South Dakota Legislative Research Council

Issue Memorandum 02-03

ALTERNATIVE LENDING AND LEGISLATIVE POLICY

Preface

During the 2002 Legislative Session, one of the most vigorously contested bills dealt with the regulation of payday lending. Although compromise legislation passed, neither side seems completely satisfied with current provisions. It is likely that the 2003 Legislature will see additional efforts to address these issues; and, as a result, the Executive Board of the Legislative Research Council has requested staff to prepare an issue memorandum on the subject of alternative lending.

Because of the broad scope of the subject matter, it would be only too easy to reproduce dozens of pages of supporting materials. This approach has been rejected here because of the excessive length, the conflicting claims, and the likelihood that some party to the debate would feel aggrieved due to failure to adequately address their viewpoints. For those who wish to sample the plethora of statistics, statutes, proposals, and studies that are available, an appendix of websites has been included at the conclusion of this memo. The memo itself will take a broader approach and touch on the entire alternative lending industry and legislative policy considerations with regard to that industry.

Types of Alternative Lending

Pawnshops. Pawning is the oldest, most traditional means of securing small amount, short-term, high interest loans. Pawnshops have existed since time immemorial and are still found in abundance in the inner city, near armed forces installations, in places with large migrant workforces, and other areas of economic depression. Pawnbrokers advance small sums of money at high interest rates secured by tangible personal property that the borrower deposits physically with the pawnshop. The borrower may then redeem the property by repaying the principal and interest (and sometimes a storage charge) before the expiration of a set period of time. Or the borrower may default on the loan, in which case the pawnbroker has the right to sell the pawned security.

Although interest rates are high and sometimes usurious at pawnshops, much of pawnshops' profits come from the practice of lending much less than the resale value of the pawned item. Many, if not the majority, of pawned items are subsequently forfeited. In fact, state or municipal regulation of pawnshops frequently focuses on the use of pawnshops to fence stolen property rather than consumer protection issues or usurious interest rates. Nevertheless, honest but impecunious borrowers frequently lose valuable personal property at a fraction of cost or even resale value because they do not have the cash necessary to redeem the pawned item. Thus, if a ring valued at $500 retail, with a $300 resale value is pawned for $150 and subsequently forfeited, although neither usury or fraud is present, the borrower has nevertheless paid a very high price for access to credit.

Credit Cards. One of the truly revolutionary financial innovations of the postwar economy has been the introduction and universal acceptance of credit cards. Although credit cards have a myriad of uses beyond the scope of this memorandum, they are unique in the field of alternative lending in that they permit cardholders to, in effect, unilaterally borrow small sums of money at will from the card issuer. This can be accomplished either by a cash advance or by accumulating an owed balance on delayed payment purchases. Interest rates on credit card balances vary widely but tend to cluster near the upper end of commercial lending rates. Many special fees may apply, which, though clearly set out in the credit agreement, are usually little known to the borrower until assessed against him.

This self-loan feature of credit cards can be extremely useful and convenient for someone needing to borrow small amounts for short periods. There are, however, insidious aspects to this type of borrowing that can constitute serious pitfalls to the unwary. As long as interest, fees, and minimum payments are being timely made by the borrower, the credit card company is, rightfully so, content to allow the cardholder to manage his own credit situation. But if payments are missed, which is usually because the creditor has overextended himself, the company is frequently quick to make repayment demands beyond the cardholder's immediate ability to pay.

Debt Consolidation. Accumulation of excessive credit card debt is often the entry point to another type of alternative lending, i.e. debt consolidation. Although often advertised as a counseling service, the essential nature of debt consolidation is usually that of refinancing. In most cases, none of the borrower's debts are actually forgiven. Rather a financing company, usually the debt consolidation service itself or some other credit institution for whom it is acting as an agent, agrees to restructure the borrower's high interest, short term, multisourced debts as a single source, moderate interest, mid-term debt obligation. The debtor pays everything that he owes, but over a longer period of time at a lower interest rate. Sometimes the debt consolidation service charges the borrower directly for its services; sometimes it is compensated by a commission from the lending institution. While debt consolidation is a very useful tool to assist overextended borrowers to work their way out of debt, it usually comes at some additional direct or indirect cost to the client.

Rent-to-Own. Another innovative credit mechanism spawned by postwar consumerism is the concept of renting-to-own various "mid-ticket" consumer items, such as televisions, appliances, and furniture. Under this concept, consumers "rent" an item, such as a refrigerator, making a periodic payment, a predetermined portion of which is allocated to the purchase of the item. If the consumer makes all of the payments in a timely manner, ownership of the item will eventually be transferred to him. If the consumer falls behind, the item is subject to repossession and the consumer will lose his "equity" in the item.

Although renting-to-own can be beneficial to prudent, low-income consumers, it is difficult for the financially unsophisticated to balance the competing rent and purchase components of rent-to-own agreements. Frequently, the consumer ends up paying additional fees for rollovers, repairs, delivery, or repossession in addition to the periodic payment. All in all, renting-to-own is frequently a fruitful source of consumer dissatisfaction.

