The National Consumer Law Center Gets it Wrong (Again)

A July 2015 paper from the National Consumer Law Center (NCLC) titled “Installment Loans: Will States Protect Borrowers from a New Wave of Predatory Lending?” claims that it analyzes the strengths and weaknesses of state laws that regulate installment loans and similar longer term loans structured as open-end lines of credit. The paper does not do this. It neither undertakes, describes, nor cites studies of traditional installment lending, but rather it reviews some state lending laws and the asserts their effects and potential effects. The paper so confuses aspects of payday lending and installment lending that it seems even the legal review is questionable and should be reexamined.

AFSA has identified three main problems with the paper:

1. With its obvious underlying focus on payday lending, the paper does not appear to understand the traditional installment lending industry to the point that it seems almost unaware of the industry and the differences between it and other lenders.

2. Much of the paper is based on unsubstantiated assertions that lead quickly to stated conclusions and recommendations, wholly unsupported by scholarly evidence or research findings.

3. To the extent that it recognizes the existence of the traditional installment lending industry, the paper contends that somehow small loans could continue to be made by the industry within annual percentage rate (APR) ranges considerably lower than permitted by state laws in those jurisdictions where the industry currently exists. Evidence does not support this contention.

I. The paper confuses traditional installment lending with payday lending.

The paper is not a study of traditional installment lenders, but an attack on payday lenders and assumptions about what these lenders may do in the future. For example, the paper states, “Given these developments [that is, legislative and regulatory changes affecting payday loans], high cost non-bank lenders will likely seek to migrate into installment lending. . . . A high-cost installment loan will be even worse than a payday loan if it binds the borrower to an unaffordable payment at an extortionate interest rate for a bigger loan and a longer period of time. This report analyzes the strengths and weaknesses of state installment loan laws in this new era” (emphasis added).

In the initial decades of the twentieth century, the traditional installment lending industry grew out of the work of the Russell Sage Foundation, the National Association of Social Workers, and the National Association of Small Loan Brokers, a trade group that supported establishing a regulated, legitimate lending industry. Recommendations for a closely regulated industry coalesced in a model state law called the Uniform Small Loan Law promulgated in 1916 and passed in some form by almost all the states by the 1960s. In many states, inflation has made this old line industry obsolete. Industry survivors where adjustments for inflation have been made in the regulations still provide the product. Notably, this means in states where rate ceilings are
sufficient to allow providers to cover operating, risk, and capital costs, the loans now made are mostly larger than in the early twentieth century as a result of inflation over these years.

Research over the decades shows that small-dollar installment lending is expensive to undertake per loan dollar extended, that lenders in this market take on considerable amounts of default risk in order to extend lending markets to subprime customers seeking small loans, and that this lending is not especially profitable. ¹ Recent research on loan and payment sizes in the traditional installment lending industry shows that lenders appear to adopt their lending to the budget capabilities of borrowers.² None of this research is acknowledged or cited in the NCLC paper, a significant omission in a document calling for legislative attention and action that would eliminate an industry established under historical state consumer protection policies.

II. NCLC’s paper is based on unsubstantiated assertions.

Instead of conducting research or analyzing research done by others, the paper relies on a variety of gratuitous and unsubstantiated statements as reason for the claims and recommendations it makes. For example, paper states: “Many statutes are plagued by imprecise and archaic language [no examples are cited]. Some express caps on interest rates by using archaic calculation short cuts – invariably producing results that favor lenders rather than consumers – that were devised in the era before computers” (emphasis added).

It is, of course, a familiar approach to establish a dichotomy and argue one side of it and belittle the other. In this case, though, it is a false dichotomy. The intent of the Russell Sage Foundation and the states that eventually passed its draft model Uniform Small Loan Law was not to favor lenders (or consumers except as consumer protection) but rather to establish a lending market that allowed small-dollar installment lending to be viable and eliminate the kind of abusive lending disfavored at that time (short-term, high-rate illegal lending).

Research cited above (and other work) has analyzed the results of these policies. The difficulty with NCLC’s approach is that it ignores evidence and/or arguments not supporting the preordained advocacy position, in this case the sub-argument that calculations in state laws


² See Durkin, Elliehausen, and Hwang, op. cit.
“invariably produce results that favor lenders rather than consumers.” It is not at all clear that this one-sided argument approach to the main thesis of the paper – that dramatically lowering state rate ceilings on small-dollar installment loans benefits consumers – is correct. States once tried this and did not like the results (see the Ham, Nugent, and Robinson and Nugent articles from the Russell Sage Foundation cited in the footnotes).

