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# THE ECONOMICS OF FAIR CHARGES FOR CONSUMER LOANS

MILLER UPTON*

## THE SETTING TO THE PROBLEM

The term *fair charges* in the title of this article defines the scope of the problem with which we are confronted. It suggests that the rate charged must be fair to all parties involved: the borrower, the lender, and the community. That is, it should not be arbitrarily levied but rather established in keeping with the needs and protection of the borrower, the operating costs and necessary profit margin of the lender, and the need for the service for the welfare of the community. The question of fairness to the borrower, however, is not as directly involved. The various usury statutes have long been adopted to accomplish this objective. The need for special consideration of the consumer loan operator, on the other hand, exists because the maximum rates allowed under most usury statutes are not in keeping with the realities of his operating cost requirements. And to the extent that the availability of the service on a high plane is directly dependent upon its economic justification, the welfare of the borrower and the community are inseparable from that of the lender.

In view of the authoritative work that has already been done in the field of such qualified and unbiased organizations as the Russell Sage Foundation, the National Bureau of Economic Research, and the New York Banking Department in support of the need for special rates on consumer loans in excess of the general legal maxima, it might seem that further attention to the matter is unnecessary.[1] However, the fears and prejudices surrounding the whole problem are so deep that extreme caution on the part of legislators is to be expected, and patient retelling of the story is not only to be accepted but desired. But of even more importance than this is the need to analyze and discuss the problem with reference to the special circumstances involved. In every jurisdiction there are particular historical and social factors that call for individual treatment.

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1. See in particular ROBINSON AND NUGENT, REGULATION OF THE SMALL LOAN BUSINESS (New York, Russell Sage Foundation, 1935); YOUNG, PERSONAL FINANCE COMPANIES AND THEIR CREDIT PRACTICES (National Bureau of Economic Research, 1939); State of New York Banking Department, SPECIAL REPORT OF THE SUPERINTENDENT OF BANKS ON LICENSED LENDERS (State of N. Y. Bankers Department, 1946).



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Clearly, the essential basis of the problem is the existence of usury statutes, which in turn have their origin in ancient, ecclesiastical, and medieval history. The limitation by law of the amount that can be charged for the loan of money in itself contributes to the difficulty, but the establishment of a single maximum without any attempt to differentiate between types of loans complicates the problem seriously. To subject the pricing of a $300 personal loan to be repaid in eighteen equal monthly installments to the same standards as a $50,000 seasonal inventory loan for a business is as irrational as trying to regulate a drug store and a steel fabricator by the same rules.

From an economic standpoint the justification of usury laws is based upon the presumption that competition is ineffective in establishing a fair price for credit. Therefore it is presumably necessary for the state's police power to be evoked to protect its economically weaker members from willful oppression and exploitation by its stronger. The uninformed or necessitous borrower, in other words, must be protected from unscrupulous lenders who would take advantage of their preferential bargaining position to gain undeserved reward at the expense of the former.

The statutory maxima established under usury laws, however, are intended only to guard against unconscionable action on the part of those not guided by morals conforming to the group. They are not intended to establish a standard of fairness for each and every loan transaction. Competition and bargaining are still relied upon for this within the limits of the legal maximum.

In keeping with this concept of the general purpose of usury laws, there has developed in some circles the distinction between *legal usury* and *moral usury*. The inference implicit in the distinction is that a rate that may conform to law may nonetheless be unconscionable under the circumstances. and conversely, a rate that may be morally sound could be illegal. The basis for the distinction rests on the fact that there can be no single rate that is right for all loans. The appropriate rate in any case is fundamentally a problem of economics and arithmetic. This point constitutes the essence of the whole problem of fair charges for loans and shall be the core of the later discussion.

Unwillingness on the part of some to accept the fact that no single rate can possibly be used for all loans can only be ascribed to confusion surrounding the meaning and nature of interest. This confusion, in turn, is the result of failure to distinguish between interest and other prices and between market rates of interest and the concept of "pure" interest.

Unlike every other price, interest is expressed in percentage terms rather than money terms. That is why the problem was referred to above as being partly one of arithmetic. A constant dollar amount of interest may vary substantially in terms of rate if there is a variation in time and principal. Similarly a constant rate may vary immensely in monetary terms in keeping with differences in principal and time. Whereas a dollar price conveys something definite in terms of comparative cost, such is not so with a percentage figure. The very mathematical nature of interest, involving three variables—cost, principal, and time—is a definite source of confusion to many and obscures the realities of the problem involved.

