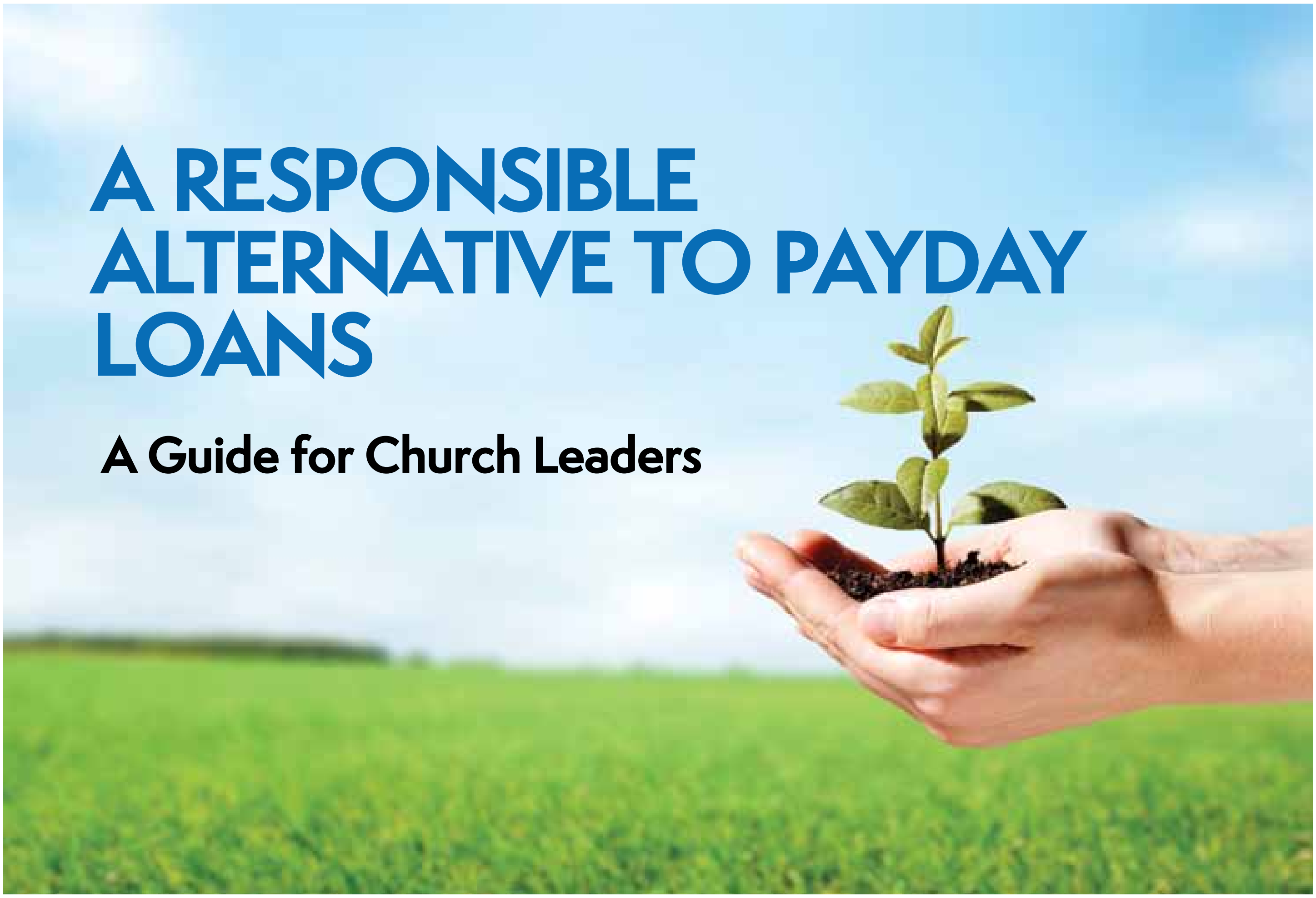
A RESPONSIBLE ALTERNATIVE TO PAYDAY LOANS

