Eric Palmer “Payday lending: America’s unsecured loan market”

[Business Ethics Case Study, 5000 words, Eric Palmer]

Some changes expected in published revision. Email epalmer@allegheny.edu for published version copy.

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Supplementary teaching materials follow the case study.

Payday lending: America's unsecured loan market
[Business Ethics Case Study, 5000 words, Eric Palmer]

Loans of money are called "unsecured" if they are granted without collateral. Collateral provides a material guarantee against at least some of the loan's value: holding the deed to a house and land in trust, for example, provides a bank with collateral against a home loan. If something can stand in place of collateral, then a similar security for the lender might be ensured. Something of the right sort was found in the United States during the 1990's by owners of check-cashing storefront businesses that operated in all cities and many towns.

Check cashing businesses provide a necessary service, charging fees to cash checks and to draft checks and money orders for their clients, many of whom do not have access to personal bank accounts. Check cashing services found that they could expand their business to a new group of customers who did have access to checking accounts, by offering "advance check cashing" services. In place of loan collateral, customers could provide the lender evidence, in the form of a recent paystub, of their ability to pay in the future, plus an indication of intent to repay, in the form of a post-dated check or electronic fund transfer agreement for the value of the loan plus interest and fees. The recipient, then, could purchase the service of "advance check cashing" against a future paycheck, a loan secured by money that would presumably be available in the recipient's checking account at the next payday.

A borrower might take the money and run, as is a concern with any loan. In this case, one might close the bank account or neglect to supply it with sufficient funds, but the penalty incurred would be significant. The value of maintaining a bank account and good credit history is apparent to most borrowers, fees charged to account holders for bounced checks are usually substantial, and, of course, the loan balance remains on the customer's record. Such a balance might also be sold to a debt collection service, which would ask for further fees on top of the balance. With no collateral, lenders have nothing to show in cases of default, but they have found the arrangement to be stable anyway because the penalty of default provides sufficient incentive for repayment. Thus, penalty replaces collateral.

Payday lending storefronts have proliferated across 35 states, increasing from about 500 locations in 1990 to over 24,000 by 2007 and reducing to about 16,500 at present. They serve about twelve million customers in the USA, or 5% of the adult census population. The largest company, Advance America, has 2,100 locations in 28 states. It has been owned by Grupo Salinas since 2012.[1] The storefront market has reduced because of rising activity facilitated through the internet, to which we turn shortly.

Advance check cashing – now more commonly known as payday lending – commonly provides an advance of up to 50% of the value estimated from a paystub plus interest and fees, all due on the date of the next paycheck. The value of a loan is typically about $350. The loans are most frequently advanced for approximately a two-week period, reflecting total charges of roughly 15% of the principal on average. Business owners originally circumvented usury laws, which are upper limits set by states upon interest rates, by introducing the practice under the name of check cashing, rather than lending. Litigation and legislation followed the introduction of the practice, with the result that such loans are now available in most states, with a fee structure that usually reflects a combined fee plus interest rate charge of about 400% per annum.[2]

Unsecured loans are now generally available across the entire nation because transactions may occur across state lines, particularly by loan application on the internet. An examination of an offering at mypaydayloan.com is illustrative of current internet arrangements.[3] Online coupon aggregator websites may provide

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[1] Statistics concerning the general characteristics of the industry have been drawn from Consumer Finance Protection Bureau (2017); if not found in that publication, they are drawn from other cited sources dated 2007 to present.

[2] For details of this history, see Katherine Samolyk, "Payday lending: Evolution, issues and evidence," in Sumit Agarwal and Brent W. Ambrose, eds. Household Credit Usage: Personal Debt and Mortgage (New York: Palgrave, 2007), 175-201.

[3] At https://www.mypaydayloan.com/cash-advance, https://www.mypaydayloan.com/faq. The first of these links was the first link to be displayed on a google search for "payday loan" using an anonymized browser, accessed January 27, 2018.

access to a first "Free Loan" opportunity for some customers of the lender. An online application accompanied by photographs of a pay stub and a postmarked envelope with address visible may lead to approval in "less than 5 minutes during normal business hours." If the application arrives early in the business day, funds arrive in the borrower's checking account on the same day. First-time customers are limited to a $600 loan and the ceiling for repeat borrowers is $1000. Text drawn from the "frequently asked questions" page explain further details of lending arrangements:

> If you have poor credit, it will not affect the approval of your loan. However, if you have filed for bankruptcy within the past year or if you have filed multiple times, we will not be able to extend an advance to you. ...
>
> The fee for advancing a payday loan is $30 per every $100 borrowed. ...
>
> Online payday loans are intended to be used for quick cash in the case of a financial emergency. ...
>
> Payments are normally due every 10 to 14 days, depending on your next payday and regardless of how often you are paid. Even if you are paid once a month, your payments will still be due every two weeks with a payday loan. ...
>
> You are allowed to extend your payday loan as many times as necessary; however, keep in mind that a payday loan is a short-term loan that should be paid back quickly. ...
>
> The minimum amount [due] is simply the fees associated with your current principal balance. ... You have 3 payment options to choose from:
> 1) Elect to pay the total amount due (fees will be waived if you are a Free Loan customer)
> 2) Elect to pay the minimum amount and extend the loan with a *new contract
> 3) Elect to pay more than the minimum amount and extend the loan with a *new contract (payment will initially be applied to the fees and the remainder of the payment will be applied to the principal)
> A *new contract means you are entering into a new loan period, which obligates you to pay the finance charge associated with your new principal balance at the end of the next pay period. ...
>
> If you fail to submit a payment request by the deadline, as a courtesy, we may debit the minimum due only. However, please be aware that this is a courtesy we extend at our discretion. Per the Check Advance Agreement, you are required to submit a payment request prior to each due date to ensure that the payment amount you desire will be debited from your account. ...
>
> If your payment is returned due to NSF [non-sufficient funds] (or Account Frozen or Account Closed), our collections department will contact you to arrange a second attempt to debit the payment. A return item fee of $25 and a late fee of $50 will also be collected with the next debit.
>
> If you have an issue with a fraudulent lender and require further assistance, please call the OLA Consumer Hotline at ... and they will assist you reporting fraud.

Mypaydayloan.com charges a “fee,” rather than interest. Were a two week loan of this sort to extend over a full year without repayment of principal, fees would total 7.8 times the unpaid principal (780%). In the event that a borrower does not select a payment option by the due date, either the lending fee or a greater sum is automatically debited from the borrower’s checking account: in those circumstances, conditions apply that are similar to option 2 or option 3 above. The “OLA consumer hotline” mentioned in the final paragraph above rings to the Online Lenders Alliance, which is one of several trade associations that publish best practices and advocate on behalf of member lending businesses in government.

Analysis

1. Repeat borrowing: a debt trap?

Payday loans are marketed in the United States as short-term solutions for debt; that is, they are portrayed as useful tools for individuals facing emergency financial shortfalls.[4] A challenge to that claim, which subsequently drew national attention to payday lending, was introduced a decade ago by the US consumer advocacy group Center for Responsible Lending, which is funded by and affiliated with credit unions that offer alternative models for short-term lending.[5] Center authors argued that payday lending is predatory: both dishonest in its marketing as a solution to debt, and usurious in its fee structure. They held that a study of public records showed that over ¾ of payday lending was what they called “phantom demand” generated by the requirement of debt service on such loans. The authors argued that, because payday loans require immediate debt cancellation at the date

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[4] See, for example, claims at mypaydayloan.com, and see the website of the leading industry advocacy group, Consumer Financial Services Association of America, which provides an explanation of the product for consumers at: http://cfsaa.com/what-is-a-payday-advance/is-a-payday-advance-appropriate-for-you.aspx (accessed 27 January 2018).

[5] The Center for Responsible Lending indicates on its website that Board member Martin Eakes “is CEO and founder of Self-Help, a community development lender that was instrumental in establishing the Center for Responsible Lending.” http://responsiblelending.org/about-us/board-directors (accessed 27 January, 2018).

of the next paycheck rather than payment of relatively small installments, such loans do not present the solutions that they advertise. Instead, among the 4/5 of loan recipients who contracted more than one payday loan per year, half took out a new loan at the next opportunity that the law allows, either immediately or within two days, depending upon state legislation. Nearly 9/10 of this group (87%) would initiate a new loan before the next paycheck, and 9/10 of payday lending business went to recipients who contract for at least five payday loans within one year. About a quarter of all borrowers took twenty-one or more bi-weekly loans per year. A 2012 study by the Pew Charitable Trusts suggests less extreme, but significant levels of debt for a larger group of borrowers: "on average, a borrower takes out eight loans of $375 each per year and spends $520 on interest."[6]

In 2014, Pew also reported on the emerging area of internet lending, pointing to practices that appear to represent the model found at mypaydayloan.com: "Many online loans are designed to promote renewals and long-term indebtedness. One in 3 online borrowers has taken out a loan that was set up to withdraw only the fee on the customer's next payday, automatically renewing the loan without reducing principal." African American, separated or divorced, and less educated people are disproportionate among borrowers.The most typical borrower is white, female, single and between 25 and 44 years old. Consequently a high proportion of single heads of households with young children are utilizing these services.[7]

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[6] Leslie Parrish and Uriah King, "Phantom Demand: Short-term due date generates need for repeat payday loans, accounting for 76% of total volume." 2009, Center for Responsible Lending; 3-6 http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf; and see Uriah King and Leslie Parrish, "Springing the debt trap," Center for Responsible Lending, 2007, 3. http://www.responsiblelending.org/payday-lending/research-analysis/springing-the-debt-trap.pdf. Pew Charitable Trusts, "Who borrows, where they borrow, and why: Executive summary and key findings." 2012. http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingexecsummarypdf.pdf