Furthermore, interest is all too often judged in terms of being compensation for forebearance rather than a price for value received and costs incurred. The "pure" interest rate (or price for forebearance) has only a slight bearing upon the actual rate charged. Much more significant are the factors of risk and operating cost. The lending of money is not a sporadic, accidental activity but rather a conscious business endeavor in which the usual economic motivations and management objectives apply. Pricing policy is governed by both cost and competitive considerations, and these will vary considerably by type of lending activity.

Since this business consideration is the heart of the whole question of "fair" charges major attention must be given to the facts. The following material reviews evidence pertaining to the costs of small loan operators. Although this is admittedly only one area of the general field of consumer lending, still it is the most meaningful. Because the small loan business has been subject to thorough supervision in some states for long periods of time, statistics on its operations are most reliable both from the standpoint of supervision and time coverage. Also, the general principles to be brought out in the small loan area, as opposed to the specific findings, will have applicability throughout the field.

## Costs of Consumer Lending Operations

As an introduction to an analysis of the costs incurred in extending consumer loans some background into the operating activities should be established. There are in general four functional categories to which the various costs can be assigned for classification purposes. Probably the most important is that of *acquisition,* by which is meant all of the activities involved in "getting the loan on the books." Included would be all advertising and promotional activity, interviewing of applicants, providing for a written application, investigating the applicant's credit standing, checking any legal

instruments involved as to their proper documentation, passing upon the acceptance of the application, setting up the account on the books, and setting in motion the accounting routine for adequately controlling the subsequent servicing of the account. All of this requires substantial personnel, time, equipment, and supplies.

The next most costly activity is that of *servicing* the account once it has been established with the lender. Particularly is this of major importance in the case of installment loans where periodic collection and recording is involved. Included are such individual operations as acceptance of payments in person or by mail, recording of such payments on the accounting forms, sending delinquent notices when a payment becomes overdue, making calls in person or by telephone on old or repeat delinquents, holding special meetings by senior personnel to decide what action to take relative to particular delinquents, and collecting over-due accounts by legal means when such action has been chosen in place of straight charge-off. Again the principal cost involved is that of personnel time with some additional expenses in the form of legal fees, equipment, and supplies.

The third separate activity is that of *termination*. The individual operations involved are largely those of collecting and recording the principal repayment, and to this extent it is similar to the servicing of an installment payment. However, there are the additional considerations of cancelling out the account file and placing it in an inactive file, properly cancelling all documents drawn in connection with the loan, and returning the originals to the borrower. In some individual cases, there may also be the need for arranging for an extension or renewal in place of final cash payment. Although this is a most important phase of the lending process from the standpoint of both the lender and borrower, it does not account for a very substantial part of the total costs.

The final category of costs is *general overhead*. This includes such items as rent, taxes, bad debts, interest, and insurance, as well as time devoted by top management in planning general policies and working with the operating personnel. Except for the individual costs of bad debts and interest this general category is of particular significance to chain operators, where the services provided by the head office in the way of establishing general administrative policies, controlling branch operating procedures, centralizing accounting controls, organizing accounting procedure, and providing the necessary operating funds, enable the separate branches to operate with a

total commitment of personnel and supplies less than is customarily required in an independent office.

On the basis of this operating background it can be seen that the consumer lending business is primarily one engaged ni selling personal service. It differs from the standard personal service business in selling substantial capital service as well, but it does not go so far in this regard as the public utilities. Also, there are a number of associated costs incurred, but nothing like in the merchandising or manufacturing businesses. Statistical support to these points is provided by the following exhibit, which expresses the major expenses incurred by the Missouri and Illinois small loan licensees over a multi-year period as a per cent of annual gross revenue.[2] The Missouri averages cover the 13-year period from 1933-1945. The Illinois averages are for the 17-year period 1930-1946.

