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the

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Sharks

*Towards a Cure for the
High-Cost Credit Market*

Christophe L. Peterson



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For Margaret P. Battin and Tera J. Peterson

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CHAPTER 1

Debt Fever: An Introduction to High-Cost Consumer Credit

If you advance money to any poor man amongst my people, you shall not act like a money lender: you must not exact interest from him. If you take your neighbor's cloak in pawn, you shall return it to him by sunset, because it is his only covering. It is the cloak in which he wraps his body; in what else can he sleep? If he appeals to me, I will listen, for I am full of compassion.

—Exodus 22:25–7

A LEADING AND ACCLAIMED BUSINESS historian said of credit that, “free market long-term rates of interest for any industrial nation, properly charted, provide a sort of fever chart of the economic and political health of that nation.”¹ In general, mainstream America has enjoyed historically low interest rates for over a decade, suggesting a robust economy and a responsive democracy. Our consumer credit system facilitates access to shelter, transportation, education, and many other goods and services both necessary and desirable in modern life. A family home bought over time with an inexpensive fixed-rate mortgage is a mainstay of the American dream, creating stability in extended families, neighborhoods, and entire communities. In financing a

car, a worker can exchange a financial obligation for the priceless freedom to travel where and when she chooses. Borrowing in order to finance an education is an irreproachable investment in one's future. For these reasons and others we should all be proud that affordable credit is available to so many Americans.

Nevertheless, we must also remember that nations are made of groups within groups and ultimately of individuals. To say a nation has an interest rate fever is only to make a generalized claim about particular people, each with names and stories, and each of whom more or less contributes to the truth of the statement. A nation infected with a fever is so called because many people pay high prices for the use of money, people like Leticia Ortega, a computer store cashier in San Antonio, Texas. Short on cash, Ortega was facing termination of her past due telephone and electrical utilities. With her next paycheck still two weeks away, she saw an advertisement for a short-term loan in the *Thrifty Nickel*, a weekly local classified listing newsletter. The advertiser, National Money Service, Inc., offered a two-week \$300 loan for a charge of \$90. Despairing for some other solution to her shortfall, Ortega borrowed the money. But after two weeks had passed she was no closer to financial solvency than before. Unable to pay the entire \$390 due, National Money Service "rolled over" the loan by withdrawing \$90 directly from Ortega's checking account. Because Ortega was living paycheck to paycheck, with no surplus income available to retire the \$300 debt, she continued to pay the \$90 every two weeks for nearly a year. Eventually she paid \$1,800—a substantial portion of her yearly income—but still owed all of the original debt. The annual interest rate of Ortega's loan was just under a feverish 800 percent.²

Even "healthy" nations have always had individuals who pay feverish prices for the use of money. The governments, corporations, banks, and wealthy individuals of our society have in general successfully immunized themselves from high interest rates through sound monetary policy, well-considered government regulation,

and, most importantly, by harnessing competitive market forces. But for America's working class, and for America's increasingly vulnerable lower-middle-class, the analogy between health and credit prices begins to suggest a different medical chart. This book argues the high-cost consumer credit often extended to this group is best seen as *a persistent low grade infection*, sometimes more and sometimes less noticed by elites, but always burning the vulnerable.

Americans in all demographic categories are borrowing more relative to their disposable income than ever before. In fact, for the first time in American history, our collective debts have exceeded our collective disposable income. As Table 1.1 shows, debt burden as a percentage of disposable income has grown steadily throughout the latter twentieth century. From a modest 31.9 percent of disposable personal income in 1949, outstanding debt grew to 71.9 percent by 1979. By the mid-1990s debt represented 91.9 percent of personal disposable income. And, despite rapid growth in stocks and productivity in the latter 1990s, by the turn of the century Americans had more debt than disposable income. Thus, as the Economic Policy Institute explained, “[a]t the aggregate level, debt is a more important feature of the household economy than at any time in modern history.”³

TABLE 1.1

Aggregate household debt as a percentage of personal disposable income, 1949–99

1949	1967	1973	1979	1989	1995	1999
31.9%	66.9%	65.2%	71.9%	84.6%	91.9%	103.0%

Source: Economic Policy Institute, *The State of Working America 2000/2001*⁴

For most Americans this increasing debt has been benign. The purchased use of money—credit—is a valuable commodity for na-

tions, corporations, and households alike. As one scholar has explained, “consumer credit is about much more than instant gratification. It is also about discipline, hard work, and the channeling of one’s productivity toward durable consumer goods.”⁵ For affluent Americans it is safe to say the increasing debt load of the past two decades may be ascribed to comparatively well-considered obligations purchased at tolerably low interest rates for mostly good reasons. Moreover, the stock market boom and dramatically rising productivity of American workers in the 1990s was kind to America’s more affluent citizens, offsetting the impact of rising debts. Despite the burst technology bubble and currently slower growth, for the relatively affluent middle class on up, America has a strong economy and bright prospects.

