of high rate credit does not in itself does not indicate that their use of such credit is rational, but it does suggest that their circumstances are such that use of high APR credit may be utility increasing. In the next sections of this chapter, we will look for



evidence that these consumers understand the high rate products that they obtained and showed signs of deliberation in their decisions.

## **V. Are Consumers' Choices Involving High APR Credit Products Purposive and Deliberative?**

The standard economic analysis of consumer behavior focuses on the outcome of decisions. While this approach has been highly successful in predicting outcomes, it provides little insight into the actual decision process itself.

### **A. The Cognitive Model of the Decision Process**

To understand consumers' choices involving high rate credit products researchers have turned to cognitive models of consumers' decision processes from psychology (Nicosia 1966; Bettman 1979; Howard and Sheth 1969; Reynolds and Olson 2001; Blackwell, Miniard, and Engel 2006). The consumer's decision is modeled as a process occurring over several stages: problem recognition, internal and external search for information, choice, and outcome evaluation. These stages are interrelated, with feedback occurring throughout the process. Developments occurring during each stage may cause the process to stop, move to the next stage, or proceed immediately to the purchase.<sup>44</sup> Consumers may simplify, use heuristics, or take shortcuts during the decision process.

#### *1. Determinants of the Extent of the Decision Process*

Empirical evidence on consumer behavior suggests several different types of factors that may affect the extent of the decision process. They are situational factors, product characteristics, consumer characteristics, and environmental factors. Among the situations are those in which the consumer has little or no relevant experience because a consumer has never purchased the product, The consumer has no past experience because the product is new, past experience is obsolete because the product is purchased infrequently, or the purchase is considered discretionary rather than necessary.

There are several product characteristics that are associated with extended decision processes. Examples include products that commit the consumer for a long period of time, that are high priced relative to the consumer's income, and products having substitutes with both desirable and undesirable characteristics relative to the product.

Evidence also indicates that many socio-economic characteristics of consumers are correlated with the extent of the decision process. Some of the characteristics probably reflect cognitive ability and the opportunity cost associated with search time. Others may reflect experience or attitudes. Decision processes are more likely to be extended than limited when, other things equal, the consumer has a college education, has moderate rather than high or low income, is under 35 years old, enjoys shopping, and perceives no urgent or immediate need for the product.

Finally, environmental factors include family and cultural influences. An extended decision process may be stimulated by differences between a consumer's attitudes and those of his family or one of his reference groups. Thus, consideration of personal characteristics may be justified, even if the characteristics' effects on the decision process cannot always be predicted.

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<sup>44</sup> Economists also recognize that consumers may not obtain complete information about alternatives before making decisions. In the economist's framework, acquisition of information may be costly. A consumer will acquire additional information only if its expected benefit exceeds the cost. For discussion, see Stigler (1961).

## 2. *Hypotheses on the Extent of Decision Processes for High Rate Credit Products*

High rate credit products have characteristics that are associated with limited decision processes. Most are short term. Because loan amount is usually small, the finance charge is high relative to loan amount but not generally relative to the borrower's monthly income.

Situational factors may also limit decision processes. A short term to maturity makes high price credit products more suited to addressing temporary shortfalls in funds than financing investment in durables. Temporary shortfalls may often be the result of unexpected expenses and may therefore be viewed as urgent. Moreover, short term use to address temporary shortfalls in cash may involve relatively short time periods since previous decisions. In such situations, consumers may perceive that information obtained from previous decisions is not obsolete.

### **B. Decision Processes of High Rate Credit Customers**

The cognitive model of the decision process suggests that extensive collection of information and weighing of all available alternatives may not always be necessary for purposive and intelligent decisions. Some other benchmark for evaluating high price credit customers' decisions seems desirable. Katona (1975) assessed consumers' decision process for household durable purchases, which typically included consideration of credit, as follows:

If careful deliberation were defined as comprising all the features of decision making that were included in the study—consideration of alternatives and consequences, discussion with family members, information seeking, as well as concern with price, brand, quality, performance, special features, and gadgets—the conclusion would emerge that almost all people proceed in a careless way in purchasing large household goods. This conclusion, however, is not justified. Deliberation may be strongly focused on one aspect of the purchase to the exclusion of all others. Therefore, it may be considered as careful deliberation if some, but by no means all, of the features of problem solving and thinking are present. Thus, evidence that consumers understand the transaction and exercise some thought seems a reasonable benchmark for judging decisions on high-rate credit products.<sup>45</sup>

#### 1. *Small Consumer Finance Loan Decisions*

In 1972, Durkin (1975) conducted a study of consumers obtaining very small consumer finance loans in Texas (Chapter 301-F (subchapter 201); formerly Article 3.16 loans).<sup>46</sup> The maximum loan size at this time was \$100. Customer and loan information was obtained from lender files. Customers were also surveyed about their loans. The survey included questions about reasons for borrowing, awareness of loan price, and satisfaction with the loan.