A Guide for Church Leaders



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"… I command you to be openhanded toward your brothers and toward the poor and needy in your land."
-Deuteronomy 15:11

"Fundamentally, poverty is a denial of choices [and includes] not having access to credit. It means insecurity, powerlessness and exclusion of individuals…"
—UN Statement (June 1998)[i]

INTRODUCTION

The Bible contains more than 300 verses on the poor, social justice, and God's deep concern for both. It also contains, mainly in the Old Testament, many references to usury and the challenges of debt. Balancing a need to help the poor with the need to protect them from unscrupulous lenders has once more become a subject of intense debate among church leaders. Working out, within the tenets of their faith, how to support the best interests of their congregations in tough economic times has risen to the top of many church agendas.

Meanwhile, the excesses of some lenders have led to calls for new laws intended to protect borrowers from unscrupulous lenders of all kinds. Consumer activists are keen to put their cases before pastors and ministers in the hope of securing support for political initiatives across the country The arguments they put forward tend to focus on ancient concepts of usury. By doing so they ignore one of the key messages of scripture and Christian theology – help the needy.

Defining Poverty

The United Nations defines poverty as a denial of choices and opportunities and includes a lack of access to credit as a part of that definition[i]. Credit is both a tool of social mobility and a safety net. It allows Americans to consume as our market-economy and our way of life requires. But, there are many hundreds of thousands of individuals and families in the US who do not have relationships with banks and the access to credit that those relationships can provide. It is this unbanked population – and the thirty million households with limited banking relationships (the 'underbanked') - that are most often vulnerable to so-called

"It is well with those who deal generously and lend with justice."

—Psalm 112:5

"predatory lenders" and it is those same unbanked and underbanked members of society who have the most to lose from proposed laws that fail to differentiate between credit that is safe and credit that is not safe.

The Biblical Concept of Usury

It is interesting to note that the term usury, as used in both the Old and the New Testaments, had a more limited meaning than today. Usury simply meant lending with interest – any interest at all. In the Biblical sense not only are Government Treasury Bonds examples of usury but so are car rental companies, where a charge is levied for the use of something which is returned later. Biblical "usury" is an absolute not a relative term.

The modern popular meaning of usury as lending at a rate considered 'excessive' has no Biblical support, but has come about because society now accepts the value of lending from safe, regulated institutions to finance certain purchases, like a house or car, for instance, or to cope with emergencies. There would be little support for a return to the medieval world, where the only legal way to borrow was to go to somebody outside one's religious community.

The Consequences of Bad Laws

Payday loans have been singled out by activists as particularly dangerous forms of credit. Unfortunately, the laws being proposed to remove this danger rarely differentiate between payday loans and safe alternatives such as traditional installment loans. This lack of differentiation can potentially lead to the wholesale removal of credit options for the most needy, causing significant hardship and preventing those affected from reaching their God-given potential. This raises significant moral, ethical and religious questions.

This failure to differentiate also leads lawmakers to seek a one-size fits all solution – usually the imposition of an interest rate ceiling that makes small sum lending unviable for the lender. These rate caps always discriminate against the poor. Rate caps do not affect larger loans, accessed by the well-off; they only affect small loans, made over short periods. They effectively deny access to the smaller loans for which the less well-off can qualify and which fulfill their limited needs. The World Bank's Consultative Group to Assist the Poor (CGAP)[ii] recognizes this and has made it a key principle for small sum lending to the unbanked:

"Interest rate ceilings hurt poor people by making it harder for them to get credit. Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people"

Only the safe, regulated *supply* of credit can be affected by new laws. The *demand* will remain, and by removing safe credit options along with options that are less safe, potential borrowers will be forced to look to loan sharks and the black market to meet their needs.

"All they asked was that we should continue to remember the poor, the very thing I was eager to do." —Galatians 2:10

THE ALTERNATIVE TO PAYDAY

Responsible lending options for the needy can help lift them out of poverty and reach their God-given potential. Activists focus on eradicating payday loans because they consider them to have characteristics that make them particularly irresponsible and dangerous. These characteristics contrast with those of a responsible loan option for the underbanked: the traditional installment loan. Church leaders must understand these characteristics so they can differentiate between good and bad loan options.