TABLE I
PERCENTAGE DISTRIBUTION OF GROSS REVENUE
MISSOURI AND ILLINOIS SMALL LOAN LICENSEES
(Based on Annual Aggregates)

| | Per Cent of Gross Revenue | | | |
|---|---|---|---|---|
| | Missouri | | Illinois | |
| | 1933-45 Average | 1933-45 Range | 1930-46 Average | 1930-46 Range |
| Salaries | 27.1 | 23.9-31.9 | 28.2 | 25.5-31.9 |
| Rent | 3.7 | 3.1- 4.6 | 4.5 | 3.9- 5.2 |
| Advertising | 6.5 | 5.9- 7.5 | 6.3 | 5.6- 7.5 |
| Bad Debts | 10.2 | 7.3-17.5 | 9.8 | 6.7-17.8 |
| All Other | 18.6 | 16.5-21.2 | 14.1 | 9.0-19.6 |
| Total Operating Expenses | 66.1 | 59.6-72.9 | 62.9 | 54.5-69.0 |
| Income Taxes[3] | 8.0 | 4.5-12.6 | 8.8 | 4.0-13.1 |
| Interest on Borrowed Funds[3] | 11.4 | 5.7-14.9 | 6.1 | 4.2- 7.6 |
| Total Expenses | 85.5 | .............. | 77.8 | .............. |
| Net Profit | 14.5 | 8.6-22.8 | 22.2 | 17.3-27.7 |
| Total Revenue | 100.0 | .............. | 100.0 | .............. |

A general point of interest to be derived from this table is the marked similarity between the operations of the two states. There are only two items of any notable divergence, one is the *All-Other* category and the other

2. The Missouri results were calculated for this article from the annual statistics contained in the *Summary of Annual Reports of Personal Finance Companies of Missouri,* compiled by the Department of Finance, State of Missouri. The Illinois findings are drawn from the author's unpublished doctoral dissertation entitled *The Importance of Direct Costs in the Granting of Consumer Installment Credit,* Northwestern University, Evanston, Illinois, June, 1948.

3. Based on 14-year coverage in the case of Illinois instead of 17 because of unavailability of data for early years.

is the *Interest on Borrowed Funds*. The first can be explained as a result of differences between the two states in accounting for Charges Earned but Not Collected. The Missouri figures include this as an added expense and source of revenue while the Illinois do not. In fact, were the 4.1 per cent average figure for this item in Missouri subtracted from the 18.6 per cent average for All Other expenses, the resulting 14.5 per cent figure would very closely approximate the Illinois experience. The difference in the interest expense averages is much more difficult to explain. All that can be said is that whereas the operating results for the two states are very similar, more of the operating profits are distributed to the borrowed capital as opposed to the owners' capital in the case of Missouri.

In any event, the *Salaries* item is seen to be by all odds the most important single cost, being almost twice as large in amount as the next largest figure. When it is realized, further, that the *All Other* category is composed of thirteen or more different minor items, no one of which averages out to be of any real significance, the relative importance of the salary cost takes on added meaning. On the basis of this more thorough information, what is more, *Bad Debts* becomes the second most important single cost item. There is good reason to believe that this condition is the peculiar result of including both urban and rural offices in the one grouping. Had the offices been segregated along this line, *Advertising* would have probably been the second most important item for the urban offices with Bad Debts coming third, although the difference would not have been very great.

Besides recognizing the special cost requirements of consumer lending it is also important in resolving our problem to appreciate the relationship of the costs to certain loan characteristics. Principal of these is the factor of size. From what has been said about the operations involved in extending credit on a business basis it should be clear that the costs involved are governed mainly by the number of loans made rather than their size. Another way of saying it is that the costs are largely incurred on a per loan basis rather than a dollar basis. An exception to this proposition has to be granted, of course, if one thinks in terms of extremes. Much more care and time will be devoted to the investigation of a $1,000,000 loan application than to a $100 one. But even here the general principle applies, for the increased attention is not proportional to the increased size of loan. In the above case, for example, nothing like 10,000 times as much attention would be devoted to the larger loan, maybe 100 times or even 1,000, but certainly not 10,000.

This raises a point of expression with which the author would like to take exception. One quite often sees or hears it said that small loans are more expensive to make than larger ones. This is an unfortunate way of expressing the point because most people think in dollar terms when considering the expense of something. In terms of dollar costs small loans are really less expensive than large ones; but the difference in dollar cost is no way proportional to the difference in dollar size, and so the small loans are *proportionately* more expensive. Or said another way, a given volume of outstandings requires more loans and therefore more costs when the average loan is small.

