



March 31, 2014

The Honorable Bill Nelson  
Chairman  
Special Committee on Aging  
United States Senate  
Washington, D.C. 20510

The Honorable Ron Wyden  
Chairman  
Committee on Finance  
United States Senate  
Washington, D.C. 20510

Dear Chairmen:

As the trade association representing traditional installment lenders, the American Financial Services Association (AFSA) thanks you for your interest in learning about the marketplace for small-dollar loans, and we welcome this opportunity to provide you with information about how our industry meets the credit needs of millions of American families in a safe and affordable fashion.

AFSA is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. Its more than 350 members include consumer and commercial finance companies, auto finance/leasing companies, mortgage lenders, mortgage servicers, credit card issuers, industrial banks and industry suppliers.

### **History of Small-Dollar Lending**

To help understand the traditional installment lending industry, it is important to know its origins. Traditional installment lenders have been around for more than 100 years. They are community-based lenders located in cities and towns nationwide that provide consumers with small loans to buy goods and services.

In 1916, a group of lenders, along with charitable community organizations, promoted state laws that would make unsecured personal loans more readily available. The result of their efforts was the Uniform Small Loan Law, landmark legislation that the authors intended to be adopted by the states to provide an exception to usury laws so that consumers could legally obtain small amounts of credit at reasonable rates that allowed lenders to make a profit. As the new industry attracted capital, average wage-earners found that they could obtain loans from these personal finance companies for personal and family household purposes. As the companies expanded, they began to serve their customers through branch offices located in the neighborhoods where people lived or worked. The branch offices emphasized convenience and personal service.

## **Traditional Installment Loans**

The same myriad qualities and attributes that initially drove the traditional installment loan industry have carried through to modern times. Traditional installment lenders continue to provide individualized service to the customers they serve in their communities.

Traditional installment loans are structured to help borrowers meet a financial need within their budget, repay the loan in substantially equal monthly payments and build a positive credit history. Traditional installment loans allow consumers to access small-dollar loans that represent financial freedom, flexibility and safety.

Traditional installment lenders work with borrowers to create a monthly budget based on their current income and expenses to determine if the borrower has the ability to repay the loan, and set the monthly payment at an affordable amount. Traditional installment loans are fully amortizing, meaning that part of each payment pays down the principal as well as the accumulated interest.

Traditional installment lenders report their customers' payment behavior to credit bureaus, which can help them build or strengthen a credit history over time. Traditional installment loans do not charge penalties for early repayment, or prepayment, and do not require large one-time balloon payments. Traditional installment loans are structured to provide borrowers with a plan for disciplined debt reduction.

Traditional installment loans provide customers with access to funds that:

- Can be repaid in affordable substantially equal monthly payments, or installments, reducing both principal and interest each month;
- Fit within the customer's monthly budget based on current income and expenses;
- Build a positive credit history, as traditional installment lenders generally report to credit bureaus;
- Do not allow for prepayment penalties or balloon payments.

Importantly, traditional installment loans are distinct from other types of small-dollar loans primarily because of their structure. Unlike other types of small-dollar lenders, traditional installment lenders underwrite their loans, meaning they consider a customer's ability and willingness to repay the loan. Likewise, the schedule of repayments for a traditional installment loan is no less than thirty (30) days. Additionally, the annual percentage rates (APR) on traditional installment loans are substantially lower than for payday, pawn or auto title loans. Structured in this time-tested fashion, traditional installment loans provide borrowers with a plan for disciplined debt reduction.

## **Consumers Served by Installment Lenders**

In addition to hourly workers, traditional installment lenders serve the "unbanked" and "underbanked" – consumers who do not have or do not regularly use traditional banking services such as savings and checking accounts. Many of these consumers have poor or thin credit histories, making it hard for them to qualify for other forms of credit. Yet, traditional installment

lenders have been making responsible and affordable loans to these very consumers for many decades.

In 2013, the Center for Financial Services Innovation (CFSI) published a report<sup>1</sup> detailing four reasons that borrowers of small-dollar credit used these products, which CFSI defined as payday loans, pawn loans, deposit advance loans, auto title loans and non-bank installment loans. CFSI's research determined that consumers use small-dollar credit: 1) for unexpected expenses such as an automobile repair, 2) to cover misaligned cash flow, 3) to make up for exceeding income, or 4) for planned purchases such as a new appliance. Of these "need cases," installment lending was used most often for planned purchases (51%) and to pay for unexpected expenses (29%). Installment loans were rarely used by borrowers with misaligned cash flow.<sup>2</sup>

Consumers from all walks of life and all ends of the credit spectrum have varying credit needs, which the CFSI study reinforced. "Our findings provide further evidence that [small-dollar credit] consumers are not a homogeneous market that can be served with a one-size-fits-all approach."<sup>3</sup>

Traditional installment lenders fully support and comply with the Equal Credit Opportunity Act (ECOA), which prohibits any kind of age discrimination. Specifically, the ECOA provides that: "It shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction (1) on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract); [or] (2) because all or part of the applicant's income derives from any public assistance program."<sup>4</sup>

### **Endorsed by State Legislators**

Both the National Black Caucus of State Legislators and the National Hispanic Caucus of State Legislators adopted resolutions in recent years acknowledging the need for small-dollar credit in which they emphasized that the "key structural qualities of loans that are safe and affordable are that the lender makes good faith efforts to assess the borrower's ability to repay the loan and that the loan is repayable in substantially equal installments of principal and interest, with no balloon payments."<sup>5 6</sup> These resolutions describe traditional installment loans. They do *not* describe other forms of non-bank loans that increasingly characterize themselves as "installment loans."

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<sup>1</sup> Bianchi, Nicholas and Rob Levy. *Know Your Borrower: The Four Need Cases of Small-Dollar Credit Consumers*. December 2013. Available at [http://www.cfsinnovation.com/CFSI\\_KnowYourBorrower.pdf](http://www.cfsinnovation.com/CFSI_KnowYourBorrower.pdf).

<sup>2</sup> *Ibid*, Table 1, p. 12

<sup>3</sup> *Ibid*.

<sup>4</sup> 15 U.S.C. Sec. 1691(a)

<sup>5</sup> National Black Caucus of State Legislators. *Resolution BFI-13-14: Promoting Safe and Affordable Lending Practices*. Available at <http://www.nbcsl.org/public-policy/resolutions/item/624-business-financial-services-and-insurance-resolution-bfi-13-14.html> (December 2012).

<sup>6</sup> National Hispanic Caucus of State Legislators. *Resolution 2013-10: Promoting Safe and Affordable Lending Practices*. Available at <http://www.nhcsl.org/94/resolution/promoting-safe-and-affordable-lending-practices> (November 2013).

## FDIC Pilot Showed Banks Can't Compete in the Space

Small-dollar loans are not sustainable products for banks, as demonstrated by the Federal Deposit Insurance Corporation (FDIC)'s Small-Dollar Loan Pilot Program conducted in 2008 and 2009. The pilot, which recognized the obvious need for responsible and affordable small-dollar credit, concluded with 28 bank participants. The banks that participated in the pilot offered closed-end installment loans with APRs at 36 percent or less, including origination fees.

The FDIC touted the program as a success, although the majority of the banks in the pilot could not make a profit on small-dollar loans. The "success" of the program was based on using the products to build relationships and cross-sell other more profitable products to customers. "About three-quarters of pilot bankers indicated that they primarily used small-dollar loans to build or retain profitable, long-term relationships with consumers and also create goodwill in the community."<sup>7</sup>

The pilot participants found that the costs of launching, marketing and offering small-dollar loans were similar to other loans. "As a general guideline, pilot bankers indicated that costs related to launching and marketing small-dollar loan programs and originating and servicing small-dollar loans are similar to other loans. However, given the small size of [these loans], the interest and fees generated are not always sufficient to achieve robust short-term profitability. Rather, most pilot bankers sought to generate long-term profitability through volume and by using small-dollar loans to cross-sell additional products."<sup>8</sup>

"Banks other than those in the pilot provide small-dollar loans, but it is likely that most banks do *not* offer these loans. Pilot bankers and other banks that have started or have expressed interest in starting a small-dollar loan program indicated that the primary obstacles to entry are the cost of launching and maintaining the program and concerns about defaults."<sup>9</sup>

The FDIC concluded that "the relationship-building small-dollar loan model is as costly to originate as other, larger loans because of the 'high-touch' nature of the loan delivery process."<sup>10</sup> The high-touch nature and the associated business costs with making small loans means that lenders must charge APRs above 36 percent to make a profit.