Payday Loans and the Cycle of Debt

Payday loans are, by their nature, due in full on the borrower's next payday. That is, they must be repaid in a single "balloon" payment at the end of a very short loan term. Because this payment is usually due

"…the biggest problem with traditional payday loans is not necessarily the underlying price of a single loan, but the structure. By requiring repayment in full after only two or four weeks, payday loans can cause a toxic cycle of debt at an ultimate cost that far outweighs the original loan amount."

in less than 30 days, this single payment can lead to significant problems for the borrower. If borrowers cannot afford to repay a payday loan in full when it comes due, they are left with no option but to refinance that loan. This results in what observers call the "cycle of debt," in which the entire balance of a loan is refinanced multiple times, triggering additional finance charges

Jennifer Tescher, Director of the Financial Health Network, perhaps the country's leading advocacy organization for the underbanked, acknowledges what we all know, pointing out that:

"…..the biggest problem with traditional payday loans is not necessarily the underlying price of a single loan, but the structure. By requiring repayment in full after only two or four weeks, payday loans can cause a toxic cycle of debt at an ultimate cost that far outweighs the original loan amount."

By creating a schedule of affordable payments, installment loans give the borrower a clear and disciplined roadmap out of debt.

Traditional Installment Loans Give a Roadmap out of Debt

Traditional installment loans are radically different from payday and title loans. They are structured to be repaid in regular installments - equal payments made up of both principal and interest that systematically reduce a borrower's total debt. In this way, these loans avoid the structural dangers of payday loans. By creating a schedule of affordable payments, installment loans give the borrower a clear and disciplined roadmap out of debt.

But structure is not the only difference between these two sources of small sum credit. Traditional installment loans are also fully underwritten. Lenders work with borrowers to make realistic assessments of the borrower's ability-to-repay, working through household budgets and ensuring that installments can be met through household income. This is how installment lenders safeguard against default, in contrast to payday or title practices which rely instead on access to a borrower's bank account or leverage such as holding the borrower's car title.

On top of this, installment loans are a time-tested (having been around for over a hundred years), highly regulated (by both State and Federal laws and regulations) product. A significant benefit to individuals and families seeking to improve their circumstances is that installment lenders report borrower credit performance to the credit bureaus. This allows borrowers to build up their credit scores and repair damaged credit. Payday lenders do not make such reports.

Installment Loans are Recognized as Safe

The high profile Center for Responsible Lending's (CRL)[iii], definition of a "responsible small loan" lays out features such as a minimum 90-day repayment term, repayment in installments; no personal check mechanism or other unfair collateral (such as a car title); reasonable limits on renewals and full consideration of a borrower's ability to repay the loan. All of these characteristics are lacking in payday and title loans, but are characteristics of a traditional installment loan.

Furthermore, the US Department of Defense (DoD) previously exempted traditional installment loans from a law functionally banning payday and title loan products as a danger to military readiness. As stated in connection with its final rule on the Warner Act[iv]:

"The intent of the statute is clearly to restrict or limit credit practices that have a negative impact on Service members without impeding the availability of credit that is benign or beneficial to Service members and their families."

Differentiating Between Credit Options is Key

The key to preserving these good, traditional installment loans while protecting consumers from bad credit options is to understand the differences between them. This allows consumer protection laws to be developed that treat bad options differently than good options. In this way, church leaders can avoid the unintended consequences of bad laws that would effectively ban currently available "good" credit for unbanked and underbanked individuals. By restricting their support to initiatives that preserve good credit options and tackle the bad, church leaders can balance biblical teachings on usury with a responsibility to serve the interests of social justice and the real needs of the most vulnerable in society.

INSTALLMENT LOANS MEET MICROCREDIT PROTECTION REQUIREMENTS

There is one area of small sum lending that has received almost universal praise from religious leaders around the world, and that is the microcredit revolution in developing nations. This type of lending is revolutionizing credit access outside our borders and is directly comparable to traditional installment lending in the USA

"In both rich and poor countries alike, credit institutions have favored the rich and in so doing have pronounced a death sentence on the poor… If economists would only recognize the powerful socio-economic implications of credit, they might recognize the need to promote credit as a HUMAN RIGHT."