[7] Pew Charitable Trusts, "Fraud and abuse online: harmful practices in internet payday lending." October 2014. p.1, Appendix A. http://www.pewtrusts.org/en/research-and-analysis/reports/2014/10/fraud-and-abuse-online-harmful-practices-in-internet-payday-lending

2. Proposed alternatives

The authors of *Phantom Demand* maintained that, because payday loans are regularly treated as longer-term installment loans by their users, the arguments that were used to relax state regulations in the 1990's should not apply and should be repealed. The authors recommended adherence to U.S. Federal Deposit Insurance Corporation (FDIC) recommendations that include interest rate caps of 36% per annum and minimum lending terms of 90 days. They also suggested that options be made more widely available for installment loans, which require multiple payments over time to reduce and finally cancel lending debt.

Small loans might also be offered by credit unions and private banks. Many national governments, following a trail blazed by India in the 1990s, ensure some forms of lending and savings account access to the poor. India provides funds guarantees, sets regulations and requires private banks to participate in savings and lending for agriculture loans and women's self-help group arrangements. In USA, such schemes would not be favored among some banks – as they are also not among some Indian banks – since the arrangements would very expensive to administer, even with government guarantees.

The National Credit Union Administration (NCUA), an independent US federal agency, has introduced regulations detailing "payday alternative loans" (PAL). Since 2010, PAL has allowed credit unions to lend $200-$1000 for terms of 1 to 6 months. A minimum of at least two substantially equal payments encompass payment of principal as well as charges. Where borrowers cannot close these loans, terms may be extended to six months maximum. Charges are limited to an application fee of up to $20 and an interest rate of up to 28% APR (annual percentage rate). On a $300 loan for a period of two weeks, this would amount to application fee plus $3.23 interest.[8] Credit unions are federally insured institutions, unlike private payday lenders, and their business model, which includes many

[8] National Credit Union Administration, "Regulatory Alert: Final Rule - Part 701, Short-term, Small Amount Loans," October 2010. https://www.ncua.gov/Legal/Documents/Regulatory%20Alerts/RA2010-13.pdf . The

services at varied scales, does not strictly demand that this particular lending arrangement be profitable.

Another innovative option relies heavily on an empirical finding cited in *Phantom Demand:* "Consumer Federation of America researchers found that households with no savings earning $25,000 or less annually were eight times more likely to use a payday loan than similarly situated households with just $500 in emergency savings." This suggests that incentivizing savings of small amounts might greatly reduce the problem of debt traps. A government scheme that matches savings dollar-for-dollar up to $250 contributed by the individual might greatly reduce the need for payday lending and would perhaps lead people into the habit of saving still more. Another novel possibility is prize-linked incentives for savings account deposits. People generally like lotteries: they see an incentive even in the slim chance that they will win a lottery payment.[9]

3. Regulation

Lending law in USA proceeds generally state-by-state, though the Federal Deposit Insurance Corporation (FDIC) presents recommendations for appropriate practices. There are exceptions from the state rules, particularly for US military personnel, for whom there is a national cap of 36% per annum on lending, but state laws apply to most people. Fifteen states have enacted limits at or below 36%, and Arkansas sets interest plus fees at 5% above the Federal Discount Rate. But internet sales, offshore incorporation and affiliation of lenders with Native American governance systems erode states' effective control. In states that effectively outlaw payday lending, borrowing rates are about half of what they are in the least restrictive states.[10]

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[9] Shai Akabas & Brian Collins, "Prize-Linked Savings Accounts Are Lotteries with No Losers," Bipartisan Policy Center, May 14, 2014. http://bipartisanpolicy.org/blog/prize-linked-savings-accounts-are-lotteries-no-losers/

[10] Pew Charitable Trusts, "Fraud and abuse online," 22-3.

Other states have less restrictive rules, and a dilemma arises for each state, since lenders will set up shop in the most permissive states. If states would better serve their people by enacting restrictions, nevertheless, each state would be better served in other respects if they keep lenient arrangements, for tax revenue and business employment accrue to the home states with lower taxation rates and lower regulation. Six states have no cap on fees for payday loans or have no explicit law on fees (Delaware, Idaho, Nevada, Texas, Utah, Wisconsin). Two states have no explicit law concerning maximum loan amount (Utah, Wyoming). Other states indicate either dollar maximums of $1000 (or less), or a proportion of 35% (or less) of the borrower's salary, if they permit lending at all. The owner of mypaydayloan.com is "Zarvad III S.A", A Costa Rica corporation registered in Utah in 2009.[11]

The US Bureau of Consumer Financial Protection (CFPB) issued more stringent rules for payday lenders late in 2017, set to take effect August 2019. The new restrictions explicitly allow NCUA's PAL lending terms, and allow non-credit union lenders to lend under such terms. The new standards for payday lending require lenders to collect detailed information concerning borrowers' credit history and ability to repay before extending loans above $500. These requirements would put a significant burden on payday lenders and would reduce their pool of eligible borrowers. For lower-value loans structured as payday lending, these strictures do not apply, but the new rules restrict sequential loans to three 15-day contract periods, requiring a lending structure that decreases the loan's principal to close out the loan over the three contract periods. They also impose a mandatory 30 day "cooling off period" before any lender may offer another such loan. The CFPB anticipated that its rules would increase lenders' expenses and that "payday loan volumes will decrease by 62 percent to 68 percent, with a corresponding decrease in revenue."