Thus, while the FDIC touted the program as a success, a careful review of the findings shows that without significant changes to the banks' lending programs, including a request for government guarantees, the majority of the banks in the pilot could not make a profit on small-dollar loans. Rather, the alleged "success" of the program was based in part on using the products to build relationships and cross-sell other more profitable products to customers. Moreover, to the extent the banks found that they might be able to make small-dollar loans, they based those conclusions upon establishing business practices that closely resembled the business practices of traditional installment lenders – AFSA's members. Traditional installment lenders

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<sup>7</sup> *A Template for Success: The FDIC's Small-Dollar Loan Pilot Program*. FDIC Quarterly 4, no. 3. 2010. Available at [http://www.fdic.gov/bank/analytical/quarterly/2010\\_vol4\\_2/smalldollar.html](http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/smalldollar.html).

<sup>8</sup> *Ibid.*

<sup>9</sup> *Ibid.*

<sup>10</sup> *Ibid.*

have already learned how to, and for many decades have, made responsible and affordable small-dollar loans to consumers who need access to small amounts of credit and who are not served by the traditional banking system.

### **Annual Percentage Rates (APR)**

Every loan, regardless of type or size, has certain expenses built into the APR, as indicated in the FDIC Pilot Program. These costs are directly related to the work the lender puts into making each loan, such as underwriting, rent, salaries, licensing and regulatory compliance. These fixed costs and overhead expenses are the same for each loan, whether the loan is for \$1,000 or \$20,000. So in general, bigger loans tend to have higher costs but lower APRs, while smaller loans will have lower costs and higher APRs. In many cases, APR will have an inverse relationship with a borrower's out-of-pocket costs.

APR tells a borrower the interest rate, but not the cost in actual dollars and cents to be paid over the life of the loan. Paying the same rate for a relatively longer period of time makes the overall cost go up. Illinois Attorney General Lisa Madigan notes on her website that the least expensive alternative to a payday loan is the installment loan, due in part to the longer repayment term. "In addition to having lower interest rates, small consumer loans have longer terms than payday loans – typically lasting about a year or more. Stretching your payments out over time is one way to help keep them manageable."<sup>11</sup>

In a recent report, CFSI noted that "much of the debate about small-dollar credit has heretofore focused on price, as expressed in Annual Percentage Rates (APR), as a primary determinant of quality. While affordable prices are certainly one aspect of high-quality small-dollar loans, what is 'affordable' to any given borrower depends on many factors, including the loan's size, repayment period, interest rate and fees, as well as the individual borrower's unique financial situation. ... In other words, whether a loan is affordable or not depends on underwriting, structure and pricing – not on price alone."<sup>12</sup>

In its March 2013 Semi-Annual Report, the Consumer Financial Protection Bureau (CFPB) recognized the difficulty in using APR to compare small-dollar loans and that consumers are most concerned about obtaining a loan quickly and conveniently. "While the cost of obtaining a loan may be a major consideration when deciding to take on debt and selecting which credit product to use, it is not the only factor in a consumer's decision-making process. For example, in some surveys, borrowers of small dollar amounts have overwhelmingly cited the speed, convenience and near-certainty that they will be approved for a loan as the primary considerations for using these products. ... Consumers on the subprime end of the credit scale potentially hav[e] fewer credit options."<sup>13</sup>

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<sup>11</sup> Illinois Attorney General Lisa Madigan. *The Truth about Payday Loans*. At <http://www.illinoisattorneygeneral.gov/consumers/paydayloans.html>.

<sup>12</sup> *The Compass Guide to Small-Dollar Credit*. February 2014. Available at <http://www.cfsinnovation.com/content/compass-guide-small-dollar-credit>.

<sup>13</sup> *CFPB Semi-Annual Report*. March 2013. p. 38. Available at [http://files.consumerfinance.gov/f/201303\\_CFPB\\_SemiAnnualReport\\_March2013.pdf](http://files.consumerfinance.gov/f/201303_CFPB_SemiAnnualReport_March2013.pdf).

States highly regulate the terms and conditions (and often the maximum rates) for small-dollar loans. Most states seek to ensure availability of credit while recognizing that small transactions have high transaction costs. In states that have no cap, lenders study the market and price their products in consideration of the cost of capital, the cost of servicing, personnel expenses, underwriting and anticipated losses.

With little statistical information about small installment loans available, AFSA began surveying its members regularly. Last year, the association published a report on “Preliminary Findings from the AFSA Member Survey of Installment Lending.” The report examined 2.4 million installment loans made between April and September 2012. The data show that “the highest APRs are associated with the smallest loans, which are also the loans with the shortest maturities.”<sup>14</sup>

The report compared loans in Pennsylvania, which has a 36 percent rate cap, with loans in Texas, which does not have a rate cap. Borrowers in both states have similar credit scores, with 84.9 percent of Pennsylvanians and 89.3 percent of Texans having credit scores under 660 – meaning that the majority of borrowers in both states would be considered subprime.

Due to the rate cap in Pennsylvania, 98.9 percent of small-dollar loans were for amounts greater than \$1,000. But in Texas, 71.7 percent of small-dollar loans were for amounts less than \$1,000. These numbers suggest that small loan sizes are generally unavailable in Pennsylvania and that borrowers in the state may be taking out larger loans than needed. This example “highlights difficulties that occur when rate ceilings prevent subprime borrowers from obtaining loans in the sizes they desire and have to obtain larger loans than necessary to be able to obtain loans at all.”<sup>15</sup> As a result, borrowers in Pennsylvania have to repay more principal, which could pose a financial risk for them.

Additional borrowing for a longer period of time means consumers have higher finance charges – or higher overall costs – despite a lower APR. In Pennsylvania, most loans had APRs from 19 to 36 percent, while in Texas, most loans had APRs from 49 to 99 percent. Yet Pennsylvanians also had higher monthly payments than their Texas counterparts. In Pennsylvania, 56 percent of the loans had monthly payments greater than \$150, while in Texas, only 16 percent of the loans had monthly payments greater than \$150.

Comparing the loan amounts, terms, and monthly payment amounts of loans in Pennsylvania and Texas demonstrates that APR caps are not in the best interest of consumers.

### **Regulation of Traditional Installment Lenders**

All of the federal and state laws and regulations affecting corporations, partnerships and proprietorships generally apply to traditional installment lenders – including regulations issued by the Federal Trade Commission, the Consumer Financial Protection Bureau, the Federal Reserve Board, the Department of Housing and Urban Development, the Treasury Department,

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<sup>14</sup> Durkin, Thomas. *Preliminary Findings from the AFSA Member Survey of Installment Lending*. March 2013. (Included as Appendix A.)

<sup>15</sup> *Ibid.*

and the Securities and Exchange Commission, and various state regulators. In addition, traditional installment lenders are subject to a multitude of state financial institution statutes, and are licensed and regulated in every state in which they operate. In short, states highly regulate the terms and conditions a licensed lender may impose on consumer small loan transactions. Traditional installment lenders are required to follow all state and federal consumer protection laws, and routinely are examined and audited by state agencies to ensure compliance.

Most states' provisions are enforced by a division of the state banking or insurance department, which is frequently empowered to supplement the statutes by enacting rules and regulations. Elsewhere, similar powers rest with other agencies or departments, such as states' departments of commerce or corporations. Finance companies generally are required to be licensed by each state in which they operate, and AFSA members are licensed in each and every state they conduct business. Many states' laws require consumer loan licensees to report regularly (usually annually) on their operations to the state supervisory authorities. In practically all states, annual examinations by these authorities are required by law, and examinations at other times are permitted. The costs of such examinations, in addition to the annual license fee for each operating office, are borne by the licensees in most states.

### **Ancillary Products**

Many traditional installment lenders sell optional ancillary products, such as credit insurance products, in conjunction with their loans, as do banks, credit unions, credit card issuers, and retail outlets.

Credit insurance, or payment protection insurance, can provide borrowers peace of mind if they have concerns about repaying all or part of a loan in the event of an involuntarily job loss, disability due to illness or accident, or death. The coverage can help reduce a borrower's financial risk if the unexpected happens. The insurance is designed to cover the debt owed, subject to stated maximum benefits per state law.

The terms and conditions of credit insurance are regulated by each state's respective Department of Insurance (DOI). Credit insurance premium rates and benefits levels are established in filed and approved forms by each state's DOI. Installment loans are a lending product authorized by state statutes. Those same statutes authorize lenders to offer credit insurance products on their loans in order to protect the security on the loan and for insuring the life or earning capacity of the borrower.

Insurance companies are required to submit their forms, which encompass the terms, conditions and benefit levels of the policy, to the state DOI for approval prior to lenders being able to offer the policies to their borrowers. The premiums charged to consumers do not vary by the age or gender of the borrower.

Credit insurance premiums and maximum benefits vary by state and insurance product, but not by installment lender. Any differential in premium rates from one installment lender to another is due to different insurance companies underwriting the policies, the policies having different benefit levels, or for other reasons unique to each state's insurance laws.

