

# Insights from Economic Research and Theory: The Challenge of Small- Dollar Lending

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# Overview

- Interest rate ceilings have been a pervasive feature of consumer credit markets, even after a period of relaxation since the 1980s.
- Recently interest in rate ceilings seems to have grown, with 36 percent often being mentioned as a desirable limit (military lending and FDIC pilot project, for example).
- Interest rate ceilings have a great effect on minimum size of loans available in the market.
- My presentation today discusses theory and evidence on the economics of consumer lending and especially the implications for small-dollar lending.

# Demand

- Most consumer credit is used to finance the acquisition of autos and household durables, which provide a flow of services over time.
- Few purchases of major durables are made without some deliberation (Day and Brandt 1973, Katona 1975) .

Households using consumer debt, by purpose of debt (percent)	1977	2010
Automobiles	34	30
Non-auto durables	14	4
Home improvement	6	1
Education	2	19
Mobile homes	2	1
Other closed end	12	7
Revolving	34	39

Source: Surveys of Consumer Finances

# Demand (continued)

- For household investment decisions, the cost of credit can be compared to the value of the services (Seligman 1927, Juster and Shay 1964).
- Rates of return on household investment can be quite high, especially for households in early life-cycle stages (Poapst and Waters 1964, Dunkelberg and Stephenson 1975).
- For example, estimated rates of return for a washer/dryer were 15 percent for 5 loads/week, 36 percent for 8 loads/week, and 57 percent for 11 loads per week (Dunkelberg and Stephenson 1975).

# Demand (continued)

- A household investment is wealth increasing if the rate of return on the asset is greater than the cost of financing its acquisition.
- Sometimes household investment may be wealth increasing, even if it is financed by relatively expensive types of credit.

# Supply

- Production cost governs the willingness to produce, and credit is no different from any other product.
- What distinguishes credit from many other products is that lenders advance funds today in return for the promise to repay in the future.
- The adequacy of funds in the future and the willingness of the borrower to repay are uncertain.
- A significant portion of cost is associated with the assumption of this risk (National Commission on Consumer Finance 1972, Durkin et al. 2013).

# Supply (continued)

- Borrowers' finite income and wealth limit the maximum amount of credit offered by lenders regardless of the interest rate (Jaffee and Modigliani 1969).
- Lenders may require borrowers to provide equity and collateral, which increase the lender's proceeds in the event of default and reduce the borrower's incentive to default (Azzi and Cox 1976, Barro 1976, Benjamin 1978).
- Primary market lenders require borrowers to provide equity and collateral to obtain lower cost credit.

# Supply (continued)

- Asymmetric information about borrowers' default costs and income prospects can lead to adverse selection that make larger loan amount/higher rate credit contracts unprofitable (Jaffee and Russell 1976, Stiglitz and Weiss 1981).
- However, borrowers can sometimes secure additional credit at higher rates by borrowing sequentially from different lenders (Bizer and DeMarzo 1992).

# Higher rate credit sources

- Some lenders specialize in small unsecured consumer loans at relatively high rates of interest.
- Historically, the higher rate lenders have been consumer finance companies (Juster and Shay 1964).
- More recently, credit cards have provided higher cost, unsecured credit to many consumers (Brito and Hartley 1995).
- Some consumers may achieve greater household investment/more highly valued inter-temporal consumption patterns using additional higher rate credit (Juster and Shay 1964).

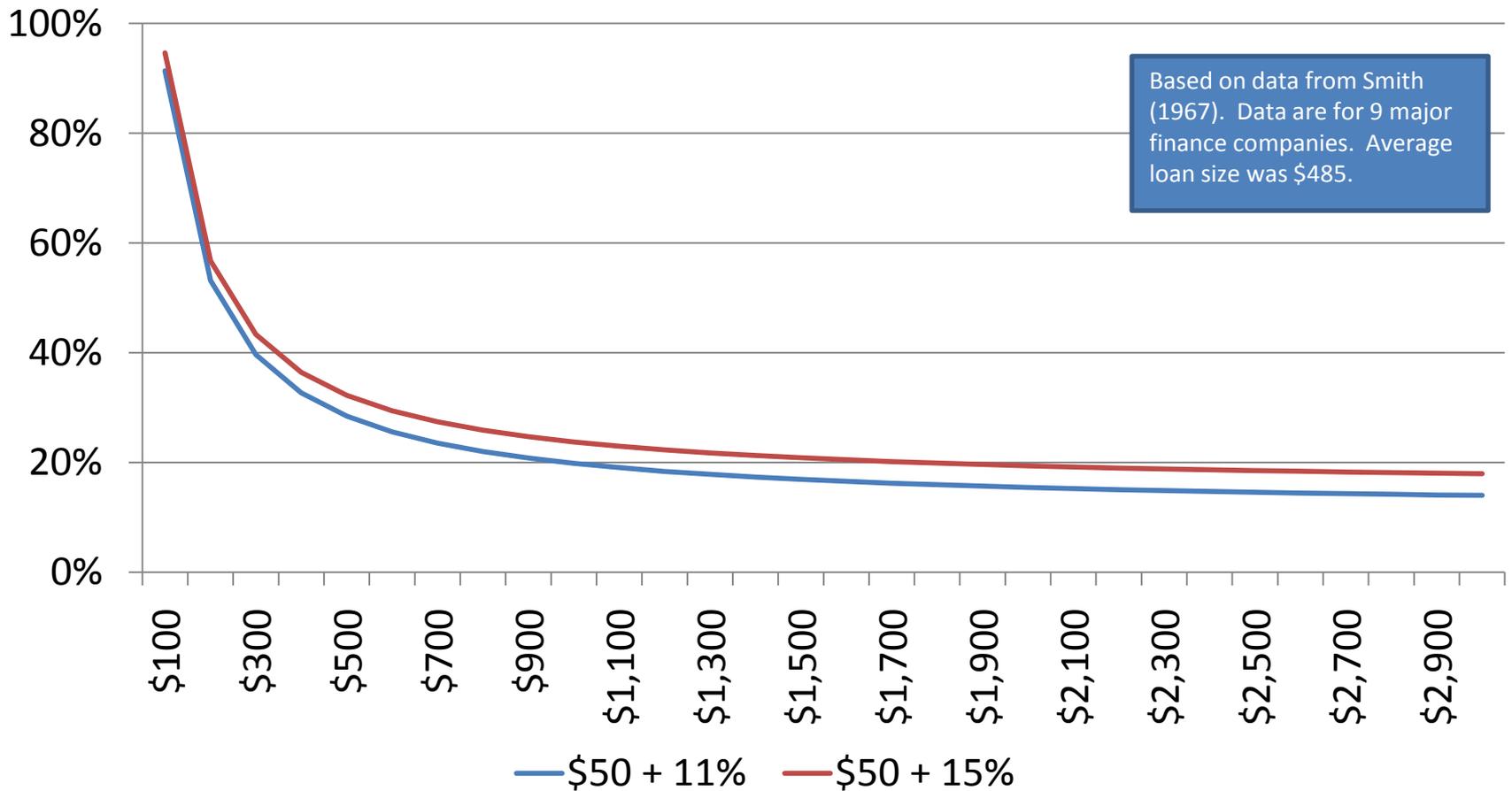
# Higher rate credit sources (continued)

