Lenders/Industry Groups – American Financial Services Association

1. About Installment Loans

Describe the product(s) or service(s) your industry provides.

AFSA member companies provide traditional installment loans - a form of non-bank consumer credit which is repaid by the borrower according to a prearranged schedule in equal payments comprising both principal and interest. Traditional installment loans have a number of characteristics which differ from other forms of non-bank, small-sum credit:

- Traditional installment lenders work out a borrower's ability to repay a loan before making it, using a monthly net income/expense budget based on information provided by prospective borrowers, thereby ensuring that proposed monthly loan payments are affordable.
- Traditional installment lenders structure payments as monthly installments, rather than a single payment, in order to provide a manageable method of repayment, allowing borrowers to pay off interest and reduce principal.
- Traditional installment lenders check the credit of borrowers when making loans to allow a realistic assessment of the borrower's ability to repay. What's more, traditional installment lenders report to credit bureaus, allowing borrowers to rehabilitate or build credit.
- Traditional installment lenders do not impose pre-payment penalties on loans;

It is important to note that traditional installment loans differ from other forms of small sum credit such as payday or title loans in the way they are structured, avoiding the "balloon payment" which is often held up as the reason for constant loan renewals which can trap borrowers in a cycle-of-debt.

Who uses your product(s) or service(s)?

Traditional installment loans are a popular form of credit, allowing easy access to small sums at relatively short notice. As such, they appeal to a wide spectrum of borrowers with widely differing circumstances. They are especially important to those traditionally underserved by the banks and other depository institutions and are often the only safe alternative for these populations who may have no other access to legal, fairly-priced credit. As such, they are critically important, freeing up funds that allow the borrower to deal with emergencies, or take advantage of opportunities that would otherwise be missed.

How do consumers use your product(s) or service(s)?

Studies have shown that people use installment lenders for a multitude of different reasons. Key among these, however, is to access small sums that help them to deal with unforeseen circumstances. A good example is car purchase or car repairs. Without a small amount of money over and above a wage, car repairs – essential to allow travel to work – could make a breadwinner late or miss work altogether, risking losing the job. Likewise, the back-to-school period increases the demand for traditional installment loans, as parents look to appropriately equip their children for the coming semester – this is evidence that less-advantaged people can make good use of borrowed money, even if they sometimes struggle to demonstrate their creditworthiness to lenders.

What is the demand for your product(s) or service(s)?

Millions of consumers need small dollar credit. Where traditional installment lending is unavailable, many consumers seek less safe alternatives.

What are "reasonable rates" for consumer loans?

Traditional installment loans are priced according to the risk to the lender of default. The true cost of the loan cannot and should not be pegged to a single "rate", (often, for reporting purposes, rendered as Annual Percentage Rate (APR), despite the fact that typical installment loans are made for periods of months). This is a misleading measure of the true cost of a loan and identifying a "reasonable rate" above which a loan cannot be made, is an unsophisticated form of policymaking.

In fact, APRs are not helpful as an indicator of the relative cost of loans of widely different amounts or maturities. This is because finance charges include both fixed and variable costs. Fixed costs are not significant when spread over larger amounts and longer maturities, but become very significant in smaller sums over shorter terms.

Certain indicators of *affordability* or the ability to repay are much more important than APRs when it comes to small loans. They include:

- Total Dollar Cost to the consumer
- Total charges as a percentage of principal
- Manageability of repayment schedule, for example, equal monthly installments of principal and interest with no balloon payment
- A budget showing that such monthly payments are less than the borrower's monthly available income

The Center for Financial Services Innovation (CFSI) supports this, saying:

> "….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…." Center for Financial Services Innovation (CFSI)

What are "abusive lending practices"?

Clearly predatory lending, operating illegally or at the very fringes of legality, for the purposes of exploiting individual borrowers, relying on unsophisticated borrower understanding of the arrangement they are entering into is abusive and must be stopped.

In addition to this, loan practices that demand balloon payments – the entirety of a loan, paid in full, on a certain date, can be problematic and veer into abusive territory. Typically, borrowers who cannot meet the balloon payment have no option but to refinance the loan, which can lead to a cycle-of-debt with multiple "refinancings" with the borrower effectively doing nothing more than servicing the debt. In these cases borrowers can end up owing huge sums, unrelated to the original loan amount.

What are "responsible lending practices"?

