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SOCIAL AND ECONOMIC BACKGROUND OF THE SMALL LOAN PROBLEM

ROBERT W. KELSO*

In the long lapse of years since that day in 1545 when King Henry VIII decreed the legality of interest for money lent¹ and fixed a maximum rate therefor, the English speaking world has sought to fix the rate of interest for all lending. It was a tenet of the medieval church that all charge for money lent was unconscionable, the older distinction between usurious charges and fair dealing having been lost sight of.² And to this day, governments seek to defeat usury by fixing the price of credit at a set maximum of something like 6% per annum regardless of the risk incurred in the lending.

Only within the past thirty five years has state wide regulation of money lending in small sums been inaugurated in the U. S. Those thirty five years have well demonstrated the practicable method of such regulation. Much has been written on that phase of the subject. But seldom if ever is real thought given to the social and economic justification of regulation of any kind.

It is the purpose of this article to point out, not the details of modern regulatory method, but rather the social and economic background of this aspect of consumer credit. Is there a genuine need for credit? Does the borrower of a small loan profit by securing it from a source that is regulated by law? Does society benefit by such regulatory practice? If these questions can be answered in the affirmative there is small justification for allowing the practice of lending in small sums to go without safeguards.

IS THERE A NEED FOR CREDIT?

Is there a positive need for this kind of credit? Many instances can be found where impecunious borrowers seek loans that thrift would have rendered unnecessary. The applicant wishes to make some improvident purchase or to meet bills for purchases that need never have been made. But these instances will be found on close examination of the whole prob-

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1. 37 HEN. VIII, c. 9 (1545).

2. See KELSO, SOCIAL BACKGROUNDS OF THE SMALL LOAN BUSINESS IN U. S., U. of Mich. Institute of Social Work, Studies, No. 1 (1947).

lem to be a small minority of applicants for loans and a still smaller proportion of actual borrowers.

There has never been a time, perhaps, since the Cromagnon that man has not found himself in need of the wherewith to sustain life and yet without means of securing it. And it is the modern age of cash economy that has vastly increased such hardships. When man lived mostly upon the soil, taking his living therefrom his needs were relatively few. With the coming of the machine age which has taken the householder off the soil and grounded his livelihood in a pay slip, the uncertainties of the job and therefore the insecurity of the home have been greatly magnified. The individual tied to a job of work lives in a sort of financial straight jacket, in which if his pay fails for ever so short a time he must ask leniency of his creditor or seek charity. His need for tide-over help is greatly augmented.

Let us inquire first, who this borrower is, in our modern machine age. Statistical studies³ reveal him to be a family man in about nine cases out of ten. He is the head of an average sized family. His age is somewhere between 30 and 40 years. Back in 1938-1939 he was earning between \$1200 and \$1600 a year. At present he will be earning more in nominal dollars but he will be receiving little more in real wages. His take-home pay, after deducting for lay offs, strikes, illness and the like will be small. He is a fellow of steady habits with a good work record. He is of good character in his neighborhood.⁴ He seldom has any tangible assets to offer as security—a small life insurance policy in some cases. His wife often comes with him to apply for the loan.

So, contrary to the popular stereotype that has persisted for centuries, until research has revealed the truth, this average borrower is a family man, seeking a loan with which to meet family crises.

Our next question is why does the lower income family man in the United States need credit? To find the answer it is necessary to examine American home economics through census and other statistics. The U. S. census for 1950 reports that the medium American family income was \$3100 in 1949; that eight million families had incomes above \$5000 a year, while ten million had less than \$2000 and nearly five million had less than

3. See ROBINSON AND STEARNS, TEN THOUSAND SMALL LOANS c. II (Russell Sage Foundation, 1930).

4. SIMPSON, THE SMALL LOAN PROBLEM OF THE CAROLINAS pp. 14ff. (Clinton, S. C. Presbyterian Coll. Press, 1941).

\$1000.⁵ Statistics of regulated small loan companies indicate that most small loan borrowers have incomes between \$1000 and \$2500, with the present value of the dollar at a low ebb. This maximum approaches \$3000. Still one of the largest chains reports for 1949 that a list of more than one million loans showed approximately 50 per cent were borrowed by individuals with less than \$3000 annual income.⁶ Families earning below \$2500 a year have no savings.⁷

In a careful field study made in 1939 of conditions in South Carolina, a state without a regulatory law, Professor Simpson of Duke University interviewed 2223 borrowers. More than half worked in cotton mills. Better than 60 per cent had work records extending over five years. The need for borrowing varied directly with the number of the borrower's dependents. About two thirds of the group sought their loans to defray living expenses. Some 30 per cent sought to refinance existing indebtedness. Borrowings were small in all cases.⁸

As a further evidence of inadequate family budgets, an analysis of the purported uses of borrowing by the 259,321 borrowers from small loan companies in New York State in 1936, revealed 20 plus per cent sought to consolidate existing debts; just under 15 per cent to meet medical and dental expenses; 15 per cent needed clothing and fuel, though less than 3 per cent needed food and rent.