This point can be supported statistically by drawing on the record of the Missouri Small Loan licensees again. The annual expense per account averaged out at $24.90 for the 13-year period. This means that on the basis of such average performance a $100 loan made for the duration of a year would have to bear 25% annual charge if it is to cover just the costs incurred. A $1000 loan for a year, on the other hand, could be serviced at a rate of 2½ per annum exclusive of profit, assuming no difference in the amount of attention that would be given the larger loan. Proof that this hypothetical reasoning is not too far from reality can be had by further citing Illinois small loan experience. The average of the total expenses as a per cent of the value of loans outstanding at the end of each year for the period 1930-1946 was 25.16%. This means that if we can take the year-end balances as reasonably representatives of the average outstandings, an average rate of 25.16% was required just to break even. During the period of time the average size loan made was $137.38, the maximum permissable being limited to $300.[4]

Another consumer loan characteristic which has distinct bearing upon costs is that of method of repayment. An installment loan is substantially more expensive to service than a single repayment one. The termination costs of each are largely the same and yet the installment loan incurs periodic collection and recording expenses in addition. It may be that the installment feature is of sufficient advantage to both the borrower and the lender to be worth this added cost, but the fact of added cost should not

4. The New York State Banking Department in its SPECIAL REPORT OF THE SUPERINTENDENT OF BANKS ON LICENSED LENDERS, *op. cit. supra* n. 1, offers further evidence of the inverse relationship of rate to size of loan and relies upon this evidence to recommend increasing the maximum loan size under the small loan statute in its state to $500. The state of Illinois has also gone to a $500.00 limit since 1946.

be overlooked. From the lender's standpoint, for example, installment repayment undoubtedly cuts down on the overall risk involved, but it does so only at the price of additional expense of service.

The factor of collateral protection also has special cost significance. To accomplish an effective lien requires the incurrence of special legal, appraisal, and recording fees. Also there are the additional costs of supplies and clerical service. In some small loan operations where the security is established in a rather automatic and perfunctory fashion these special costs may be held to a minimum. But in those cases where rather specialized individual treatment is accorded the borrower, they may loom very large. Support of the point may be made by reference to other fields of credit. In real estate finance the borrower is very aware of the costs attached to providing an effective lien because he must pay them directly. And in the general field of commercial credits, loans secured by receivables or inventory are invariably more expensive to make and to obtain.

All of this leads us by indirection to a most important consideration —that of the bearing of risk on the cost of loan granting. On an individual loan basis a variation in the rate of interest charged by a lender cannot possibly compensate for a presumed variation in the risk involved. A single loan would never be granted if there were any likelihood that it wouldn't be repaid, for no interest compensation could offset the loss of principal. An analogy could be taken from insurance: no one would insure another's life alone at the standard insurance rates, for such would merely involve shifting the risk from one person to another. The insurance principle is based upon the shifting of risk from the individual to the group, or what might be more appropriately termed mutual sharing of a risk. So it is with the risk of credit loss. Professional lenders perform an insurance function in that they include in their rate an amount to cover bad debt losses which cannot be related to individual loans but which can reasonably be predicted in the aggregate on the basis of past experience.

Accordingly, some types of lending are more expensive than others as a result of a higher general loss experience. Lenders which are more selective in their credit risks can afford to charge a lower overall rate, whereas those which are more promiscuous in their credit granting or specialize in high risk loans are forced to charge a higher rate. This is not to say the overall risk of the latter type business is greater than that of the former, only that of the individual loans. That is, the loss ratio may be consistently higher, but if it is predictable within reasonable limits the business risk is no greater.

Again the same holds true in the insurance field. The company that engages or specializes in substandard risks does not assume any greater overall risk but it must charge its customers higher premiums. Accordingly, individuals who qualify as standard risks must suffer an unnecessary penalty if they buy their insurance there.

As a general concluding point it can be said that the costs of consumer lending possess the character which the economist would refer to as being fixed in the short run but variable in the long run. Since the basic business requirements are labor and money, both of which are very mobile over time, it is possible for shifts to be made quickly and with only little loss when changing business conditions of a rather durable sort dictate. On the other hand, once an office is opened for business the major costs are set regardless of business volume. Therefore, within the limits of the personnel force and physical facilities, the larger the volume the greater the profit. Whether an office or department makes one loan or a hundred during a week the total costs are practically the same.

