

No. 09-36
September 2009

WORKING PAPER

CONSUMER WELFARE AND THE REGULATION OF TITLE PLEDGE LENDING

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Consumer Welfare and the Regulation of Title Pledge Lending

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Recent years have seen growth in the use of certain types of nontraditional lending products, such as payday lending and auto title lending, and a relative decline of others, such as finance companies and pawnbrokers. Despite the fact that much of the growth in the use of these products is simply a substitution from some types of high-cost lending to others, the onset of the financial crisis has spurred renewed scrutiny of nontraditional lending products, even though there is no suggestion much less evidence that those products contributed to the crisis, and indeed, may be playing a positive role in mitigating the fallout from the crisis.

Congress is currently considering major new regulations on short-term lending products, such as title lending, that could produce their demise—even though there is no evidence that such products were related in any way to the financial crisis. The loss of this important source of credit for many Americans, especially unbanked consumers and independent small businesses, would create hardship for many Americans who rely on auto title lending to meet urgent short-term expenses for utilities, housing and home repairs, and business expenses. This negative effect would be especially painful in light of the continuing problems in credit markets that have reduced access to traditional types of credit for consumers and small businesses, such as credit cards and home equity lines of credit. Credit card issuers are reducing availability, slashing credit lines, and raising interest rates and fees, leading a growing number of consumers to turn to alternative

¹ George Mason University Foundation Professor of Law; Senior Scholar, Mercatus Center at George Mason University School of Law; Editor, *Supreme Court Economic Review*. I would like to thank the members of the American Association of Responsible Auto Lenders (AARAL) for their generosity in spending time talking to me and providing basic information about the industry. All funding for this project was provided by the Mercatus Center.

products to address short-term credit needs. Small businesses are finding it difficult to obtain bank loans and credit cards. In light of the continued problems of consumers and small business getting access to credit, wiping out a type of credit that provides a useful option for consumers and small businesses at the present time would be especially harmful to consumers and the economy.

Two proposed pieces of legislation are particularly threatening to nontraditional lending products such as title pledge lending. The first, S. 500, the Protecting Consumers From Unreasonable Credit Rates Act of 2009, introduced by Sen. Richard Durbin (companion legislation introduced as H.R. 1608 by Rep. Jackie Speier in the House), would place a flat interest cap of 36 percent on all consumer credit products. By fixing interest rates at an uneconomically low rate in light of the cost and risk of making small personal loans, the legislation would likely result in the elimination of most forms of nontraditional lending, including pawnshops, payday loans, and title loans.² The House of Representatives is also considering legislation to create a new Consumer Financial Protection Agency (CFPA) that would have unprecedented power and authority to determine the types of financial products that consumers can choose and which could dramatically reduce the ability of consumers to gain access to nontraditional lending products.

There are few systematic studies of the overall welfare effects of auto title lending. But economic theory, studies of similar nontraditional lending products, and available information on auto title lending suggests that title lending is a valuable source of credit for three types of borrowers. First are moderate-income borrowers who are

² Many states have specific laws that exempt certain types of loans, such as pawnshops, from their general usury ceilings, thereby recognizing the impossibility of lending at the permitted rates.

excluded from mainstream credit products because of damaged credit histories and prefer title loans to payday loans. Second are lower-income unbanked consumers who use title lending to address short-term exigencies and for whom loss of access to title loans would create personal difficulty, such as bounced checks, disconnected utilities, or lack of funds for emergencies such as medical expenses or car repairs. These consumers would have to either sell their car or turn to pawnbrokers in order to get cash for needed expenses. Third, title lending also is an important source of credit for independent small businesses.

Well-intentioned but fundamentally misguided paternalistic regulation that deprived consumers of access to title loans would likely force many borrowers turn to even more expensive lenders, illegal lenders, or to do without emergency funds. Moreover, given the substantial variety in the types of borrowers and reasons for borrowing by title loan customers, one-size-fits-all title regulations would certainly amount to one-size-fits-none in practice.

Although title lending is expensive and some consumers eventually will lose their cars for nonpayment, title lending is an important source of credit for many Americans and is beneficial for the economy overall. If deprived access to title loans, many consumers would substitute to less-preferred sources of credit or lose access to legal credit altogether. Moreover, although the price of title loans is high, there is no evidence that title lenders are earning supernormal economic profits once the high cost and risk of making these loans is taken into account. The title loan market, like other markets for nontraditional loans, appears to be highly competitive and barriers to entry appear to be low. Pricing is highly transparent and simple, allowing easy comparison shopping by

consumers. Absent an identifiable market failure, the case for heavy-handed intervention is weak.

Second, efforts by legislators to regulate the terms of small consumer loans (such as by imposing price caps on interest rates and fees, or limitations on repeated use “rollovers”) almost invariably produce negative unintended consequences that vastly exceed any social benefits gained from the legislation. Moreover, prior studies of price caps on lending have found that that low-income and minority borrowers are most negatively affected by the regulations and the adjustments that they produce. Volumes of economic theory and empirical analysis indicate that further restrictions on title lending likely would prove counterproductive and harmful to the very people such restrictions would be intended to help.

The Economics of Usury Regulation

Substantive regulation of credit terms, such as price caps on interest rates (often referred to as “usury” regulations) has one intended consequence and several unintended consequences. The intended consequence of usury regulations is obvious: Usury regulations limit the interest rate of loans actually made to borrowers. If, for example, a legislature caps interest rates at some fixed percentage, lenders will not legally charge interest rates above that rate. But there are also several unintended consequences of usury regulations that can be extremely harmful to consumer welfare. The unintended consequences of usury regulations can be summarized under three basic headings: term re-pricing, product substitution, and credit rationing.

Term Re-pricing

Term re-pricing³ describes the process by which lenders offset limits of what they can charge on regulated terms by increasing the price of other terms of the loan or related loan products. For instance, during the period of high interest rates in the 1970s and early 1980s, when interest rates were capped by law below the market level, bank credit card issuers imposed annual fees to compensate.⁴ In days past when most consumer credit was installment credit issued by department stores and other retailers, those retailers could offset their inability to charge market interest rates for store credit by marking up the price of the goods they sold and thereby burying the cost of the credit losses in an increased cost of goods and services or reducing the quality of the goods.⁵ The practice of charging up-front “points” on home mortgages, for example, originated as a mechanism to evade usury ceilings on mortgage interest rates. Lenders may also tie access to credit to the purchase of other goods and services whose price is not regulated, such as banks requiring the opening of checking or savings accounts.⁶ For instance, even under the FDIC’s current Small-Dollar Loan Pilot Program, the economic viability for banks participating in the program depends on their ability to cross-sell borrowers on other banking services and loans; the small-loan program does not provide a sufficiently high interest rate standing alone to make the program profitable.⁷ Lenders may also raise

³ Term re-pricing is sometimes referred to as “evasion,” as they are an effort to “evade” the distorting effects of usury restrictions on credit supply by adjusting unregulated price or other terms of the bargain. See Michael Staten, *The Impact of Credit Price and Term Regulations on Credit Supply*, Harvard University Joint Center for Housing Studies UCC 08-8 (Feb. 2008).

⁴ See Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79, 152 (2000).

⁵ See DAVID CAPLOVITZ, *THE POOR PAY MORE* (1963).

⁶ See A. Charlene Sullivan, *EVIDENCE OF THE EFFECT OF RESTRICTIVE LOAN RATE CEILINGS ON PRICES OF CONSUMER FINANCIAL SERVICES* (Credit Research Ctr. Working Paper No. 36, 1980).

⁷ See *An Introduction to the FDIC’s Small-Dollar Loan Pilot Program*, FDIC QUARTERLY Vol. 2, No. 3 at p. 23 (2008).

the price for related services that they provide or reduce the availability of other benefits or services, such as providing fewer free services or shorter operating hours.⁸

Lenders also respond to usury caps by increasing the minimum required amount of the loan, so as to amortize the costs of issuing the loan over a higher loan amount.⁹ But increasing the minimum size of loans can force borrowers to borrow larger amounts than they prefer or can reasonably manage, thereby reducing the usefulness of the loan and, perversely, promoting over-indebtedness.¹⁰ The final result will be to vitiate many of the intended benefits of the regulation by circumventing the intended effects of the price controls but to make consumers worse off as a group by encouraging a new pricing system that is less efficient and less transparent than that which would otherwise prevail. Furthermore, by making prices less transparent and more heterogeneous, price controls interfere with competition by making it more difficult for consumers to compare prices and other terms among lenders. Recent news reports since the imposition of new regulations on credit card terms under the Credit CARD Act issuers have reimposed

⁸ RICHARD L. PETERSON & GREGORY A. FALLS, *IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE* (Credit Research Ctr. Working Paper No. 40, 1981).

⁹ See Mark H. Haller & John V. Alviti, *Loansharking in American Cities: Historical Analysis of a Marginal Enterprise*, 21 AM. J. LEGAL HIST. 125, 140 (1977) (noting that interest rate caps on small lending operations in the 1930s led to an increase in minimum loan size and an exiting of the market by legal lenders).

¹⁰ See ANNE ELLISON & ROBERT FORSTER, *THE IMPACT OF INTEREST RATE CEILINGS: THE EVIDENCE FROM INTERNATIONAL EXPERIENCE AND THE IMPLICATIONS FOR REGULATION AND CONSUMER PROTECTION IN THE CREDIT MARKET IN AUSTRALIA* 38 (2008) (noting that in countries with strict interest-rate regulations, “Lenders not only reject borrowers who fail the credit score required for any given lending model, they also set lending minimums at a level at which set up and administration costs are not disproportionate to the sum advanced, with this varying according to the pricing model concerned. Typically however, such levels are set significantly above where high risk low income borrowers would want to borrow. The effect of this policy is either to exclude such borrowers from the credit mainstream or to lead them to borrow more than they might otherwise.”); POLICIS, *ECONOMIC AND SOCIAL RISKS OF CONSUMER CREDIT MARKET REGULATION: A COMPARATIVE ANALYSIS OF THE REGULATORY AND CONSUMER PROTECTION FRAMEWORKS FOR CONSUMER CREDIT IN FRANCE, GERMANY AND THE UK*. 30 (2006).

annual fees, raised interest rates, increased some behavior-based fees, changed many fixed-rated cards to variable-rate cards, and cut credit lines.¹¹

Term re-pricing is a common response to regulation for many types of consumer credit, but probably less so for auto title lending. Title loans are very simple and very transparent loans with a small number of terms, especially when compared to especially complex products such as mortgages or credit cards, reducing the potential for term re-pricing. Most title loans have only one price—the interest rate—and do not charge additional fees or prepayment penalties.¹² As a result, title loans have relatively few terms that can be re-priced in order to make title lending profitable for the lender. Moreover, auto title lending amounts, however, are limited by the resale value of the car, thus it is difficult to increase the amount of the loan.