Responses to the question on reasons for borrowing suggest some urgency for many consumers. The single greatest reason for borrowing was to pay old bills or consolidate debts. The next most frequently mentioned reasons were medical expenses and automobile purchase or repair. Together these three responses accounted for nearly two in five reported reasons. Adding other responses such as utility bills, food,

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<sup>45</sup> See also Day and Brandt (1973), Brandt, Day, and Deutscher (1975), and Shay and Brandt (1981) for analyses of consumers' credit decisions using a cognitive model of the decision process.

<sup>46</sup> Durkin and McAlister (1977) provide a similar analysis of customers obtaining larger, Chapter 342-E (subchapter 201) consumer finance loans.

and taxes or insurance suggest that most customers faced an urgent need for funds, which may have limited their decision process.

Information from lender files included the Annual Percentage Rate and finance charge, which permitted a comparison with reported Annual Percentage Rate and finance charge from the survey. Only 2.4 percent of customers were able to report an interest rate that indicated that they were aware of the Annual Percentage Rate. Thirty-nine percent said that they did not know, and 27.2 percent reported dollar charges. Virtually all of the remaining 31.1 percent of customers reported rates that were too low.

In contrast, two-thirds of customers reported a finance charge that indicated that they were aware of the finance charge. Thirty-eight percent reported the exact amount of the finance charge; another 8.3 percent reported an amount that was close ( $\pm 20$  percent) to the exact amount; and 20.1 percent reported an accurate finance charge for a different contract, which may have been a refinancing that occurred between the sampling and interview dates or a generalized price (\$34 per \$100 borrowed for 6 months, for example). Nearly all of the remaining one-third said that they did not know the finance charge or reported amounts that were too high or too low.

The relatively high level of awareness of the finance charge suggests that many consumers may have considered the finance charge in their decision.<sup>47</sup> Even if they did not use information on finance charges to shop for credit, it would be difficult to conclude that these consumers did not make informed decisions. In contrast, the lack of awareness of Annual Percentage Rates suggests that these consumers were unlikely to have used the Annual Percentage Rate in making their decisions.<sup>48</sup> The failure of virtually all customers to consider the effect of discounting, which may be the result of consumers simplifying their decision process, is not a serious error because of the very short term to maturity for these loans,

Most borrowers also had institutional knowledge of credit costs. That is, they were aware that finance company loans were more expensive than bank loans. About two-thirds of borrowers said that borrowing from a finance company was more expensive than from a bank. The decision to borrow from a finance company apparently was often influenced by consideration of credit availability. About half of customers who said that borrowing from a finance company was more expensive, reported that they borrowed from a finance company because they could not get a similar loan from a bank. Twenty-three percent of customers reported that they had actually been turned down by a bank or finance company in the last five years.

Consumers using very small consumer finance loans generally evaluated their purchase decision positively. When asked to evaluate whether the loan was worth it or not, 84.8 percent of customers said that the loan was worth it. Most customers gave reasons related to the need for funds as the reason for their satisfaction. Of those who said that the loan was not worth it, about half cited the high price as the reason for dissatisfaction. Seventeen percent of dissatisfied customers reported difficulty of getting out of debt as the reason for dissatisfaction, but these customers accounted for just 2.6 percent of all customers.

In sum, most customers used small consumer finance loans because they had an urgent need and did not have better alternatives. They were aware of the finance charge and were thereby able to make informed decisions, regardless of whether or not they shopped or had alternative sources of credit. Customers generally evaluated their decisions positively, saying that the loan was worth it because it provided needed funds.

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<sup>47</sup> Consumers using very small, short term consumer finance loans were had a greater level of awareness of the finance charge than consumers using mainstream credit. Day and Brandt (1973) found that a little more than half of consumers using mainstream credit products were able provide estimate of the finance charge.

<sup>48</sup> Durkin hypothesized that respondents may have disregarded Annual Percentage Rates as unimportant because they did not understand Annual Percentage Rates and saw no relationship between the Annual Percentage Rate and finance charge.

## 2. *Payday Advance Decisions*

Elliehausen and Lawrence (2001) surveyed a representative sample of payday loan customers of companies belonging to the industry trade association. Companies belonging to the association operated about half of the offices offering payday loans at that time. Customers were asked about their use of payday loans, recent payday loan decisions, other credit use, and perceptions of credit availability.

Payday loans are often used to address urgent needs. Nearly two-thirds of payday loan customers obtained their most recent new advance (not renewal) because of an unexpected expense or shortfall in income. Only 11.9 percent used a payday loan for a planned expenditure. The remaining 22.5 percent of customers used payday advances for various other purposes, some of which likely also were urgent.

Payday loan customers were generally aware of finance charges but not Annual Percentage Rates. Eighty-five to 96.1 percent of payday loan customers reported accurate finance charges paid for their most recent payday loan.<sup>49</sup> In contrast, only 20.1 percent of customers were able to report an accurate Annual Percentage Rate, although 78.0 percent of customers recalled receiving information on the Annual Percentage Rate. Thus, payday loan customers appear to use the finance charge rather than Annual Percentage Rate in their decisions. The short term use of the product suggests use of the finance charge in payday loan decisions usually did not cause consumers any significant harm.