The Pennsylvania department of Banking reported the total number of borrowers from legal small loan agencies together with an analysis of purposes offered by borrowers as follows—clothing 6 plus percent, medical and dental 11 per cent, fuel 4 plus per cent, to meet current debts, 12 plus per cent.

One of the largest lending agencies now under regulatory laws, reported for 1949 that reasons offered, and accepted by the lenders, show some 40 per cent were the consolidation of existing debts while clothing, rent and

5. As of Dec. 1950, the Federal Bureau of Labor Statistics reports income of the American city dwelling family of 4 persons to range from \$2532, in Houston, Texas, to \$2985 in Washington, D. C. But the Bureau of National Affairs computes the comparable figures for a family of 3 persons as ranging, in 34 cities, from \$3120 in New Orleans to \$3762 in Seattle. The same Bureau reports as of October, 1950, that the city workers' family budget for a family of 4 persons ranged from \$3453 in New Orleans to \$3926 in Washington, D. C. The index of intercity price difference rose from 87 in June 1947 in Houston and Kansas City to 100 in Milwaukee and Washington, D. C. See Bureau report 17.955.

6. See also NEIFELD, *THIS PERSONAL FINANCE BUSINESS* pp. 154ff. (1933).

7. LEVIN, MOULTON, AND WARBURTON, *AMERICA'S CAPACITY TO SAVE* pp. 154ff., 101 (The Brookings Institution, 1943).

8. SIMPSON, *op. cit. supra* n. 4, pp. 7ff.

medical bills accounted for 20 per cent more. Taxes and repairs covered another 10 per cent. The analysis covered more than a million loans. The broad conclusion to be gained from these analyses is that the necessities of daily living are the great and compelling reason for seeking small loans by the family man who cannot secure them without credit.

If then the lower income families in America have only breadwinners' wages to maintain the budget it is obvious that sudden emergencies cannot be met without credit or charitable help. That crises do arise, and frequently, is likewise obvious—the birth of a child, a death, a fire, a long continued strike or lay-off, or sickness—these either stop the income completely or fix a drain upon it that cannot presently be borne.⁹

WHAT IS THE JUSTIFICATION FOR PUBLIC REGULATION?

If we assume that the borrower of a small loan is in the average a family man of small income with no assets to offer as security and only his reputation and his job to commend him, we still face the question whether this is not a matter between him and the lender. What right or duty have the public to step in?

Ever since mankind has realized that the family, as home and breeding lair, is the basic unit of race culture and race propagation, the laws that man sets over himself have been gauged to protect the fireside. The laws of marriage and divorce regiment the mating process severely. Granting to the householder the right to protect his home to the point of extremity is another of these safeguards. The nation's far-flung mother's assistance program in child conservation, keeping the child in his own home where possible, is also a part of this cloak thrown about the economically distressed home. The schemes of made work in time of unemployment are designed not only to feed the hungry workman, but primarily to feed his dependents and keep his family together. To stand at the shoulder of the family man who is in hard straits for family support yet without bargaining power, to see that he has fair treatment, would seem to be no more than a minimum of public concern for his welfare and that of his wife and children.

Far back into the earliest times the man of small means has been prayed upon by those who would make even a little profit out of his extremity. Superficial thinking might conclude that this condition has obtained only because human nature is selfish and man will take advantage of his fellow.

9. For an extended discussion of this point see NEIFELD, *op. cit. supra* n. 3, p. 191f.

In all probability the reason lies deeper. Granting human cupidity at its full, the usurer has existed through all times because he meets an economic need—the necessity for tide-over. The potential borrower is therefore always present wherefore the usurer who would meet his present need but exact an unfair price therefor, to be paid out of the borrower's future, is ever ready to render assistance. With no bargaining power the small income householder falls a ready victim. It is this situation that justifies public protection through regulatory law which provides an economic substitute for the usurer and subjects the business of lending and borrowing to supervision by government authority.

DOES THE BORROWER PROFIT BY THIS LEGAL PROTECTION?

Reasonably adequate regulation exists in all but a few states. So extensive is this coverage that about three fourths of our families live under these regulatory laws.¹⁰ If the borrower gains in money and in protection against usurious treatment, that is to be discovered by a comparison of treatment received in unregulated areas and that accorded him under adequate legal protection. Kansas and South Carolina, both unregulated territory, are revealing examples of lending without safeguards.