Statements in the paper not consistent with research evidence continue in the discussion of insurance products. Among the pejorative rhetoric and debatable claims in this section of the paper is the following: “With most types of credit insurance, only a small part of each premium dollar paid by the borrower is used to pay claims, while the insurance company pays the lender more than half of each premium dollar in commissions and profit sharing” (emphasis added). A footnote to a single, presumably specialized, court case and a single advocacy letter are offered as support.

State insurance regulators have generally preferred that loss ratios on credit life insurance average about 50 percent in order to balance the interests of consumer beneficiaries with those of the state that the insurance companies remain solvent and able to honor their future liabilities through sufficient reserves. To maintain such a balance, most states allow maximum premium charges that produce a loss ratio of around 50 percent. Some states have favored a loss rate a bit higher by making maximum allowed premium rates a bit lower.

The maximum allowed premium rate is known as the prima facie premium rate. Evidence in recent years shows that loss rates through regulating prima facie rates on credit life insurance have averaged about 49 percent nationally, with considerable variation among states. This loss rate brought about by state regulation hardly shows only a “small part of each premium dollar paid is used to pay claims.” Besides maintaining insurance liability reserves, the remaining part of the premium dollars must also cover the operating costs of the insurance companies. Such costs could be substantial relative to premium dollars involved, considering the small sizes of the policies/certificates involved (and related small premiums).

This is not to say that lenders do not receive any commissions from the sale of insurance. They do, and they likely would not sell, or even offer, credit insurance without receiving some compensation. They do after all, invest time in offering the insurance company’s product (even if their own affiliate) and in completing the associated paperwork and claims processing. But research indicates that the sales effort in this area has become less common over time. Survey research published in the Federal Reserve Bulletin shows that the portion of borrowers purchasing debt protection including credit insurance has fallen dramatically over the years since 1977 and that frequency that installment lenders never even mention its availability has risen.4

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3 See Consumer Credit Industry Association, The Fact Book of Credit-Related Insurance (Atlanta: Consumer Credit Industry Association, 2014). According to this source, “The credit life insurance countrywide loss ratios have generally fluctuated around 40% to 45% for the last 18 years but have trended upward in recent years with slight decreases in 2011 and 2012 and a slight increase in 2013” (page 10, derived from data from the National Association of Insurance Commissioners, the association of state commissioners). This source also illustrates by chart loss ratios on credit disability (accident and health) insurance and both types taken together have fluctuated within a similar range, tending to trend lower during good economic times and to rise during rougher periods.
But with little to no supporting evidence, the paper claims otherwise in a series of gratuitous remarks that seem demonstrably wrong. For example, NCLS’s paper says: “Even though most of these add-on products are ostensibly voluntary; generally lenders achieve very high penetration rates – in some cases, nearly 100%.” This is a gratuitous remark, inconsistent with the available research evidence cited above, and offering as support only a decades-old single court case. The paper continues immediately, “If 100% of the borrowers are purchasing an unnecessary and exorbitantly priced product [a big if, emphasis added], that is a good indication that the decision about whether to purchase the product is not really voluntary. Often lenders add the insurance products into every loan as a matter of course, and remove them only if the consumer notices and objects.” These are claims begging for supporting evidence, but there is none at all supplied.

Concerning consumers’ use of the product, credit insurance clearly is not a product for everyone, as demonstrated by its low and declining penetration (purchase) rate on installment credit, possibly an indication that many consumers believe they do not need more insurance. But research evidence suggests that consumer acceptance of its usefulness is quite high among purchasers and even among non-purchasers (see study cited in footnote 4).

III. The paper offers no evidence to support the claims that small-dollar loans can be made at a low APR.

Concerning lending costs and rates necessary for lenders to be willing to lend, the paper prefers lending rates no greater than 36 percent APR on the smallest loan sizes with lower permitted APRs on larger loans. But such a rate ignores how a rate in this range produces insufficient revenues per loan dollar for lenders to be willing to make small, relatively short-term loans. This difficulty was addressed at considerable length by the National Commission on Consumer Finance (NCCF), established by Congress to study this question by the same act of Congress that instituted Truth in Lending (reference in footnote 1).

A small loan made at this rate simply does not produce much revenue but it must cover necessary production costs for credit investigation, financial review with the customer and help with budgeting, booking the loan, record keeping, and the cost of capital and risk. Costs arise from the necessity of maintaining lending locations entailing rent charges, employing personnel who must be paid salaries, and acquiring office supplies and equipment with prices and amortizations and legal costs of regulatory compliance. Risk costs might be substantial on a loan of this kind. Almost by definition, a customer seeking a loan of this kind would be a risky individual.