Some studies have tried to support the thesis that in the small loan field efficiency is dependent upon large-scale operation. So far as this contention is concerned these studies are subject to severe criticism. What they do support, however, is the thesis that efficiency is dependent upon full utilization of the personnel and facilities committed to a single office regardless of its size.

On this point alone the consumer lending business is no different from any other credit business or even any other business. The efficiency of any operation is dependent upon adequate utilization of its facilities. The unique feature of the consumer loan business is its extreme mobility over time. This potential flexibility in operation is decidedly advantageous. It is matched in this regard only by some other financial institutions, such as brokerage houses, commercial paper houses, sales finance companies, and commercial credit companies.

While on the point of comparison with other businesses, it is well to give attention to the comparative net profit results and their basis. Table I shows an average net profit in relation to gross revenue of 14.5 per cent for Missouri and 22.2 per cent for Illinois. These percentage figures alone are meaningless. To judge the profitability of any business the return over a reasonable length of time must be related to the average investment required to generate the revenue, not to the revenue itself. In this regard the consumer lending business is similar to the public utility field—the amount

of dollar investment needed is high in relation to annual revenue. Whereas the annual net sales might be three or four times the average dollar investment in assets for a merchandising business, one or two times for a manufacturing business; in the case of utilities it will range more around ⅓ or ¼ times. Expressed another way, a utility would have to earn from nine to sixteen times as much on its revenue as a merchandising business to show the same return on investment.

Applying this reasoning to the Missouri licensees we find that over the thirteen-year period covered the annual ratio of revenue to operating assets averaged out at .258.[5] Since a total investment figure is involved, this "turnover" ratio needs to be related to the total investment return of net profit plus interest on borrowed funds, which came to an average of .259 per cent of gross revenue. Multiplying the two figures together we get an average return on total operating assets of 6.68 per cent. That is, on every dollar invested in the operations of the business 6.68 cents were earned every year on the average for the Missouri industry in general. Naturally, some individual companies showed better average results than others.

All too often undeserved significance is given to the profit margin of a business. It is not uncommon for an electric power utility to realize a profit of 30% of the gross revenue and more. This does not signify monopolistic exploitation, for the return on investment may still be within the regulated allowance of, say 6%. A high profit margin must be allowed when the investment turnover is low, if the industry is to function properly. On the other hand, if, as in merchandising, annual turnover of total investment is three or four times or more the profit margin will be as low as 4, 3, 2 per cent and even less.

On this basis alone the small loan business would not seem outstandingly profitable in comparison with other credit businesses or other industries in general. However, on a total investment return of this sort it is not uncommon for an individual company to realize substantially more on its ownership investment. The explanation for this rests on what is technically known as capital structure leverage. It is the result of the way in which the business is financed, not the way it is operated. When a business is able to earn 7 per cent on its total investment and yet is able to borrow half of this investment at a fixed rate of 4 per cent, the owners benefit to the extent

5. This is to be expected since the gross revenue arises from the rate charged, which is a fraction of the principal sum when expressed on a year's basis.

of the difference and realize a total return of their own of 10 per cent. Had they borrowed two-thirds of the total requirements at 4 per cent they would have realized a return on their own investment of 13 per cent.

The classic example of applied leverage is in the commercial banking business. Here an individual bank might earn only 1 per cent on its total assets and yet show a 10-12 or even higher per cent return on its ownership because of the extensive reliance upon depositors' funds. The reason why loan companies are able to apply leverage to a greater extent than other types of business is because of the highly liquid character of their assets and the protection such affords the business creditors. However, it should be recognized that there is a substantial risk element attached to the leverage factor. The principle works in both directions, and only a slight drop in net profit can have a magnified effect upon the reduction of the rate of return on the owners' investment.

### Bearing of Cost Characteristics of the Consumer Lending Business on the Immediate Problem at Hand

Having given consideration to the factor of costs in the making of consumer loans, we are now concerned with how this knowledge contributes to the resolving of the problem of fair charges. In the first place, it is clear that the extension of consumer loans on a large-scale basis is an ordinary business endeavor, being motivated by profit prospects on the one hand and subject to cost and competitive considerations on the other. On the surface this point might seem too elementary to justify special attention, but too often the impression is given by some, either consciously or unconsiously, that the whole activity has a special social demeanor, more akin to some charitable or philanthropic undertaking than an ordinary business pursuit. The fact of the matter is, as Professor Kelso has so well demonstrated in his article, that there is a substantial consumer demand (both need and want) for the service. That like any other service or good its use is neither immoral nor improvident if kept within proper bounds. That for the demand to be satisfied in the most socially desirable manner legitimate private enterprise in the field must be encouraged. And finally, in order to achieve this end of encouraging private enterprise there must be provided the opportunity for charging a price which will cover all of the basic operating costs, including an adequate return to the risk capital.