Thirty-eight percent of customers reported that they considered another source before obtaining their most recent payday loan. Nearly all of the customers considering another source considered a depository institution or a finance company. That payday loan customers considered these sources is not surprising since their ownership of a checking account and relatively frequent use of mainstream credit suggests that they are familiar with these sources. In contrast, only 0.6 percent considered a pawnbroker, and 2.5 percent considered an automobile title loan company. Pawnbroker and automobile title loans do not appear to be very close substitutes to payday loans in the mind of payday loan customers.

About half of payday loan customers had been using payday loans for a year or less. Most use was short term, which is consistent with the design of the product. Over a quarter of payday loan customers' longest sequence of consecutive loans (new loan and renewals) was two weeks or less, and 56.6 percent of customers' longest sequence of consecutive loans was 6 weeks or less. Customers may have resorted to payday loans several times during the year, however. While a little more than a third of payday loan customers had four or fewer loans during the last 12 months, 27.2 percent had five to eight payday loans, and 38.1 percent had nine or more payday loans during the last 12 months. Most customers with a large number of loans had intervals between borrowings, but some had payday loan sequences lasting 14 weeks or longer. Obtaining a relatively large number of payday loans during the year or renewing existing loans frequently is expensive but not necessarily evidence of a problem. Consumers living from paycheck to paycheck may experience several unexpected emergencies during a year, causing them to need funds more frequently than

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<sup>49</sup> Because actual finance charges and Annual Percentage Rates were not known, consumers' knowledge of costs was based on awareness finance assessed on the basis of awareness zones. An awareness zone is a range of finance charges or Annual Percentage Rates that are available in the market. Respondents that report a value that falls within the awareness zone are classified as aware. For discussion of awareness zones, see Shay and Schober (1973) or Durkin (2000).

initially expected. However, such frequent payday loan use undoubtedly did not help some borrowers to manage their finances and may have exacerbated the difficulties of others.<sup>50</sup>

Nevertheless, by far most customers were satisfied with their most recent advance. Of the 12.2 percent of customers who were dissatisfied, 61.6 percent cited the high price as the reason for dissatisfaction. Difficulty of getting out of debt (which might indicate that customers did not understand that the product is designed for short term use) and lack of information about the product were rarely mentioned as reasons for dissatisfaction.

Conclusions about the payday loan decision are similar to those about the small consumer finance loan decision. Most customers used payday loans because they had an urgent need and had few alternatives. Customers generally used payday loans over relatively short time intervals consistent with the design of the product. They were aware of dollar cost of payday loans and evaluated their decision to use payday loans positively.

### 3. *Refund Anticipation Loan Decisions*

Elliehausen (2005) surveyed a nationally representative sample of refund anticipation loan customers about their refund anticipation loan decision, other credit use, and perceptions of availability. Forty-one percent of refund anticipation customers reported using refund anticipation loans to pay Christmas, credit card, or other bills; 21.2 percent reported unexpected expenditures; 12.9 percent reported planned purchases; and the remaining 25.0 percent reported various other reasons for using refund anticipation loans. Need may have played a role in refund anticipation loan customers' decision to use refund anticipation loans, but many customers may have another motive. Refund anticipation loans may be part of a precommitment strategy to force saving. About a third of refund anticipation customers said that they had extra amounts withheld in order to get a refund. The uses of the funds were often foreseen. More customers mentioned paying Christmas bills or planned expenses than unexpected expenses as the reason for obtaining a refund anticipation loan. And the behavior appears to have become a habit for many customers. Less than a third of RAL customers were first-time customers. Of the more than two-thirds of refund anticipation loan customers with previous experience, 72.3 percent had three or more previous refund anticipation loans.

About half of refund anticipation loan customers were classified as aware of the refund anticipation loan fee. Only about a quarter of recalled receiving an Annual Percentage Rate, and hardly any reported an accurate Annual Percentage Rate. The levels of awareness of the refund anticipation loan fee may be influenced by the greater complexity of the transaction. The refund anticipation loan was purchased jointly with tax preparation and possibly other services. Customers may have focused on another aspect of the transaction which they considered more important or more difficult. The level of awareness may also have been influenced by previous experience. As mentioned, many customers had obtained refund anticipation loans three or more times in the past. Customers who were satisfied with previous experience may make decisions with little information gathering or deliberation.

Virtually all customers were aware of an electronic filing option, and 64.8 percent of customers reported discussing other options for obtaining funds faster before obtaining the refund anticipation loan. Most customers not recalling the refund anticipation loan fee were able to report other information about the transaction. Half reported the tax preparation fee, nearly three-fourths reported the cash advance amount,

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<sup>50</sup> Factors associated with difficulty in managing finances such as not saving, relatively heavy credit card indebtedness, and overdrawing checking accounts are associated with frequent use of payday loans (Lawrence and Elliehausen 2008, Elliehausen 2009).

and a third reported both the loan and cash advance amounts. Thus, customers may have considered some information in decisions about refund anticipation loans.