In some states, lenders have the option to require that consumers purchase certain credit insurance products. If the purchase is required by the lender, then the premium for the insurance must be included in the finance charge and in the APR calculation, and disclosed in an itemization of the amount financed. If lenders offer credit insurance as an optional product, they do not have to include it in the APR, but must disclose that the product is optional, in accordance with the federal Truth-In-Lending Act as well as most state laws.

Payment protection insurance is not required for obtaining credit, but if purchased it can be cancelled at any time. In some states, the lender may require certain payment protection insurance. However, in those cases, the borrower has the right to purchase the coverage from an independent carrier; the coverage does not have to be purchased from the lender granting the loan.

### **Collateral**

Traditional installment lenders *do not* accept collateral in the form of a preauthorized ACH, payroll deduction or personal check from borrowers as a condition of the loan. Depending on the company, traditional installment lenders may accept personal property – such as televisions or computers – or titled property – such as vehicles – as collateral.

Traditional installment lenders are governed by the Federal Trade Commission’s Credit Practices Rule (12 CFR 227), which restricts the acceptance of certain types of collateral.

### **Refinancing**

Loan refinances by traditional installment lenders are based on sound underwriting. In contrast to payday loans, where the loan rolls over if the full amount is not repaid by the due date, traditional installment lenders re-evaluate the borrower’s situation, then make a new loan if the borrower demonstrates an ability to repay.

When traditional installment loan borrowers refinance a loan – whether to lower their monthly payment amount or to borrow more money – the lender underwrites a new loan in much the same way that a lender helps a homeowner refinance a mortgage. Consumers are re-evaluated for ability and willingness to repay the loan, and only if the underwriting criteria are met does the refinancing move forward.

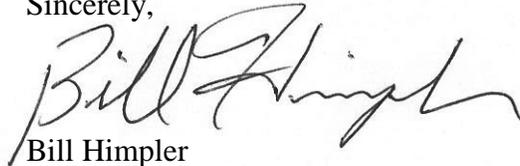
### **Conclusion**

Traditional installment lenders provide a responsible form of small-dollar credit for consumers, many of whom would be classified as subprime. Traditional installment loans are fully underwritten considering a consumer’s ability to repay. Traditional installment loans are fully amortizing with equal, affordable monthly payments. Traditional installment lenders pull credit reports on prospective borrowers and furnish repayment information to the credit bureaus – helping their borrowers build credit. APRs may seem high compared to other forms of credit, but small-dollar loans cost the same to make as large loans. Traditional installment lenders are

commercially sustainable businesses that do not rely on customers' deposits. They are highly regulated in each of the states in which they operate. Ancillary products are sold in conjunction with traditional installment loans, but are optional. The only collateral that traditional installment lenders accept is personal or titled property. When borrowers refinance with traditional installment lenders, a new loan is underwritten.

We look forward to working with you on this issue. Please contact me at 202-466-8616 or [bhimpler@afsamail.org](mailto:bhimpler@afsamail.org) with any questions.

Sincerely,

A handwritten signature in black ink that reads "Bill Himpler". The signature is fluid and cursive, with the first name "Bill" being larger and more prominent than the last name "Himpler".

Bill Himpler  
Executive Vice President  
American Financial Services Association

## Appendix A

June 24, 2013

### Summary of Preliminary Findings from the AFSA Member Survey of Installment Lending

1. Government ceilings on interest rates extend to the farthest reaches of recorded history.
2. In contemporary US, most controversial are current ceilings on smaller loan sizes in some states where advocate individuals and groups would like to see ceiling rates much lower.
3. As long as four decades ago a federal study commission showed that production and risk costs of making small installment loans *compared to the amount of the loan* meant that lending rates would need to be higher on these loans than on other consumer credit before legal lenders would be interested in lending. The commission showed statistically what the Russell Sage Foundation had argued beginning almost a century ago, leading to development of the Uniform Small Loan Law in 1916.
4. Findings from the AFSA survey of lenders are consistent with hypotheses developed many years ago from the economic theory of credit rationing. These hypotheses suggest that users of small dollar amounts of installment credit from secondary credit sources are “rationed” borrowers in an economic sense, those borrowers unable to obtain as much credit as they need or want from primary lenders at low rates. Specific findings include:

- Most loans (more than 85 percent) clearly are subprime on the basis of credit scores. (Table 1)
- These installment loans are both small and short term. More than 80 percent of the loans are made for \$2000 or less and almost 90 percent for two years or less. (Table 2) These are precisely the loans the federal study commission determined would require high rates.
- High APRs are due to both small size and high risk. (Table 1 and Table 3)
- Loans are made with low payments to satisfy both demand among rationed borrowers for small payments and supply by lenders who also are interested in easy repayment. Almost 50 percent of the loans have payments of \$100 or less monthly and more than 83 percent \$150 or less. (Table 4)

5. Survey results demonstrate clear evidence of lending risk. Delinquency among loans made is correlated with:

- Loan size (inversely, Table 6).
- Credit Score (inversely, Table 7).
- APR (directly, Table 8).

6. Loans vary substantially by state, due to regulatory differences that limit the locations acceptable to lenders.

- Frequency of lending varies sharply among states. States with low rate ceilings have few loans (Table 9).
- There are loans made to residents of low rate Arkansas, but almost all of them (99 percent) are to residents of counties that border other states, especially Oklahoma, Missouri, Louisiana, and Texas. This suggests the loans actually are made elsewhere.
- Compared to loans to Texas residents, loans to residents of low-rate Pennsylvania:

- Are much less common.
- Are considerably larger. (In Pennsylvania fewer than 1 percent of loans are made in size under \$1000 compared to almost 70 percent in Texas, Table 10.)
- Have considerably lower APRs. (In Pennsylvania, more than 99 percent of loans carry APR 19 to 36; in Texas 96 percent carry APR 49 to 99, Table 11.)
- Have larger payment amounts due to larger sizes. (In Pennsylvania about 55 percent of loans have payment amount greater than \$150, compared to about 16 percent in Texas, Table 12.)
- Have about the same borrower credit scores, for loans where scores are recorded (Table 13). Larger loans at the same score suggests many Pennsylvania borrowers are borrowing more than they need or want in order to obtain loans at all.
- Are more expensive in total finance charges. This can happen when the rate ceiling in Pennsylvania prevents borrowers from obtaining Texas-type small loans there and they must borrow more than they need and for an extended period (Table 14).

June 24, 2013

## Preliminary Findings from the AFSA Member Survey of Installment Lending

Interest rate ceilings on loans of money or goods are possibly the oldest continuously running controversy. Found in recorded history as early as the ancient Babylonian Code of Hammurabi (c. 1770 BC), imposed rate ceilings probably extend even farther back into unrecorded tribal antiquity. Historical evidence shows that through much of history ceilings have been evaded, which suggests, at a minimum, that ceilings have been continuously controversial (for extended historical discussion, see Homer and Sylla 1996 and Gelpi and Julien-Labruyere 2000, included in the references at the end of this paper).

Today in the twenty-first century United States, a good deal of the modern argument over interest rate ceilings concerns a variety of consumer lending products and processes sometimes collectively referred to as “small dollar.” High interest rates on smaller loans have attracted the attention of various individuals and organizations who would like to see these rates much lower. Much of the discussion has centered on single-payment so called “payday loans” found in many states and which exhibit very high Annual Percentage Rates (APRs), but sometimes other kinds of loans like small dollar installment loans become lumped into such discussions. Typical APRs on these other loans are much lower than on payday loans though higher than on some other familiar kinds of consumer credit. Heretofore, it seems that relatively little is recently known about this other small dollar form of consumer lending, despite discussions that sometimes lump such lending with payday. The purpose of this paper is to provide background, some discussion of relevant economic theory, and a look at some newly available statistical information on small dollar installment lending.

### Background

At the outset, it seems worthwhile to review the reasons why small loans exhibit high interest rates in the first place. This phenomenon arises from the economic fact of “production cost economies of size.” In other words, lending costs rise as loans become larger (because of the need for more careful screening, the need to take and record more payments over time, etc.), *but well less than proportionately*, due to production cost economies of size. A multi-million dollar loan to a top-rated international corporation may cost more to investigate, book, and collect than a small loan to a risky consumer, *but not per loan dollar*.