[11] See proceedings against the corporation by the State of New Hampshire Banking Department in 2013 ("Notice of order to cease and desist" business within the state without a licence (Case 10-460)). New Hampshire permits payday lending at an interest rate of 36% per annum, with no other charges allowed; no such businesses are currently registered in New Hampshire. Zarvad III S.A's 2009 registration in Utah lapsed after ten months.

In January 2018 a change in leadership occurred at the CFPB. Sixty days after the CFPB had made these new arrangements official federal policy, on the same day upon which business entities were required to register for compliance with the impending 2019 regulations, the CFPB released a brief statement that included the following: "The Bureau intends to engage in a rulemaking process so that the Bureau may reconsider the Payday Rule. ... Recognizing that this preliminary application deadline might cause some entities to engage in work in preparing an application to become a RIS [Registered Information System], the Bureau will entertain waiver requests from any potential applicant."[12] The Competitive Enterprise Institute released a study on the following day that included the following claim: "While the CFPB is statutorily limited from regulating the interest rates of small-dollar loans, it has sought to undermine the industry through onerous regulations that make these loans unprofitable for lenders."

4. Exploitation

"Exploitation" refers to a variety of activities that may be deemed appropriate or inappropriate. Exploitation that does not involve the engagement of more than one individual – exploitation of a resource for personal gain, such as the use of the sunshine, or the exploitation of another's writing freely provided on the internet – are generally accounted as appropriate, and such cases will not be of concern here. Exploitation of another's time or efforts may be judged both ethically appropriate and mutually beneficial: the housepainter may contract with the homeowner; similarly, the caller to a toll-free technical help line might reasonably assume that the worker at the other end has chosen such work and is appropriately compensated. Exploitation of an opponent's weakness in a sport is often judged appropriate, though other values associated with being a *good* sport may reverse the appraisal in a particular case. Exploitation may be ethical, but still be disvalued

[12] Consumer Finance Protection Bureau. "CFPB Statement on Payday Rule," January 16, 2018. https://www.consumerfinance.gov/about-us/newsroom/cfpb-statement-payday-rule/

for other reasons: there may be nothing at all unethical in exploiting the politeness or timidness of others in a group by taking the last cookie, even if doing so shows a disregard for the host's own true intention when the last available one is offered. Even if a violation of politeness results in an unequal final distribution of cookies among guests, the result may be ethical and we need not find that the outcome should have been different: some may just value the cookies more than others, some may have food allergies, and others may prefer to be polite. Social norms like politeness may coincide with ethical norms, but the two may be appropriately distinguished, as the cookie example suggests, and as is shown by common (socially accepted, or normative) practices that ethicists argue should be negatively valued, and that they may intend to address and alter.

Payday lending is exploitation of some kind, then. Should payday lending be disvalued? Should it be disvalued because it is somehow an unethical kind of institutional or structural practice? If so, on what grounds? Is it unethical because it is taking unfair advantage, or generates disproportionate gain for one party? Or does it arise only in cases of harm? Each of these may be cases that some call "unconscionable contracts:" debt bondage, dead peasant insurance, and markets in human organs may display one or several of these aspects. Is payday lending odious for another reason, perhaps because it is taking unfair advantage *and* is coercive, regardless of whether or not it is harmful to either party? An example of this is offering lower pay rates to workers who are evidently more needy and lack other options because of their social status. Philosophers frequently use these terms but they analyze unethical exploitation in very different ways, and those who appear to agree on the terms also may judge the same case differently.

Specific discussion of payday lending is uncommon in philosophy. Business ethicists dispute whether the terms of payday lending are justified for both free market and regulated cases. Robert Mayer argues that some payday lending is unethical: it is exploitative in a way that is inequitable (unfair) and coercive. Yet Mayer's analysis may surprise: the defaulting debtor is cast alongside the lender as exploitative of other borrowers in "a sort of conspiracy between the top and the bottom against the middle." So, Mayer finds an interest rate cap justifiable because payday lending addresses an immediate need, and borrowers with such a need have limited opportunity to shop about for better rates: "Unless prices are capped, the more solvent majority of borrowers is compelled to cross-subsidize the least solvent debtors, who have a high rate of default."