Considering the high level of repeat usage, it is not surprising the refund anticipation loan customers generally were also satisfied with current loans. Eighty-five percent of customers said that they were satisfied with their last refund anticipation loan. Virtually all satisfied customers reported the quick receipt of needed money as a reason for satisfaction. Of the 14.0 percent of customers who said that they were dissatisfied, 70.2 percent cited the high price as a reason for dissatisfaction. Lack of information was not perceived as a problem. Eleven percent of dissatisfied customers mentioned inadequate information as a reason for dissatisfaction.

Although only about half of customers were aware of refund anticipation loan cost on their most recent loan, it is not clear that decisions were not purposive and intelligent. Customers were able to report information about their loans. Virtually all were aware of the electronic filing, and more than half discussed other options for receiving funds faster before obtaining a refund anticipation loan. Evidence also suggests that refund anticipation loans are part of an annual forced saving plan, in which some customers use tax withholding to accumulate funds for large purchases or paying Christmas, credit card, or other bills.

#### 4. *Rent to Own Decisions*

Lacko, McKernan, and Hastak (2000) surveyed a nationally representative sample of rent to own customers about their experience with rent to own stores. A major focus of the survey was to ascertain the extent to which rent to own transactions result in the purchase of rented items. Survey responses indicate that 69.9 percent of customers purchased items that they rented. Three-fourths of customers initially intended to purchase the rented item. Purchases were consistent with customer purchase intentions. Eighty-seven percent of customers intending to purchase actually did purchase. About half of purchases were rented for a year or less, suggesting that many customers exercised the early purchase option. Nearly all items on which customers made substantial payments towards ownership were purchased by the customer.

A quarter of rent to own customers intended a temporary rental.<sup>51</sup> Ninety percent of these customers returned the item. Most returned the items after a relatively short period, averaging five months. The relatively short rental period is consistent with these customers' initial intentions.

By far most were satisfied with their rent to own experiences. Seventy-five percent of customers said that they were very or somewhat satisfied. Eight percent said that they were somewhat dissatisfied, and 10.5 percent said that they were very dissatisfied. The remaining 6.5 percent were neither satisfied or dissatisfied or said that they did not know.

Lacko, McKernan, and Hastak did not question respondents about costs, but responses to questions about satisfaction with rent to own experiences suggest that many respondents were aware that the price is high. When asked why they were satisfied or dissatisfied with their rent to own experience, 26.7 percent of all customers mentioned high price as a reason.

High price was the most commonly reported reason for dissatisfaction. Two-thirds of dissatisfied customers said that they were dissatisfied with their rent to own experience because of high prices.

Satisfied customers typically reported characteristics of the item being rented or services provided by the rent to own company as a reason. However, 16.1 percent of satisfied customers said that because of high

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<sup>51</sup> The remaining 8.1 percent of customers were not sure or did not know their intentions. About half of those who were not sure or did not know their intentions eventually purchased the items.

prices they were only somewhat satisfied. The percentage of satisfied customers mentioning high prices is far greater than the 3.5 percent of satisfied customers cited low price as a reason for satisfaction.

Very few customers gave inadequate cost information as a reason for their evaluation. Five percent of dissatisfied customers (1.0 percent of all customers) reported hidden or added costs as a reason for dissatisfaction.

The consistency of purchase intentions with actual behavior suggests that rent to own customers generally know whether they will purchase the item at the beginning of the rental period. The survey evidence indicates that at least a quarter of customers believe that rent to own prices are high. The actual proportion of customers believing that rent to own prices are high may be greater. Customers may have been aware of that purchasing items using rent to own is relatively expensive but did not volunteer this information when responding about their reasons for satisfaction or dissatisfaction. It is therefore likely that many consumers who intended to purchase were aware that rent to own purchases are expensive. Nevertheless, most customers evaluated their rent to own decisions positively. The analysis of customer characteristics in a previous section of this paper suggests that limited availability credit from other sources likely have played a role in their decisions.

## **VI. Do Consumers Benefit from Access to High Rate Credit Products?**

The review of available empirical evidence in previous sections indicates that users of high rate credit products are typically rationed consumers, which theory suggests are may benefit from availability of high rate credit, and that users of high rate credit to varying degrees show some signs of deliberation in their decisions, although decision processes tend not to be extensive. The ultimate question is whether or not consumers benefit from the use of such credit. A few recent researchers have attempted to test empirically whether consumers benefit from access to payday loans using a variety of different ways to measure possible benefits.

### **A. Community Well Being in the Aftermath of Natural Disasters**

Morse (2006) examined the effect of availability of payday loans on measures of community well-being after the occurrence of floods, fires, or other natural disasters. Natural disasters, she argued, create a natural experiment in which the treatment, financial distress, is exogenously induced on communities with and without access to payday loans. To obtain a comparison group of comparable communities that did not experience financial distress, she matched disaster and non-disaster communities (defined as ZIP-code areas) on the degree to which residents in the community were credit constrained (a characteristic that Elliehausen and Lawrence (2001) argued was strongly related to payday loan demand) before the disaster. Morse considered two types of variables that have a negative effect on well being, home foreclosures and small property crimes (larceny, vehicle thefts, and burglaries). Increases in financial distress may lead to greater mortgage defaults and ultimately foreclosures. She hypothesized that if payday loans increase welfare their availability would mitigate negative effects of disasters and hasten a return to normal life following distress.