As a result, the loan charge to cover production costs is going to have to be higher for the small loan per loan dollar. For small loans, the dollar production cost of the loan looms large not in total but rather relative to the dollars of the loan. Much of the production cost arises 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. There also is the cost of the lending capital itself and the cost of risk, which can also be substantial relative to loan amount for small loans. Almost by definition, a borrower in need of a small loan is going to be a risky borrower.<sup>16</sup>

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<sup>16</sup> The credit card industry has spent huge sums of money to automate the lending process for small amounts of credit and reduce overall lending costs, but this impersonal kind of lending is not available to all consumers, especially the riskiest ones. Evidence from the Federal Reserve’s most recent Survey of Consumer Finances in 2010 shows that only 68 percent of families (economic units) have credit cards. And, riskier borrowers who have credit cards may also quickly reach their smaller credit limits but occasionally still need additional credit to meet some emergency or for some other need or desire. The basic theory of why credit-constrained consumers can obtain more credit only at higher rates is in Juster and Shay (1964), especially Appendix I, discussed here later. See also, Durkin, Elliehausen, Staten, and Zywicki (forthcoming, 2013), Chapters 3 and 5.

To cover the average cost of extending a small size loan, a lender will need to charge a number of dollars for the loan that is large *relative to the amount of the loan*, even though the dollar amount of the cost is not in itself very large. Despite the loan size, the lender still needs enough revenue to justify obtaining and maintaining the lending location, hiring and paying the personnel, acquiring the supplies and equipment, raising the capital, and allocating the risk cost. Translating these necessities for small loans into an Annual Percentage Rate as required by Truth in Lending makes the disclosed rate appear very high, even though the dollars involved are much less startling. This anomaly occurs simply because the production cost looms large relative to the loan dollars involved and the short term of the loan on which the lending cost must be recovered.

Difficulties surrounding the relationship of production cost to loan amount and maturity on small loans is hardly a new question. It is worth recalling that the National Commission on Consumer Finance (NCCF) extensively discussed the matter in its *Report* to the Congress in late 1972. The NCCF was a federal study commission established by Title IV of the federal Consumer Credit Protection Act of 1968, the same law that established Truth in Lending as Title I. According to Section 404: “The Commission shall study and appraise the functioning and structure of the consumer finance industry, as well as consumer credit transactions generally. The Commission in its report and recommendations to the Congress, shall include treatment of the following topics: 1) The adequacy of existing arrangements to provide consumer credit at reasonable rates....” The Commission consisted of three members of the Senate, three members of the House of Representatives, and three public members appointed by the President. The Commission had a staff of economists and lawyers and retained the services of a number of outside economists and lawyers as consultants. In addition to its extensive *Report*, the Commission also issued six volumes of supporting technical studies.

In Chapter 7 of its *Report*, the Commission explored the relationship among lending production costs, rate ceilings, and credit availability for consumer finance companies making small installment loans. As part of its investigations, the Commission undertook extensive data gathering and empirical work. To study costs of consumer finance companies, the Commission engaged the late Professor George J. Benston of the University of Rochester, the leading expert in the country at the time on the use of statistical cost studies of production processes of financial institutions (see Benston 1975 and Benston 1977). While the Commission undertook its work many years ago, the underlying principles have not changed and the Commission’s work remains illustrative. As a first look at small loan lending more recently, it is useful to examine the Commission’s findings.

One of the Commission’s interesting findings based upon its cost studies was how the annual percentage rates necessary before a consumer finance company would make loans of small sizes would have to be quite high, approaching triple digits at the smaller loan sizes, due to the necessity of covering production and risk costs with only small amounts of loan dollars. Adjusting the Commission’s findings for inflation over the years since then, the Commission’s cost work suggests the necessity of APRs of at least 43 percent before installment finance companies would make loans of \$1600 today. Smaller loans would require even higher rates because of the necessity of recouping the production costs from even smaller loan amounts.

In more detail, since the time of the Commission’s *Report*, there has been substantial domestic inflation. The smallest loan sizes the Commission explored in 1972, \$100 and \$200, in 2012 had the purchasing power of about \$549 and \$1098. It is possible similarly to adjust the underlying production costs the Commission explored for inflation to look at the relationship between costs and loan interest rate necessary to cover costs in today’s dollars. Adjusting directly for changes in the consumer price index over this period is not unreasonable because much of the operations of consumer finance companies making such loans has not changed very much. While some cost-causing features of lending have

undoubtedly changed over the decades, for example, office automation has reduced record keeping costs, most have not. Consumer finance company lenders still must pay personnel costs, rents, equipment costs, utilities, postage, and taxes. Salaries and benefits of employees per price-adjusted loan dollar likely have not decreased, even with office automation, because the more sophisticated nature of the technologies employees now use for record keeping and today's more stringent regulatory obligations require better educated and trained employees.

Translating the Commission's findings directly into today's dollars, the Commission's conclusion was that the Annual Percentage Rate on today's \$549 loans for one year would have to exceed 94 percent before lenders would be willing to make such loans at the risk level the Commission suggested was necessary to "allow for enlargement of the market through a higher degree of risk acceptance" (National Commission on Consumer Finance 1972, p. 144). Further, rates on today's \$1098 loans would need to exceed 56 percent before lenders would consider loans of this size, and rates would have to exceed 36 percent for any loan size less than \$2196 (see discussion and table in National Commission on Consumer Finance 1972, p. 144).

Even then, these conclusions about necessary rates assumed that loans would be made for a one year period. The Commission specifically noted that shorter term loans would need even higher APRs because the loans would be outstanding and earning revenue even less time but the operating costs would still need to be recovered. According to the Commission, "Recognizing that loans of [typical small sizes found then], the required APR will be higher than in Exhibit 7-16 [of the Commission's *Report*] because the costs of putting the loan on the books and servicing it must be recaptured over the shorter time" (National Commission on Consumer Finance 1972, p. 145). The Commission's cost estimates also assumed monthly payments. Operating costs would be higher for loans with more frequent payments because they would require more personnel costs for servicing the more frequent payments, other things equal.

The historical record demonstrates the seriousness of the Commission's concerns over credit availability. Well known to the Commission, beginning in 1910 the Russell Sage Foundation had undertaken a philanthropic program to fight illegal loan sharks then prevalent in many places. The Foundation proposed for passage in the various states model legislation known as the Uniform Small Loan Law and advocated its acceptance. This model act provided for exceptions to low state rate-ceiling laws to permit state-licensed lending entities to provide small dollar cash loans to consumers legally. By the 1960s, almost all states had passed a version of this law. Even so, well known inadequacies of legal rates on the smallest loan sizes had come to the National Commission's attention and were the motivating factor in its study of this area and its recommendations at the end of 1972.<sup>17</sup>

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<sup>17</sup> The Uniform Small Loan Law's early choice of 3½ percent rate per month was based on the Russell Sage Foundation's studies of cost and experience of remedial loan companies and other small loan lenders at the time (see Clark 1931, pp. 46-7, Robinson and Nugent 1935, pp. 115-7), and Carruthers, Guinnane, and Lee 2009, p. 13).

Even then, the Foundation recognized that most lending costs are fixed, so that a 3½ percent ceiling made a \$100 loan less profitable than a \$300 loan, discouraging production of the smaller loans. The Foundation's position on transparency and simplicity of the transaction prevented it at first from supporting any particular remedy for this problem, however, such as allowing the lender to charge a higher percentage finance charge for smaller loans or a fixed fee per loan (see Carruthers, Guinnane, and Lee 2009). Either of these changes would complicate the transaction. Graduated rate ceilings, which allow higher rates on smaller loans, later became a common feature in state small loan laws.

## Hypotheses from the Economic Theory of Credit Rationing

In their economic analyses of the consumer's credit decision, Juster and Shay (1964) explained why consumers may sometimes be willing to borrow at high rates of interest (see also Durkin, Elliehausen, Staten, and Zywicki 2013, Chapter 3, for further discussion). To summarize, Juster and Shay argued that many products purchased using credit provide benefits over a period of time. Examples include car purchase for transportation to place of employment, home or car repair, and emergency health care expenditures. Such benefits imply a rate of return and a present value that can be compared with the cost of acquiring the product or service, and acquisitions that produce returns greater than costs are wealth and utility increasing. Limited empirical evidence at that time suggests that the return on durable assets can be quite large for many households (see Poapst and Waters 1964 and Dunkelberg and Stephenson 1975).

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 investing in high return durable goods or necessary household services will borrow when the rate of return on the purchases is greater than the lending rate of primary lenders. In the equilibrium case, the amount borrowed does not exceed the limit set by primary lenders, and the rate of return on investment, the interest rate (discount rate), and marginal rate of time preference are all equal in equilibrium.

However, discontinuities in market availability of borrowing can prevent consumers from taking advantage of potentially utility-increasing opportunities or needs through borrowing. Notably, rationing can prevent a consumer from borrowing further at lower rates, if the consumer exhausts availability of credit at the lower rate charged by primary lenders. In this case the borrower might well consider secondary lenders. The rate of return on the expenditures could be as high as the higher rate charged by secondary lenders (or even greater than the higher borrowing rate in which case the preferred amount of borrowing exceeds the secondary lenders' limit).

