



## BAGGAGE OF CONSUMER INSTALLMENT CASH LENDING A New Sorting of the Suitcases

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Although credit use has been widespread for thousands of years, certain arguments against its use have persisted through the centuries. Today, these arguments carry a lot of baggage. A [recent paper from the National Consumer Law Center](#) displays a lot of this baggage, but this is just one example of the reasoning behind common anticredit arguments.

In “[Baggage of Consumer Installment Cash Lending: A New Sorting of the Suitcases](#),” Thomas A. Durkin examines a wide range of anticredit arguments that have persisted throughout history. He discusses reasons for using credit in the first place, interest rate ceilings on loans, lending profitability, loan renewals, the Rule of 78s, and credit insurance. By focusing on individual products’ success rather than on mythology perpetuated over time, policymakers will better serve the consumer lending market.

### SUITCASE NUMBER ONE: MYTHOLOGY OF THE REASONS FOR CREDIT USE

- *Myth.* The use of credit is an attempt to live beyond one’s economic means. This has been considered either a moral evil or a cause of future economic strife.
- *Reality.* The lending and borrowing process does not increase the amount of consumers’ resources or let them live beyond their means, unless they do not repay their loans. People typically borrow to change the timing of their spending, not to increase the amount. By borrowing, they are able to make large expenditures today on such things as education and durable goods that provide returns over time, even if they have to reduce future spending to make the payments.

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## SUITCASE NUMBER TWO: MYTHOLOGY THAT INSTALLMENT CASH LOANS WITH HIGH ANNUAL PERCENTAGE RATES ARE NECESSARILY PREDATORY

- *Myth.* The government has always protected consumers from predatory loans by placing caps on interest rates.
- *Reality.* As loans get larger, the costs and risks usually rise. But it is important to see that they can fall relative to the size of the loan, meaning that a larger loan can carry a lower interest rate, and a higher rate on a smaller loan is not necessarily predatory. Although a multimillion-dollar loan can generate a lot more costs than a thousand-dollar loan, it can have a lower cost per loaned dollar and therefore a lower rate. Furthermore, a large annual interest rate may translate into a very low dollar cost if applied to a low balance that is repaid quickly.

## SUITCASE NUMBER THREE: CONCEPTUAL MYTHOLOGY ABOUT RATES AND PRICES

- *Myth.* The annual percentage rates (APRs) for installment loans are much higher than those for other loans, so the full costs of installment loans to the consumer are much higher than the costs of other loans.
- *Reality.* APRs are a good tool for comparing similar loans, but they can be deceiving when it comes to loans that have different payment schedules. For loans that have installment payments, the charge for interest declines for each payment made on the loan, leading to a smaller finance charge than simplistic application of a rate to a balance would predict. Further, because dollars are the actual loan costs, there are situations where the number of dollars expended can be especially useful in making decisions.

## SUITCASE NUMBER FOUR: MYTHOLOGY ABOUT OPERATIONS AND PROFITABILITY

- *Myth.* High loan prices bring about enormous profits for lenders.
- *Reality.* This myth was tested extensively in the 1960s and 1970s, with the result that the market for installment lending was profitable, but no more so than other markets. When price ceilings were lifted from the installment lending market, the short-term response was a slight increase in profitability, but over time, these profits were replaced by competition and more extensive lending service.

## SUITCASE NUMBER FIVE: MYTHOLOGY ABOUT CALCULATING RATES, REBATES, AND RULE OF 78s

- *Myth.* Lenders use interest rates to take more than they should, cheating consumers by taking more than they have earned.
- *Reality.* For loans that are set up to produce payments of equal size, rebates of unearned charges can involve complicated mathematical adjustments if these loans prepay. Historically, many algebraic methods were available for these calculations, but a method called the

Rule of 78s often found its way into state regulations as a method that was both easy to use and fair to both borrowers and lenders. Today, interest in the Rule of 78s is mostly historical, although it still seems to generate controversy greater than its use or impact.

#### SUITCASE NUMBER SIX: MYTHOLOGY ABOUT DELINQUENCY AND RENEWAL

- *Myth.* A high proportion of loan renewals in a portfolio indicates abusive “loan flipping.”
- *Reality.* Most loan renewals involve adding new money, not making defaulted accounts current. Mathematical simulations of portfolios easily show that lenders can have a high steady state of renewals while simultaneously having rules in place that make “loan flipping” impossible.

#### SUITCASE NUMBER SEVEN: MYTHOLOGY ABOUT ANCILLARY PRODUCTS, ESPECIALLY CREDIT INSURANCE

- *Myth.* Products such as credit insurance are simply ways for lenders to add more costs to the original loan.
- *Reality.* The concerns with credit insurance seem to stem not from the uselessness of the product, but rather from the methods of distribution through the lending process. Although critics argue that lenders sometimes try to mislead customers into buying the product, evidence shows that many customers are not even offered the product, and the small proportion who do buy it appear mostly very satisfied.

#### CONCLUSION

Policymakers should proceed with caution when acting on installment lending myths. Individual lending products should be allowed to stand or fall on their own merits and, if useful, should be permitted to thrive in a policy environment that favors their success. If existing regulations on traditional consumer installment lending are not serving borrowers and lenders, it does not follow that more regulations would necessarily be more useful or better. Maybe fewer regulations—or, in some cases, repeal of existing regulations—would be a better policy choice for the consumer lending market.