Responding to Mayer, Matt Zwolinski argues that payday lending's model displays the marks of a functioning market with usual rates of return on capital. He finds that "payday lending is ... sufficiently constrained by competitive pressures to ensure that no party is in a position to take unfair advantage of the other." Zwolinski also provides a general justification of usury that suggests it may be ethical, even if it is often harmful:

> even if usury is a form of exploitation, it is usually a form of *mutually beneficial* exploitation. Both parties benefit from the exchange, even if one party benefits less than fairness requires. Suppressing mutually beneficial exploitation prevents unfairness, to be sure, but it also often makes both parties worse off than they otherwise would have been, and this often has a disproportionately harmful effect on the most vulnerable party.

Zwolinski finds no compelling reason for altering open payday lending conditions. Mayer replies that the social role of government demands that limits be placed on the lender for the sake of both the defaulting borrowers, who might then be excluded, and repaying borrowers: "when government caps the price of credit, lenders are prevented from boosting the fee they could charge to the solvent debtors to cover these losses. Their only real option is to lend more cautiously."

So, Zwolinski implies that lenders should price the poorest out of a free market. Mayer instead relies on the judgment of lenders insofar as their rate options have been restricted by regulators, and he suggests a 15% bi-weekly rate is appropriate, as it has been shown to be a viable ceiling rate in the markets of some states. Both authors consider payday lending to be appropriate in one or another form as it is currently pursued in the USA.[13]

The arguments of these two authors concern the justice of institutional practices, but their analyses include no discussion of the details of the structure of the payday lending contract, the frequency of renewals, the unrealized alternative arrangements that have been proposed, and the history of national policy and corporate influence that are detailed above. Those details suggests that, for some theorists who choose to articulate ethics through principles, something other than or more than an analysis of fairness, consent, and government's role may be required for ethical appraisal of payday lending. The details of the case may suggest to other ethicists – virtue and relational (care) ethicists, who focus either upon the case itself or upon the relations of power and vulnerability on display between agents – that unethical exploitation of both non-defaulting and defaulting borrowers generally applies in all current payday lending arrangements. [14]

Discussion

1. Why do governments enact usury laws? Should these transactions be considered to be loans, or advance check cashing? How are the two distinguished, and what is the importance of the distinction?

2. If the suggested 36% annual rate caps were to apply to payday lending, then the option may well disappear, since transaction costs and default rates are high for these loans. Does the ethical case for payday loans, in your opinion, outweigh the case against them?

3. Credit unions in USA now offer payday alternative loans (PAL), as detailed above. Credit unions are not-for-profit, tax-exempt member-owned financial cooperatives:

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[13] See writing of Mayer and Zwolinski in Further readings section.

[14] Wertheimer's writing (see Further readings) is the current standard initial reference for contemporary philosophical analysis of exploitation. Discussion pp. 8-10 briefly notes the general concerns of case-based and relational approaches. The general terms for a theory of exploitation that might be adapted to a business ethics focus follow, pp. 10ff.

in general terms, credit union account holders own the shop and they don't pay taxes on its activity, which is actually arranged to serve the same account holders, and so is arranged to maximize value for them, and not arranged to maximize profit. Credit unions are federally insured institutions, and their business model, which includes many services at varied scales, does not strictly demand that the PAL arrangement be profitable, since other activity in the business might serve to make up for a loss on PAL loans. None of these claims apply to payday lenders.

Credit unions that offer PAL arrangements target very much the same market as the private businesses that offer payday loans. Is this a just arrangement? What arguments do you see supporting such a claim, what arguments undermine it, and how would you finally accept, qualify, or reject the claim that credit unions should be allowed to offer the PAL alternative?

4. Mayer and Zwolinski analyze the institution of payday lending in terms of voluntary contractual relations, fairness, coercion, harm, and government's role in promoting good for its people. Each author holds that one or another arrangement that is currently available in payday lending in USA is appropriate.

Is one correct in his general analysis? If so, why? If neither is correct, why is neither correct?

5. Alan Wertheimer, himself quoting legal scholar Judith Shklar, suggests that ethics grounded in principles may have its limitations: ethics should also attend to forms of wrongdoing as independent phenomena in their own right, since 'Common sense and history surely tell us that these are primary experiences and have an immediate claim on our attention.'

Are the conditions of payday lending a wrong that should be addressed? Have you an account or analysis of why or why not? How might that wrong be effectively addressed in your society? Or, if the institution is not structurally unjust, but it might be improved anyway, should it be improved? How should it be improved?

Further readings

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Preliminary exercise – Payday lending case study supplement

Before reading the payday loan case study, please complete the following exercise.

Put yourself in the following person's shoes, make a careful decision, and explain the basis for your decision.

It's June 2019. Jane Doe is a 28 year old single mother of two children, ages 7 and 9 who lives in Meadville, Pennsylvania. She has worked for the past 6 months as a machinist at Laser Tool, 7 miles northwest of town, and she receives sufficient shiftwork to cover expenses for her small family. She has managed $300 savings in that time, she has no other savings, and she plans to use that much for a trip to Cedar Point Amusement Park with her children in August, their first vacation since 2017.