Based on this theory, 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.<sup>18</sup> Within this theoretical context, Juster and Shay identified characteristics that likely distinguish rationed and unrationed borrowers. Their distinction between unrationed and rationed borrowers is useful in assessing consumers' use of high APR credit products.

Specifically, rationed borrowers are likely to be 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 to pay for large expenses personally costly. And because of their moderate incomes and relatively 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.

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<sup>18</sup> A large, disproportionate percentage of unrationed borrowers using high APR credit products would raise a question whether the credit use is irrational, as marginal borrowing rates for unrationed borrowers are normally relatively low. But surveys of users of high rate consumer credit products have found that they are not representative of the population as a whole or even of credit users generally, but rather are more limited in their credit options. For discussion, see Durkin, Elliehausen, Staten, and Zywicki, Chapter 8.

In these cases, subjective yields on any liquid asset holdings are higher than nominal yields for many consumers because of strong precautionary motives. Many consumers use liquid assets grudgingly even when events occur that impair their earning potential or 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.

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

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 automated credit reporting agencies (credit bureaus) is now close to comprehensive. Credit reports thus generally 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. Lenders' requirements for borrowers' equity in the purchases 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 durable goods 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 at the lower rates they offer.

Nonetheless, higher cost credit products from secondary lenders have also proliferated. Unsecured credit has become more 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 lower cost than in the past.

There also are various "subprime" versions of credit cards, automobile financing, mortgage loans, and other credit. As this term suggests, such products are mostly used by those who exhibit greater amounts of credit risk than mainstream consumers and likely are more credit constrained at low rates. 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 disrupted aspects of subprime credit markets, but after necessary reevaluation and restructuring, these credit sources are unlikely to go away.

There also are new short term subprime cash-lending products to go with the small loan industry that has existed for decades and 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 have enabled consumers to obtain an advance on expected tax refunds. Small installment loans are different from these other products

because their multipayment nature suggests they can be better adapted to the budgets of rationed borrowers.

Juster and Shay suggested several empirically testable hypotheses about rationed and unrationed borrowers' demand for credit. Looking at the hypotheses relevant for small installment lending, they predicted that:

- (1) unrationed borrowers' demand for credit would be more sensitive to interest rates than rationed borrowers' demand;
- (2) a simultaneous increase in the interest rate and term to maturity that reduces the amount of monthly payments would increase borrowing by rationed borrowers and decrease borrowing by unrationed borrowers;
- (3) and, more generally, that rationed borrowers would respond more strongly than unrationed borrowers to differences in monthly payments.

Juster and Shay tested these hypotheses in an experimental study in which a panel of consumers was asked to express preferences for different hypothetical sets of credit terms. Consumers were classified into rationed and unrationed groups based on their income and family life cycle stage, and responses were used to compute elasticities of credit demand for rationed and unrationed groups.

Evidence from the experimental data was consistent with the predictions of Juster and Shay's theoretical model. The evidence strongly supported hypotheses that unrationed borrowers' demand was more sensitive to interest rates than rationed borrowers' demand (hypothesis 1) and that a simultaneous increase in the interest rate and term to maturity that reduces the amount of monthly payments increased rationed' borrowers' demand and decreased unrationed borrowers' demand (hypothesis 2). They also found that rationed borrowers responded more strongly than unrationed borrowers to changes in monthly payments (hypothesis 3).

Significantly, Juster and Shay's analysis reconciled the apparent inconsistency noted at that time between consumers' lack of sensitivity to interest rates and the predictions of neoclassical economic theory as handed down from Fisher (1907, 1930) and Seligman (1927): Rationed consumers, whose demand for debt exceeded the amount available at going interest rates and who, therefore, were not sensitive to these interest rates, likely comprised a large majority of the population at that time. Thus, aggregate data from then and earlier largely reflected the behavior of these rationed borrowers. The aggregate data obscured the behavior of the smaller group of unrationed borrowers, who were sensitive to interest rates.

The hypothesized large proportion of rationed consumers at the time also provides insight into consumers' lack of knowledge of interest rates also noted then: Rationed consumers do not need to know the interest rate to minimize credit costs. Rationed consumers find the longest available maturity and shop for the lowest monthly payment (payment size is perfectly correlated with interest rate for a given loan size and maturity). Juster and Shay found that knowledge of interest rates actually paid on recent credit transactions was concentrated mainly among the unrationed consumers, who need to know the interest rate to make rational credit decisions. Nevertheless, at that time, before Truth in Lending, many of the unrationed borrowers also underestimated or did not recall the rate paid. Later studies have shown that lack of knowledge has changed in the years since Truth in Lending went into effect in 1969 (see Durkin and Elliehausen 2011, Chapter 7).

Juster and Shay believed that the proportion of unrationed consumers (and, therefore, consumers' overall sensitivity to interest rates) would increase gradually over time. They pointed to secular growth in consumer income and a trend toward longer terms to maturity as factors that would shift consumers from

rationed to unrationed groups. In addition to the factors identified by them, advances in creditors' ability to assess and price risk have likely reduced the proportion of rationed consumers in the population in recent years. It seems that all these factors likely have reduced the proportion of rationed borrowers in the marketplace, but certainly not to zero.

There also were limited subsequent empirical tests of Juster and Shay's theory. In an experimental study, Walker and Sauter (1974) presented to a random sample of consumers pairwise comparisons of five alternative sets of financing terms for a household appliance. The sets of financing terms varied in terms of interest rate, product price, monthly payment size, and amount of downpayment. For each of ten possible pairs of alternatives, consumers chose the alternative that they preferred. Comparing the responses of lower income and higher income consumers, Walker and Sauter found that greater proportions of lower income consumers than higher income consumers preferred alternatives with lower monthly payments regardless of interest rate over sets with higher monthly payments or positive downpayment. They interpreted these results as consistent with Juster and Shay's hypotheses.<sup>19</sup>

More recently, Attanasio, Goldberg, and Kyriazidou (2000) used automobile purchase data from the 1987-1995 Consumer Expenditure Surveys to estimate interest rate and maturity elasticities for households hypothesized to be more or less likely to be rationed. Both their modeling and their statistical work are somewhat technical, but they provided evidence based on actual consumer behavior that credit choices of households likely to be rationed are sensitive to loan term (hence, other factors being equal, to the size of monthly payments). In contrast, they found that credit choices of households likely to be unrationed were sensitive to the interest rate but not loan term. Classifying consumers as rationed or unrationed on the basis of age or income alone is not precise, since rationing involves both high demand for debt and limited resources for servicing the debt.<sup>20</sup> Nonetheless, these findings provide additional support for Juster and Shay's theoretical model of consumer credit use.

Available information specifically about the characteristics of borrowers of small installment loans suggests the likelihood of their being rationed by primary lenders, although the only study specifically of these borrowers (undertaken for the National Commission on Consumer Finance) is also quite old (Durkin 1975). This study shows that at that time small loan borrowers were concentrated among the lower income segments of society. The results of a survey of borrowers showed that most of

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<sup>19</sup> Walker and Sauter's analysis has several technical flaws that diminish its contribution to understanding consumers' credit preferences, however (see Burstein 1978). For instance, they did not take into account that the size of monthly payment is not independent of price, downpayment, interest rate, and term to maturity. Some of the alternatives were clearly preferable to others, and choice between a higher product price or a higher interest rate is a matter of indifference for all consumers when the monthly payment and the downpayment are the same. Several pairs of alternatives did involve tradeoffs that theory predicts would cause rationed or unrationed borrowers to choose one or the other of the alternatives, but Walker and Sauter's classification of consumers as rationed or unrationed consumers solely on the basis of income is inadequate. (For example, a household in retirement may have low income but would not normally be rationed because demand for credit would often be low.) Walker and Sauter reported statistically significant differences by education, occupation, marital status, and sex. However, they did not discuss how such differences might be related to Juster and Shay's or any other hypotheses about consumers' behavior.

<sup>20</sup> Attanasio, Goldberg, and Kyriazidou also estimated their model for age groups (less than 35 years and 35 or older) interacted with education (high school diploma or less and some college or college degree). Partial derivatives were not statistically significant except for the group of households headed by persons less than 35 years of age with a high school diploma or less education. For that group, the partial derivative with respect to maturity is statistically significant and positive. As lower levels of education are associated with lower income, this group is likely to have both high demand and limited resources.

them belong to the parts of the population that often had trouble at the time obtaining credit elsewhere. Many of them reported being turned down elsewhere.

### Recent Experience

With this as background, what does this mean for small dollar installment cash lending today? Little statistical information about small installment loans or borrowers has been available, but recently the American Financial Services Association has surveyed its members about small dollar installment loans. The survey collected information on the characteristics of 5.2 million installment loans outstanding as of the end of December, 2012. To focus on the most current lending, the discussion here reflects loans outstanding on December 31, 2012 and that were made in the previous six months. There were 2.5 million of these loans made by surveyed companies during this six month period.