Product Substitution

Product substitution arises when certain types of substantive regulations (such as interest-rate caps) make it impossible to price a particular consumer loan product in a manner that makes it economically feasible for the lender and borrower to enter into a transaction. For instance, rate caps on title lending may make it impossible for a lender to price its risk sufficiently for a borrower to obtain a title loan, but the borrower instead

¹¹ See, e.g., Hans Bader, *New Credit Card law Eliminates Cash Back and Rewards Programs, Harms Responsible People*, D.C EXAMINER (Aug. 21, 2009), available at <http://www.examiner.com/x-7812-DC-SCOTUS-Examiner~y2009m8d21-New-Credit-Card-Law-Eliminates-Cash-Back-and-Rewards-Programs-Harms-Responsible-People>. Issuers have also terminated accounts for some users, an example of rationing, as discussed below.

¹² Fox and Guy report that about one-third of title lenders in their survey charged a fee in addition to the interest rate on the loan. Some were up-front fees and some were behavior-based fees for late payments and the like. JEAN ANN FOX & ELIZABETH GUY, *DRIVEN INTO DEBT: CFA CAR TITLE LOAN STORE AND ONLINE SURVEY 11* (Nov. 2005). Most of the largest title lenders, however, do not charge up-front fees, thus in terms of loan volume, those who do charge fees is likely much smaller than the figure reported by Fox and Guy.

might be able to obtain a pawn loan or payday loan for cash credit, or a rent-to-own for consumer goods. If term re-pricing and product substitution are sufficiently flexible, the end result of the regulatory scheme may be simply to change the mix or composition of credit held by consumers, but not the overall amount of debt.¹³ Overall, however, borrowers will be worse off because they will be holding a portfolio of credit products that differs from their preferred combination.

Some commentators, for instance, have claimed that the growth of auto title lending in some states resulted from regulations that eliminated payday lending.¹⁴ If so, this would illustrate product substitution resulting from a reduction of access to payday loans. In fact, one consumer-rights activist stated his opinion that the enactment of severe regulatory restrictions that substantially reduced payday lending in Virginia resulted in a substitution to increased auto title lending.¹⁵ On the other hand, Zinman found no significant substitution to auto title lending in Oregon after it banned payday lending.¹⁶ As is discussed below, the differing experiences of these two states may reflect the different demographic bases of title lending in different states, which may cause consumers to engage in different patterns of product substitution.

¹³ See Richard L. Peterson, *Usury Law and Consumer Credit: A Note*, 38 J. FIN. 1299 (1983).

¹⁴ See Dena Potter, *Payday Lender Laws Slash Loan Numbers*, WASHINGTON TIMES (June 21, 2009), available in <http://www.washingtontimes.com/news/2009/jun/21/payday-lender-laws-slash-loan-numbers/>.

¹⁴ Edward C. Lawrence and Gregory Elliehausen, *A Comparative Analysis of Payday Loan Customers*, 26(2) CONTEMPORARY ECONOMIC POLICY 299, 305 (2008).

¹⁵ Jay Speer, executive director of the Virginia Poverty Law Center, claims that the dramatic reduction in payday lending in Virginia that followed a tightening of the state's payday lending regulations led to an increase in auto title lending: "The good news is that there are less payday loans. The bad news is that they just shifted to car-title lending." Potter, *supra* note 14.

¹⁶ Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap 9* (working paper, Dec. 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335438.

Rationing

Finally, regulation may result in rationing of credit to particular borrowers if it is impossible for them to obtain any formal credit on affordable terms. Such rationing could force borrowers to turn to the informal sector (friends and family or illegal loan sharks) or to do without credit. Deprivation of access to credit could cause substantial economic and personal harm if it forces the consumer to go without the means to meet necessary expenses such as medical care, car repairs, living expenses, rent, or work-related expenses such as transportation or appropriate work clothing. Put simply, foreclosing viable options for credit because those options are thought to be too expensive does not make the need for credit go away nor does it make less-expensive credit cheaper or more available. If a low-income person needs \$500 for a home repair, eliminating title lending as a credit option does not eliminate the need to make the repair. It simply forces the borrower to find funds elsewhere or live with a leaky roof or a broken furnace, which could have other undesirable consequences.

Florida's experience with title lending illustrates the point. The state was one of the earliest states to adopt title lending and soon became one of the largest title lending states.¹⁷ In 2000, however, the state imposed severe interest rate ceilings on auto title loans which wiped out the industry.¹⁸ It is not clear where these borrowers who had been relying on title turned for credit subsequently or whether they instead had to sell their car in order to get needed funds.

¹⁷ POLICIS, THE EFFECT OF INTEREST RATE CONTROLS IN OTHER COUNTRIES 16 (2004). As discussed below Hispanic immigrants are much more likely to be unbanked than the general population, and unbanked consumers may rely on title lending for credit, thus Florida's high level of title lending was not surprising.

¹⁸ AMANDA QUESTER AND JEAN ANN FOX, CAR TITLE LENDING: DRIVING BORROWERS TO FINANCIAL RUIN 10 (2005) (noting that state law limits APR to 30 percent for loans of \$2,000 or less). Policis reports that the number of auto title lenders operating in the state dropped from 600 before the legislation was enacted to 58 the year following. POLICIS, THE EFFECT OF INTEREST RATE CONTROLS, *supra* note 17, at 16. By the next year no licenses at all were renewed.

The overall impact of usury regulations is likely to be negative, as they force lenders and borrowers to change the terms, types, and amounts of consumer credit offered when compared to what they would agree to under a voluntary contract. Economists have almost uniformly concluded that forcing these adjustments in lending and borrowing behavior is harmful to consumer welfare.¹⁹ If a consumer truly preferred to borrow from a pawnshops rather than a title lender, or preferred a mortgage with higher up-front costs and a lower interest rate, then that's what she would have chosen in the first place. Regulations that encourage substitution from one type of high-cost credit to another, or encourage a more confusing and opaque price scheme, are unlikely to make consumers better off. Once lenders make adjustments and offsetting behaviors in response to substantive regulations, it is quickly understood that the benefits to be gained by interest-rate caps are small and the costs from the unintended consequences are extremely large. Consumers are left with fewer choices, higher borrowing costs, and less flexibility.

Title Pledge Lending

Title pledge lending grew out of traditional pawnbroker operations, mainly to enable making larger loans than traditional pawnshop loans backed by items such as consumer electronics, musical instruments, and jewelry. In a title pledge lending arrangement, the lender holds as collateral the title to the borrower's car and/or either a copy of the keys to the car or a device that permits the title lender to disable the car's

¹⁹ See Thomas A. Durkin, *An Economic Perspective on Interest Rate Regulations*, 9 GEORGIA ST. L. REV. 821 (1993); Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 217 (1986).

ignition.²⁰ Lenders may verify employment, income, and perform a credit check, but practice is not uniform. Most scrutiny focuses on the value of the car rather than the borrower. The amount the lender will lend against the collateral varies: Some studies have found that lenders typically will lend about 33 percent of the resale value of the automobile;²¹ others have found a typical loan value of 50–55 percent and even up to 100 percent of the value of the car²². The loan is typically for 30 days with a rollover option. Most loans are rolled over and paid off in about 4–6 months. Most loans are for \$250 to \$1,000, although some loans are larger, depending on the value of the car.²³ The American Association of Responsible Auto Lenders (AARAL), an industry group that represents several large title lenders, states the average loan size for its members is \$700. A study of the Illinois title lending industry found the median loan principal to be \$1,500.²⁴ Many are small: A Tennessee study reported that 82 percent of new title loans in 2006 were for \$1,000 or less and 50 percent were for \$500 or less.²⁵ But some loans are larger: The same study found that over 7 percent of title loans were for \$1,750–\$2,500.²⁶ If the borrower defaults, the lender can repossess the collateral. Beyond that the loan usually is nonrecourse—if, for example, the car is in not in operating condition because of a mechanical breakdown, stolen, totaled, or resold for less than expected, the

²⁰ Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 164 (2004).

²¹ WOODSTOCK INSTITUTE AND PUBLIC ACTION FOUNDATION, DEBT DETOUR: THE AUTOMOBILE TITLE LENDING INDUSTRY IN ILLINOIS (Sept. 2007).

²² FOX & GUY, *supra* note 12, at 11. In addition, they found some states with average loan size as little as 20% of the value of the car. There some sense that the size of loans relative to the value of the car has been increasing over time. A 1997 study by John Caskey reports a standard loan of about 25 percent of the value of the car. JOHN CASKEY, LOWER INCOME AMERICANS, HIGH COST FINANCIAL SERVICES (1997). More recent studies tend to find ratios of 50 percent or more.

²³ TENNESSEE DEPT. OF FINANCIAL INSTITUTIONS, THE 2008 REPORT ON THE TITLE PLEDGE INDUSTRY 4 (Feb. 20, 2008) (reporting that over 65 percent of title loans were between \$250–\$1000 with average value of new title loan of \$557.70); Barr, *supra* note 20.

²⁴ WOODSTOCK INSTITUTE, *supra* note 21.

²⁵ TENNESSEE REPORT, *supra* note 23, at 4.

²⁶ As discussed below, many small independent businesses use title lending for operating capital which may account for many of the higher-value loans.

lender is still limited to repossession and cannot sue the borrower for any deficiency.²⁷

Providers of title loans must include these types of costs and risks in the price of the loan.

Mechanically, title loans are comparable to the pawnbroker loans from which they arose. A crucial difference from pawnbroker loans, however, is that in an auto title loan the borrower retains possession of the car rather than surrendering it to the lender. The APR on a title loan is typically 120–300 percent, depending on the amount borrowed.²⁸ Many title lenders also operate payday loan operations (often under the same roof), just as many payday loans and pawnshops operate together.