Payday Loans. Payday loans, or deferred deposit loans, are currently the fastest growing form of alternative lending. In some ways reminiscent of the old-fashioned promissory note, a typical payday loan transaction will involve the borrower writing a personal check to the lender for which the borrower receives cash, usually discounted for fees and interest. Usually repayment is due in the very short period of a week or two, and the fees involved are likely to be a more significant component of the cost than the interest. The borrower can redeem the check on the due date by paying the face amount, allow the lender to cash the check, or, with the approval of the lender, roll the loan over in compensation for an additional fee. The lender typically will rely on the state's bad check law to secure payment of any dishonored check, sometimes with any additional civil penalties permitted by statute. It is, in fact, the use of the bad check law, which gives payday lending its financial viability since the private collection of dishonored promissory notes would be prohibitively expensive as the primary enforcement strategy for small loans.

Auto Title Loans. Another specialty area of alternative lending is the auto title loan. Auto title lenders make small amount, high interest loans, usually buttressed by significant fees, to borrowers who are willing to deposit or encumber their car titles with the lender. The lender, in effect, enforces repayment by inhibiting clear title to the borrower's vehicle or, in some cases, by impounding or repossessing the vehicle. Although the car used for collateral in this type of loan is not likely to have much resale value, the loss of the vehicle to the borrower, even temporarily, is often an unacceptable option to repaying the loans. Auto title loans were very popular a few years ago, but are generally declining today because of the competition of payday loans. The costs and inefficiencies of executing on collateral, such as an auto title, is usually much higher than collecting bad checks, thus giving payday loans a significant competitive advantage.

Commercial Loans. Although commercial loans are, by definition, traditional, rather than alternative lending, it must be noted that many commercial lenders, such as banks, savings and loan associations, and credit unions, have demonstrated an increased willingness to make short-term loans for relatively small amounts than was their custom in the past. In part, this change is a reaction to the rise of alternative lending, especially, in my opinion, credit card lending. However, an appreciation for customer service is certainly a contributing factor as is the trend to deregulate certain restrictions on interest rates and service fees.

Loan Sharking. Finally, although it is obviously illegal, it is important to mention loan sharking, which is still widely practiced today in areas where organized crime continues to flourish. The physical violence, extortion, and racketeering associated with loan sharking continue to color middle class attitudes toward small loan lending to the detriment of the alternative lending industry.

Legislative Policy Considerations

As legislators survey the new lending environment and the innovative credit mechanisms and instruments that are gaining wide public acceptance, it may be appropriate to survey a few traditional public policy considerations often referenced in the debate over the contraction of private debt.

Usury. The foremost of these is the question of usury. In ancient times, interest rates were essentially market-driven. But with the rise of Christianity in the fourth century, biblical prohibitions against usury and the universality of the Catholic Church cast a moral shadow on money lending. Although the Renaissance gave rise to modern banking, a strong religious sentiment persisted in America against lending money at interest as late as the early twentieth century. Most states consequently enacted usury laws, which set maximum allowable interest rates. However, changes in the financial markets, high inflation, and economic deregulation have eroded the efficacy of traditional usury statutes. Modern legislators have struggled to translate usury rates appropriate to long-term commercial loans into equivalent short term, small amount credit.

Consumer Protection. During the Progressive Era, many legislators began to feel that government had a legitimate role to play in protecting the individual against unfair business practices. Eventually these concerns went considerably beyond outright criminal activity such as fraud or coercion to embrace the general concept that the law should attempt to do something to level the playing field between consumer and corporation. Many state statutes place a somewhat higher burden on business to ensure that the individual consumer is treated fairly in order to partially offset the power disparity between business and consumer. The problem for legislatures has been to define an appropriate sphere of legislative concerns in the gray area of business practices between outright illegality and questionable fair play.

False or Deceptive Advertising. All advertising inherently encompasses individual perceptions and intentional or unintentional half-truths. Although all business transactions are premised on the old Roman adage, Let the Buyer Beware, some legislatures have attempted to limit some types of advertising that is felt to have too great a likelihood of misleading the public. Thus, certain types of advertising such as tobacco and gambling ads have been prohibited or curtailed. Certain industries have been restricted from advertising in ways and through media likely to reach children or adolescents. Many groups have advocated an increased government role in making sure that advertising on the public airways should be less deceptive and manipulative.

Trade Regulation. Recent decades have brought an increased awareness that trade regulation often entails grave unintended consequences. Legislation restricting one industry may give its competitors an unfair advantage; legislation to assist some profession may adversely impact another. Free marketers will deplore most trade regulation as ineffective at best, debilitating at worst. Consumer advocates maintain that there is a clear need and purpose for wise and considered regulatory provisions.

The Current Legislative Climate

In recent years there has been a flood of legislation focusing on the payday loan industry. There are several reasons for this high degree of legislative interest.