Evidence from this survey suggests that the overwhelming majority of these loans were subprime in nature (discussed in more detail below). About half of the loans reported a credit score, and about 85 percent of them can be classified as subprime (Table 1). Among the loans with scores, about 27 percent were deep subprime, with scores below 551. Only about 2 ½ percent of the loans with scores went to borrowers with good credit standing (fifth column from left in the table). In other words, most of the customers for this kind of installment loans probably were ineligible for much credit from mainstream lenders.

The subprime character of these loans immediately suggests some specific hypotheses about small installment loans based ultimately upon the work of Juster and Shay. (Among the hypotheses about these loans, the fourth concerns the geographic distribution of the loans, suggesting they may not be available everywhere. Consequently, the other hypotheses apply only to the areas where the loans are available.)

First, the loans likely are quite small. Since they are mostly subprime in character, many of them likely are made to borrowers who have little availability of credit at primary lending sources or who have loans from primary lenders but have exhausted any further credit availability from them and are only eligible for relatively small loans at secondary (subprime) lenders. This suggests that large loans are unlikely.

Second, the loans likely exhibit relatively high APR's both because they are small and because they are made to risky borrowers.

Third, consistent with the findings of Juster and Shay, the loans likely are of appropriate size to keep the payments low and within budgets of subprime consumers. This would come about because credit constrained consumers will demand longer maturities and smaller payments whenever possible and lenders will be more likely to lend in a way where payment size of constrained consumers suggests a greater likelihood of receiving the money back.

Fourth, because rate ceilings vary substantially among the states, prevalence and characteristics of these loans probably vary substantially among the states as well.

Examination of the survey data produces findings consistent with each of these hypotheses. First, survey results show that these cash loans are mostly quite small. Almost 83 percent of the loans were made in amounts of \$2000 or less (sum of the first three lines of Table 2). This suggests they were substitutes for amounts of credit otherwise available on credit cards, likely indicating these customers were unable to obtain credit using cards, or at least as much credit as they preferred. Consistent with their

generally small size, these loans also exhibited short maturities: Almost 90 percent were made for a term of 24 months or less (sum of first three columns of Table 2). Almost 70 percent had terms of one year or less.

Not surprisingly, loan size and maturity are correlated. The smallest loans have the shortest maturities and larger loans longer maturities (demonstrated by the slant of the numbers in Table 2 downward to the right). The relationship between size and maturity so that the largest loans have the longest maturities, likely is an attempt to fit the loan payments effectively into monthly budgets. This is unlike payday lending where the single-payment payday loans are due in one lump, probably causing frequent budget difficulties.

Second, the survey results also show that the APRs on these loans are higher than on the most familiar mainstream kinds of credit for consumers like mortgage credit and credit card credit. APRs range upward to and over 100 percent on an annual basis for the smallest loans (Table 3). The loans also show an inverse relationship between loan size and APR: the highest APRs are associated with the smallest loans, which are also the loans with the shortest maturities. This is exactly what the National Commission on Consumer Finance predicted in 1972 that a competitive market would produce. Further, the range of rates is right where the National Commission predicted in 1972 they would have to be, based on its cost studies, before lenders would be willing to make loans of this kind.

Third, consistent with suggestions from Juster and Shay, the survey results also demonstrate directly what appears to be an attempt to fit repayments into households' budgets. Virtually all the smallest loans have monthly payments of \$100 or less (less than two tanks of gas in recent months), and up to \$1000 loans \$150 or less (intersection of the first two lines of Table 4 with the first three columns).

The survey also shows that, on balance, installment borrowers are slightly younger than the population average (not in table). Further, there is some indication that smaller loans more often go to younger borrowers and larger loans to older ones (Table 5), but neither relationship is especially strong. Rather, there is indication that borrowers of all ages borrow in amounts across the board, but with some limited tendency toward a direct relationship between age and loan size.

In sum, the survey of installment lending shows that the industry makes mostly small subprime loans with short maturities, the kind of loans that might be expected of secondary lenders as predicted by Juster and Shay. The Annual Percentage Rates of charge on these loans are relatively high by the standards of many common (and larger) kinds of loans made to middle class consumers, but the rates are right where the National Commission on Consumer Finance predicted a generation ago they would have to be before lenders would make this sort of loan. There is evidence of attempt to make repayment plans fit into budgets, which is much different from the single-payment nature of other subprime cash loans like payday, auto title, and pawn loans. Although there is indication that younger consumers tend to borrow in smaller amounts, this relationship is not strong and loans of all sizes range across all age groups.

#### Further Evidence of Lending Risk

The survey results also demonstrate further evidence of the relationship between various loan features and after-the-fact measurement of lending risk in this lending segment. For instance, the survey showed that about one quarter of the loans were in some state of delinquency on the survey date (December 31, 2012), a high proportion. A portion of these loans (though not all) are destined for eventual repayment but probably with some (costly) difficulties, like employee reminders and even potential legal action for some of them.

There are clear correlations between delinquency on the survey date and loan features. For example, small loans are much more likely to be delinquent than larger loans (Table 6). More than 35 percent of the smallest loans were delinquent on the survey date (even though likely most of this money is headed eventually toward repayment, even with some difficulty), but only about 10 percent of the largest loans. This undoubtedly reflects the greater willingness of lenders to take chances with smaller amounts of money than large amounts.

Likelihood of delinquency is definitely correlated with credit score (Table 7). More than a third of the loans in the lowest score group were in delinquent state on the survey date, but only about 5 percent of those in the highest score grouping. This relationship is not surprising, but it is very strong. Based on this evidence, it is easy to conclude that both loan size and credit score are predictors of risk. (The totals in this table differ slightly from Table 6, because not all loans report a credit score.)

The fact of greater risk on loans with different sizes and credit scores clearly shows itself in the relationship between delinquency and APRs charged (Table 8). Simply stated, riskier loans, as demonstrated by their actual delinquency state on the survey date, are also the ones that receive the highest APRs. This demonstrates the common-sense notion that lenders are willing to make loans to the riskiest borrowers only if they receive compensation for the risk.

While loan size clearly is also a factor, with the smallest loans exhibiting the highest APRs, the smallest loans also are the riskiest and for that additional reason are going to be associated with high APRs. Again, this is consistent with the contentions of the National Commission on Consumer Finance in 1972 and noted above that only sufficient rates would “allow for enlargement of the market through a higher degree of risk acceptance” (National Commission on Consumer Finance 1972, p. 144). It is possible to contend that causality is the other way and the high APRs cause the delinquency, but this seems unlikely in most cases, since calculations show that higher APRs have a much greater impact on lenders’ revenues (and compensation for the costs of risk) than they do on monthly payments, since repayment of the principal sum and not interest on the loan represents the dominant share of the payment amount, as it also does on other kinds of small dollar credit..

#### Differences among States

To examine the fourth hypothesis above, that prevalence and characteristics of installment lending vary substantially among the states according to regulatory features, it is possible to array the loans according to residence area of the borrowers. By concentrating on totals, the discussion so far masks any differences that may exist among the states. Differences among state may arise either because of differences in local demand or because of variations in supply factors, notably including variations in regulation. As the National Commission on Consumer Finance pointed out in its report in 1972, demand for small cash loans is widespread but legal rate ceilings will alter supply.

Distribution of the loans in the database according to the residence of the borrower (zip code) shows large differences in concentration of these loans among the states. One state (Texas) accounts for one quarter of the surveyed loans, and only nine states combined account for about three quarters of the loans (Table 9). In contrast, there were fewer than 1000 loans each made to residents in zip codes of 18 states, including the populous states of Minnesota, Maryland New York, New Jersey, and Massachusetts. Sixteen states, including Massachusetts, New York, and New Jersey had fewer than 100 loans.

Median loan size made also varied sharply among the states. All nine of the states with the largest number of loans outstanding showed median loan size made of \$1000 or less. In contrast, ten other states

showed median loan size made of more than \$3000, including Colorado and Washington at more than \$4000 (not in table).

Geographic distribution of these closed end cash loans naturally reflects the distribution of the lending locations or offices where lenders make these closed end loans, and the location of the offices reflects rate ceilings. All of the nine states that account for the bulk of the small loan lending are states permitting relatively high rates of charge on these small loans. In contrast, all of the states with very few loans are low rate states.

It is, of course, possible for borrowers to approach a lender in another state if regulatory differences suggest greater availability of lending offices and credit there. For this purpose, Arkansas offers a good test. It is a known low rate state, but the survey shows more than 20,000 loans made to Arkansas residents despite this regulatory distinction. Arkansas is especially noteworthy because it borders four of the states identified in Table 9 as states with many small closed end cash loans (Texas, Tennessee, Oklahoma, and Louisiana).