But for less well-off Americans, the ever-rising proportion of disposable income dedicated to outstanding debt hints at a darker future. At the end of the twentieth century a new and distressing trend of spreading financial infection has emerged—an interest rate fever for which a growing number of working-class and lower-middle-class Americans have scant resistance. With approximately 90 percent of all stocks and bonds owned by the wealthiest 10 percent of American society, the stock market boom of the 1990s scarcely benefitted our most vulnerable groups.⁶ According to the most recently published federal survey of consumer finances, approximately 12.6 percent of all American families have annual incomes of \$10,000 or less. Of these families—including families with household heads at ages close to or in retirement—less than two percent have invested in mutual funds, less than four percent own any stocks at all, and no statistically significant number own bonds.⁷ Table 1.2 explains that while vulnerable families’ assets grew, their debts grew faster. The result was that the least wealthy 40 percent of American households saw a dramatic decline in their net worth despite the growing economy. Thus, as one scholarly work puts it, “the real story of the 1990s was not the

stock market boom, but the debt explosion.”⁸ Or, in the more restrained—and portentous—words of Federal Reserve Board Chairman Alan Greenspan, “families with low-to-moderate incomes and minorities did not appear to fully benefit from the highly favorable economic developments of the mid-1990s.”⁹

TABLE 1.2

Average assets and liabilities of the least wealthy 40 percent of American households (constant 1998 dollars)

	Stocks*	All other assets	Total debt	Net worth
1983	\$ 400	\$16,800	\$12,500	\$4,700
1992	800	19,100	17,600	2,300
1995	1,100	20,600	20,700	1,000
1998	1,700	23,800	24,400	1,100

*All direct and indirect stock holdings

Source: Economic Policy Institute Analysis of Survey of Consumer Finance Data

At the same time net worth has declined, low to moderate income Americans have also experienced stagnation or a decline in the real value of their wages. Between 1973 and 1999, the median weekly wage in the United States fell 12 percent from \$502 to \$442. Although the real value of median weekly wages recovered slightly in the mid- to late 1990s, it still has not recovered to its 1988 level. In the words of Federal Reserve Board researchers, “mean incomes for all education groups in 1998 were lower than they had been in 1989.” For families headed by a worker with no high school degree, real income declined *even* in the rapid growth years between 1995 and 1998.¹⁰

Unsurprisingly, key indicators of financial instability have increased in proportion to declining real wages and net worth. For

instance, the 1990s saw significant increases in the number of households with debt service payments equal to more than 40 percent of household income—an important indicator of financial hardship caused by over-indebtedness. Perhaps more ominous is a startling increase in the number of lower-middle-income families who were late in paying bills over the past decade. Of families with annual incomes between \$25,000 and \$49,999, in 1989 only 4.8 percent were late sixty days or more in paying at least one bill. By 1998 this figure nearly doubled to close to one family in ten.¹¹

While working poor families saw increased debt load and decreased earning power, their access to traditional banking services has also decreased. Prefacing a major market shift in the financial servicing of America's working poor, the number of families without a bank account increased by 77 percent between 1977 and 1989.¹² Many of the key pressures keeping working poor families out of banks and savings associations remained, and perhaps increased, in the 1990s growth economy. A Federal Reserve Board report shows that while most banking fees paid by solvent customers remained static, those fees commonly charged to consumers in financial trouble grew dramatically in the late 1990s. Stop payment orders, overdraft charges, not sufficient funds fees, and below minimum balance fees—all acutely felt by families experiencing income shocks—grew much faster than inflation in the last decade. For instance, bank and savings association overdraft charges grew 17 and 23 percent respectively between 1994 and 1999 alone. Not sufficient funds check fees and stop payment order prices both rose about 15 percent in this five year period. And bank fees charged to customers whose savings account balances dipped below minimum requirements grew by a surprising 31.3 percent.¹³ At the turn of the century, the best estimates suggest 13 to 15 percent of all American families are “unbanked”—“nearly double the proportion in England.”¹⁴ Of families without checking accounts, 86.2 percent had annual incomes less than \$25,000 and 44.7 percent had annual incomes less than \$10,000. About 57 percent of these families

were non-white or Hispanic. Currently, over 20 million Americans have no access to mainstream banking services.¹⁵