Morse's regressions indicate that areas with payday lenders recovered more quickly following a natural disaster—with fewer foreclosures, deaths, and admissions to alcohol and drug abuse treatment programs and with more births—than areas without payday lenders. For each measure of well-being, the estimated coefficient for the effect of payday loans (that is, the interaction of treatment, post-disaster time group, and availability of payday loans) had the hypothesized sign (negative for the negative measures and positive for

the positive one) and was with one exception statistically significantly different from zero.<sup>52</sup> On the basis of these findings, Morse concluded that despite its high price, payday lending increases welfare by increasing communities' resiliency to financial difficulties.

## **B. Financial Difficulties and Payday Loan Bans**

Morgan and Strain (2008) examined changes in the number of returned checks, complaints about collection behavior against lenders and debt collectors, and bankruptcies following legislation in Georgia and North Carolina that permanently closed all payday lenders operating in these states.<sup>53</sup> If payday loans exacerbate financial strain, then their availability would be expected to increase problems with returned checks and debt servicing. If instead payday loans help manage financial strain, Morgan and Strain hypothesized, availability of payday loans would be associated with lower levels of such problems. They examined post-payday-ban changes in North Carolina relative to other states not experiencing a change in payday lending laws.<sup>54</sup>

Morgan and Strain's findings indicated that consumers' problems generally increased significantly in Georgia and North Carolina relative to other states following the payday loan bans. The number of returned checks increased, although the increases for North Carolina were not statistically significant. Complaints about collection behavior of debt collectors increased in both states following the bans. Complaints against lenders, which were far less numerous than complaints against debt collectors, increased in Georgia but declined by a small amount in North Carolina following the payday loan bans. Chapter 7 bankruptcies increased significantly in both Georgia and North Carolina. Chapter 13 bankruptcies, which involve continued payments to creditors rather than debt discharges, decreased in Georgia and North Carolina relative to other states following after payday loans were banned. The difference in the estimated effect of the payday loan bans on Chapter 7 and Chapter 13 bankruptcies might be explained by greater difficulty in managing finances when payday loans are no longer available. Removing a means of managing finances might prompt a debt-strapped borrower to choose a Chapter 7 debt discharge rather than seek a workout under a Chapter 13 plan.

Zinman (2008) provides further evidence on effects of restrictions on payday loans. Zinman examined panel data from surveys of payday loan customers before and five months after Oregon imposed a restrictive rate ceiling, which caused many payday loan companies to exit the state. Zinman found that the use of payday loans in Oregon fell relative to Washington, the comparison group state for his analysis. Use of several other types of short-term credit (automobile title loans, credit card advances, and bank overdraft credit lines) individually in Oregon did not increase significantly relative to Washington. Apparently these loan products

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<sup>52</sup> In an earlier version of the paper, Morse considered three negative effects on well-being (foreclosures, mortality, and admission to drug and alcohol abuse treatment programs) and one positive effect (births). Increases in distress may cause delays in medical treatments resulting in higher mortality or alcohol and drug abuse with consequent need for treatment. And financial distress may delay the formation or expansion of families, with fewer foreclosures, deaths, and admissions to alcohol and drug abuse treatment programs and with more births—than areas without payday lenders. She hypothesized that if payday loans.

<sup>53</sup> Georgia passed legislation making payday lending a felony subject to class-action lawsuits and prosecution under racketeering, effective May 2004. The North Carolina Commissioner of Banks effectively ended payday lending when it ruled that payday lending through a local agent of a national bank, which was the method for payday lending in North Carolina after the 2001 expiry of the payday loan exemption to the state's usury limits, was a violation of North Carolina law.

<sup>54</sup> For two of the three types of problems, Morgan and Strain also considered liberalization in Hawaii's payday loan law (an increase in the maximum loan size for payday loans from \$300 to \$600 in July 2003), which would have the opposite effect of a ban. (They were unable to consider changes in check returns because Hawaii does not have a Federal Reserve check processing center.) Relative to other states, complaints about collection behavior of debt collectors and lenders in Hawaii decreased, Chapter 13 bankruptcies decreased, and Chapter 7 bankruptcies increased significantly after Hawaii increased the payday loan size limit.



were not available to former payday loan customers or were not generally viewed as close substitutes for payday loans. The incidence of returned checks and late payments of bills did not change significantly either. Taken together, however, the use of any short-term credit (including payday loans) in Oregon declined significantly relative to Washington, but the decline was smaller in size than that for payday loans alone. Thus, collectively these non-payday forms of short-term credit appeared to make up for some of the loss in payday loan credit, even if on one product was an especially close substitute for payday loans.<sup>55</sup>

Zinman also examined customers' perceptions of credit availability and their own financial situation. Five months after Oregon's restrictive rate ceiling became effective, payday loan customers in Oregon reported more frequently relative to customers in Washington that short-term credit was more difficult to obtain in the last three months. After the rate ceiling became effective, customers in Oregon did not more frequently report a worsening of their financial situation in the previous six months. However, after the rate ceiling, a greater proportion of customers in Oregon relative to customers in Washington said that they expected their financial situation to get worse in the future. Whether availability of short-term credit was related to customers' assessment of their financial situation was not examined.