Examination of the zip codes of Arkansas loans shows that almost all of the borrowers reside in the 31 counties that border other states, in particular Oklahoma, Missouri, Louisiana, and Texas. Consequently, it seems probable that most of these small loans were made by lenders across the state border. In sharp contrast, only 313 of the 20,566 Arkansas loans were made in the 44 interior counties, despite inclusion there of the largest population centers in the state, the Little Rock and Pine Bluffs areas. Likely at least some, if not all, of the loans in the interior counties also involved borrowing across the state line.

Loans to borrowers in other low rate states also may be made across state lines, but it seems that unless rates on the smallest loan sizes are relatively high, small dollar lenders are not going to populate these states and loans actually made by lenders who do locate there are going to be considerably different from the loans made in states with many loans. California and Pennsylvania provide examples. Neither has an especially high rate ceiling on the smallest sizes and neither borders another state with this characteristic. In fact, the loans actually available to the residents of these two states are much different from those in the states permitting higher rates on the smaller sizes, for instance, Texas.

Using Pennsylvania for the comparison state, cash lending was much more common by surveyed companies in Texas during the period of the lending survey. There were 23.9 loans outstanding at surveyed companies in Texas on the survey date per 1000 population, but only 1.5 loans per 1000 population in Pennsylvania. Furthermore, the loans had very different characteristics.

Loans in Pennsylvania are much larger than in Texas. In Pennsylvania, the survey found almost no loans of \$500 or less and only about 1 percent of the loans at \$1000 or less (Table 10).<sup>21</sup> This Pennsylvania distribution compares to about 42 percent of Texas loans in the smallest size and almost 70 percent in amount of \$1000 or less. This difference suggests that small loans sizes are mostly unavailable in Pennsylvania but also the potential that borrowers in Pennsylvania might sometimes need to borrow more than they really prefer in order to find lenders willing to make any loan.

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<sup>21</sup> It appears that the bulk of the Texas loans at surveyed companies were made under Chapter 342, Subchapter F of the Texas Finance Code, a provision that allows higher rates on loans of \$1300 or less. There is no comparable provision of Pennsylvania law. For recent discussion of Section 342 of the Texas Code see Hutchings and Nance (2012).

Other comparisons are consistent with the loan size difference. For instance, APRs on Texas loans are higher (Table 11). This is consistent with the contention of the National Commission on Consumer Finance that high rates are necessary on small loans in order for the lenders to be able to recover lending costs on the small dollars of credit involved. In Pennsylvania, almost all loans were made at APRs from 19 to 36 percent but the mostly smaller loans in Texas showed rates 49 to 99 percent, in line with what the NCCF suggested would happen. (Looking more closely at the Pennsylvania distribution, more than 80 percent of the loans carried APRs of 25 to 27 percent, reflecting the rate ceiling at the upper end of this range (not in table)). Almost all of the rest of the loans carried APRs of 22 to 24 percent.) Payment size also reflected loans size difference. In Pennsylvania, almost 55 percent of the loans were made with monthly payment size greater than \$150; the corresponding proportion in Texas was about 16 percent (Table 12).

It is interesting to note that the difference in credit scores is not as pronounced between the states as the other loan characteristics (Table 13). Clearly, most borrowers in both states can be considered subprime (scores below 661). It is possible that lenders in Pennsylvania are willing to take the risks of making larger loans with some borrowers, albeit a smaller number than in Texas. It is possible that this reflects individual lender favorable experiences with certain borrowers that make them willing to grant the loans despite subprime credit scores or no credit scores. (Almost all Pennsylvania loans had scores.) It also again suggests the possibility that some Pennsylvania borrowers may be taking larger loans than they otherwise would prefer if smaller loans were available under the state's lower rate ceilings.

This highlights difficulties that occur when rate ceilings prevent subprime borrowers from obtaining loans in the sizes they desire and have to obtain larger loans than necessary to be able to obtain loans at all. A first difficulty arises from the potential risk that these consumers may not have the requisite self discipline or show enough care to retain in their reserves the excess funds they must borrow beyond what they want to borrow. If they also spend the additional funds, this increases their repayment burden beyond what it would be with a smaller loan. Simply put, they have to repay more principal over a longer time and this can pose financial risks for them.

A second difficulty is that the additional borrowing for a longer time also means higher finance charges, despite the lower APR. It is easy enough to see this effect from some examples using typical APRs and loan sizes in Texas and Pennsylvania.

Suppose a credit constrained borrower in Pennsylvania needs or wants a \$500 loan, a typical small loan in Texas, but it is unavailable from either primary or secondary lenders in Pennsylvania. In Texas, suppose this small loan would entail 6 monthly payments of \$107.88 at APR of 95 percent. Total finance charge over the six months would be \$147.31 (top panel of Table 14).

Suppose also that a secondary lender in Pennsylvania is unwilling to make a Texas-type small loans but is willing to lend a typical Pennsylvania-type small loan. This entails a loan of \$2000 at 27 percent. To keep the payments roughly equivalent, the loan is made for 24 payments of \$108.76 (lower panel of Table 14). The problem is that the finance charge more than quadruples despite the lower APR, due to the larger loan and longer maturity.

The calculus is similar if the borrower wants a \$1000 loan, a typical large loan for these Texas small dollar lenders. In this case where the Texas lender would make this loan at 72 percent APR for 12 months of payments of \$119.28. Such a loan is illegal in Pennsylvania.<sup>22</sup> A borrower there in need of a

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<sup>22</sup> The small number of such loans visible in Table 11 probably are loans made by telephone, mail, Internet, or to individuals who subsequently moved to Pennsylvania from some other state.

\$1000 loan but unable to obtain one because of the ceiling might instead obtain a \$2000 loan at 27 percent, assuming the borrower qualifies for the larger loan. Using the same example for the Pennsylvania loan, it would involve almost the same payment size as the Texas loan (\$108.76 in Pennsylvania at 27 percent APR versus \$119.28 in Texas at 72 percent APR). But because the loan would be both larger and longer in Pennsylvania, the finance charge would accrue for a longer time and in total would be considerably more than on the shorter Texas loan at higher APR, assuming the Pennsylvania borrower even qualifies for the larger loan at the lower rate. It is not at all clear that these Pennsylvania borrowers are better off when looking for small loans under the Pennsylvania rate ceiling than they are in Texas where the rate ceilings are much higher but small loans are available.

Finally, the survey results show that Texas borrowers are somewhat younger than their counterparts in Pennsylvania (Table 15). In Texas, the survey found that about 29 percent of loans were to borrowers under age 35, compared to about 19 percent in Pennsylvania. This also is consistent with the Juster-Shay conception of rationed borrowers.

Table 1. Credit Score

Installment Loans Outstanding End of September 2012  
and Made During Previous Six Months

	<u>Credit Scores</u>					
	$\leq 551$	551-619	620-659	660-699	$\geq 700$	All
All	27.2	42.4	15.8	12.2	2.4	100.0

Notes for Tables 1 through 5:

Values are percents of the total.

Columns and rows may not add exactly to totals because of rounding.

Source for Tables 1-14: Installment Loans Survey.

Table 2. Installment Loan Maturities (Months)

	1-6	7-12	13-24	25-36	37-120	>120	All
Loan Amount (TIL Amount Financed)							
< \$501	15.5	15.3					30.8
501-1000	0.4	26.0	0.7				27.2
1001-2000	0.2	11.1	12.7	0.6			24.6
2001-5000		0.1	7.1	6.1	0.7		14.0
5001-10,000			0.3	2.3	0.6		3.1
>\$10,000				0.2	0.1		0.3
All	16.1	52.6	20.8	9.1	1.4		100.0

Table 3. APR (Percent)

	<18	19-36	37-48	49-99	100-199	≥200	All
Loan Amount (TIL Amount Financed)							
< \$501		0.1	1.1	18.1	11.4		30.7
501-1000		1.3	7.0	17.5	1.3		27.2
1001-2000		5.2	9.4	10.0			24.6
2001-5000		11.7	2.3				14.0
5001-10,000	0.1	3.0					3.2
>\$10,000		0.3					0.3
All	0.1	22.0	7.3	57.3	13.1	0.2	100.0

Table 4. Payment Amount (Dollars)

	<50	50-100	101-150	151-200	>200	All
Loan Amount (TIL Amount Financed)						
< \$501	1.9	28.7	0.2			30.8
501-1000	0.1	14.6	12.2	0.2	0.1	27.2
1001-2000		3.0	16.4	5.1	0.1	24.6
2001-5000		0.3	6.0	6.3	1.4	14.0
5001-10,000				0.3	2.9	3.1
>\$10,000					0.3	0.3
All	2.0	46.6	34.7	11.9	4.8	100.0