Observing these trends, many have begun to ask this question: If working poor and lower-middle-class families have, over the past two decades, borrowed more, but banked with traditional first-tier lenders less, with whom are they doing business? A short survey of recent headlines begins to answer this question:

- “Short-term Loan Firms Prospering: Critics Say High Interest Rates, Easy Terms Have Led to Exploitation of Working Poor”
- “Easy Money: Subprime Lenders Make a Killing Catering to Poorer Americans. Now Wall Street Is Getting in on the Act”
- “Payday Lenders Face Fiery Criticism: Consumer Advocates Say Federal Law Allows Institutions to Operate Like Loan Sharks”
- “Time to Restore Loansharking Laws”
- “Borrowing Trouble: How Can Legislators Not Be Offended By Payday-Advance Business that Charge Outrageous Fees to Cash Strapped Consumers?”
- “How High Can the Finance Companies Go? With Interest Rates, the Sky Is the Limit”
- “Banking on a Costly Alternative: Low Earners Turn to Check Cashing Stores”
- “Wolf At the Door: Vulnerable Need Protection Against Predatory Lenders”
- “Shark Attacks: An Encounter with Predatory Lenders Can Leave You Without Your Money—Or Your Home”
- “Feeding Off the Bottom”
- “Little Loans Come at Staggering Cost”
- “New Lenders with Huge Fees Thrive on Workers With Debts”
- “It Was Illegal When It Was Loansharking”¹⁶

Unfortunately, hard data on financial service providers that cater to the working poor is notoriously sparse.¹⁷ Nevertheless, upon ex-

aming the growth and business practices, as well as the stories associated with many second-tier lenders, the answer becomes clear. Working poor families have turned to a looseknit patchwork of businesses, including small moneylending firms, multinational consumer credit corporations, high-rate credit card issuers, mortgage loan companies, payday loan/check-cashing outlets, automobile title loan companies, rent-to-own furnishing stores, and pawnshops, to serve their financial needs. Although this industry has a wide variety of practices, norms, and agendas, the one unifying characteristic possessed by all is that they sell credit at relatively high cost.

WHAT IS HIGH-COST CREDIT?

The personal finance industry catering to high-risk, low-income borrowers defies easy description. A variety of names are associated with this industry including alternative finance lenders, sub-prime lenders, specialty lenders, small loan lenders, fringe bankers, predatory lenders, and sometimes loansharks. In the eighteenth and nineteenth centuries the word “usury” contextually linked the group together—given widespread interest-rate caps which drew a rough line between socially acceptable and unacceptable credit. Originally the word “usury” came from the Latin noun *usura* which referred to the “use” of anything; “hence, usury was the price paid for the use of money.”¹⁸ But as moderately priced consumer credit sold to the middle class became entrenched in the twentieth century, the legal as well as cultural lines distinguishing usurious credit eroded. For some “usury” refers to an unfair loan. Others use the word to describe an illegal loan without hinting at any concurrent moral condemnation. The word can also refer to the body of law regulating the amount of interest charged. It may also refer to a particular statutory limitation in a particular jurisdiction. Sometimes usury refers not to an entire loan, but only to the amount of interest that exceeds the legal rate. Courts have disagreed whether non-interest charges are included for purposes of

calculating usury law violations. Often it is not clear from the context which meaning the authors intend. At the beginning of the twenty-first century the word “usury” has become something of an inconveniently ambiguous anachronism.

A more useful reference increasingly used in both federal and state law is the simple description “high cost.”¹⁹ The essential difference between mainstream creditors and “alternative finance lenders” is relatively expensive prices. Moreover, “high cost,” unlike usury, is a fluid enough concept to readily include both interest and non-interest charges, such as origination fees, brokerage fees, processing fees, application fees, credit insurance premiums, appraisal fees, refinancing charges, late payment penalties, early payment penalties, and dozens of other creditor inventions which tend to obscure the true cost of a loan. Admittedly, at what point credit should be considered high cost is open to debate. Some would say all consumer credit has high costs, in comparison to commercial loans, while others would argue no loan has a high cost if the borrower willingly agrees to it. We can save this argument for another day. For the purposes of this book, it is not necessary to discuss at length at what particular point a loan should be considered “high cost.” Certainly, an 800 percent annual percentage rate (“APR”) “payday” loan qualifies. A 6.7 percent APR thirty-year fixed-rate mortgage with low points and fair contractual terms does not. Whether a 29 percent APR revolving credit card contract qualifies as high cost is an open question. For our purposes, the term is one of convenience aimed at describing the upper end of consumer credit usually extended to the poor and those with risky credit records. Nevertheless, a more detailed picture of high-cost credit can come from examining a selection of some prominent high-cost credit arrangements and lenders.