Title loans are extensively regulated at the state level. According to a 2005 survey of state laws, four states place no interest-rate caps on title loans made by licensed lenders and 13 states have either enacted title loan laws or issued court decisions that authorize high-cost title loans under long-standing pawnbroker exceptions from state usury laws.²⁹ Other states have either special regulations that allow title loans but at a low and uneconomic rate cap, and 31 states have small-loan rate caps or usury limits that technically restrain car title loan rates, although title loans are often structured to avoid those limits.

Industry sources report that about 14–17 percent of title loans default but only about half of defaults (8 percent overall) result in vehicle repossession.³⁰ The high percentage of defaults that do not lead to repossession reflects the reality that that many

²⁷ Even if permitted under law, as in a few states, lenders report that they almost never seek a deficiency judgment in practice.

²⁸ Personal conversations between author and members of AARAL; *see also* Barr, *supra* note 20, at 166 (reporting range of 264–300 percent APR for title loans); Quester & Fox, *supra* note 18 (listing average APRs of 183–377 percent in survey of several states); WOODSTOCK INSTITUTE, *supra* note 21 (256 percent APR in Illinois).

²⁹ FOX & GUY, *supra* note 12, at 6.

³⁰ *See* TENNESSEE REPORT, *supra* note 23, at 9 (reporting 17.5 percent chargeoff rate as measured in dollar amount).

of these cars have mechanical failures or other damage that makes it not worthwhile to expend the cost of repossession (as well as the borrower's decision not to pay). One large title lender stated that it had a repossession rate of 4–6 percent.³¹ A study by the State of Illinois found a repossession rate of 4 percent, with a subsequent redemption rate of twenty percent, resulting in a total repossession rate of 3.2 percent.³² The cars used as collateral for the loans tend to be older vehicles and are owned outright. One study of court records involving auto title loans found that vehicles that were pledged as collateral were 11.4 years old and had 90,823 miles on average.³³ At the time of default, many of the cars have major mechanical failures or other major damage, which explains both the borrower's choice to default as well as the lender's decision not to absorb the cost of repossession.³⁴ Moreover, 70 percent of title loan customers own two or more cars.³⁵ Bad debt and repossession expenses amount to about 20 percent of operating revenues.³⁶ Title lenders are rarely named beneficiaries on auto insurance policies, thus if the car is totaled and the borrower defaults the borrower may be able to retain the insurance proceeds.

³¹ QUESTER & FOX, *supra* note 18, at 7 (citing presentation by John J. McCloskey of Community Loans of America).

³² Some less-reputable lenders have higher repossession rates. But this appears to be the small minority of lenders. See QUESTER & FOX, *supra* note 18, at 7 (reporting that Sal Leasing, Inc. had a repossession rate of 18%)

³³ WOODSTOCK INSTITUTE, *supra* note 21

³⁴ Personal conversations with industry members reports that one large lender contracts out repossession services and reports that repossession costs about \$350 per vehicle repossessed. This provides one explanation for why many loans in default do not result in repossession, especially if the car has mechanical problems. Many smaller lenders perform their own repossessions and may be more aggressive about repossessing even nonfunctioning vehicles.

³⁵ See website of American Association of Responsible Auto Lenders, http://www.responsibleautolenders.org/about/what_is_title_lending. Others may have access to public transportation.

³⁶ TENNESSEE REPORT, *supra* note 23, at 9. Larger companies reported higher losses on bad debts and higher expenses (as a percentage of operating revenue) on repossessions than smaller companies. *Id.* at 10-11.

By way of comparison, Skiba and Tobacman find that 58 percent of first-time pawns default and only 37 percent are redeemed.³⁷ Caskey reports that default rates on all pawnshop loans range from 13.9–30.2 percent in the states that he examined.³⁸

Why Do Consumers Use Title Loans?

Traditionally, consumer demand for nontraditional lending products to access cash has been dominated by four basic types of credit: pawnshops, payday loans, personal finance companies, and revolving balances on credit cards.³⁹ In addition, lower-income consumers traditionally have made substantial use of informal credit, mostly friends and family, but also illegal loan sharks.

Although title loan credit, like any type of credit, has a potential for misuse by the borrower, when compared to available alternatives the use of title loans by consumers and small businesses has many advantages. That is, consumers compare the availability based on their own credit circumstances, the ease of understanding the terms, the cost of applying for the loan with other instruments, and the interest rate and make the choice based on those factors. Depriving consumers and small businesses who already have

³⁷ Paige Marta Skiba & Jeremy Tobacman, *Measuring the Individual-Level Effects of Access to Credit: Evidence from Payday Loans*, Working Paper (July 3, 2007).

³⁸ John P. Caskey, *Pawnbroking in America: The Economics of a Forgotten Credit Market*, 23 J. MONEY, CREDIT, & BANKING 85, 90v (1991).

³⁹ The discussion here focuses on cash-credit products. But consumers foreclosed from other types of credit may make use of a variety of other less-attractive types of credit, such as rent-to-own transactions, or other types of cash credit, such as tax refund anticipation loans. See Gregory Elliehausen, *Consumers' Use of High-Price Credit Products: Do They Know What They Are Doing?* Working Paper, Networks Financial Institute at Indiana State University, 2006-WP-02 (May 2006). Because of their seasonal nature and the requirement that the borrower actually be scheduled to receive a tax refund, tax refund anticipation loans frequently are not available for consumers. When available, their prices are similar as for other nontraditional credit products. As a result, I do not extensively discuss those products here. In addition to these products, there are a variety of other sources of credit for consumers to fund product purchases, such as retail store credit, rent-to-own, and mail-order retailers that also provide credit.

limited credit options of title lending as a credit option would likely result in substantial harm for many consumers and small businesses.

First, for many consumers and independent businesses, their vehicle is one of their most valuable economic assets, especially if they do not own a home (some 80 percent of title lending customers are not homeowners⁴⁰). If they are unable to pledge the vehicle for a title loan, many cash-strapped consumers would be forced to sell their car instead. This would generate cash to pay bills but, of course, would also deprive them of their transportation immediately and with certainty. Since most title loans for operating vehicles are redeemed eventually, consumers seem better off with the option of keeping the car and borrowing against it. Given that title loan customers *could* sell their car if they preferred that option, the fact that they do not indicates that they prefer a title loan over being forced to sell their car to get cash.

Second, title pledge loans can be obtained in 30 minutes or less (and even faster for repeat customers) and are paid out in cash. By contrast, acquiring even a small bank loan can take days or even weeks and involve substantial processing time and costs. Thus, for consumers or small businesses who need cash quickly to pay a utility or repair bill, to make sure payroll checks clear, or to prevent a bank check from bouncing, title lending provides cash in a hurry and which a traditional lender cannot meet. Title lenders, like all nontraditional lenders, also keep more customer-friendly hours, which can be especially useful for shift workers and other similarly-situated workers who may find it difficult to apply for credit during “bankers’ hours.”

Third, title loans, like most nontraditional lending products, also have highly transparent and easily understood pricing schemes. Title loans have only one price

⁴⁰ ILLINOIS DEP’T OF FIN. INSTS., SHORT TERM LENDING: FINAL REPORT 26 (2000).

point—the interest rate—and generally do not charge up-front fees or prepayment fees, thus the borrower simply pays interest on the time the loan is outstanding. There are no “hidden” fees or penalties. Borrowers can readily understand the price of the credit and the consequences of default (repossession). Most title loans, like pawnbroker loans, are nonrecourse loans, which means that even borrowers who default can be confident that the consequences of default will be predictable and limited. This provides some degree of certainty relative to other forms of credit that offer more open-ended costs and personal exposure. Many title lenders do not conduct credit reports on borrowers and do not report defaults on title loans to credit bureaus. Thus, consumers with damaged credit or who fear the consequences of default on their credit rating may find title lending relatively attractive.

This simple price structure is beneficial to borrowers. Research has found that most consumers do not understand how, for example, a loan’s annual percentage rate (APR) is calculated and thus it is a less-useful shopping tool in practice than in theory.⁴¹ APR is especially irrelevant for relatively short-term lending products such as title loans, which are almost always paid off within a month or a matter of months. An *annual* percentage rate, therefore, is meaningful only for loans that are rolled over repeatedly for an entire year, not for those who borrow only for one or a few months. In fact, research indicates that users of nontraditional lending products do not rely on APR in shopping, but are highly aware of the cost of the loan in terms of the interest rate or fees that are

⁴¹ Consumers are often unable to understand the full cost of traditional installment loans such as the APR and related terms. See JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM’N., IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS 35 (2007); Jinkook Lee and Jeanne M. Hogarth, *The Price of Money: Consumers’ Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL’Y AND MARKETING 66 (1999); Diane Hellwig, Comment, Exposing the Loansharks in Sheep’s Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense, 80 NOTRE DAME L. REV. 1567, 1591-92 (2005) (summarizing studies).

charged in connection with the loan, which is probably more relevant for shopping for short-term loans.⁴²

Fourth, unlike payday loans or credit cards, an auto title borrower can have only one such loan outstanding at any given time, relieving the potential of escalating debt or multiple loan defaults and the indebtedness is limited by the value of the car. Upon opening a title loan, the lender records a lien against the vehicle, preventing the borrower from pledging the loan elsewhere. This prevents the concern sometimes expressed about payday lending that a borrower may have multiple outstanding payday loans using the proceeds from one loan to pay off others. The nonrecourse nature of auto title loans (which limits liability), the inherent caps on the amount borrowed (set by the value of the car), and the fact that a borrower can only have one title loan at a time suggests that even though the loss of a car might create a hardship for borrowers, auto title loans should provide minimal risk of major financial breakdown and bankruptcy. In fact, one report found that less than 1 percent of the customers of a large Illinois title lending company filed for bankruptcy.⁴³ By contrast, reducing the access to short-term credit may lead to increased bankruptcy filings by converting short-term liquidity problems into a personal financial crisis. For instance, bankruptcy filings rose dramatically in Japan following its imposition of strict interest-rate controls, reversing a period of decline in filing numbers.⁴⁴

⁴² See Thomas A. Durkin, *A High-Rate Market for Consumer Loans: The Small Small Loan Industry in Texas*, in II TECHNICAL STUDIES, National Commission on Consumer finance, US Government Printing Office, 1975 (as reported in Elliehausen, *Consumers' Use*, *supra* note 39, at 28); see also Elliehausen, *Consumers' Use*, *supra* note 39, at 30 (noting that for payday loans 85–96 percent of payday loan customers reported accurate finance charges but only 20% reported accurate APRs).