This is a rather general application of the factor of costs, however. A much more pointed question is how to allow for an adequate price in the

field when the costs differ so in amount in accordance with variations in loan characteristics. For one thing, regardless of the particular type of consumer loan involved, the basic operating activities of acquisition, servicing, termination, and general overhead are the same. The main differences between types of consumer lenders is in the matter of risk assumed and size of loan granted.

So far as this latter difference is concerned there is the possibility of scaling rates by size. This is, in fact, an approach that has gained in popularity in recent years and the principle of which is at the heart of the uniform small loan laws. The difficulty with it is that to be applied exactly in conformance with the basic idea there would have to be a different rate for each variation in dollar amount, and this clearly is administratively unmanageable.[6] What is more, it would mean that the very smallest loans would be priced at astronomical rates. Establishing broad brackets by which to establish the rate variations does not overcome the difficulty but merely hides it. Some loans continue to bear more than their proportionate cost while others bear less, for it is to be remembered that most of the costs are incurred on a per loan basis rather than a dollar basis.

To the extent that the factor of risk is inversely correlated to that of size, which is to say that the small loans are the riskier and vice versa, scaling of rates by size can also reckon with this basic difference in lending activity. In this case, however, the difference that does exist is by broad category rather than by single dollar variation, and so there is greater justification for bracket rates. On this point alone, rather than that of size difference, the early specification of a $300 maximum in the Russell Sage model code was well-founded. The more recent tendency to classify loans by even smaller categories of size for rate purposes is also probably well conceived from the standpoint of coping with differences in risk but not for the differences of size.

One suggestion for dealing with the size problem is that of covering the operating costs mainly by fees and minimum charges and levying a

6. Proposal has been made for coping with the Missouri problem by adopting very narrow size brackets for variations in rates. For example, the Committee for Enactment of Fair Lending Legislation in Missouri in its report dated January 12, 1949, recommended a triple-rate plan which in its application would have the effect of varying the rate for every change in loan size between $100 and $2500. Any bracket structure would have this same effect; the only difference is that the average rate applicable would not be quoted in every case. The author feels that too narrow limits in the brackets established make administration cumbersome and the hope for reduced rates through price competition and discrimination remote.

nominal percentage rate in addition to cover the cost of forebearance and those other minor expenses related to dollar size. In other words, there could be a special investigation fee, a special legal fee to cover the costs of collateral protection, and a delinquency fee for overdue accounts requiring special follow-up, all of which would be expressed in dollar terms. In addition, there would be a minimum dollar charge to cover the very smallest accounts and a uniform percentage rate that would be applied to the dollar principal of every loan.

The approach is more administratively feasible than the bracket rate scheme and has certain political attributes. In other words, it is a convenient expedient. On the other hand, it does not permit price comparison, and therefore effective competition. Nor does it encourage the economical servicing of the smallest loans through price discrimination. Were the fixed dollar fees converted into percentage form on some loans, the resulting rates would be far above what would ordinarily seem appropriate. For this reason the method may be realistic in terms of costs of granting small loans, but it does not conform to the need for price comparison. The point was made in the beginning of the article that because of the time factor the cost of credit must be converted to a rate and not merely expressed in monetary amount.

This consideration leads to still another cost variable—the duration of the loan. Just as a company specializing in small loans must charge a higher average rate, so one specializing in short loans must do likewise. The common time interval for rate quotations being a year, loans having a term of less than this are at a disadvantage when a flat rate is used and vice versa. For example, a three-month loan will receive only one-fourth as much revenue as a full year's loan of the same size and charging the same rate. Or looked at from another direction, a lender specializing in three-month loans will incur four times as much acquisition cost as one specializing in year loans and having the same volume of outstandings. There is one compensating factor, and that is the item of risk. All other things being equal, the shorter loan offers greater safety to the lender. But rarely is the saving sufficient to counteract the decided disadvantage of higher overall acquisition costs.