On Wednesday, the transmission of her 2012 Ford Fiesta car failed on the way home from work. She will have to pay $60 for towing to the garage, where mechanics tell her that they can almost certainly fix it for another $640 by Saturday. She can rely on others to get her to and from work through Friday, but friends can only be asked for so much, and she has no other people to rely on in town. She has saved $50/month recently, so she knows what she can afford: that much, and not much more (perhaps less – the children will need school supplies soon). She has no credit cards. She has asked the garage for a loan; they have offered her an installment plan for payment over the coming 6 months at $140/month.

She also finds the https://www.mypaydayloan.com/ website online. They will provide her with a loan for $500, half the amount of her bi-weekly paycheck.

Exercise: Look very carefully at the website. Put yourself in Jane's shoes. Try to be smart, and careful. Would you take the installment loan, the payday loan, or try to solve the problem another (legal) way? Explain your choice, carefully (take at least 150 words to do so). Your answer will be posted for others in the class to read.

Payday Lending: Eric Palmer's thoughts (post-class handout)

Jane (single mother, under $25K income/year) is the most typical payday loan recipient. She can actually make it, if she is smart, lucky, and ready to disappoint her kids. Even a $100 one month payday loan would cost $60/month, so would leave her further in debt. If she can save $20 more per month, and uses up all her savings, she will be able to stay afloat for 4 of the 6 months it takes to complete the auto shop's installment loan (at about 20% interest – much better than she might expect from informal lending, about the rate of the credit cards that she doesn't qualify for). She might pawn her saxophone to get $70 for the fifth month and sell plasma 3 times at Biomat in Erie Pennsylvania for the sixth (about $20-30 per donation, minus travel cost). Or there may be some turn for the better on her horizon. Or a turn for the worse.

Vulnerability to debt and lack of awareness of financial implications is not restricted to recipients of payday loans. The majority of Americans say they simply could not come up with $2000 if an emergency struck. James Surowecki observes that "A study by economist at the Atlanta Fed found that thirty per cent of people in the lowest quartile of financial literacy thought they had a fixed rate mortgage when in fact they had an adjustable-rate one." (See Desjardins 195 for ARM explanation.) It should be unsurprising that failure scales with weakness in mathematics skills and education. Surowecki adds:

> A study of subprime borrowers in the northeast found that, of the people who scored on the bottom quartile on a very basic test of calculation skills, a full twenty percent had been foreclosed on, compared with just five percent of those in the top quartile.
>
> The less people know, the more overconfident in their abilities they tend to be. In a German study, eighty per cent of those surveyed described themselves as confident in their answers on a questionnaire, yet only forty-two per cent got even half the questions right. This is known as the Dunning-Kruger effect: people who don't know much tend not to recognize their ignorance, and so fail to seek better information. (James Surowecki, "Greater Fools" New Yorker July 5 2010.)

This strongly suggests to me that, in the USA, we desperately need a lot of regulation of lending, and of all financial activity for *most* individuals who have not demonstrated their ability to understand such loans, through currently non-existent education or licensing programs.

The freedom to do what you wish with your money is obviously valued and valuable; but it should be balanced against freedom from the chains of debt. Lending schemes that routinely impoverish individuals, even though they are impoverishing them of their own free choice, are neither more nor less antisocial than other business activities that lead to similar outcomes, such as gambling (gambling is legal in some states, which also do particularly brisk business in gambling addiction counseling, bankruptcy services and payday loans).

For more, see**:** Pew Charitable Trusts, "Fraud and abuse online: harmful practices in internet payday lending." http://www.pewtrusts.org/

TEACHING NOTES

0. Run through Jane's scenarios.
Jane is a realistic character, at 24K income per year, 2.5% savings rate.
Payday loan is impossible to pay back, even if the minimum: she saves $50 or reaches for $70/month, but the fees are $240/month on a $400 loan(!). Auto shop's loan bleeds her slowly enough that she might just make it, with creativity and some extra income (garage sale, blood donation...). The interest rate is 20% -- much more lenient than one might expect.

57% of Americans "don't have enough cash to cover a $500 unexpected expense." They might turn to family, credit cards or payday loans, but 1/3 of all Americans claim that they simply would not be able to come up with $2000 within a month for an emergency.[15]

In Eric Palmer's first run of the Jane case, only one of 14 undergraduate students laid out a solution that was not a serious financial mistake. Several suggested that Jane should save half of her income for several months. It's worth pointing out that no-one in Jane's shoes could seriously entertain that option.

1. Page 195, Desjardins *Business Ethics* characterizes "predatory loans". Are payday loans predatory? Why/why not? Are credit cards predatory? Why do governments enact usury and predatory lending laws?

2. What are the alternatives? (If the suggested 36% annual rate caps were to apply to payday lending, then the option may well disappear, since transaction costs and default rates are high for these loans. Does the ethical case for payday loans, in your opinion, outweigh the case against them?