—Muhammad Yunus
Banker to the Poor

Organizations like Five Talents[vii], which arose from a global meeting of Anglican leaders, are driven by church leaders who are deeply concerned by the plight of the poor and those dying of famine, AIDS/HIV and other diseases and believe that making credit available is one way to tackle it.

Yet even this type of lending has had its fair share of criticism, focused on "over lending" by unscrupulous elements entering the industry. To address this, CGAP[viii] has issued a set of principles of microfinance and the international Smart Microfinance campaign has issued a set of client protection principles[ix] aimed at ensuring microcredit never becomes predatory.

Traditional installment loans meet all of the CGAP criteria, which were expressly designed with safety and suitability in mind. It is the rigorous assessment by a lender of a borrower's ability to repay that is the defining characteristic that traditional installment loans share with 'smart' microfinance loans and which payday loans and their like lack.

CONCLUSION

A balance must be struck between ensuring protection from predatory lending, and allowing access to credit that could assist individuals and families in achieving their God-given potential. This is where church leaders should begin in assessing what is right for their congregations and for society. It is essential to communities underserved by banks all across the country that attempts to tackle challenges associated with payday loans do not eradicate their access to safe traditional installment loans. By differentiating between loan products that are dangerous and those that are safe and speaking up in defense of safe credit options, faith-based groups can have a significant impact on achieving much needed balance.

Leaving the less fortunate without access to credit would have social consequences for which no church should want nor need to bear responsibility. ■

Endnotes:

[i] *"Fundamentally, poverty is a denial of choices and opportunities, a violation of human dignity. It means lack of basic capacity to participate effectively in society. It means not having enough to feed and clothe a family, not having a school or clinic to go to, not having the land on which to grow one's food or a job to earn one's living, not having access to credit. It means insecurity, powerlessness and exclusion of individuals, households and communities. It means susceptibility to violence, and it often implies living on marginal or fragile environments, without access to clean water or sanitation"*(UN Statement, June 1998 – signed by the heads of all UN agencies)

[ii] http://cgap.org

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

[iv] John Warner National Defense Authorization Act (2007)

[vi] Banker to the Poor – Mohammed Yunus (1999)

[vii] Five Talents - *Five Talents fights poverty, creates jobs and transforms lives by empowering the poor in developing countries through innovative savings and microcredit programs, business training and spiritual development.* www.5talents.org

[viii] http://cgap.org

[ix] http://smartcampaign.org/about-the-campaign/smart-microfinance-and-the-client-protection-principles

INSTALLMENT LOANS:
MYTHS & LEGENDS

1 Traditional installment loans are "high cost" credit?

They are not. Because the Federal Truth in Lending Act requires an "annual" percentage rate, APR numbers can appear to be high, while the dollar cost in interest for the consumer is actually low. This fact was noted by Jennifer Tescher, Director of the Center for Financial Services Innovation, one of the country's leading advocacy organizations for the unbanked and underbanked, in her letter to the FDIC concerning the need for protecting and providing small-dollar loans:

"Double-digit interest rates in excess of 36 percent APR can provoke community outrage, yet over the course of a month, what may seem like an overly high interest rate may generate a relatively small cost to the consumer."

This statement is illustrated by considering the difference between a $500 loan with an 18% APR versus a $500 loan with a 69% APR. When paid over a seven-month period under a traditional installment monthly payment plan, the 18% loan carries a monthly payment of $76, compared to a monthly payment of $89 for the 69% loan. The difference is actually only 40 cents a day.

The majority of the monthly payment on a traditional consumer installment loan is the repayment of principal. If someone cannot afford an $89 dollar-a-month payment, they most likely cannot afford a $76 dollar-a-month payment. And yet, the ability of the lender to offer the loan and stay in business often depends on that 40 cents a day.