All this leads to the central question, "How can a fair charge for consumer loans be determined?" On the basis of what has been said it should be clear that there can be no categorical answer to this question. Whether or not a charge is fair depends for one thing upon the average loan size of the lender togther with the average loan duration and any other special

service offered the borrower or special cost incurred by the lender, primary of which would be risk involved.

The question of fairness also is related to the public's attitude as to how small the loans are to go. This consideration is directly tied in with the average loan size and the desire to encourage the legitimate extension of consumer loans in the first place. If the legislators have in mind servicing the needs of those who might want $10.00 loans, then one of two things must conform to this objective. Either the lender must be permitted to charge the same rate on much larger loans, that is the average loan size must be substantially above this minimum figure, or if he is to be made to specialize in very small loans, the permissible rate must accordingly be very high. This is indeed a question that many legislatures have not faced up to squarely. General statements are made as to the need for providing legislation which will permit the extension of "small loans," but the question, "How small?" is a most vital complementary consideration.[7]

This problem raises another inescapable dilemma that the legislature must recognize and take an unequivocal position on. If the very smallest loans are to be granted readily at what would seem reasonable rates, the larger loans must be charged at rates higher than is justified by their pro-rata share of the costs. In other words, price discrimination must not only be accepted but encouraged. The larger loans must subsidize the smaller, as it were. At first glance this might seem a somewhat uncouth solution. Investigation into pricing policy of almost any type of business, however, will evidence a certain amount of price discrimination. In the case of the lending business in general it is rather pronounced. And in the small consumer loan business it is imperative. The question to be faced by the legislature is not whether it is to be permitted but rather the extent to which it should be carried. The lower the maximum rate permitted the greater the area of price discrimination that will be required if very small loans are to be available.

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7. This point is well stated in the report of the committee appointed to investigate money-lending agencies of the House of Representatives of the 62nd Missouri Legislative Assembly. It reads, "The problem is not adequately met merely by establishing a rate sufficient to keep licensed small loan companies in business within the state. Further than that, the rate must be sufficiently high to render a full and complete loan service. That is, the rate must be sufficient to encourage the making of loans in the lowest brackets as well as the larger loans and to provide a loan service for borrowers who do not have 'gilt-edged' collateral or whose circumstances are such that they cannot be classified as A-1 credit risks." House Journal, 62nd General Assembly, 1943, Missouri, Vol. II.

In support of this point some hypothetical reasoning might be offered. If we take an average cost per loan outstanding over a representative period of time and relate it to different average annual loan sizes we can get some idea of the different rates that must be charged. The $24.90 average annual expense per account for the Missouri loan operators from 1933-1945, which was cited earlier, is exclusive of interest and profit. If a 6 per cent return on total investment be considered reasonable, at a rate of investment turnover of 25 per cent, a profit margin (after taxes but before interest) of 24 per cent would be required. This would mean that roughly 25 per cent of gross revenue would have to be provided over and above total operating costs and taxes. And the total cost per loan (including a reasonable return to capital investment) would approximate $33.20 ($24.90 plus ⅓ of $24.90).

At this cost a $10 loan for a year would have to be priced at 332%, if it were to bear its pro-rata share. Were the duration but for three months instead of a year the rate would have to amount to 1328%. A $100 year loan could be serviced at 33.20%, but if it were repaid in equal monthly installments the rate would have to almost double because of the gradual decline in principal balance over time.

Over the 13-year period the average loan size for Missouri was $111.22. On this average balance an average rate of 29.85% would have been required to cover total costs of $33.20 per account. Had the maximum rate permitted been lower, the average loan balance would have had to be higher. Or were the average balance permitted to be higher, the rate could have been lower. Had the average balance been $200, for example, the average rate charged could have been 16.60%. And an average balance of $400 could have been serviced at 8.30%. Such reductions in rates, however, can only be accomplished by increased price discrimination. With each such change the small loans bear less of their pro-rata share of the costs and the large loans bear more.

One final factor related to costs and the establishment of "fair rates" which has been given very little attention in the treatment of the small loan problem is that of the proper role of competition. Here as in other areas of our economy we have taken the fatalistic position that competition is not only inoperative but malignant. And, in consequence, though we espouse competion in principle we do all we can to create monopolistic situations in practice. Instead of developing these monopolistic centers and then regulating them, it would seem much more logical and in keeping with our

basic philosophy to regulate a business only within broad limits while taking definite measures to improve the competitive opportunities.