3. Credit unions in USA now offer payday alternative loans (PAL), as detailed above. Credit unions are not-for-profit, tax-exempt member-owned financial cooperatives: in general terms, credit union account holders own the shop and they don't pay taxes on its activity, which is actually arranged to serve the same account holders, and so is arranged to maximize value for them, and not arranged to maximize profit. Credit unions are federally insured institutions, and their business model, which includes many services at varied scales, does not strictly demand that the PAL arrangement be profitable, since other activity in the business might serve to make up for a loss on PAL loans. None of these claims apply to payday lenders.
Credit unions that offer PAL arrangements target very much the same market as the private businesses that offer payday loans. Is this a just arrangement? What

[15] 2017: https://www.cbsnews.com/news/most-americans-cant-afford-a-500-emergency-expense/ https://www.cnbc.com/2017/03/22/1-in-3-americans-could-not-come-up-with-2000-in-an-emergency.html

arguments do you see supporting such a claim, what arguments undermine it, and how would you finally accept, qualify, or reject the claim that credit unions should be allowed to offer the PAL alternative?

Keep in mind that credit unions can only offer a very limited quantity of PAL loans, subject to liquidity and the tolerance of their directors. Unless the government provides support – support that parallels schemes found in other nations (India: crop loans and microbusiness loans are provided through private as well as national banks, service by private banks is government mandated and supported against risk.). USA was headed in the direction of developing such support until reversal in 2018.

More Teaching notes (previous round):
Put 1,2,3,4 on board, provide an overview at start of half-hour presentation
1. Check cashing: a check is a promise to pay...
Last quarter of 20th century, there were two banking systems in the USA; familiar banking system and "Alternative financial services" -- check-cashing for those without banking accounts. Payday loans started as re-labelling check cashing as "advance check-cashing" for post-dated checks. Repayable next payday.

- Everyone clear on the loan structure?
- What is right with this picture? What is wrong with this picture?
- Why do we have usury laws?
- 16 states have enacted limits as low as 17%, others 36% and others, higher or no limit. For US military personnel, there is a national cap of 36% per annum. *Why do you suppose there is such a difference?* Is this a benefit to military personnel, or paternalism on the part of the government?
- **Should states of the USA allow payday loans?** Utility… I don't think so. There is also a problem of states undercutting other states – see further below.) Freedom, yes (and New Hampshire has apparently cut off all usury laws). Exploitation: "Predatory lending" and "usury" – what do you think?

2. Social impact

Center for responsible lending authors, in *Phantom Demand* calculate that [fees including?] interest average 16.9% for the average sized loan ($350), for a term that averages 18 days.[16] Since ¾ of loans suggest the need for longer-term loans. This yields high *annual* interest (in these schemes, often about 400%). But they aren't loans ... are they? (They're "cash advance")

[16] Phantom Demand, Appendix 3, 4.

- Center for Responsible Lending suggests that payday loans should fall under usury laws. Good argument?

Is CRL argument about basis for change in legislation correct? I don't know.

- If 36% rate caps apply, the option would disappear, as transaction/maintenance costs are high. Is that ok with you? (Note: lenders have sometimes produced much more return while remaining within such an interest rate... care to guess how?)

- Note that the CRL is funded by Martin Eakes, who is central to a credit union referred to on the cite. Is this a conflict of interest?
- Why did I include the closing paragraphs about state regulations?
- **What alternatives do you see?**

4. Solutions?

The simplest pretty-good solutions concern **government intervention.** (Some credit unions, because they are credit unions, have offered lesser versions of some of these ideas.)

The first solution is to have government guarantee banks against losses for small unsecured loans at 36% or 28% interest rates. This provides access even to those who have been "unbanked." The government of India provides some such guaranteed loans and demands that all banks participate in the scheme. In USA, this scheme would not be popular among banks, as the loans would very expensive to administer, even with government guarantees.

A second solution relies heavily on this empirical finding: "Consumer Federation of America researchers found that households with no savings earning $25,000 or less annually were eight times more likely to use a payday loan than similarly situated households with just $500 in emergency savings."
http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf (Page 18)

--This suggests (to those who run credit unions especially) that **incentivizing savings of small amounts for the poor will greatly reduce the problem**. For example: a government scheme that matches savings dollar-for-dollar up to $250 contributed by the individual may greatly reduce this "phantom demand", and perhaps train people into saving still more. If US government incentivized first $500 savings, a lot of social good might result. Another possibility is prize-linked savings accounts, because people generally like lotteries: they see an incentive even in the slim chance that they will win a lottery payment. (http://bipartisanpolicy.org/blog/prize-linked-savings-accounts-are-lotteries-no-losers/)

[Extra for time-filling, if things run swiftly]

States undercutting other states

There is diversity of views across states (Arkansas sets interest plus fees at prime +5%)[17] Like Testor's safety move, there is a dilemma for states: banks will go to the least restrictive state. And with interstate banking and internet access, I believe that no state can effectively legislate more strictly than the least restrictive, but I am not perfectly sure of the law in this. Only those without access to internet are really protected by Arkansas' step.