⁴³ ILLINOIS REPORT, *supra* note 40, at 21.

⁴⁴ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 73.

Fifth, consumers value the informality and customer-friendly nature of nontraditional lenders, title lenders included. Many customers of nontraditional lenders have had relatively negative experiences with traditional financial institutions—bounced checks, harassment for unpaid bills, and the general demoralizing experience of a less-educated, less-sophisticated consumer interacting with a banking and financial system that is perceived as being unwelcoming and unhelpful to lower-income consumers with financial struggles. A report on payday lenders, for example, found that customers appreciate that payday-loan outlets are friendly, helpful, customer-service oriented, and treat them more respectfully than traditional lending institutions.⁴⁵ Moreover, nontraditional lenders compete intensely on nonfinancial margins: As noted, they offer longer hours, they provide highly-personalized customer service, and they have many more storefronts than traditional lenders, competing on convenience.⁴⁶ This suggests that these are services valued by their customers.

Sixth, according to the Illinois report, 77 percent of title loan customers had no credit cards at all, and only 11 percent had a general-use bank card.⁴⁷ Consumers who do have credit cards generally look to revolving credit card debt as their first source of credit.⁴⁸ But those who revolve credit card balances tend to be older, higher-income, and more likely to own a home than those who use nontraditional credit products, such as

⁴⁵ McGray quotes one payday lending customer, for instance, who states of the payday lending company, “They treat me with respect, they’re really nice.” Douglas McGray, *Check Cashers, Redeemed*, N. Y. TIMES MAGAZINE (Nov. 9, 2008).

⁴⁶ Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* 9-11 (FDIC Center for Financial Research Working Paper, Paper No. 2005/09, 2005); CASKEY, LOWER INCOME AMERICANS, *supra* note 22, at 55. The importance of location may be less important for auto title loans than for other types of nontraditional types of credit because of the greater mobility for the borrowers (because they have cars and so are not constrained by the need to walk or take public transportation) and the greater value of the loans which justifies traveling further, in comparison to payday and pawnshop loans which are much smaller.

⁴⁷ ILLINOIS REPORT, *supra* note 40, at 22.

⁴⁸ Lawrence & Elliehausen, *supra* note 14, at 305.

payday loans. Studies of payday loan customers, for example, find that even if they have a credit card, they were at their credit limit or would incur over-the-limit fees if they used it.⁴⁹ They also were more likely to have paid late fees on their credit cards than other consumers.⁵⁰ Moreover, most payday loan customers have only one or two credit cards, usually with low credit limits; thus they are unable to add accounts sequentially in order to increase their available credit as those with multiple cards and higher credit limits can.⁵¹ This suggests that for most title loan customers, credit cards are not a viable alternative source of credit.

But even those low-income borrowers who do have credit cards may find them an expensive and undesirable source of long-term credit. Because modern credit cards rely so heavily on behavior-based fees (such as over-the-limit and late fees), they may be uniquely unsuitable for the types of consumers who rely on nontraditional lending products like payday lending and auto title loans. Title loans are simple, transparent, short-term loans that are suitable for borrowers with irregular incomes and difficulty maintaining regular payments on longer-term debts. For borrowers with unstable income and employment, credit cards (assuming that they can get a credit card) may be particularly unsuitable products. But those forced to substitute to greater use of revolving credit likely end up paying even higher costs for credit and run into greater financial difficulty.⁵²

Both credit card delinquencies and delinquency-related revenues are higher in states with interest-rate ceilings that squeeze auto title lending and payday lending out of

⁴⁹ Lawrence & Elliehausen, *supra* note 14, at 310.

⁵⁰ Michael S. Barr, et al., *Consumer Indebtedness in the Alternative Financial Services Market*, U. Mich. Law, Working Paper, April 2007.

⁵¹ Lawrence & Elliehausen, *supra* note 14, at 309.

⁵² Ellison & Forster, *supra* note 10, at 55.

the market.⁵³ Credit-constrained borrowers find themselves pushed toward maximized use of their credit card credit lines and have difficulty making payments, thereby triggering repeated over-the-limit fees, late fees, and other behavior-based fees. As credit card lenders have increasingly moved toward risk-based pricing through greater use of such fees, interest-rate restrictions have increased the frequency and amount of these fees, dramatically impacting borrowers who tend to trigger these fees at a disproportionate rate. Interest-rate caps thus force a particular group of consumers to use credit cards more often and in a less-efficient manner than they would prefer, exposing them to repeated delinquency and the imposition of expensive behavior-based fees.⁵⁴ “Low APR products which depend on penalty-based pricing and which are intolerant of irregular payment patterns appear to expose low-income and vulnerable borrowers disproportionately to the risk of financial breakdown.”⁵⁵ By contrast, those who use higher-cost products “appear more likely to be using credit vehicles which are a closer fit with the specific needs of those on tight budgets and are less exposed to the possibility of financial breakdown.”⁵⁶

Who Uses Title Loans?

Auto title lending serves three very different demographic groups: relatively high-income borrowers who prefer title lending to other available credit products, the unbanked who view it as a superior alternative to pawnbrokers, and small independent businesses that use title lending as a source of operating capital. A recent study of U.S. consumers found that in states with strict usury ceilings (and thus where title and payday

⁵³ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 45.

⁵⁴ POLICIS, THE EFFECT OF INTEREST RATE CONTROLS, *supra* note 17, at 37.

⁵⁵ *See* POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 55.

⁵⁶ POLICIS, ECONOMIC AND SOCIAL RISK, *supra* note 10, at 55.

loans were not available), unbanked consumers who couldn't obtain title loans tended to substitute to pawnshops, while those with access to mainstream credit markets made greater use of retail and revolving credit.⁵⁷

Moderate-Income Borrowers

First, auto title lending is used by a moderate-income segment of the population, consumers of sufficient wealth and income to own a car outright (often one of reasonably high value) but with impaired credit that reduces access to mainstream lenders.

According to the American Association of Responsible Auto Lenders, the typical title loan customer for its members is 44 years old and has a household income of more than \$50,000 per year, but is excluded from traditional lenders such as credit card companies, banks, credit unions, and small loan companies. Most are employed.

The most comprehensive profile of title loan borrowers to date, a study prepared for the New Mexico state legislature in 2000, found that 30 percent of title lending customers earn over \$50,000 per year, a higher percentage of higher-income customers than other nontraditional loan products.⁵⁸ Another 41 percent of title loan customers earned between \$25,000 and \$50,000.⁵⁹ One lender reports today that its largest group of customers has a household income between \$50,000 to \$75,000 per year and that over

⁵⁷ Ellison & Forster, *supra* note 10, at 40.

⁵⁸ See William J. Verant, *Consumer Lending Study Committee Report for the Forty Fourth Session of the New Mexico State Legislature*, Submitted by the Financial Institutions Division Director, as request by House Memorial 36 (Jan. 2000), as reported in Elliehausen, *Consumers' Use*, *supra* note 39. Figures reported here are those reported in the 2000 report, unadjusted for inflation. Adjusting for inflation would raise all of the values. For example, \$25,000 in 2000 would be the equivalent of \$30,963 in 2008, and \$50,000 in 2000 would be the same as \$61,926 in 2008. Elliehausen compared title lending with pawn, rent-to-own, and tax refund anticipation loans, all of which had much lower income ranges, and payday lending, which was comparable to title lending.

⁵⁹ *Id.*

half of its customers earn more than \$40,000 per year.⁶⁰ Almost 10 percent of its customers earn over \$100,000 per year. A study by the state of Illinois of data provided by the Illinois Title Loan Company found that 36 percent of title loan customers earn under \$30,000 per year, 55 percent earn over \$40,000 per year, and over 30 percent earn more than \$50,000 per year.⁶¹

The New Mexico study also found title loan customers to be somewhat older on average than users of other nontraditional lending product, with 32 percent reporting ages of 45 and above and only 28 percent under 35 years old.⁶² The Illinois report found that 39 percent of auto title borrowers were age 35–44 and 17 percent were between 45–54 years old.⁶³

Moderate-income consumers who use title loans almost always have impaired credit, notwithstanding their moderate incomes and employment status. These borrowers apparently view auto title lending as a superior alternative to payday loans, the next-closest alternative, or if available, to revolving on credit cards, although users of nontraditional credit products typically don't have credit cards or are maxed out.⁶⁴ First, the loan size for an auto title loan is typically larger than for a payday loan, although this varies, of course, based on the value of the collateral. The average size of a payday loan is usually about \$300 (and is often capped under state regulation). The average loan size

⁶⁰ As reported to author by AARAL members.

⁶¹ ILLINOIS REPORT, *supra* note 40. Other studies, however, have found that the average salary of title loan borrowers is low and more comparable to pawnshop borrowers. *See* QUESTER & FOX, *supra* note 18, at 6. This finding seems anomalous, however, and may reflect the study methodology.

⁶² Elliehausen, *Consumers' Use*, *supra* note 39, at 17.

⁶³ ILLINOIS REPORT, *supra* note 40.

⁶⁴ The degree of substitution between payday and title loans is unclear. Although they are relatively similar as a demographic matter in terms of income and age when compared to other nontraditional sources of credit, direct evidence indicates that payday borrowers do not view title loans as a major alternative. Elliehausen found that that 38 percent of payday loan customers considered another source of credit before obtaining their most recent payday loan, but that they primarily considered a depository institution or a finance company. Only 0.6 percent considered a pawnbroker and only 2.5 percent considered a title lender. *See* Elliehausen, *Consumers' Use*, *supra* note 39, at 30.

for an auto title loan, by contrast, is about \$700, ranging from \$500 to substantially more than \$1,000.⁶⁵ Second, the APR for title loans are typically lower than for payday loans, presumably both because the loan is collateralized (providing security for a loan reduces the risk and thus tends to reduce interest rates) as well as the generally larger loan size that allows underwriting costs to be spread over a larger loan amount. The typical APR on a payday loan is in the range of 400–450 percent, as compared to about 120–300 percent for auto title loans. The Illinois study reported that the average APR for payday loans was 533 percent compared to 290 percent for auto title loans. Third, the loan maturity for an auto title loan typically is longer than for a payday loan. Whereas the standard maturity for a payday loan is two weeks, the typical maturity for an auto title loan is one month or more. Fourth, borrowers can prepay title loans without any penalty.