“Only Until Payday”—Deferred Deposit Lenders

Perhaps the archetypal high-cost creditor is the payday lender. While the industry prefers the term “deferred deposit lender,” companies within the industry are also known as check cashers, check lenders, deferred presentment lenders, post-dated check lenders, sale-lease-back companies, and payday advance companies. Payday lenders trace their American origins to the “five for six” salary lenders prevalent at the end of the nineteenth century. Customers of these early salary lenders would often borrow five dollars on Monday and in exchange pay six dollars on Friday or Saturday. Contrary to popular Hollywood imagery of extortionate mafia lenders, the term “loanshark” actually evolved in large Eastern cities some time after the Civil War to describe specifically these early salary lenders.²⁰ The term did not come to describe the mafia until at least the 1930s. Today’s payday lenders provide nearly identical loans as our first loansharks, only now lenders have the added security of holding the debtor’s personal check.

In a typical contemporary transaction, a customer might borrow \$100 by writing a check made out to the creditor for \$117.50. The date written on the check reflects the due date of the loan. Typically, a loan is for two weeks. Thus, two weeks after obtaining the post-dated check, the creditor will collect by depositing the check. Lenders verify the debtor’s identity by asking for documents or identification such as a drivers license, recent pay stubs, bank statements, car registration, or telephone bills. Most lenders will telephone the borrower’s human resource manager or boss to verify employment. Virtually all lenders require the names, addresses, and telephone numbers of close family and friends in the event the borrower skips town. Payday lenders decide whether to issue a loan on the spot without obtaining a credit report. Both parties are aware the checking account does not have sufficient funds to cover the check when it is signed. After the paperwork is complete, the debtor walks away with \$100 in cash or a check drawn

on the lender's account. When the two weeks are up, the debtor can redeem the check with cash or a money order, permit the check to be deposited, or attempt to renew the loan by paying another fee. If the borrower cannot pay off the loan, the obligation continues to accrue \$17.50 in interest every two weeks. Although the initial \$17.50 fee represents only 17.5 percent of the loan amount, the annual percentage rate of the transaction is around 456 percent.²¹ In comparison, the average reported interest rates of mafia lenders in New York City during the 1960s was a relatively inexpensive 250 percent.²²

Surprising to some, a 456 percent APR loan is not unusual. Because the federal government does not collect data on payday lender interest rates, there are no firm nationwide statistics showing payday loan prices. However, studies by state agencies, consumer advocates, and academics regularly suggest *average* payday loan annual percentage rates are roughly between 391 and 550 percent. In the quick cash, no credit check, easy money, storefront credit shops that line America's strip malls, loans with quadruple-digit annual percentage rates are common. For example, while an Indiana Department of Financial Institutions survey found the average Indiana payday loan interest rate was 498.75 percent, one company offered a \$100 loan at a \$20 charge per day—a staggering 7,300 percent APR loan. North Carolina consumers purchase about 63 percent of their payday loans at annual interest rates between 406.08 percent and 805.15 percent. Payday lenders in Salt Lake City charge an average rate of 528.49 percent. A consumer advocate coalition study surveying lenders in nineteen states and the District of Columbia found an average payday loan interest rate of 474 percent.²³

Moreover, these calculations of average interest rates severely underestimate the true prices of payday loans. Payday creditors typically charge other unexpected fees in the course of a normal loan. For example, insufficient funds fees applied to normal

bounced checks also apply to payday loan checks. Usually both the payday lender as well as the debtor's bank or credit union will charge the debtor separate fees for bouncing a loan check. Some lenders will require debtors to give two separate checks for one loan so when the debtor defaults, the lender can collect two insufficient funds fees. These insufficient funds fees can be as expensive as the interest on any given payday loan. Some creditors will charge an insufficient funds fee every time they attempt to deposit the original loan check, usually once every two weeks. For example, if a lender charges a \$25 insufficient funds fee on a \$100 loan carried for a typical six months, the contract will oblige the debtor to pay an additional \$300 above and beyond the disclosed interest rate.