- Very small loan sizes are available in some states from consumer finance companies, pawnshops, payday lenders, and auto title loan companies.
- Loan sharks also operate in some markets.
- Very small loans tend to be used by credit-constrained consumers, who have little discretionary income or precautionary savings.
- Such loans largely would not be used for household investment but may be used to avoid consequences of cash shortages.

# Empirical evidence on costs

- Much of the cost of making a loan is fixed: Costs are not very sensitive to loan size (National Commission on Consumer Finance 1972, Durkin and Elliehausen 1998).
- As a consequence, APRs necessary to recover costs and provide a competitive return on invested capital are inversely related to loan amount (National Commission on Consumer Finance 1972).
- APRs necessary to recover costs are also inversely related to term to maturity.

# NCCF estimates of APR necessary to recover costs of 12-month consumer finance company loan, by size of loan



# Effects of a rate ceilings on the minimum size of loans

- With a rate ceiling of 42 percent, loans less than \$282 would not be profitable (about \$2,100 in 2013 dollars).
- With a rate ceiling of 36 percent, loans less than \$352 would not be profitable (about \$2,600 in 2013 dollars).

# Emergence of the small loan industry

- The Russell Sage Foundation pursued credit reform in the early 20<sup>th</sup> century to combat loan sharks.
- Efforts included promoting greater enforcement of laws and creating charitable lending institutions, but these efforts were unsuccessful.
- Ultimately the foundation concluded that rate ceilings that allowed lenders to obtain a market rate of return on capital would best attract sufficient capital to satisfy market demand for small loans (Robinson and Nugent 1935).

# Emergence of the small loan industry (continued)

- The outcome of the foundation's efforts were the Uniform Small Loan Laws, which established a 42 percent ceiling, disclosure of terms to borrowers, and licensing of lenders.
- These laws enabled the emergence of the consumer finance industry.
- Even at 42 percent, lenders specializing in smaller loan sizes with shorter terms to maturity (salary lenders) were not profitable.
- The foundation recognized the demand for smaller loan sizes, was aware of the ceiling's effect on availability of such loans, but made no effort to modify its recommended rate or further study the market for smaller loans.

# “Experiments” with lower rate ceilings

- After implementing Uniform Small Loan Laws in the 1920s, Missouri, West Virginia, and New Jersey subsequently reduced maximum rates from 42 percent to 30, 24, and 18 percent, respectively.
- The volume of licensed lending in these states declined commensurately with the reduction in the rate ceiling.
  - Licensed lenders left the market.
  - Remaining lenders consolidated offices.
  - Lenders offered only loans near the maximum loan size.
  - Loan sharks re-emerged.

# FDIC Small-Dollar Loan Pilot Program

- Voluntary program designed to deliver loans of \$1,000 or less with an APR not greater than 36 percent (Miller et al. 2010).
- “Data collection was expanded to ... [\$1,001-\$2,500] after the first year of the pilot, when some bankers relayed ... the importance of these loans to their business plans. In particular, they indicated that some of their customers could qualify for larger loans and that these loans cost the same to originate and service as ... [smaller loans] , but resulted in higher revenues. (p. 30)”

# FDIC Small-Dollar Loan Pilot Program (continued)

- “... given the small size ..., the interest and fees generated are not always sufficient to achieve robust short-term profitability (p.32).”
- By far, most of the banks participating in the program indicated that they used the small-dollar loans to build long-term relationships with customers and to create goodwill in the community.

# Conclusions

- Prospects for low-rate small loans in a market economy are not good.
- Fixed costs make small, short-term loans relatively expensive.
- Consumers who use small, short-term loans tend to have little discretionary income or liquid assets, characteristics that make them relatively risky.
- Alternatives to the market: Charitable lending has been inadequate, and government subsidized credit seems unlikely.

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