Auto title loans may be especially valuable to consumers in an environment like the current one of high unemployment rates and recession. Payday loans (and credit cards) provide a mechanism for consumers to borrow against their future *income* to bridge short-term liquidity problems. Auto title loans, by contrast, enable borrowers to tap their current *wealth* to meet short-term financial obligations. The ability to access wealth to meet short-term obligations may be especially valuable to a borrower who is currently unemployed and may be so for an indefinite period of time. Such a person with no regular income flowing in might meet real hardship from the use of rollover payday loans or revolving credit cards over the span of several months when he has no income to pay it off. By contrast, auto title loans permit the borrower to rollover the loan so long as equity remains in the car, which may provide flexibility for unemployed or underemployed consumers and small-business owners.

⁶⁵ Authors' conversations with AARAL members.

Unbanked Customers

Some lower-income and unbanked consumers prefer title loans as an alternative to pawnshops. According to conversations with industry figures, about half of title loan customers do not have bank accounts.⁶⁶ Payday loans, by contrast, require the borrower to have a bank account against which a post-dated check can be drawn, thereby disqualifying unbanked customers. For unbanked customers, title loans are an alternative to pawnbrokers. Twenty-nine percent of auto title borrowers earn less than \$25,000 per year, not an insignificant percentage, but one that is much smaller than for other types of nontraditional lending products (by comparison, 65 percent of pawnbroker and 60 percent of rent-to-own customers earn under \$25,000 per year).⁶⁷ According to one study of credit use by low-income consumers, 7 percent of low-income borrowers had used an auto title loan in the past twelve months, including 12.6 percent of low-income borrowers in the study who owned cars.⁶⁸ According to those authors, more consumers used auto title loans in the preceding 12 months than pawnshops (5 percent), payday lenders (4.2 percent), or rent-to-own (3.2 percent), a preference that was consistent across all income groups. A 1996 study by John Caskey of 300 households in Atlanta, Georgia found that

⁶⁶ According to the 2001 Survey of Consumer Finances approximately 9 percent of the population is unbanked. See George Samuels, *Banking the Unbanked Through Remittances*, <http://www.bos.frb.org/commdev/c&b/2003/fall/unbanked.pdf>. Immigrants, especially Hispanic immigrants, are much more likely to be unbanked than the general population. See MICHAEL A. STEGMAN, *SAVINGS FOR THE POOR: THE HIDDEN COSTS OF ELECTRONIC BANKING* (1999).

⁶⁷ Elliehasuen, *Consumers' Use*, *supra* note 39, at 19. Presumably this is because lower-income households are less likely to own a car.

⁶⁸ ELLEN SEIDMAN, MOEZ HABABOU, AND JENNIFER KRAMER, *A FINANCIAL SERVICES SURVEY OF LOW- AND MODERATE-INCOME HOUSEHOLDS* (2005). 56.1 percent of those surveyed owned cars.

about 9 percent of respondents with annual incomes of \$25,000 or less had an auto title loan in the past year.⁶⁹

Unbanked borrowers have limited credit options in general, and title loans may be comparatively superior to their alternatives. States with liberal consumer credit regulatory regimes have a much higher volume of auto title lending than states with much stricter regimes, suggesting that title loans are popular with consumers when given the choice.⁷⁰ A report by Policis contends that the growth in auto title lending has come predominantly as a substitution for pawnshops by the unbanked as consumers prefer auto title lending to pawnshops.⁷¹ States with strict regulatory regimes have a much lower level of auto title and payday lending than other states and a higher level of pawnbroking, retail debt, and revolving debt.⁷² In states with stricter interest-rate ceilings (and thus, less availability of credit) low-income consumers make greater use of rent-to-own, especially among the unbanked who lack other means of acquiring appliances, furniture, and consumer electronics.⁷³

Pawnshops are especially unappealing to consumers and the market share of pawnshops has declined relative to other nontraditional lending products in recent years. The cost of pawnshops is comparable to payday loans, but they require the borrower to part with personal property to use as collateral for the loan. As noted, default rates on traditional pawnbroker loans are high. In addition, because the value of the loan is limited to some fraction of the resale value of the personal goods pawned, pawn loans

⁶⁹ CASKEY, LOWER INCOME AMERICANS, *supra* note 22.

⁷⁰ POLICIS, THE EFFECT OF INTEREST RATE CONTROLS, *supra* note 17, at 12.

⁷¹ *Id.* at 13, 18.

⁷² *Id.* at 35.

⁷³ *Id.* at 12-13.

tend to be quite small (\$70 on average).⁷⁴ Because of the small dollar value and high default risk, the APR on a pawnshop loan is typically at least as high as for a title loan.⁷⁵

The borrower must also transport the goods to be pawned to the pawnshops—often the goods are delicate (such as electronics), cumbersome (such as musical instruments), or risky to transport (jewelry). Thus, the ratio of transportation costs to the value of many pawned goods is high, which explains the traditionally local operation of pawnshops.⁷⁶ Moreover, this awkwardness of transportation limits the borrower's ability to shop among competing pawnbrokers for the best price. Because of their small size and high transaction costs, pawnshops loans are of limited usefulness in managing financial difficulties, and those who rely on pawnbrokers for loans have a higher incidence of delinquency and higher frequency of missed payments on mainstream credit than those who use payday loans.⁷⁷ Even more revealing of consumer preferences is that pawnshops borrowers typically have been turned down for a payday loan and turn to pawnshops only as a last resort.⁷⁸ Those who borrow from pawnshops tend to have extremely limited credit options, primarily friends or check-cashers.⁷⁹

Those who turn to repeated use of credit card cash advances to make ends meet fare even worse. States with stricter interest-rate ceilings exhibit consistently higher patterns of delinquency on credit cards than less-regulated states, suggesting that in

⁷⁴ Skiba & Tobacman, *Measuring the Individual-Level Effects*, *supra* note 37). (average payday loan is \$300); *see also* Robert W. Johnson & Dixie P. Johnson, *Pawnbroking in the U.S.: A Profile of Customers* 16 (Credit Research Ctr., Monograph No. 34, 1998) (average loan of \$70 with typical range from \$35–\$260); JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS AND THE POOR 44 (1994) (finding average pawnbroker loan of \$50–\$70).

⁷⁵ CASKEY, FRINGE BANKING, *supra* note 74, at 36. Skiba and Tobacman find that pawn loans have a ninety-day term, with a monthly interest rate of 20 percent on loans from \$1–\$150 and 15 percent on loans above \$150. Skiba & Tobacman, *Measuring the Individual-Level Effects*, *supra* note 37.

⁷⁶ Calder, *Pawnbrokers*, *supra* note, at 92.

⁷⁷ Ellison & Forster, *supra* note 10, at 62.

⁷⁸ Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* (working paper, Sept. 8, 2008), available in <http://ssrn.com/abstract=1266215>.

⁷⁹ *See* PETERSON & FALLS, *supra* note 8; *see also* Johnson & Johnson, *supra* note 74, at 47.

heavily-regulated states there are many consumers who are using credit cards but for whom shorter-term less complicated credit products may be more appropriate.⁸⁰ Low-income borrowers in heavily-regulated states are especially prone to delinquency in the event of an economic downturn, as their tendency to employment and earnings disruptions makes it especially difficult for them to maintain long-term obligations on revolving debt.⁸¹ Low-income borrowers in heavily-regulated states also show a much higher rate of missed payments on mainstream credit loans than those who use payday loans.⁸² A 2008 study of Australian low-income consumers found that those who use credit card cash advances had higher levels of total indebtedness on average than payday borrowers.⁸³

As the analysts at Policis observe, “It is this syndrome [the tendency to trigger expensive fees on revolving credit] that explains consumer preferences for sub prime models in states without [rate] ceilings. Borrowers prone to irregular payments and who find it difficult to pay down debt tend to prefer shorter term borrowing and relatively predictable pricing and are reluctant to expose themselves to the risk of punitive sanctions or damage to their credit standing.”⁸⁴ For these borrowers, credit cards tend to operate as *de facto* “fee harvesting” cards because of the repeated high fees assessed against those borrowers. As Policis notes, this is *not* because households in those states are less prone to irregular payment behavior, because these problems are ubiquitous among households on tight budgets. Instead, it is because the *consequences* of irregular payment were so much greater in states where alternative credit products exist. In states

⁸⁰ POLICIS, THE EFFECT OF INTEREST RATE CONTROLS, *supra* note 17, at 37.

⁸¹ *Id.* at 38.

⁸² Ellison & Forster, *supra* note 10, at 62.

⁸³ Ellison & Forster, *supra* note 10, at 78.

⁸⁴ POLICIS, THE EFFECT OF INTEREST RATE CONTROLS, *supra* note 17, at 38.

without ceilings, “borrowers are more likely to use high rate credit models repayable over the short term so that penalty and ancillary charges are less likely to be the major component of the cost of credit.” Borrowers who use short-term credit products “are also less likely to postpone repayment of their borrowing for very extended periods, so that they are less likely to become trapped in a long term cycle of debt.” Moreover, lenders who offer nontraditional loan products are thought to manage their accounts more actively and to build a degree of flexibility into their lending arrangements, which provides flexibility for borrowers with frequent short-term income disruptions.

Prohibiting the option of auto title loans is likely to harm the very borrowers that such regulation is intended to help. For moderate-income consumers, a ban on title lending will likely lead to a shift to payday lending or greater use of revolving credit. Unbanked consumers will likely substitute pawnshops or rent-to-own to try to make ends meet. Banked consumers are likely to see little reduction in their access to credit but just a substitution to greater use of a different type of credit. In fact, by pushing them to use credit that is less appropriate for their personal situation (such as revolving credit with substantial behavior-based fees), they are more likely to run into financial collapse than they would be with a title loan. Unbanked consumers may see a reduction in credit availability, resulting in more bounced checks, more utility shutoffs, and more evictions from an inability to pay rent. It is hard to see how this combination of consequences—greater use of pawnshops, more bounced checks, and more utility shutoffs—can improve consumer welfare.