However, insufficient funds fees are hardly the only culprit. Hidden fees are limited only by the lender's imagination. For example, Check City, a Utah payday lender, includes in its boilerplate contract a \$75 per hour "collection fee" for time expended collecting a loan. The contract is silent on how much time the creditor may take. And, to help ensure the lender can pocket this independent fee, the contract states, "I authorize Check City . . . , at any time on or after the due date of my loan or payroll advance, to initiate a charge to any checking account of mine, by electronic funds transfer or otherwise, for the unpaid amount of my loan, including interest, all costs and expenses of collection (including attorneys fees) and late and returned check charges."²⁴

Many states have usury laws limiting interest to around 36 percent annually. In these states the payday lending business is conducted by evading interest-rate caps. Such evasion is easier and more common than it sounds. Currently, one common loophole involves "charter renting." Payday lenders interpret federal banking law to exempt nationally chartered banks from state interest-rate caps. Payday loan companies form relationships with federal banks where the payday lender solicits, manages, and issues each

loan, but ostensibly uses the federal bank's funds in exchange for a per-loan fee. The result is that payday lenders often operate with impunity even in states where popularly elected legislatures have passed outright bans on payday lending.²⁵ For example, the New York state legislature has limited interest rates to no more than 25 percent annually. Still, payday lenders linked to out-of-state banks have attempted to offer payday loans within the state. A chagrined New York Banking Department superintendent recently complained "banks that choose to offer this type of loan product at exorbitant interest rates are blatantly abusing [federal] authority. These types of actions, when judged in the court of public opinion, can lead to a groundswell of outrage resulting in reputational harm and safety and soundness problems."²⁶ But despite this and similar complaints around the country, payday lenders attached to even the most insignificant of federal banks remain free to charge whatever interest rates they choose.

Payday lenders defend their products by pointing out their loans are intended only to help consumers deal with short-term cash shortfalls. They argue it is not fair to quote annual percentage rates for loans which only last for one or two weeks. However, what empirical data is available shows payday loans are often in reality medium- or long-term obligations. For example, North Carolina regulators counted the total number of payday loan transactions of given customers at a given company in a year. About 87 percent of borrowers would roll over any given loan at least one time with any given lender. Not counting debtors who borrowed from multiple locations, 38.3 percent of customers renewed their payday loans more than ten times. About 14 percent of borrowers renewed their payday loans with the same lender more than nineteen times per year. Illinois regulators found payday loan customers "who were borrowing continuously for over a year on their original loan." Indiana also found approximately 77 percent of payday loans are rollovers of existing loans. Consumer

advocates have found the average customer borrows 10.19 payday loans per year, with some debtors borrowing many more times. In fact, one debtor renewed 66 times in order to pay off a single payday loan—approximately a two-and-one-half year debt—assuming a typical two-week renewal cycle. Even an industry-funded study found about 40 percent of payday loan borrowers rolled over more than five loans in the preceding twelve months, including about 20 percent of all borrowers who renewed existing loans nine times or more.²⁷

Trouble comes for many debtors after they borrow and they realize how difficult repayment can be on a limited income and paycheck-to-paycheck standard of living. A government study indicates “the average customer is usually a woman in her middle thirties earning just over \$24,000 a year. She usually rents her home and once she becomes a customer of a short-term loan company she usually remains a customer for *at least* six months.”²⁸ Similarly, an informal Florida survey found the typical payday debtor is a twenty-eight-year-old white female who earns between \$14,500 and \$20,000 per year working in the service or health care industries.²⁹ For such debtors, payday loans may become a trap they cannot escape without missing rent, utilities, car payments, or food expenditures. These loans can create a biweekly cycle of income and expenses leaving only enough surplus income to pay the most recent accrual in interest and fees. In the words of the Illinois Department of Financial Institutions:

Industry members who have testified at . . . public Illinois Senate hearings have referred to their customers as average citizens who encounter unexpected financial hardships. What they have failed to mention was that the financial strains placed on consumers were rarely short-lived. Customers playing catch-up with their expenses do not have the ability to overcome unexpected financial hardships because

their budgets are usually limited. The high expenses of a short term loan depletes the customer's ability to catch-up, therefore making the customer "captive" to the lender.³⁰

A leading consumer advocate report goes one step farther saying, "[t]hese loans are designed to keep consumers in perpetual debt."³¹

While industry representatives dispute such claims, Janet Delaney from Alabama might not. She is employed as a hospital food-service worker, making around \$16,000 a year. When she needed \$200 to cover impending bills she turned to a local payday lender. The business loaned Delaney her shortfall for a \$38 fee. But when her next payday rolled around, she still didn't have enough money to cover the check. Instead she rolled over her loan for an additional \$38. A University of Alabama law student who eventually highlighted Delaney's plight explained, "[a] year later, she had paid \$1,220 in fees and still owed \$200. Over a twelve-month period, Ms. Delaney paid 610 percent interest, returning to the payday lender thirty-two times and borrowing from two other payday lenders just to make the fee payments."³²

Many states have responded by passing laws which prohibit lenders from "rolling over" payday loans. State legislators hope these laws will prevent the abuses associated with long-term payday loan debt. However, these restrictions have proven even easier to evade than traditional interest-rate caps. Despite a Utah rule prohibiting rollovers beyond twelve weeks, the author of one study recorded a "refreshingly candid" conversation with a young female cashier at a Salt Lake City check lender. "Brandy" explained "[w]e have them paying for sometimes two or three years. . . . They just have to keep on paying. They will, like, pay for the loan two or three times and still owe the loan."³³ Rollover prohibitions are difficult to enforce, because lenders can structure the transaction to allow the debtor to pay off the old loan with proceeds from a "new

loan.”³⁴ Also, nothing prevents debtors from taking out another payday loan at a different location.