First, although payday lending is a relatively new phenomenon, the growth of the industry is nothing short of astounding. The number of payday lenders ten years ago was probably less than three hundred. Today there are over ten thousand, with an estimated three hundred new offices opening each month.

Second, the precise legal status of the payday lending business is not clear. In some states the payday lending industry has approached the Legislature asking for exemption from or clarification of usury and small loan statutes. Competitors have urged restrictions; consumer groups regulation. Legislators have struggled to fit payday lending into the matrix of existing banking, criminal, and commercial statutes.

Third, use of extensive television and radio advertising makes payday lending highly visible to the public.

Fourth, although both industry and some independent studies indicate that customer satisfaction with payday lending is fairly good, many unsatisfied customers have been both highly critical and vocal about perceived unfair practices.

Fifth, the payday lending industry itself admits that from state to state, company to company, and office to office, payday lending practices vary widely and that customers can expect considerable variation in terms, services, and costs.

With such a flurry of legislative initiatives, a precise picture of the current state of regulatory statutes is continuously being outdated. However, a good recent summary is provided by Heather Morton in a May 2002 National Conference of State Legislatures Legisbrief:

> At least 32 states and the District of Columbia allow payday lending. Generally, it has been exempted from state usury or small loan laws. Lenders must comply with maximum fee, roll-over and loan size limits. Most states require licensing and periodic examinations to ensure that lenders are complying with applicable federal and state laws.
>
> At least 17 states and two territories essentially prohibit payday lending through strict small loan interest rate caps, which make it unprofitable. Alabama, Alaska, and Rhode Island have set a 36 percent annual interest rate cap on small loans. In these states, a lender can charge only a $2.77 fee on a $200 payday loan, instead of the $30 to $45 charged in states that allow payday lending without an interest rate cap.
>
> As concerns rise, state legislators and regulators are evaluating their payday lending laws. Hawaii removed the sunset provision from its check cashing and payday lending act last year. North Carolina's law lapsed when legislators could not agree on whether to remove the sunset provision and reenact it. Kansas limited the number of payday loans that may be issued to a borrower. Florida provided penalties for Deferred Presentment Act violations.

Rhode Island placed licensing requirements on payday lenders. Mississippi revised its licensing requirements for a check cashing and payday lending business, authorized a lender to charge a returned check fee if it is disclosed in a written agreement, and prohibited a check cashing business from encumbering a customer's direct payroll deposit for any outstanding deferred deposit agreement.

And legislators are continuing to evaluate payday lending. California proposes to set a limit on the face amount of a deferred deposit check and to require payday lenders to inform customers about their rights and responsibilities. Kentucky is considering requiring separate business licenses for check cashing and deferred deposit service businesses, annual examinations and the display of interest rates for payday loans.

Although Morton's comments illustrate a number of innovative features of individual states' approaches, an attempt to categorize the states' response to payday lending might be generalized along the following three overall responses.

Specific Authorization. A number of states, presumably at the behest of the payday lending industry, have passed specific legislation recognizing, authorizing, and regulating payday lending. Usually this has been done by overriding broader usury and small loan statutes to the extent that they conflict with the specific payday loan provisions.

Specific Compliance. Other states permit payday lending but require substantial compliance with general usury and small loan laws. This approach creates a fairly difficult environment for the payday loan industry, but has the virtue of limiting the adverse effects on inter-industry competition.

Substantial Deregulation. A few states have taken the decidedly laissez faire approach of permitting any interest rate or fee that is freely and knowingly agreed to by lender and borrower. While it is too early to know how well this approach will work in practice, it certainly deals the lending industry a strong hand.

The Future of Alternative Lending Legislation

In reading the current legislative and industry literature on alternative lending, it is astonishing to note the degree to which legislative interest is focused on the most dynamic segment of the spectrum, payday lending. Already close to being a three billion dollar industry, payday lending will almost certainly absorb a disproportionate share of legislative interest in personal credit during the next few years.

But, it is equally important to notice that the overall legislative response to the advent of payday lending has been essentially an ad hoc approach. Supporting documentation seldom makes any attempt to articulate any policy-based philosophy for regulating payday lending. Nor is there much evidence of concern about the alternative lending industry in its many and varied interrelating facets. It is difficult to imagine that any state will successfully legislate an appropriate and responsible policy on payday lending without first expending considerable time and debate on the overbranching question of public access to short-term borrowing through alternative lending.

Contacts for More Information

National Conference of State Legislatures
http://www.ncsl.org

Council of State Governments
http://www.csgmidwest.org

American Bankers Association
http://www.aba.com

American Association of Retired Persons
http://www.aarp.org

Community Financial Services Association of America
http://www.cfsa.net

Consumer Federation of America
http://www.consumerfed.org

Federal Reserve Bank of Minneapolis
http://www.minneapolisfed.org

Financial Service Centers of America
http://www.fisca.org

National Consumer Law Center
http://www.consumerlaw.org

U.S. Public Interest Research
http://www.pirg.org

This issue memorandum was written by Reuben D. Bezpaletz, Chief of Research Analysis and Legal Services for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.