A small but intensive study in Kansas of 107 cases showed instances of illegal charges at their worst. Rates in some instances reached 5000 per cent a year. The common range was between 1000 and 2000 per cent. The highest rate allowed under the uniform small loans law is 42 per cent a year or 3½ per cent per month on the unpaid balance when the loan is \$50 or less, and a rate graduated downward for larger loans.¹¹

In the South Carolina study, Simpson found the borrowers of small sums in a deplorable state of bondage to the usurer. The average annual rate of interest on small loans of various sizes ranged from 278 per cent to white borrowers on loans of \$10 or less to 598 per cent. The corresponding percentages for loans between \$10 and \$25 were 224 and 362. For loans between \$25 and \$50, percentages were 40 and 216. On loans to negro borrowers rates were one fourth to one half higher.¹²

Such conditions are common throughout unregulated territory. Thus, in a survey made by the Better Business Institute of Huntington, West Vir-

10. See SMALL LOAN LAWS OF THE U. S., Pollak Foundation Pamphlet #37 (1947).

11. For an able discussion of illegal lending, see HARDY, CONSUMER CREDIT AND ITS USES c. VII, pp. 73ff. (1938).

12. SIMPSON *op. cit. supra*, n. 11, pp. 21-28.

ginia, in 1929, at a time when no regulatory law was in effect in that state, it was found that about \$120,000 a year was being paid by factory employees to loan sharks. Charges actually collected ranged from 240 to 340 per cent—in some cases as high as 1000 per cent.¹³

A common practice in unregulated territory in the South takes the form of a sale by the borrower to the lender of his next pay check, which he agrees to buy back at next pay day with a premium. If he cannot pay the whole amount on the appointed day he must sell another pay check. This process goes on from week to week, often for years on end. Salary buying was especially flagrant in Georgia. The charge there was usually \$1 on each \$10. The borrower must go on renewing his agreement and paying his premium until such time as he could find enough cash to discharge the principal with the premium.

But if the amount of charge seems outrageous, the collection methods used by illegal lenders are, if anything, worse. The borrower is threatened with loss of his job. He is dunned at the factory gate in the presence of his fellow workmen. He is hounded through his neighborhood. He is threatened with criminal prosecution for embezzlement. Garnishment all too frequently results in the borrower's discharge from his job.¹⁴

By contrast with these methods, a steadily increasing volume of evidence found in the reports of state banking departments that carry supervision under a regulatory loan law, shows fair treatment of the borrower. Legal lenders are required by the law

- (1) To obtain a license to operate from the state.
- (2) To file a bond of an amount stated in the statute.
- (3) To limit the size of loans within a fixed maximum.
- (4) To limit charges (called interest and outlay for services and expenses) to a definite maximum.
- (5) To submit a regular supervision and inspection by a state official.
- (6) To keep adequate records, open to inspection.
- (7) To charge interest only on the unpaid balance with the right in the borrower to pay the whole balance at any time during the life of the loan.

That legal lending agencies are living up to these requirements in full measure is indicated by impartial reports of state banking departments.

13. HARDY, *op. cit. supra*, n. 11, p. 74.

14. See Birkhead; *Collection Tactics of Illegal Lenders*, 8 LAW & CONTEMP. PROB. 78 (1941).

Some of the largest chains issue bulletins with helpful advice on family buying and budgeting. Lenders seek to maintain a helpful and friendly relationship to their clients. Associations of the companies maintain committees jointly with welfare agencies, which seek to handle borderline cases where the welfare workers find need of forbearance in loan collections. Seldom is representation necessary to stay foreclosure on the borrower's property where he has given it as security. An overall survey of 4,115,224 loans made in eleven states¹⁵ for which data was available shows repossession of household goods in .026 per cent of the total. Of these 1075 repossessions only 210 or .005 per cent were by legal process for goods being used by the borrower. Voluntary surrender accounted for 655 or .016 per cent. Automobiles were repossessed in .293 per cent of the cases; and other chattels in .009 per cent. Total possession of all chattels were had in 13,543 out of the 4,115,224 of which only 4599 were by legal process. It is apparent from this analysis that most small cash loans are character loans, and also that lenders appear to carry on their traffic with a high degree of consideration for their clients.

The illegal lender operates outside the law and charges all that the traffic will bear. His loans are usually of small size and must be paid within a period too short for the hard pressed borrower to meet. In the South this is called the "short loan" business. The result is a new loan to cover the old. The borrower winds up by paying on his original loan many times its full face value and an exorbitant amount of interest and charge besides.

It would seem to be a justifiable conclusion that the borrower is better off under the protection of the standard small loan statutes than he has been when at the mercy of the illegal lender.

DOES THE PUBLIC BENEFIT BY REGULATION OF THE SMALL LOAN PROBLEM?

Benefits to the public, if there be any, cannot be expressed in dollars. They must be found in greater stability of our national institutions; in greater equities in human relations; in a finer quality of American citizenship—a greater pride, it may be, in cleanness of living, less shame, akin to the shame of the nation when it tolerated slavery. These are intangibles. They are nevertheless real. It remains to find whether they exist.