In addition to high prices on longer term payday loans, many have observed a systemic pattern of questionable business practices and state law violations in the payday lending industry. For example, in 718 payday lender inspections conducted over a three-year period, North Carolina Banking officials found 8,911 violations of simple state consumer-protection rules.³⁵ Moreover, many commentators have complained payday lenders manipulate the criminal justice system to help collect debts. Ambiguous fraudulent check laws and theft statutes in many states allow payday lenders to threaten criminal prosecution for writing “bad” checks.

Payday lenders in Ohio, for example, sue under the “Civil Damages for Crime Victim” statute . . . which provides triple damages to victims of theft offenses, including bad checks. Inspection of court records in Dayton Municipal Courts Division over eight months in 1999 found 381 actions by five payday lenders. Defaulting customers were charged triple damages, 10 percent interest on the damages, and court costs. The total dollar amount for the judgments from all 381 cases was \$285,406. In 60 percent of the cases, wages were garnished.³⁶

Similarly, a Texas regulator testified that in only one year, payday lenders filed 13,000 criminal charges against their customers in one Dallas precinct. Of course, payday lenders know perfectly well debtors are signing checks which cannot clear when written—a cash shortage is the whole premise of payday loans. But even in states which prohibit criminal justice action, a hollow threat of prosecution by a county attorney can provide enough leverage and fear to accomplish the same objective. It goes without saying traditional creditors such as banks, credit unions, and savings and

loan associations, unlike payday lenders, cannot use the criminal justice system to collect their bad debts.³⁷

Fueled by these and other remarkably profitable trade practices, the payday lending industry has exploded. Although the business of selling short-term credit at high prices has an old pedigree, the relatively young version of securing debt with personal checks has grown exponentially in the past two decades. In North Carolina, payday lending outlets roughly quadrupled in four years, growing from 307 in 1997 to 1,204 in 2000. Payday lending outlets quintupled in Salt Lake City between 1994 and 2000. Wyoming payday lenders tripled between 1996 and 1997. Iowa's payday lenders increased from eight to sixty-four in two years. Colorado officials have estimated payday lenders have grown to make up 20 percent of that state's licensed lenders. One Wisconsin consumer advocate observes, "[t]he payday lenders are moving in by the day here. . . . We're watching it happen."³⁸ An explanation for this growth is not difficult to find. By one estimate in the late 1980s, opening a payday lending outlet required an initial investment as small as \$65,000 and could create before-tax returns of \$117,000 in a single year.³⁹ The Tennessee Department of Financial Institutions "reported to its state legislature that licensed payday lenders earned over 30 percent return on investment in the first nine months of legal operation."⁴⁰ One economics professor estimates check cashing/lending operations earn ten to twenty times higher return on equity than traditional banks.⁴¹ Summarizing this trend, John D. Hawke, U.S. Comptroller of the Currency, recently pointed out "there are now more payday loan offices in California than McDonald's and Burger King restaurants."⁴²

Neither does this astounding growth appear to be slackening off. A recent trade association convention drew standing-room-only crowds for those interested in converting other businesses into payday loan outlets. This continuing growth will inevitably affect our culture and change the assumptions we hold about fi-

nancial services. For example, in Louisiana, a company called Mr. Payroll has teamed up with Circle K convenience stores to sell payday check loans alongside fountain drinks, gasoline, and Twinkies. Not to be outdone, Utah regulators have issued a payday loan license to Atlantis Burger, allowing debtors to purchase triple-digit-interest-rate loans while stopping off for a hamburger. Some predict payday loans will soon be offered through ATM terminals. Finally, the Illinois Department of Financial Institutions warns the payday loan market may grow an additional 600 percent in the coming decade.⁴³

The Venerable “Hock Shop”