2 Traditional installment loans are unregulated

Unlike some small sum loan products, traditional installment loans have a long history of effective regulation. Each state has its own unique rules, regulations, and licensing requirements for traditional installment lenders and all traditional installment loans fall under the same federal regulations, including the Truth in Lending Act, which requires detailed disclosures of costs.

3 Traditional small-dollar installment loans are the same as payday loans

Traditional installment loans are radically different from payday loans in the way they are structured, originated and regulated. Traditional small-dollar installment loans are more like traditional credit union and bank loans. In addition, traditional installment loans are offered for longer terms and require equal monthly payments of principal and interest which fully pay off the loan at its maturity. A complete list of differences between payday and installment loans is at Annex B.

4 There are "cheaper" alternatives to traditional installment loans

There are not. Because of the "high touch" relationship required in traditional installment loans, there are simply no other options that provide the same service and disciplined and responsible loan repayment terms. Only nonprofit and government subsidies would allow for lower interest rates on this type of loan, and often the difference in cost to the consumer is negligible, while the burden to taxpayers is extreme.

PAYDAY & INSTALLMENT LOANS:
A SIDE-BY-SIDE COMPARISON

PAYDAY LOANS	TRADITIONAL INSTALLMENT LOANS
CFPB Director Cordray defines **payday loans** as “short-term, high-cost loans made in exchange for a commitment to repayment from the person’s next paycheck.”	**TILs** are true installment loans. This helps protect the borrower’s household budget and does not commit the borrower to repayment from a single paycheck. **TILs** are paid in affordable monthly installments.
Payday loans are required to be repaid in a single “balloon payment” – a lump sum that comes due when the loan period expires.	**TILs** are fully amortized, repaid in scheduled payments of equal size, made up of both principal and interest, just like traditional credit union or bank loans.
Payday lenders do not test the borrower’s ability to repay, relying instead on a postdated check or similar access to the borrower’s bank account as its repayment guarantee.	**TIL lenders** assess a borrower’s ability to repay a loan using a monthly net-income/expense budget to ensure that proposed installment payments can be met through monthly cash flow without stress on the borrower.
If a borrower cannot afford to repay the loan in full when it comes due, **payday loans** leave no option but to refinance that loan. This can cause a ‘cycle of debt’ due to the forced balloon payment.	**TIL lenders** schedule regular, affordable payments made up of principal and interest, based on budget review to determine the borrower’s ability to pay. This helps lead the way out of debt in a timely fashion.
Credit bureaus do not accept data from **payday loan** companies, so successful repayment of a loan brings no benefit to a borrower’s credit score.	**TIL lenders** report to credit bureaus, allowing borrowers to rehabilitate damaged credit or establish first-time credit, which in turn allows access to more credit options, often at lower interest rates.
Payday loans generally carry APRs that are four to ten times those for most TILs. Payday loans also cost more in real dollar terms than TILs.	**TILs** are more affordable than payday loans and carry APRs that are one-quarter to one-tenth those for payday loans. **TILs** therefore are more affordable than payday loans—and even cost less than credit cards when the borrower makes only minimum required payments.
Payday lenders *do not* refund unearned charges in the event that a loan is repaid early.	**TIL lenders** *do* refund unearned charges in the event that a loan is repaid early.
Government supervision of **payday lenders** varies widely from state-to-state and is completely lacking where laws allow only Internet or Indian reservation loans.	**TIL lenders** have long operated within a legal framework and are licensed and thoroughly regulated by State and Federal consumer protection and other agencies.
Payday loans are effectively banned from use by military personnel under the provisions of the *John Warner Defense Authorization Act (2007).*	**TILs** have been found to be a beneficial form of credit and are, therefore, exempted from the restrictions in this J. W. Defense Authorization Act (2007) in its final rule, which notes the need to “isolate detrimental credit products without impeding the availability of favorable installment loans....”
Payday loans may have a significant punitive effect on defaulters through a bank’s NSF fees, which can be in addition to default fees imposed by the payday lender.	**TIL** lenders work with borrowers who are late with payments and lenders often work out terms to see the loan to completion. TIL lenders never invoke the criminal process to collect a loan.

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