Small Independent Businesses

A third group of title loan borrowers are small independent businesses that use title loans as a source of short-term working capital, such as landscaping, plumbing, or handyman services. A vehicle title loan provides a useful source of operating capital for these independent businesses. For example, an independent landscaping company may need several hundred dollars to purchase sod and bushes for a job, or for temporary cash to meet payroll while finishing a job or awaiting payment. The proprietor may pledge his pickup truck to obtain the necessary capital to buy the supplies to complete the job. Then when the job is complete (often only days later), payment is made and the owner can redeem the collateral. The likelihood of default and repossession is extremely low (assuming that the customer pays in a timely manner) and the likelihood of rolling over the loan is very low as well. Moreover, some of these businesses may be seasonal and volatile in nature, making short-term credit (even at relatively high cost) more useful and appropriate than long-term bank loans or other types of credit.

Although characterized as “consumer credit” both conventionally and as a matter of Indiana law, title lending (like many other types of “consumer lending” including, most notably, credit cards) is also widely used by small, independent businesses, such as landscaping, handyman services, and many home-based businesses. There are about 26 million businesses in the United States,⁸⁵ most of which are small businesses or self-employed.⁸⁶ Many small and self-employed businesses do not have access to small business loans and relay on consumer credit, such as credit cards, home equity loans, auto

⁸⁵ See Office of Advocacy, U.S. Small Business Administration, Non-employer Firms and Receipts by Industry, 2002-2007, available at http://www.sba.gov/advo/research/ind97_07.pdf,

⁸⁶ See U.S. Census, American Community Survey 3-year Estimate, 2005-2007, available at http://factfinder.census.gov/servlet/DatasetMainPageServlet?_program=ACS (reporting 21 million firms without employees).

title loans, and other sources of consumer lending to finance their businesses. Women and minority entrepreneurs, who have traditionally faced higher levels of exclusion from business credit markets, are especially dependent on consumer credit to finance their businesses.⁸⁷

According to industry members, small, independent businesses constitute approximately 25–30 percent of their customer base. Because they tend to be larger and an even greater percentage of loan amount and value because they are larger and more frequent customers, often borrowing for very short time periods of a few days, small businesses may be an even larger percentage of total dollars loaned. Title lending may be a useful source of credit for these independent businesses. Title loans usually are closed on the spot within thirty minutes, providing the small business proprietor with immediate access to cash. Bank loans, by contrast, often require a lengthy underwriting process that delays access to needed cash and may require borrowing more money than is needed at that time. Moreover, title loans typically only charge interest and do not charge up-front fees or prepayment penalties. Thus, they are uniquely useful for those who need money quickly and who expect to repay the loan within a few days or a week. Even if the original loan term is 30 days, if the balance is paid within a few days, interest is charged only on the period the loan was outstanding. Independent businesses may at times use several title loans in sequence (perhaps even rolling over the loan), making it appear that they are in a “debt trap” of sorts as can be the case with other short-term loan products. In

⁸⁷ See Alicia Robb, Robert W. Fairlie, and David T. Robinson, *Patterns of Financing: A Comparison Between White- and African-American Young Firms - Fourth in a Series of Reports Using Data from the Kauffman Firm Survey*, Kauffman Foundation Firm Survey Research. (February 2009), available at <http://ssrn.com/abstract=1456451>; Susan Coleman and Alicia A. Robb, *Comparison of New Firm Financing by Gender: Evidence from the Kauffman Firm Survey Data*, Working Paper (February 20, 2009), available at <http://ssrn.com/abstract=1260980>.

reality, of course, they are engaging in a series of independent transactions to gain working capital for a series of independent jobs.

The use and the risks born by these small business borrowers are obviously distinct from either group of the previously mentioned consumer borrowers yet regulatory regimes appear to make no distinction among them.

The Peril of One-Size-Fits-All Regulation of Title Loans

As the foregoing discussion makes clear, title loans are most often used by three different segments of the population for distinctive purposes. Each group of customers presents a different set of risks and reasons for why title lending is used. Some are more likely to rollover loans than others; some may be more susceptible to repossession than others. What is clear, however, is that any one-size-fits-all regulatory scheme will fit all of these groups poorly. Moreover, by capping interest rates, heavy-handed regulation will force title lenders to re-price their product and impose more and different fees to make the product economically feasible. This will undermine one of the most valuable purposes of title lending products—its clear and transparent pricing scheme. Term re-pricing that results in the imposition of up-front fees or prepayment penalties will be especially problematic for many users, especially small independent businesses that use vehicle loans as a source of operating capital.

Why Consumers Use Nontraditional Lending Products

There are no comprehensive studies of the reasons that trigger use of title lending by consumers. Studies of other similar products, especially payday lending, however,

suggest that consumers generally use nontraditional lending products to address short-term needs for cash and to meet emergencies.

Use of nontraditional lending products is most often precipitated by an unexpected expense that the borrower could not postpone, such as a health emergency, necessary home repair, or utility bills, not because of spendthrift behavior. In one survey of payday-loan borrowers, 86 percent of respondents reported that they “strongly” (70.8 percent) or “somewhat” agreed (15.7 percent) that their use of a payday lender was to cope with an unexpected expense.⁸⁸ At the time of their most recent payday loan, over 80 percent of payday-loan customers reported that they lacked sufficient funds to deal with the expense.⁸⁹ Those who use alternative lending products tend to have minimal savings, and unbanked consumers (many of whom use title loans) find it especially hard to save for emergencies.⁹⁰

Comparisons of high-cost lending in Europe reveal that low-income borrowers in countries with strict credit regulation (such as France and Germany) are much more likely to suffer utility cutoffs than consumers in countries with more lightly-regulated consumer credit markets, such as the United Kingdom.⁹¹ French and German consumers also report having more difficulties purchasing food, clothing, and fuel than those in Britain, and they are more likely to have difficulty paying for rent and housing.⁹²

Access to flexible, short-term credit is especially useful to lower-income consumers for two reasons. First, consumers with higher risk profiles in more heavily

⁸⁸ GREGORY ELLIEHAUSEN, AN ANALYSIS OF CONSUMERS’ USE OF PAYDAY LOANS 35 (Financial Services Research Program Monograph No. 41, Jan. 2009).

⁸⁹ Lawrence & Elliehausen, *supra* note 14, at 309.

⁹⁰ POLICIS, THE EFFECT OF INTEREST RATE CONTROLS, *supra* note 17, at 9; Seidman, et. al., *supra* note 68.

⁹¹ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 63.

⁹² POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 64.

regulated markets have more difficulty getting access to credit generally, which when combined with their more volatile income patterns tends to create difficulties dealing with recurrent obligations like rent, utility payments, and groceries. Their incomes tend to be more volatile than their expenses, creating liquidity problems. Where credit options are limited, borrowers are restricted in their ability to smooth income fluctuations. Thus, they can introduce “flex” into their budgets only by skipping payment of selected bills such as rent.⁹³ Second, borrowers in markets with heavier regulation are aware of the dire consequences of missing debt payments—a blemished credit record that can disqualify them for future credit. In less heavily-regulated countries, by contrast, blemished credit often results in a higher price of future credit, but not a complete disqualification from obtaining credit. In order to avoid delinquency and default, therefore, borrowers in heavily-regulated markets are much more likely to prioritize payment of debt over payment of utilities and to divert funds saved for utilities and other necessities to debt payment in order to avoid delinquency.⁹⁴

Although details on title loan customers are not available, research on the use of other nontraditional loan products is instructive. A study conducted in 2007 found that 43 percent of payday-loan customers had overdrawn their checking account at least once in the previous 12 months (in 2001, 68 percent of respondents had done so).⁹⁵ Almost 21 percent of payday-loan customers were 60 or more days past due on a consumer credit account during the previous twelve months. Fifty-five percent stated that during the preceding five years, they had had a credit request denied or limited, and 59 percent had

⁹³ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 36.

⁹⁴ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 37.

⁹⁵ Elliehausen, *An Analysis*, *supra* note 88, at 43.

considered applying for credit but did not because they expected to be denied.⁹⁶ Over 16 percent of payday-loan customers had filed for bankruptcy in the past five years—four times the rate of all consumers. Jonathan Zinman similarly found that payday loan customers primarily use their funds for “bills, emergencies, food and groceries, and other debt service.”⁹⁷ Thirty-one percent of borrowers reported using the funds for emergency expenses, such as car repairs or medical expenses.⁹⁸ Only 6 percent said that they used the funds for “shopping or entertainment.”⁹⁹

This research suggests that eliminating nontraditional lending products could force low-income consumers to make decisions that would be more harmful and expensive than the use of nontraditional lending products. Research by Federal Reserve economists Donald Morgan and Michael Strain found that when Georgia and North Carolina outlawed payday lending, the incidence of bounced checks, consumer complaints about debt collectors, and chapter 7 bankruptcy filings rose.¹⁰⁰ Direct fees imposed for checks returned for insufficient funds can be quite significant. For example, a bounced check may lead to fees imposed by both the payee as well as the financial institution that may exceed \$50 total per transaction, an implied APR far higher than for payday loans.¹⁰¹ Moreover, these fees are cumulative—bouncing several checks can result in the imposition of substantial fees each time. Dishonored checks also impose indirect costs. If a check is for payment of insurance, the policy will be terminated; and if

⁹⁶ *Id.*

⁹⁷ Zinman, *supra* note 16, at 9.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ Donald R. Morgan and Michael R. Strain, *Payday Holiday: How Households Fare after Payday Credit Bans* (Fed. Res. Bank of NY Staff Report no. 309) (Feb. 2008).