Meltzer (2011) analyzed data from the Urban Institute's National Survey of America's Families for households in Massachusetts, New York, and New Jersey, states that because of restrictive laws had no payday loan company offices during the study period. Each of these states bordered states that had payday loan offices. He compared different measures of distress for households in border counties that were near out of state payday loan offices and households living in counties that did not have proximate availability of payday loans. Measures of distress included inability to pay rent or bills in the past year, moving residence for financial reasons, reducing meals for financial reasons, doing without telephone services, and delaying medical treatment due to lack of insurance or money.

Melzer's regressions predicting the incidence of different types of financial distress in the last 12 months indicated that payday loan access (that is, living in a county that is near out of state payday loan offices) was associated with higher, generally statistically significantly higher incidence of distress for households having incomes between \$15,000 and \$50,000, the range of income in which payday loan use is concentrated. Access to payday loans was not significantly related to distress for lower income households (which often did not qualify for payday loans because they did not meet lenders' checking account ownership or regular income requirements) or higher income households (which generally have access to lower cost sources of credit).

### **C. Payday Loans and Bankruptcy**

Skiba and Tobacman (2008) investigated whether or not a borrower's use of payday loans was associated with greater likelihood of bankruptcy filing. The data for their analysis were from loan applications at a payday loan company's Texas offices. The applications were matched with public records on bankruptcy filings, which allowed Skiba and Tobacman to identify payday loan applicants whose subsequent credit problems led them to file for bankruptcy. Skiba and Tobacman used a statistical model to estimate the effects of payday loans on marginal customers. The margin was a threshold payday loan risk score. The risk score was developed by a credit reporting firm that specializes in the non-traditional credit performance data. The risk score is a prediction of credit risk specific to payday lending. Individuals just above the threshold

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<sup>55</sup> Zinnman did not consider pawnshop, non-cash advance credit card borrowing, and loans from friends or relatives, which may also be substitutes for payday loans in some cases.

were offered payday loans. Individuals just below were rejected, but because their scores were nearly equal to those of marginal accepted applicants, Skiba and Tobacman argued, their unobserved financial characteristics were similar to those of accepted applicants, making marginally rejected applicants suitable as a comparison group.

In regressions for the probability of bankruptcy filing, Chapter 7 bankruptcy filings were not significantly different for applicants whose first application was approved and applicants whose first application was not approved, but Chapter 13 bankruptcy filings were significantly higher for applicants whose first application was approved. The statistical association between payday loan approval and Chapter 13 bankruptcy filing does not imply that payday loan approval caused bankruptcy filing, however. Payday loan use is typically a response to financial distress, which may ultimately end in bankruptcy.

Skiba and Tobacman were able to provide information on the financial condition of the applicants who subsequently filed for bankruptcy. These applicants had substantial debts: Applicants whose first applications were approved, for example, reported on average \$103,783 in secured debt and \$34,171 in unsecured debt, which in total was 1.7 times greater than their total assets.<sup>56</sup> These applicants had substantial debts and an economic incentive to file for bankruptcy. Twenty-three percent of the applicants who filed for bankruptcy had payday loans outstanding, sometimes at more than one payday loan company, at the time they filed for bankruptcy, but payday loans constituted a very small fraction of applicants' \$34,171 of unsecured debt. Payday loans likely did hasten some of these consumers' decision to file for bankruptcy. However, it is far from clear that payday loans drove most of these consumers into bankruptcy. The \$54 dollar finance charge for the average \$300 payday loan was an insignificant fraction of the average monthly income of these consumers.<sup>57</sup> Thus, payday loans would seem to be a factor in some bankruptcy decisions but not in others.

Mayer (2004) provides additional evidence supporting a conclusion that payday loans may contribute to but do not play the definitive role in bankruptcy filing decisions. Mayer examined a sample of 3,600 bankruptcy petitions in three counties in different parts of the country. Payday loans were listed in 9.1 percent of the petitions. For petitioners with payday loans, payday loans were a very small percentage of total unsecured debt. The median percentage of payday loans to total unsecured debt was six percent. The percentage of credit card debt was over five times greater.

In many cases, payday loans may have contributed to petitioners' financial difficulties. Sixty percent of petitioners with payday loans owed more than one payday loan. The distribution of number of payday loans varied widely. In a few cases, petitioners accumulated substantial payday loans. Mayer reported that the largest number of payday loans owed by a petitioner was 23 for a total of \$5,675 and that another petitioner owed 21 payday loans totaling \$5,985.<sup>58</sup> In these cases, the total amount of payday loans was greater than net monthly income. These two examples are extreme cases and not usual. The median number of payday loans was two. The median amount of payday debt was \$880, which was 46 percent of net monthly income.