Pawnbrokers are the veterans in the high-cost credit market. For a variety of reasons, some not related to credit, pawnbrokers have faced a continuing struggle to improve their public image dating back thousands of years.⁴⁴ First, fairly or not, pawnbrokers are associated with stolen goods. Many jurisdictions require identification and thumbprinting of pawnshop customers to discourage resale of stolen property. Similarly, pawnshop gun sales, sometimes in questionable compliance with federal gun control laws, do not help reputation-building efforts.⁴⁵ Pawnshops have also often been associated with gambling, as well as adult bookstores, strip clubs, and liquor stores. Pawnbrokers in close proximity to casinos tend to do brisk and steady business by financing gambling binges and reselling pawned merchandise to winners. One Massachusetts pawnbroker describes regularly taking out ads saying “Lose to the bookies? Come see us!”⁴⁶ A surprisingly common municipal squabble involves local planning commissions or city councils harassing pawnbrokers with restrictive zoning ordinances.⁴⁷

But most important of all, critics accuse pawnbrokers of using credit to profit from the misfortunes of the impoverished. Usually consumers seeking pawn credit are highly cash-constrained. A re-

cent survey indicated 69 percent of pawnshop customers had been more than 60 days late in paying some bills during the previous year. 70 percent had been contacted by a debt collection agency. And “16 percent had their wages garnished within the previous two to three years for a purpose other than child support,” according to one researcher.⁴⁸ One pawnbroker, owner of the Happy Hocker in Cleveland, Ohio, estimates that at least 80 percent of his customers do not have bank accounts.⁴⁹ Almost all pawn debtors lack the credit history and real property security to obtain cheaper credit from banks or credit unions. In the words of the CEO and founder of Cash America, Inc., the nation’s largest pawnshop chain, “I could take my customers and put them on a bus and drive them down to a bank and the bank would laugh at them. That’s why they’re my customers.”⁵⁰

Although some pawnshop customers only shop at pawnshops for negotiable prices on second-hand consumer goods, loaning money is the backbone of most pawn operations. Typical pawn loans are very simple transactions where the creditor provides a fixed-term loan to a customer who leaves a personal item in the possession of the lender as collateral. After the customer repays all the required interest and fees, the lender will return the security to the borrower. The majority of customers return and reclaim their goods. Veteran pawnbrokers estimate 45 out of 50 borrowers will eventually succeed in redeeming their security. A leading scholar on pawn credit comparably estimates 10 to 30 percent of borrowers default on their pawn loans. Pawnbrokers’ interest rates vary with the regulations of different states and localities. In states with unregulated markets, pawnshop interest rates average around 240 percent APR. But in states with active interest-rate regulation, such as Oregon, charges can reach as low as 40 percent annually. Nevertheless, in Texas, which boasts more pawnshops than any other state and also regulates pawn charges, the average annual rate is around 200 percent. Although no national data is available,

Cash America, with 420 shops in eighteen states around the country, extends pawn credit at an estimated aggregate average annual interest rate of 205.3 percent.⁵¹

One positive feature of pawn credit is its tendency to be naturally short-term and terminal. Unlike payday loans where consumers often are forced to repay their loans over relatively long periods, a defaulting pawn debtor simply forfeits the personal item left with the pawnbroker as collateral. On the other hand, pawn customers do not have access to the goods which secure their loans. When a customer pawns a television set or diamond ring this may not be serious. However, the most secure loans are those where the customer cannot get by without the collateral. "I've seen people take their dentures out of their mouths before," explains Steve Anderson, manager of ACME Pawn in Colorado Springs, Colorado. "One guy took his gold tooth out of his mouth and we took that."⁵²

Often the only items a working-class family owns which will obtain the necessary credit are tools. This can leave carpenters, auto mechanics, and other self-employed and journeymen workers without the means to conduct their trades. For instance, the Wichita, Kansas economy relies heavily on manufacturing of airplane parts. When the market for air travel dried up following the September 11, 2001 World Trade Center and Pentagon terrorist attacks, local pawnbrokers reported an "onslaught" of machinist tools from laid off aerospace workers.⁵³ Unfortunately, many workers have difficulty finding employment again since they must pay back their loan, plus a stiff premium, before reclaiming their tools. Undoubtedly, this phenomenon is nothing new and has caused untold misery for thousands of years. Thus, the biblical injunction in Exodus exhorting, "if you take your neighbor's cloak in pawn, you shall return it to him by sunset, because it is his only covering. It is the cloak in which he wraps his body; in what else can he sleep?" While few contemporary Americans pawn clothing, the profit motive which spawned the ancient dictum is not lost on Wall Street. In the twenty days follow-

ing the September 11, 2001 terrorist attacks the Dow Jones Industrial Average lost 8 percent, the NASDAQ lost 12 percent, but Cash America saw the price of its publically traded stock jump 8 percent in the opposite direction as traders clamored for opportunities to weather the impending downturn. A headline on one daily business newspaper offered the financial advice: “Get Into the Pawnbrokers for Hard Times Ahead.”⁵⁴