¹⁰¹ Michael W. Lynch, *Legal Loan Sharking or Essential Service? The Great “Payday Loan” Controversy*, REASON (2002); Barr, *supra* note 20, at 155. The Illinois study estimates total fees “in excess of \$43” for a bounced check. ILLINOIS REPORT, *supra* note 40, at 31.

for utilities (such as telephone or electricity), the bounced check may lead to termination of service, penalties, and a substantial security deposit to reconnect service. Bounced checks may also result in termination of a bank account and even a risk of criminal prosecution.¹⁰² In all, these various costs may exceed hundreds of dollars, a far higher rate than that charged by payday lenders. Bouncing a check is also very damaging to one's credit score, making subsequent access to credit even more difficult.

Many financial institutions offer overdraft protection to guard against bounced checks. But the APR on these overdraft loans can also easily exceed the cost of a title loan. DeYoung and Phillips estimate that if a bank charges a \$20 fee to cover a \$100 overdraft, and the customer brings the account back to a positive balance after two weeks, the APR would be 520 percent for just one check.¹⁰³ According to a study by the Federal Deposit Insurance Corporation, the average APR on a two-week checking account overdraft is 1,067 percent.¹⁰⁴ Economist Jonathan Zinman found that when Oregon imposed a cap on the finance charge that could be assessed on payday loans, there was a dramatic drop in the number of licensed payday lenders, a short-run deterioration in the overall financial condition of Oregon households, and some evidence that the ban led to an increase in late bill payments and greater use of overdraft protection by consumers as a substitute.¹⁰⁵

¹⁰² According to one news story, at most banks "if you've bounced too many checks you're banned for five to seven years." McGray, *supra* note 45.

¹⁰³ Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing*, Federal Res. Bank of Kansas City Research Working Paper, RWP 09-07 at p. 6 (Feb. 2009).

¹⁰⁴ FDIC STUDY OF BANK OVERDRAFT PROGRAMS (Nov.2008). Ironically, and evidencing the ill-suited nature of APR as a measure for these sorts of short-term loans, the measured APR is higher when the loan is repaid quicker.

¹⁰⁵ Zinman, *supra* note 16. The imposition of new regulations on payday lending operations in Virginia in 2008 has led to an estimated 84 percent reduction in the volume of payday loans and a dramatic reduction in the number of licensed payday lending outlets, from 832 to 526. *See* Potter, *supra* note 14.

Consumers may also use an unsecured installment loan from a personal finance company. Although some consumers still use them, as a general rule, finance company loans have become less available over time as they have been replaced by many of the alternative lending products described herein. According to a recent study by the Woodstock Institute of Illinois, interest rates on installment loans range from 5 percent to 1,142 percent, with a median interest rate of 95 percent.¹⁰⁶ Personal installment loans tend to be larger in value than other alternative lending products, ranging from \$175 to \$17,247, with a median amount of \$1,397. The lower APR (compared to other short-term products) reflects the larger average principal amount, which creates another set of problems. The Woodstock Institute study found that 46 percent of installment lenders also financed ancillary products such as single-credit, disability, and unemployment insurance into the loan principal, thereby raising the principal balance to be financed and reducing the measured APR.¹⁰⁷

Another alternative source of credit for payday loan customers is the informal sector of friends and family.¹⁰⁸ A recent survey of households in low- and moderate-income areas of Los Angeles, Chicago, and Washington, DC found that 49 percent of respondents said they would rely on friends or family to borrow \$500 for three months.¹⁰⁹ Angela Littwin's survey of credit use by low-income women found that 93 percent had actually borrowed money from friends and family in the past and many had lent money to friends and family as well.¹¹⁰ Ten percent of her subjects have borrowed *only* from

¹⁰⁶ TOM FELTNER & SARA DUDA, BEYOND PAYDAY LOANS: CONSUMER INSTALLMENT LENDING IN ILLINOIS (March 2009).

¹⁰⁷ WOODSTOCK INSTITUTE, *supra* note 21.

¹⁰⁸ LENDOL CALDER, FINANCING THE AMERICAN DREAM 60-64 (1999).

¹⁰⁹ SEIDMAN, *supra* note 68

¹¹⁰ Angela Littwin, *Beyond Usury: A Study of Credit Card Use and Preference Among Low-Income Consumers*, at 8.

friends and family.¹¹¹ Elliehausen found that 28 percent of payday loan customers said that they would have tried to borrow from friends and family if payday loans were not available.¹¹²

But friends and family may not be able or willing to lend when needed, in the amounts needed, or for needed purposes. This reality is reinforced by the fact that most social networks are limited in scope; most of the friends and family of low-income individuals frequently also have low incomes and thus have limited funds to lend.¹¹³ Many people do not have friends or family to whom they can turn for emergency funds, such as immigrants, orphans, or transients.¹¹⁴ Perhaps more significantly, people find borrowing from friends and family personally embarrassing and potentially damaging to personal relationships. Informal borrowing may also be less useful than standard credit in managing one's finances because personal acquaintances may be willing to lend only for expenses considered particularly meritorious (such as medical emergencies) and not for other expenses or for business purposes.¹¹⁵ As a result, many borrowers are willing to borrow from their families only for an emergency (such as to meet urgent utility bills) but not for other purposes.¹¹⁶ Social borrowing also tends to be zero-sum in nature, as it does not introduce any new capital into the social circle but simply redistributes existing funds within the circle.¹¹⁷

¹¹¹ Angela Littwin, *Comparing Credit Cards: An Empirical Examination of Borrowing Preferences Among Low-Income Consumers* 36 (working paper); available in <http://ssrn.com/abstract=1014460>.

¹¹² Elliehausen, *An Analysis*, *supra* note 88, at 39.

¹¹³ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 35.

¹¹⁴ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 79.

¹¹⁵ ECONOMIC AND SOCIAL RISKS, *supra* note 10. Consistent with this, Seidman, et. al., find that borrowing from friends and family is most prominent for emergencies.

¹¹⁶ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 79.

¹¹⁷ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 36.

Illegal Loan Sharks

Illegal loan sharks may be a final source of credit of last resort. In the United States, illegal loan sharking originally arose as an outgrowth of early twentieth century small loan laws that capped the fees and interest rates for small consumer loans at a level that was unprofitable, causing legitimate lenders to raise their minimum loan amounts or to exit the market.¹¹⁸ Organized crime syndicates looking for new economic enterprises following the repeal of Prohibition entered the market in the 1930s and by the 1950s and 1960s controlled much of the small-loan market in many major American cities.¹¹⁹

A recent comparison of France, Germany, and the United Kingdom indicates that stricter regulation of consumer credit, and thus reduced access by higher-risk borrowers to legal credit, is correlated with higher rates of illegal lending activity.¹²⁰ In Germany, where credit regulations are among the strictest in Europe, 60 percent of low-income Germans have had credit applications refused, and almost 10 percent have resorted to illegal lenders. Rates of illegal lending in France and Germany are two-and-a-half to three times higher than in the United Kingdom, where interest rate caps are less strict and exclusion from credit markets less severe and widespread. News reports indicate that in Italy the turmoil in consumer credit markets during the past year led to an increase in lending by illegal loan sharks to consumers and small businesses.¹²¹

In 2006, Japan severely tightened its rate ceiling on consumer loans (as in the United States, many consumer loans were also small business loans), resulting in a two-

¹¹⁸ Haller & Alviti, *supra* note 9, at 140.

¹¹⁹ Haller & Alviti, *supra* note 9, at 143.

¹²⁰ See POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10; POLICIS, THE EFFECT OF INTEREST RATE CONTROLS, *supra* note 17.

¹²¹ Mary Jordan, *As Italy's Banks Tighten Lending, Desperate Firms Call on the Mafia*, WASHINGTON POST p. A01 (March 1, 2009).

thirds drop in the acceptance of consumer loan applications in the two years following the enactment of the law.¹²² During that period there has been a dramatic growth in illegal loan sharking in Japan, primarily run by organized crime (“Yamaken” lenders).¹²³ Research indicates that use of illegal lenders “has risen rapidly among borrowers who have become shut out of the market as the result of the changes in the regulatory environment.”¹²⁴ Japanese consumers who admit to having contacted a loan shark during a 12-month period were twice as numerous among those who were unable to borrow as much as they wanted from a legitimate consumer finance lender (26 percent) as among those who were able to obtain the amount that they wanted (13 percent). Those declined by legitimate lenders were also more likely to contact loan sharks (27 percent) and even more likely among those who had been asked to provide guarantors or collateral for a loan (42 percent).

More borrowers are excluded from formal credit markets in countries such as Germany and Japan with strict interest-rate controls, thus loan sharks reach higher up the income ladder and are more likely to be used by small businesses than where credit restrictions are not as tight.¹²⁵ The overwhelming reason that borrowers report resorting to illegal lenders is that they could not borrow from anywhere else (over 80 percent).¹²⁶ As might be expected, lending by illegal lenders is much higher in cost than for legitimate lenders, and collections by illegal lenders rest on threats, intimidation, violence, and other forms of exploitation such as provision of sexual favors when unable

¹²² POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 47.

¹²³ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 47-49.

¹²⁴ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 48 (citing Hiroshi Domoto, *Behavioral Analysis of Consumer Loan Users*, REGIONAL BANKS MONTHLY REPORT (Oct. 2007)).

¹²⁵ *Id.* at 49, 83.

¹²⁶ *Id.* at 50.

to pay.¹²⁷ Illegal lenders often add multiple fraudulent fees to loans (often fees for loans that are never closed) or induce payment of ancillary charges, such as advertisements that require long phone calls to toll telephone lines to acquire useless information.¹²⁸ In Japan, there have been several highly publicized incidents of borrowers driven to suicide by the pressures of illegal lenders' collection efforts.¹²⁹

The flexibility and deregulation of consumer credit markets in the United States has substantially reduced the importance of illegal loan-shark lending.¹³⁰

Nontraditional Credit Products and Over-indebtedness

Interest-rate restrictions do not appear to reduce problems of over-indebtedness among low-income households, as term re-pricing and product substitution simply shift consumers to different products—usually products that are less-preferred and inappropriate for their particular needs. In fact, the Policis report concludes that interest-rate ceilings may exacerbate over-indebtedness problems, as regulation promotes an increase in loan size and loan maturity in order to cover the administrative costs of making the loan. Increased loan size tends to increase overall indebtedness, and an increased use of longer-term installment debt locks borrowers into less-flexible debt payment obligations, increasing their vulnerability to income and expense shocks, such as an underemployment or surprise expenses like a car repair or medical bills.¹³¹

As noted, foreclosing some types of products may cause a shift to other products (such as revolving credit and credit-card cash advances) that are laden with behavior-

¹²⁷ *Id.* at 51-52.