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<sup>56</sup> Nearly one percent of the applicants filed for Chapter 7 bankruptcy within two years of the first application, and 1.56 percent applied for Chapter 13 bankruptcy. Applicants whose initial payday loan application was rejected and subsequently filed for bankruptcy had on average \$145,317 in secured debt and \$32,221 in unsecured debt. Total debt was on average 93 percent of total assets, but more than half of these applicants reported debts greater than assets.

<sup>57</sup> Skiba and Tobacman reported average monthly pay of \$1,699 for the entire sample.

<sup>58</sup> One case involving an accumulation of 17 payday loans appeared to be fraudulent. Using a closed checking account, the petitioner obtained 14 of the 17 loans at different branches of the same company in a two-week period before filing for bankruptcy. The payday loan company challenged the discharge of debt and eventually obtained an agreement with the petitioner for repayment of the principal.

These petitioners had substantial debts and probably would have ended up filing for bankruptcy anyway, but payday loans likely hastened the outcome. That these cases often involved different payday lending companies and frequent renewals underscores the risk of such behavior to both customers and lenders.

For the 40 percent of petitions with payday loans with just one payday loan, the average amount of the payday loans was about \$350, which was 1.3 percent of the amount of unsecured debt of petitioners with payday loans. The cost of servicing a \$350 payday loan—that is, the finance charge—would be about \$53 or 2.4 percent of the average net monthly income of unsecured debt of petitioners with payday loans. It is unlikely that payday loans drove these petitioners to bankruptcy.

#### **D. Payday Loans and the Military**

Carrell and Zinman (2008) investigated the effect of payday loan access on indicators of performance of US Air Force personnel at all 67 bases in 35 states. They note that base assignments are at the discretion of the Air Force and are based on airmen's occupation and experience satisfying the personnel needs of the Air Force. Thus, airmen vulnerable to financial distress do not have choice in locating in places where payday loans or any other types of credit are readily available. Airmen's access to payday loans is, therefore, random. As measures of performance Carrell and Zinman considered forced enrollment in a weight loss program, presence of an unfavorable information file, and eligibility for reenlistment. Eligibility for reenlistment depends on job performance. The first two measures also influence eligibility for reenlistment. Performance data were outcomes aggregated by occupation, enlistment term, base, and year.

Regression analyses indicated a statistically significant positive relationship between availability of payday loans and two measures of performance (presence of an unfavorable information file and eligibility for reenlistment) for first term airmen. Availability of payday loans was not significantly related to any measure of performance for more experienced second term or career term airmen. Carrell and Zinman found that the positive relationship was with one exception limited to airmen with non finance/acquisition occupations and lower Air Force Qualifying Test scores. The exception was that for high test score airmen availability of payday loans was positively related to enrollment in a weight loss program. These findings suggest that any unfavorable effects of payday loans on performance were largely among inexperienced and financially unsophisticated airmen. The statistically significantly positive relationship between payday loan availability and enrollment in a weight loss program for high test score airmen, however, is puzzling.

#### **E. Experimental Studies**

Wilson *et al.* (2008) conducted an experimental study investigating how availability of payday loans and overdraft protection affected subjects' ability to manage a hypothetical household budget over a 30-month interval, which was implemented by computer simulation. The budget consisted of monthly bills and income that placed subjects in tight financial situations. The subjects were university students. The students were paid to participate, with the amount of payment depending on the students' performance. Subjects were required to maintain a minimum level of consumption and were offered optional discretionary consumption opportunities. Monthly bills included regularly recurring payments and unexpected expenses. Failure to pay bills resulted in penalties that were deducted from consumption. Subjects were required to pay any missed bills and late fees in order to continue to the next month (and increase the amount of the payment for participating in the experiment). Some subjects had payday loans or overdraft protection as alternatives to missing bills.

An analysis of subjects' performance indicated that subjects' likelihood of surviving to month  $t$  (satisfy obligations while maintaining the minimum required consumption level) was inversely related to the level of

average monthly consumption to income. That is, subjects who consumed a larger share of their monthly income were less likely to survive. Availability of payday loans increased the likelihood of survival by 31 percent, but a greater number of payday loans used reduced the likelihood of survival by about 3 percent for each additional loan. This finding suggests that availability of payday loans potentially could increase consumers' well-being and that benefits likely diminish as use becomes more frequent. Whether the performance of students in managing hypothetical budgets reflects the ability of distressed consumers managing actual budgets is not beyond doubt, however.