Although this approach is not possible with all businesses it would certainly seem to have virtue in the consumer loan business. Granted that the weakness in this regard has always been the ignorance of the borrower, from the cost or general economic standpoint few businesses lend themselves so well to the automatic regulatory aspect of competition. And the defective position of the consumer is just the thing that can most easily be overcome by a positive educational and institutional program. The substantial improvement over the last thirty years in the willingness of consumers to shop for credit and to appraise alternative credit sources intelligently is strong testimony to what can be accomplished in this regard.

In the absence of effective competition there is no way of determining a fair charge. The greatest economist would be unable to provide an absolute answer for even an individual case; so it should be clear that a government cannot establish a general statute that will provide equity in all cases. To a great extent the question is resolved in the subconscious of the user. Since we all have different tastes and wants, to establish dogmatically the equity of another's transaction is to assume the role of the "benevolent dictator" with all of its insidious implications. Even from the objective cost standpoint, an individual, no matter how well trained, could not possibly anticipate all of the potential means of realizing economies of operation and all of the possible changes in consumer needs. Without effective competition there can be no absolute equity, all that a regulatory body can do is prevent flagrant abuse.

In regulating rates charged for consumer loans, therefore, the legislative body must take into account its ability, willingness, and determination to encourage competition as an automatic determiner of fairness. If competition is to be relied upon and fostered then all that may be called for is a general increase in the maximum rate allowable and a prohibition of certain malpractices. If the social force of competition is to be ignored, then what must follow is a rather arbitrary stratification of the business in all of its basic operating phases, in which case inequities are not removed but rather contained in narrow limits.

## General Conclusions

All market rates of interest are based upon the summation of four inescapable cost factors: (1) pure interest, or the cost of forebearance,

(2) risk, (3) operating expenses, including acquisition, servicing, termination, and overhead, and (4) profit. In other words, the lending of money is an ordinary business operation involving the same general economic motivations and considerations as the selling of shoes, the practicing of law, the manufacturing of watches—or any other well-accepted business undertaking. Naturally, it has certain operating requirements which are rather special to itself, but these individual operating particulars should not be permitted to obscure its basic business character in general.

Such being the case, successful regulation of the business requires a thorough knowledge and appreciation of all the intricacies of its demand and cost relationships. Particularly does this hold true if competition is either impotent or ignored. Too often in the past has there been evidence of regulatory measures which have been motivated by prejudice and founded upon ignorance. If the widespread consumer demand for the service is to be accomodated most effectively, this consumer expression must be respected and legitimate private lenders encouraged.

This attitude, in turn, means that the legislative authority must recognize the major issues and assume a definite stand in regard to them. If small loans are to be encouraged, how small should they be? Is there to be different treatment for different sizes of loans, or shall each loan bear its own pro-rata dollar cost? If there is different treatment by loan size, will it be limited by certain fixed brackets? If so, what objective standards will be used as guides in the setting of these limits? Will there be classification of loans by risk as well as by size? By duration? By method of repayment? By type of collateral protection? And finally, is competition going to be relied upon at all as an automatic market determinant of equity?

If an individual reads this article with the expectation of being told what exact rate is fair for consumer loans or even for particular types of consumer loans, his frustration would be at the exploding point by now—if, indeed, he would bother to continue this far. Such an individual, however, is blind to the realities of the situation and ignorant of the multitude of variables that bear upon the question. What is even worse, his inclinations make him an easy victim of the glib "scientist" and vulnerable to the incongruous philosophy of the "Benevolent Dictator." An individual transaction may possibly be judged "fair" on its own merits by the application of broad standards, but certainly no general position can possibly be established that will provide for absolute equity in all cases. The most that can be done on a broad scale is avoid gross inequity in some cases.

In short, those who seek an absolute answer to the question, "What is a fair charge?" are caught by the confusion and prejudice long associated with the pricing of money. There is no single fair charge; a charge is only fair when it conforms to all the special circumstances involved, namely, the value of the loan to the borrower, his ability to pay, and the costs incurred in making the service available. The economic considerations are therefore paramount in judging fairness, but the science of economics can provide no generally definitive answer.