¹²⁸ *Id.* at 39, 51.

¹²⁹ *Id.* at 51.

¹³⁰ John M. Seidl, *Let's Compete With Loan Sharks*, HARV. BUS. REV., May-June 1970 at 69.

¹³¹ POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 74, 78.

based fees that more marginal borrowers are most likely to trigger and which might result in even higher effective costs than title lending or other nontraditional products. A study of Australian low-income households found that borrowers who took cash advances on credit cards were almost twice as likely to become insolvent as other low-income credit users.¹³² Thus, even if eliminating title loans might paternalistically protect some consumers from unwise and impulsive decisions, it would likely harm the larger number of consumers who would lose a valuable option for managing their finances.

Moreover, as recent events have made clear, the risk that consumers will misuse credit to become recklessly over-indebted is not unique to auto title lending or other nontraditional lending products, but can also include mortgages, credit cards, student loans, and auto loans. Yet no one proposes to abolish mortgages or student loans because of the risk that some consumers will misuse them or lenders may overreach. In fact, given the relatively small dollar amounts at stake and inherent limits on the amount of the loan, auto title lending is much less likely to prove fatal to a household's balance sheet than other obligations, such as an excessive mortgage or other debts.¹³³

The concern over further constricting available lending options is especially pronounced in the current dysfunctional credit market environment. Banks and other lenders are drastically reducing consumer lending, just at the moment when consumers are especially in need of credit to deal with employment interruptions and unexpected expenses. Anecdotal reports indicate that as a result of this reduction in access to credit, and especially a dramatic reduction in the availability of credit-card credit, middle-class consumers and small businesses increasingly are turning to nontraditional lenders, such

¹³² *Id.* at 78.

¹³³ As noted, the bankruptcy rate for auto title loan customers is less than 1%. *See supra* note 43, and accompanying text.

as payday loans and pawnshops.¹³⁴ Banning title lending, particularly in these uncertain times, would whipsaw these middle-class consumers, driving them still further down the “lending ladder” to pawnshops or other products.

Regulation and Competition

At first glance, title lending seems very expensive, leading to fears of market failure. In fact, however, there is no evidence of market failure in the title lending industry or persistent economic profits and the observed prices can be explained by the economic realities of the industry once the costs and risks of the business are accounted for.

Despite the relatively high cost of auto title lending, there is no indication that title lenders are earning supernormal economic profits from their activities once risk and cost are taken into account. Small loans are difficult to make economically because of the high fixed costs associated with making a loan, such as employee time, operation of the storefront, rent, etc. Nontraditional lenders, more than traditional lenders, compete on higher-cost margins, such as longer hours, more intensive customer service, and store density resulting in a higher cost structure for nontraditional lenders and a reduced ability to capture economies of scale in operations. This may be especially so in the context of auto title lending. Because of the variability in the quality of the collateral and the need for the lender to assess the value of the collateral, auto title lending is a highly personal,

¹³⁴ Gary Fields, *People Pulling Up to Pawnshops Today Are Driving Cadillacs and BMWs*, WALL ST. J. (Dec. 30, 2008); Jeff Swiatek, *More Middle-Class Families are Learning that Payday Loans Add Up*, INDIANAPOLIS STAR (Feb. 3, 2009) (“Payday loans, typically a way working-class people get cash in a pinch, are increasingly being sought by middle-income families living without a cash cushion. Lenders and others say the short-term loans are being taken out by people who used to get needed cash from a bank, a credit union or a credit card. With the recent credit crunch and recession, high-interest payday loans have become an alternative.”). Layaway, which had been completely replaced by credit cards, has returned to department stores as well.

labor-intensive form of lending.¹³⁵ Automated underwriting is not practical. Moreover, because of the nonrecourse nature of the loan and the potential for deterioration or destruction of the collateral, auto title lending has substantial idiosyncratic risk associated with it. Repossession on default is expensive relative to the value of collateral and many title lenders contract-out for repossession services. As a result, although prices are high, there is no evidence of sustainable economic profits or market failure.

Similar factors are present in the context of payday lending, and researchers have concluded that there is no evidence of persistent economic profits (or “rents”) in the payday loan industry once risk and costs are taken into account.¹³⁶ Given the low barriers to entry in the auto title lending industry, it is unlikely that results are different than for payday loans.

Where not excluded by prohibitively low interest-rate caps, barriers to entry appear low. Capital start-up requirements are modest and competition appears to be robust. Standard economic theory predicts that where competition is strong and barriers to entry are low, competition tends to dissipate any economic profits in the industry and to improve consumer welfare.¹³⁷ Pricing is highly transparent and simple, enabling borrowers to shop among competing offers. Empirical studies of the payday loan industry find that where competition is stronger, payday lending costs are lower, just as standard economic theory would predict.¹³⁸ There is no reason to believe that this result would be

¹³⁵ CASKEY, LOWER INCOME AMERICANS, *supra* note 22, at 56.

¹³⁶ See Paige Skiba & Jeremy Tobacman, *The Profitability of Payday Loans*, Working Paper (Dec. 7, 2006); Flannery & Samolyk, *supra* note 46; Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?*, 12 FORDHAM J. OF CORP. & FIN. LAW 203 (2007).

¹³⁷ Philip Bond, David K. Musto, & Bilge Yilmaz, *Predatory Lending in a Rational World*, Federal Reserve Bank of Philadelphia Working Paper 06-2 (Nov. 2006).

¹³⁸ See Donald P. Morgan, *Defining and Detecting Predatory Lending*, Fed. Res. Bank of New York Staff Report no. 273, at 5-6 (Jan. 2007).; DeYoung & Phillips, *supra* note 103; POLICIS, THE EFFECT OF

different for the title lending industry. Regulation that reduces the number of auto title lenders, therefore, would likely result in higher prices for consumers, not just for title loans, but for competing nontraditional lending products such as payday loans and pawnshops.

Interest-rate ceilings, on the other hand, may have the counterproductive effect of reducing competition and encouraging implicit collusion among lenders. Scholars have postulated that interest-rate caps have been found to provide a “focal point” for pricing consumer loans, leading loan prices to drift toward fixing on the statutorily mandated maximum and have found a focal-point effect with respect to interest rates on payday loans¹³⁹ as well as credit cards.¹⁴⁰ Studies repeatedly find that interest rates on consumer loans are set by the forces of supply and demand, not regulation.¹⁴¹

Conclusion: The Costs of Substantive Price Regulation Exceed the Benefits

For almost as long as there has been consumer credit, regulators have tried to limit the prices that can be charged for those loans. Price regulation, however, has three unintended consequences: (1) term re-pricing, (2) product substitution, and (3) rationing. Examining all of these unintended consequences, economists and regulators have concluded that once all of the offsetting behaviors have been taken into account, the costs of price caps and other substantive regulation exceed the benefits. The offsetting behaviors taken by lenders and borrowers in response to price-control efforts tend to

INTEREST RATE CONTROLS, *supra* note 17, at 26 (finding that prices on payday loans have fallen as competition has intensified).

¹³⁹ DeYoung & Phillips, *supra* note 103.

¹⁴⁰ Christopher R. Knittel & Victor Stango, *Price Ceilings as Focal Points for Tacit Collusion: Evidence from Credit Cards*, 93 AM. ECON. REV. 1703 (2003).

¹⁴¹ See POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 10, at 32; Staten, *supra* note 3.

make pricing less transparent and more heterogeneous, thereby making it more difficult for consumers to compare among different offers and thereby also stifling competition. Product substitution forces consumers who need credit to use less-preferred forms of credit, such as forcing them to use payday lenders or pawnshops instead of title lenders. *De jure* or *de facto* bans on title lending may be especially harmful to consumers and small businesses in the current environment where rising unemployment rates increase the need for short-term credit but also reduce the availability of payday and similar types of credit. Auto title lending enables borrowers, especially those who do not own homes, to access the equity in their vehicles to bridge these short-term employment interruptions, rather than experiencing utility shutoffs, eviction, or the need to forego other necessary goods and services such as medical care. Finally, some consumers will have credit rationed while others will be unable obtain credit at all, or may be forced to turn to informal or even illegal lenders.

Those who use auto title lending do so primarily because they have to, not because they want to. They use title lending and other nontraditional lending products to deal with short-term exigencies. Other potential options, when available, would hurt them even more, such as the high costs for bounced checks, overdraft fees, or disconnected utilities. Auto title lending provides a valuable service for many consumers and small businesses, especially unbanked consumers or those who lack access to credit cards or other conventional loan products. Title loan customers have limited credit options: Consumers who use title lending are not likely to be made better off by misguided paternalistic regulations that narrow their limited options still further.

Prior studies of the impact of usury restrictions have found that low-income and minority borrowers are those most negatively affected by the regulations and the adjustments that those regulations produce.¹⁴² As one study summarized the impact, once all of the various adjustments are made in response to interest-rate ceilings, “substantial numbers of some consumer groups will be less satisfied with the new credit terms. It is ironic that customers who are most likely to be dissatisfied are those who are traditionally considered to be the primary beneficiaries of such legislation—those in the lower socioeconomic groups.”¹⁴³ Further restrictions on title lending would likely prove counterproductive and harmful to the very people they are intended to help.

¹⁴² ROBERT W. JOHNSON & A. CHARLENE SULLIVAN, RESTRICTIVE EFFECTS OF RATE CEILINGS ON CONSUMER CHOICE: THE MASSACHUSETTS EXPERIENCE (Credit Research Ctr. Working Paper No. 35, 1980).

¹⁴³ Orville C. Walker, Jr. & Richard F. Sauter, *Consumer Preferences for Alternative Retail Credit Terms: A Conceptual Test of the Effects of Consumer Legislation*, 11 J. MKTG. RESEARCH 70, 78 (1974); see also Richard F. Sauter & Orville C Walker, Jr., *Retailers Reactions to Interest Limitation Laws—Additional Evidence*, 36 J. MKTG. 58 (1972), John J. Wheatley & Guy G. Gordon, *Regulating the Price of Consumer Credit*, 35 J. MKTG. 21 (1971).