It can be seen easily that many of the several million borrowers of small sums each year would have come to public relief if they could not have secured tide over credit. In a special spot study of 100 cases in the Detroit

15. California, Iowa, Maryland, Michigan, Minnesota, Nevada, New York, Ohio, Utah, Virginia, Wisconsin.

area, more than one third of the cases had been in receipt of public relief.¹⁶ It is some benefit to the public that the funds do not have to be paid out for the support of this fraction of the clientele of the legal small loan agencies. But it is a far greater benefit to the community that as many citizens as possible be kept from the need to seek charitable relief; that the citizen preserves as far as may be his independence as the head of a family. Dependent individuals are apt to be poor citizens—men largely without hope, families largely without a future.

There is arguable gain to the public, also, in the establishment and maintenance of a legitimate loan business, running into sizable volume. Legitimate lenders are known as "the poor man's banker." Some 85 per cent of all the public have no banking connections. They could not secure a loan because they have no security to offer. The commercial bank handles depositors money in trust. It must lend on security. Now that our banks have gone into the business of lending small sums, they are affording some advantage to the lower income families, but examination will show that loans made by the banks are larger in amount than the average of those made by the small loan companies. While commercial banks are rendering a valuable and increasing service to the working man and his family, it is the family man who must find \$100 or less who is most important in this problem. It is important to the public that transactions so dangerously one-sided are brought under public supervision, thus safeguarding the lack of bargaining power.

Nor is it a small advantage to the public that the usurer should be driven out of his predatory occupation. There is no place for him in honest living. If he could run his business on an honest basis, charging for his loans what his effort justifies and no more, he could be welcomed to any community. The family is in need of credit. It is a foregone conclusion, however, that the shark would continue to play Shylock. The only recourse is to eliminate him and replace him with an economic substitute, a legitimate, carefully supervised lending business.

To effect this change would go a long way toward setting an example to honest business. Governments maintain police and other officials at great expense to track down individuals who prey upon their fellows. The loan shark has been one variety of unfair dealer who until recent years went un-

16. Maslan, *Some Family Welfare Aspects of the Small Loan Business*, cited in *KELSO, op. cit. supra*, n. 2, pp. 19-21.

checked. His victims have been left to civil rights which they were helpless to enforce. Usury, by whatever name, is duress and extortion, long interdicted by the law. Now at last has been found a constructive way to deal with it. With continuing oversight the lending business can be kept on a basis of fair dealing.

But the greatest advantage the public can gain from the new regime in lending is greater guarantees of solidarity for the American family. There can be no doubt that small loans serve in many thousands of instances to head off the break up of families.

SUMMARY

The borrower of a small loan in the United States is in the average a man with a family of dependents. His income is small, ranging somewhere below \$2500 a year—seldom reaching beyond \$3000. He is a fellow of good reputation in his neighborhood, has a respectable work record. He does not know much about budgeting his income and too often gets himself into debt for the many things the family needs and other things they could, with some privation, do without. His greatest need is for a small sum to meet his emergency.

Down to about 1916 there was no protection for this borrower other than the ancient 6 per cent rule which was not observed. Rate is related to risk and effort and expense, not to a moral dictate established by statute. Beginning in that year the Russell Sage Foundation with the assistance of social work interests and many of the existing loan companies brought out a so-called model small loan regulatory law. It took account of the experience of some states that had tried some sort of regulation as early as 1911.

This model statute has been adopted in most of our states. It has now reached a seventh edition, and is reasonably workable. Its adoption has so far reformed the small loan business that the so-called "shark"—the usurer—has had to retreat to an ever narrowing expanse of unregulated territory.

So at long last, the old era of prohibition of lending at more than an uneconomical and traditionally established rate has given way in America to a new era of regulation and supervision of a recognized business. Six basic concepts are to be noted in the new legal attitude toward small loan lending. They are—

- (1) Small loan lending is a public necessity.
- (2) The regulatory law must allow the business to be conducted on a commercial basis, liberal enough to attract capital in quantity sufficient to meet borrower's needs.

(3) Charges for lending must be above the conventional banking rate for larger loans, at least large enough to meet the expenses and overhead services called for to handle installment loans.

(4) To protect the borrower the lender must be supervised and regulated by the public.

(5) The regulatory law must cover all small cash lending and should set a maximum in its definition of a "small loan."

(6) Penalties for violation of the provisions of the law must be heavy enough to ensure observance.

Under such limitations the lender can carry on a respectable business, comparable in profits to general business in his community, while the borrower can seek a loan, however small, with full knowledge of what he has to pay back and with the assurance that he will not be taken at an unfair advantage.