Table 5. Age of Borrower

	18-24	25-34	35-44	45-54	55-64	≥65	All
Loan Amount (TIL Amount Financed)							
<\$501	5.5	7.2	5.8	5.5	4.1	2.6	30.8
501-1000	1.9	5.2	5.7	6.0	4.9	3.4	27.2
1001-2000	0.9	4.0	5.4	6.0	4.9	3.2	24.5
2001-5000	0.3	2.0	3.2	3.7	2.9	1.9	14.0
5001-10,000		0.4	0.8	1.0	0.7	0.3	3.2
>\$10,000			0.1	0.1	0.1		0.3
All	8.7	18.9	20.9	22.3	17.7	11.5	100.0

Table 6. Delinquency and Loan Amount

	<\$500	501-1000	1001-2000	2001-5000	5001-10000	>\$10,000	All
Delinquent:							
Yes	35.3	25.2	20.1	13.4	10.1	10.6	23.3
No	64.7	74.8	79.9	86.6	89.9	89.4	76.7
All	100	100	100	100	100	100	100

Table 7. Delinquency and Credit Score

	<550	559-659	660-699	650-699	≥700	All
Delinquent:						
Yes	33.9	20.2	14.0	10.1	5.5	21.3
No	66.1	79.8	86.0	89.9	94.5	78.7
All	100	100	100	100	100	100

Note for Tables 6 through 8:

Values are percents of each column.

Columns and rows may not add exactly to totals because of rounding.

Table 8. Delinquency and APR (Percent)

	<18	19-36	37-48	69-99	100-199	≥200	All
Delinquent:							
Yes	9.5	12.4	21.8	28.6	36.9	50.7	23.2
No	90.5	87.6	78.2	71.4	63.1	49.3	76.8
All	100	100	100	100	100	100	100

Table 9. States with Many and Few Loans

States with Many Loans:	Percent of Total	Median Size (Dollars)
Texas	25.0	598
Georgia	8.6	755
Tennessee	8.2	745
South Carolina	7.3	731
Oklahoma	6.6	789
Illinois	5.9	1000
Alabama	4.9	552
Louisiana	4.2	674
New Mexico	3.8	556
Total Nine States	74.5	

Examples of Populous States  
with Very Few Loans<sup>1</sup>

	Number of Loans	
Minnesota	918	*
Maryland	172	*
New York	96	*
New Jersey	62	*
Massachusetts	12	*

Notes for Table 9:

<sup>1</sup> After rounding, each of these states accounts for 0.0 percent of the total. In addition, there also were 13 additional states not listed in the table with fewer than 1000 loans.

\* Not enough loans to construct a meaningful average size.

Table 10 Installment Loan Maturities (Months)

		Pennsylvania Loans						
Maturities (Months):		1-6	7-12	13-24	25-36	37-120	>120	All
Loan Amount (TIL Amount Financed)								
< \$501			0.1					0.1
501-1000		0.3	0.4	0.1				0.8
1001-2000		0.6	4.1	9.6	0.6			15.0
2001-5000		0.1	0.8	24.3	32.5	0.6		58.3
5001-10,000				1.5	18.5	3.7		23.8
>\$10,000					0.8	1.2		2.0
All		1.0	5.5	35.5	52.5	5.5		100.0

		Texas Loans						
Maturities (Months):		1-6	7-12	13-24	25-36	37-120	>120	All
Loan Amount (TIL Amount Financed)								
< \$501		27.8	13.9					41.7
501-1000			27.1					27.1
1001-2000			25.1	3.1				28.3
2001-5000				1.9	0.5			2.5
5001-10,000				0.1	0.3			0.4
>\$10,000								
All		27.8	66.1	5.2	0.8			100.0

Table 11 APR

Pennsylvania Loans

APRs (Percent):	<18	19-36	37-48	49—99	100-199	≥200	All
Loan Amount (TIL Amount Financed)							
< \$501							0.1
501-1000		0.7		0.1			0.8
1001-2000		14.9		0.1			15.0
2001-5000		58.3					58.3
5001-10,000		23.8					23.8
>\$10,000		2.0					2.0
All		99.7		0.2			100.0

Texas Loans

	<18	19-36	37-48	49—99	100-199	≥200	All
Loan Amount (TIL Amount Financed)							
< \$501				41.5	0.2		41.7
501-1000				27.0			27.1
1001-2000		0.7		27.6			28.2
2001-5000		2.5					2.5
5001-10,000		0.4					0.4
>\$10,000							
All		3.7		96.1	0.2		100.0

Table 12. Payment Amount

Pennsylvania Loans						
Payments (Dollars):	<50	50-100	101-150	151-200	>200	All
Loan Amount (TIL Amount Financed)						
< \$501		0.1				0.1
501-1000	0.1	0.5	0.1			0.8
1001-2000		8.6	5.7	0.7		15.0
2001-5000		1.8	28.4	23.8	4.3	58.3
5001-10,000				2.4	21.4	23.8
>\$10,000					2.0	2.0
All	0.2	11.1	34.1	26.9	27.7	100.0

Texas Loans						
	<50	50-100	101-150	151-200	>200	All
Loan Amount (TIL Amount Financed)						
< \$501	6.2	35.5				41.7
501-1000		12.6	14.5			27.1
1001-2000		0.1	14.5	13.7		28.3
2001-5000			0.5	1.6	0.4	2.5
5001-10,000					0.4	0.4
>\$10,000						
All	6.2	48.2	29.5	15.3	0.8	100.0

Table 13. Credit Score

		Pennsylvania Loans					
Scores:		<551	551-620	621-660	661-700	≥700	All
Loan Amount (TIL Amount Financed)							
< \$501							
501-1000		0.2	0.2	0.1	0.1	0.1	0.7
1001-2000		3.6	5.7	3.1	1.5	0.8	14.8
2001-5000		15.8	22.1	12.3	5.7	2.6	58.5
5001-10,000		5.7	9.2	5.3	2.7	1.0	24.0
>\$10,000		0.5	0.8	0.5	0.2	0.1	2.0
All		25.9	38.0	21.2	10.2	4.6	100.0

		Texas Loans					
Scores:		<551	551-620	621-660	661-700	≥700	All
Loan Amount (TIL Amount Financed)							
< \$501							
501-1000		10.0	14.3	5.4	1.7	0.4	31.8
1001-2000		6.8	11.6	5.4	2.2	0.5	26.4
2001-5000		8.0	14.7	8.6	4.3	0.9	36.4
5001-10,000		0.7	1.8	1.2	0.6	0.1	4.5
>\$10,000		0.1	0.3	0.1	0.1		0.7
All		25.6	42.6	20.8	8.9	2.0	100.0

Table 14. Examples of Loan Terms and Charges on Typical Small and Large Loans in Texas and Pennsylvania

Texas Loans

Small loan	
Amount	\$500
APR	95 percent
Maturity	6 months
Payment size	\$107.88
Interest	\$147.31
Large loan	
Amount	\$1000
APR	72 percent
Maturity	12 months
Payment size	\$119.28
Interest	\$431.32

Pennsylvania Loans

Small loan	
Amount	\$2000
APR	27 percent
Maturity	24 months
Payment size	\$108.76
Interest	\$610.25
Large loan	
Amount	\$4000
APR	27 percent
Maturity	36 months
Payment size	\$163.30
Interest	\$1878.83

Table 15 Borrower Age

Pennsylvania Loans

	18-24	25-34	35-44	45-54	55-64	≥65	All
Loan Amount (TIL Amount Financed)							
<\$501			0.1				0.1
501-1000	0.1	0.2	0.2	0.2	0.2	0.2	1.0
1001-2000	0.8	2.5	3.6	3.3	2.9	2.2	15.3
2001-5000	1.9	9.5	13.9	14.2	10.6	6.6	56.7
5001-10,000	0.4	3.0	6.3	7.2	5.4	2.1	24.4
>\$10,000		0.3	0.6	0.7	0.6	0.1	2.3
All	3.3	15.5	24.6	25.6	19.6	11.3	100.0

Texas Loans

	18-24	25-34	35-44	45-54	55-64	≥65	All
Loan Amount (TIL Amount Financed)							
<\$501	7.2	9.5	8.0	7.6	5.7	3.9	41.9
501-1000	1.8	5.4	6.3	6.8	5.5	4.0	29.9
1001-2000	0.6	3.6	5.5	6.7	5.5	3.4	25.2
2001-5000		0.4	0.6	0.7	0.5	0.2	2.5
5001-10,000		0.1	0.1	0.1	0.1		0.5
>\$10,000							
All	9.6	19.0	20.5	21.9	17.3	11.7	100.0

Notes for Tables 10 through 13 and Table 15:

Values are percents of the total.

Columns and rows may not add exactly to totals because of rounding.

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