Traditional installment loans are considered by many to be structured in line with responsible lending practices, calculating the borrower's ability to repay the loan, giving the borrower a clear path out of debt through regularly scheduled equal payments made up of both principal and interest, and reporting to credit bureaus, allowing conscientious borrowers to rehabilitate or build credit.

Furthermore, traditional installment loans (which, as their name implies, have been around a long time, unlike more exotic small-sum loan products) are made from storefronts in the borrowers' communities, ensuring both accessibility and accountability.

The Center for Responsible Lending supports the installment loan model, saying:

> "Responsible alternatives to payday loans should have these features: At least a 90-day repayment term, repayable in installments; No personal check mechanism or other unfair collateral (such as a car title); Reasonable limits on renewals (If borrowers are renewing short-term loans more than four times per year, the loans are not helping them); Full consideration of borrower's ability to repay the loan; No mandatory arbitration clause."[i] Center for Responsible Lending (CRL)

And the well-respected Center for Financial Services Innovation (CFSI) defines a high-quality (i.e. responsible) small-dollar loan as one that:

- Is made with a high confidence in the borrower's ability to repay
- Is structured to support repayment
- Is priced to align profitability for the provider with success for the borrower
- Creates opportunities for upward mobility and greater financial health
- Has transparent marketing, communications, and disclosures
- Is accessible and convenient
- Provides support and rights for borrowers

1. Consumer Lending Alternatives

What other options for credit are available for consumers?

Many less appropriate alternatives exist. For example, since banks and credit unions do not offer small dollar loans, some consumers who could qualify may take out loans larger than what they really need, thus incurring a higher debt level than they would using a traditional installment loan. But a much more likely scenario is the less safe alternative of payday lending (possibly across the border in another state), unlicensed internet payday lending, or loan sharks.

2. Recommendations

What recommendation(s) do you have for state regulation of lending practices?

AFSA has two interrelated recommendations to policymakers concerned with state regulation of lending practices:

Policymakers must understand the differences between types of small-dollar loan products:

The nature of traditional installment loans clearly differentiates them from loans such as payday or title loans that carry a balloon payment and increased risk of trapping a borrower in a "cycle-of-debt". Laws and regulations intended to tackle problems associated with the cycle-of-debt should be developed in ways that do not inadvertently affect traditional installment lenders. One-size-fits-all policies can only lead to a drying-up of credit for needy borrowers and the creation of "credit deserts" where no legal credit options are available, within states.

APR limits are not the best way to regulate traditional installment lenders:

APR limits, imposed to tackle problems associated with payday or title loans, can be devastating to traditional installment lenders and the borrowers that relay on them, and stem from a deep lack of understanding among the public in general, and regulators in particular, as to the true cost of credit – the price of a loan, over time, and the cost incurred by the lender making it.

In fact, as we have discussed above, APRs are not helpful as an indicator of the relative cost of loans of widely different amounts or maturities. This is because finance charges include both fixed and variable costs. Fixed costs are not significant when spread over larger amounts and longer maturities, but become very significant in smaller sums over shorter terms. The cost of traditional installment loans, made over very short periods, for very small sums, cannot be accurately measured by APR, indeed, higher APRs might indicate lower cost loans - typically a smaller loan borrowed over a shorter period will cost less in terms of total dollars and in finance charges as a percentage of principal but have a higher APR.

Thus, imposing an arbitrary limit on APRs will mean that people who need small loans will be forced to borrow more money for longer terms than they need, and to pay higher real charges or be denied access to credit altogether. We need look no further than Japan for examples of where artificially imposed APR caps have, in effect, wiped out much of the formal consumer-lending industry. Borrowers are forced to look elsewhere for credit – to loan sharks and other illegal options. This must be guarded against very carefully here in the USA.

3. Other Concerns/Discussion

What other thoughts or concerns do you have regarding consumer lending?

Policymakers should be looking to crack down on the most problematic sources of credit, while maintaining wide credit access for needy borrowers. APR limits are a broad-brush solution that don't represent the true cost of credit in the small dollar lending scenario, and thus should be avoided. Traditional installment loans can be an element of a comprehensive policy solution, providing a well-regulated, safe form of small dollar credit while restricting less safe forms.

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[i] http://www.responsiblelending.org/payday-lending/tools-resources/alternatives-to-payday-loans.html