A prisoner's dilemma, of sorts: All states would better serve their people if they had restrictive banking laws; each state is better served in other respects (tax revenue, business employment) if they do not. Incentives run in both directions, 'defectors' from the norm of protecting their citizens win big as banks concentrate (Delaware, North Dakota, New Hampshire). All are caught within the defectors' system, in this era, since interstate banking laws are not practically enforced, even if enforceable, in this situation (if one can get an internet loan within New Hampshire, the claim is supported – I expect that it is not at all difficult to achieve this).

[17] Arkansas Business: http://consumerist.com/2008/03/arkansas-attorney-general-to-payday-lenders-shut-down-or-ill-see-you-in-court.html

A provision in the Arkansas state constitution limits the allowable interest rates on loans and consumer credit transactions. According to Article 19, Section 13, the maximum allowable amount for general loans "shall not exceed five percent (5%) per annum above the Federal Reserve Discount Rate at the time of the contract." Any contracts that charge higher interest will be void as the interest. The consumer loan provision is even better: "All contracts for consumer loans and credit sales having a greater rate of interest than seventeen percent (17%) per annum shall be *void as to principal and interest* and the General Assembly shall prohibit the same by law."

Handout: Exploitation: when is it unethical?

"Exploitation" refers to a variety of activities that may be deemed **appropriate**. Exploitation of a resource for personal gain, such as the use of the sunshine. Exploitation of another's time or efforts may be judged both ethically appropriate and mutually beneficial: the housepainter may contract with the homeowner. Exploitation of an opponent's weakness in a sport is often judged appropriate, though other values associated with being a *good* sport may reverse the appraisal in a particular case. Exploitation may be ethical, but still be disvalued for other reasons: Social norms like politeness may coincide with ethical norms, but the two may be appropriately distinguished, since there are common (socially accepted, or normative) practices that ethicists argue should be negatively valued, and that they may intend to address and alter.

It would be difficult to create a definition of **unethical** exploitation, then. We may try considering cases instead. Is payday lending unethical? If so, on what grounds?

1. If it is **taking unfair advantage**, causes harm or **abuse,** or **generates disproportionate gain** for one party, it may be judged unethical, and referred to as an "**unconscionable contract**" in law, and challenged. Cornell's Legal Information Institute provides a clear checklist for unconscionability:

> Unconscionability: A defense against the enforcement of a contract or portion of a contract. If a contract is unfair or oppressive to one party in a way that suggests abuses during its formation, a court may find it unconscionable and refuse to enforce it. A contract is most likely to be found unconscionable if both unfair bargaining and unfair substantive terms are shown. An absence of meaningful choice by the disadvantaged party is often used to prove unfair bargaining. [18]

Debt bondage, corporate-owned life insurance on employees (informally called "dead peasant insurance"), and markets in human organs may display one or several of these aspects.

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[18] Cornell Law School Legal Information Institute. "Unconscionability," https://www.law.cornell.edu/wex/unconscionability .

Is payday lending odious for another reason, perhaps because it is **taking unfair advantage *and* is coercive**, **regardless of whether or not it is abusive** to either party? A relevant example is offering lower pay rates to workers who are evidently more needy and lack other options because of their social status (e.g., because of race, in a particular society). It is important to see that this basis for a judgment that payday lending is unethical is different than the unconscionable contract claim. Payday lending provides a needed service ... but, given the alternatives that credit unions could create if supported by government programs that were rescinded shortly before they were to take effect in 2017, payday lending may be judged an unethical institution, and lenders as exploiters of an unethical practice.

I will leave you to make your judgment regarding payday lending. Generally, you see in bold on this page a number of criteria that have been used to judge when exploitation is unethical. And you may see a reason why we might want to appeal to cases rather than principles, when judging about exploitation. Alan Wertheimer, himself quoting legal scholar Judith Shklar, suggests that ethics grounded in principles may have its limitations: ethics should also attend to forms of wrongdoing as independent phenomena in their own right, since 'Common sense and history surely tell us that these are primary experiences and have an immediate claim on our attention.'

1. We probably want to allow for some forms of exploitation, don't we?

2. Why is dead peasant insurance generally considered unethical? How is that different than organ sales? (vs. Surrogate motherhood?)

3. How would you begin to argue whether payday lending is unethical?

Further readings

Wertheimer, Alan. *Exploitation*. Princeton University Press, 1999.

Zwolinski, Matt and Wertheimer, Alan, "Exploitation", The Stanford Encyclopedia of Philosophy (Summer 2017 Edition), Edward N. Zalta (ed.), https://plato.stanford.edu/archives/sum2017/entries/exploitation/