A $500 loan for six months at APR 36 percent produces total revenue of $53.79, about $8.96 per month. And so if one loan in a portfolio of similar loans goes bad and does not repay, the lender must make ten good loans just to recover the lost capital on the bad loan, without considering operating costs on any of the loans. The lender still needs enough revenue to justify obtaining and maintaining the lending location, hiring and paying the personnel, acquiring the supplies and equipment, and complying with the regulations.

As discussed more fully by the Congressional NCCF translating these necessities for small loans into an APR under Truth in Lending rules makes the disclosed rate very high, even though the dollars involved are not especially large. This anomaly occurs simply because risk and production costs are large relative to the loan dollars involved and the short term of the loan on which the lending cost must be recovered.

In their recent paper referenced here in footnote 1, Durkin, Elliehausen, and Hwang looked at directly at some of these issues. They constructed a series of APRs recommended by the NCCF as necessary for small loans lenders to produce loans of various sizes then compared them with some existing state ceilings and the availability of loans of various sizes in those states based on survey data from nonbank installment lenders. According to them,

The table [below] provides such a comparison using the NCCF’s estimates of APRs that would “… allow for enlargement of the market through a higher degree of risk acceptance” (National Commission on Consumer Finance 1972, p. 144) and adjusting loan amounts and production costs for inflation. The table compares these NCCF rates to actual rates on surveyed loans in the $100 size groupings ranging upward from the selected loan amounts. All of the calculations of the NCCF rate used in the table assume a 12 month maturity except the $500 loan which assumes a 6 month maturity.

APRs on the surveyed loans demonstrate exactly the pattern recommended by the NCCF in 1972 based upon its cost analyses and its contention that market competition would keep rates in this range if rate ceilings were to allow them. Actual rates on loans are highest on the smallest loan sizes and fall off in the pattern predicted by the NCCF. In the intermediate size groups ($1000, $1500, and $2000) it appears that rates in the table are moderately above predicted rates for some states in large part because a portion of the loans in these states within the indicated size groups are actually for terms less than the assumed maturity of 12 months. This moves the overall mean for the grouping upward, but the mean rates are still relatively close to the NCCF recommendation based on costs, and they show the predicted downward trend relative to loan size.

By loan size $2500, actual rates on surveyed loans in all states in the table are right around the NCCF projected level. As discussed earlier, loans of this size are available from the surveyed companies in all the states in the table, but the smaller sizes are not available in California or Pennsylvania, the low rate states in the right hand columns. This is consistent with the writings of the National Commission but also with the earlier theoretical work of Juster and Shay who predicted exactly this outcome.

IV. Conclusion

The paper from NCLC is a clear disappointment. It claims it “analyze the strengths and weaknesses of state laws that regulate installment loans and similar longer term loans structured as open-end lines of credit,” but it actually just restates desires of consumer advocates for market rates lower than they must be to encourage lending. Like modern novels, it dwells at length on subplots and flashbacks found in the authors’ preferences for a story as they want to tell it.
Avoiding further commentary here on the story as they outline it, it never recovers from the three core problems outlined earlier: 1) The paper neither undertakes nor cites meaningful studies on installment credit; 2) it makes many unsubstantiated assertions that lead quickly to stated conclusions and recommendations but are unsupported by scholarly evidence or research findings; and 3) it contends that somehow small loans could continue to be made by the lending industry within APR ranges considerably lower than permitted by state laws in those jurisdictions where the industry currently exists. Extensive evidence over a long period of time does not support this contention.

Table. APRs Recommended by the National Commission on Consumer Finance and Actual APRs on Surveyed Loans

Selected Loan Sizes and States

<table>
<thead>
<tr>
<th>Loan Sizes</th>
<th>NCCF APRs(^1)</th>
<th>Actual Rates in Selected States(^2)</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>TX</td>
<td>SC</td>
</tr>
<tr>
<td>$500</td>
<td>91</td>
<td>68</td>
</tr>
<tr>
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<td>78</td>
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</tr>
<tr>
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<td>31</td>
<td>43</td>
</tr>
<tr>
<td>2500</td>
<td>30</td>
<td>36</td>
</tr>
</tbody>
</table>

\(^1\)Rates that would “… allow for enlargement of the market through a higher degree of risk acceptance” (National Commission on Consumer Finance 1972, p. 144). Calculated rates are for 12 month maturities except for $500 category which is for 6 month maturity.

\(^2\)Mean rates on surveyed loans for loan amounts (Truth in Lending “Amounts Financed”) in the $100 increment upward from the loan amount indicated (e.g. mean rates for the $500 loan amount line are for surveyed loans of $500-599). The $2500 category is for loan amounts of $2500 or more.

\(^3\)In Pennsylvania 79 percent of surveyed loans were for $2000 or more; the corresponding percentage in California was 91 percent.

* Insufficient number of surveyed loans to provide a meaningful mean rate.