Karlan and Zinman (2010) analyzed data from a field experiment in South Africa. A lender randomly reconsidered applicants for short-term, high-rate small loans to consumers who would marginally be rejected under the lender's standard underwriting criteria. Reconsidered applicants, which formed the treatment group, were offered a four-month instalment loan with an annual percentage rate of 200 percent. The control group consisted of still rejected applicants. They evaluated consequences of providing the loan over the medium term using data from a survey conducted six to 12 months after the application and over the longer term using credit scores 13 to 15 months and 25-27 months after the application. Although the loan product in this study is not a payday loan, the results provide evidence on whether or not short-term borrowing at triple-digit interest rates increases rationed consumers' well being.<sup>59</sup>

Analysis of the data indicated that the control group of rejected applicants did not obtain the loan elsewhere and that overall the treatment group increased its total borrowing and shifted much of their borrowing from informal to formal sources of credit in the 6 to twelve months following the initial loan by the lender. Moreover, the percentage of applicants in the treatment group that had credit scores increased relative to the control group one and two years after the initial loan. The increase in the percentage with credit scores indicates increased credit use, since having little or no credit history is usually the reason for lack of a credit score. Thus, differences between treatment and control groups can be interpreted as effects of relaxation of credit constraints among rationed borrowers.

Karlan and Zinman considered a variety of tangible and subjective measures of well-being for the 6 to 12 months following the initial loan. They found positive effects on job retention, income, food consumption, and mental outlook for the treatment group relative to the control group. They found one negative effect on mental health (principally stress), however. Over the longer term, Karlan and Zinnman found no deterioration in credit scores for the treatment group relative to the control group one and two years after the initial loan. These findings suggest that access to high-rate credit produced benefits in the medium term without a deterioration in applicants' performance in using and servicing debt.

## **VII. Conclusions**

This discussion of high-rate credit products has employed an economic model of the consumer's credit decision and a psychological model of the decision process to evaluate consumers' decisions to use high rate credit products. The model predicts circumstances in which high-rate credit permit a consumer to increase utility or wealth. The economic model helps answer the question: are the borrowers using high rate loans likely to benefit from use of such credit? The psychological model is a cognitive model describing the decision process from the recognition of a problem through information gathering to the post-purchase evaluation of the decision. The cognitive model of the decision process helps answer the question: are borrowers' decisions purposive and intelligent?

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<sup>59</sup> The experiment was part of the lender's evaluation of its underwriting criteria for short-term, high-price loans.

Evidence presented indicates that customers of high rate credit products disproportionately have characteristics of groups that economic theory predicts might benefit from use of higher rate credit. Customers are concentrated in relatively early life cycle stages and have children. Customers have low or moderate incomes, depending on the product. And customers are credit constrained (rationed). Some (payday loan customers and refund anticipation loan customers with bank accounts) tend use more credit than all families and have experienced credit problems. Others (pawnbroker loan customers, refund anticipation loan customers with no bank accounts, and rent to own customers) have characteristics that make qualifying for credit difficult and are less likely than all families to use mainstream credit products.

Most consumers using high rate credit products are aware of the cost of such credit. They generally are able to recall reasonably accurate finance charges but are largely unaware of Annual Percentage Rates for recent loans. Because most high rate loan products have a short term to maturity knowledge of the finance charge is generally sufficient for making informed decisions. Consumers can evaluate costs and benefits without consideration of their timing. Net undiscounted benefits will not differ much from net present value of benefits.

Many customers show signs of deliberation in their decisions, but most probably do not have an extended decision process. Many customers have previous experience with the product and may not exert much effort in subsequent decisions. Relatively low loan amounts and short terms to maturity also may contribute to lack of awareness and lack of deliberation. Customers are largely satisfied with their decisions and generally do not believe that they have insufficient information. Decision processes for high price credit products do not appear to be much different from decision processes for mainstream credit products. The decision to use high price credit typically is a result of the consumer's situation rather than a lack of knowledge or information.

Efforts to determine whether or not consumers actually benefit from high rate credit products have focused largely on payday loans. They examine a wide variety of outcomes, many of which are quite far removed from the circumstances of the payday loan decision. That a \$300 two-week loan used by a very small proportion of the population could significantly influence outcomes such as property crime rates, bankruptcy rates, job performance, or check returns seems incredible. To be convincing, these studies must assure that the differences in outcomes are caused by differences in payday loan access rather than something else and that the consumers who have access to payday loans are similar to consumers who do not. It is not clear that these studies have succeeded. State laws that regulate payday lending are the product of a political process that also produces laws affecting many other aspects of the local economic and social environment, including the availability of other financial services, quality of educational services, and the types of employment opportunities. A state that sharply limits personal or auto loan rates, for example, would hardly be inclined to authorize rate ceilings that permit payday lending. Geographic proximity or accounting for differences in a limited set of economic or social variables is unlikely to eliminate entirely the effects of other influences on outcomes. Thus, while suggestive, these studies are not fully convincing.<sup>60</sup>

The most convincing evidence to date on the effects of high rate credit is from Karlin and Zinman's (2010) experimental study, which granted small, short term, high rate instalment loans to random sample of marginal rejected applicants at a South African lender. Greater levels in various self reported measures of well being and longer term improvements in credit scores for applicants who obtained the loans than for applicants who did not receive loans suggest that access to high rate credit produced benefits in the medium term without a deterioration in applicants' performance in using and servicing debt. Further evidence for

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<sup>60</sup> See Casky (2010) for further discussion of these studies.

different lenders and other types of high rate credit is necessary to generalize beyond this one experiment, however.

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