Although the bursting of the American technology bubble undoubtedly gave pawnbrokers a shot in the arm, the industry has been growing steadily for the past twenty years. Low-to-moderate income consumers have lost access to banks and credit unions since the late seventies, so they have naturally moved to pawnshops for their financial needs. Moreover, pawnbrokers themselves explain widespread overextension of lower-middle-class debtors has forced increasing numbers to turn to a formerly unthinkable source of credit to overcome income shocks and unexpected expenses. “Our business is at an all-time high,” explains Tony Mills, owner of Big Time Pawn in Tulsa, Oklahoma. “There are a lot of people in serious debt . . . and then, if they lose their jobs . . . they are bringing in things to get quick cash.” In the 1980s alone, the number of pawnshops nationwide *more than doubled*. Although the greatest number of pawnshops per capita are in the southern and mountain states, some northeastern and far west states have experienced dramatic pawnshop growth as well. For example, Pennsylvania saw a 130 percent increase in pawnshop licenses between 1980 and 1991. While pawnshops grew slightly less quickly in the 1990s than in the 1980s, the explanation given by most pawnbrokers is not particularly heartening—competition from payday lenders.⁵⁵

Rent-to-Own Resurgent

Another important player in the high-cost consumer credit market issues credit akin to pawn loans. Rent-to-own lenders lease ap-

pliances, furniture, electronic equipment, and occasionally jewelry for weekly payments. If a customer successfully makes payments for a specified duration of time, the rent-to-own store transfers ownership of the item to its customer. Rent-to-own contracts vary from around fifty to one hundred and fifty weeks with seventy-eight weeks being the norm. More expensive items usually rent for longer periods. Typically, customers can return an item at any time, ending the arrangement. Rent-to-own purchase prices are usually two or three times the retail value of the good. Moreover, because a significant portion of rent-to-own merchandise has been used previously and then repossessed, the actual depreciated value of the items is much less than normal retail value. Contracts also typically provide for a number of ancillary charges such as late payment fees, rental contract reinstatement fees, and rental property retrieval fees. Rent-to-own firms also sell renter's insurance plans which prevent the firm from suing the customer if an item is lost or stolen. But, unlike normal insurance, the lost item is not replaced. A "vast majority" of customers sign up for these protection plans. About 95 percent of customers borrowing from Rent-A-Center, which in 1993 controlled 25 percent of the 2.3 billion dollar U.S. market, purchased such insurance, generating 29 million dollars of revenue.⁵⁶

The industry vociferously maintains rent-to-own contracts are not loans. In support of this notion, the industry has consistently claimed only 25 to 30 percent of transactions result in purchases. However, according to the most comprehensive study available, conducted by the Federal Trade Commission, about 67 percent of rent-to-own customers intend to purchase the merchandise, 8 percent were unsure of their intentions, and only 25 percent intend to rent items for a short while and then return them. Moreover, FTC data indicates rent-to-own transactions more closely resemble loans than leases since "70 percent of rent-to-own merchandise was purchased by the customer." Thus, while rent-to-own dealers describe the transaction as a traditional lease with a bonus

of ownership provided as an incentive to renew, in reality the transaction is more like a chattel-secured installment loan with high interest and foreclosure rates.⁵⁷

Nevertheless, the rent-to-own industry has aggressively lobbied state legislatures around the country to avoid regulation under consumer credit laws. In the past fifteen years, forty-six states have passed industry supported legislation treating rent-to-own transactions as leases over the objections of consumer advocates. The industry has also pressured Congress for separate lenient treatment. Hiring some of the nation's most expensive lobbyists, the rent-to-own industry hopes to wipe out state laws by passing a relatively weak federal bill posing as consumer protection. Even in a Congress focused on alleviating an impending recession following the September 11 terrorist attacks, rent-to-own lobbyists were still hard at work trying to pass legislation to preempt laws in New Jersey, Minnesota, Wisconsin, and Vermont, which still treat rent-to-own business as a credit transaction.⁵⁸ Rent-to-own stores have a strong social incentive to avoid characterizing their contracts as loans since, when viewed as credit, rent-to-own contracts are typically one- to three-year loans with annual interest rates ranging between 70 percent and 360 percent. Most commentators estimate the national average rent-to-own APR is somewhere around 100 percent.⁵⁹

The rent-to-own industry commonly practices aggressive and direct marketing tactics. The comments of Gerald Defiore, a former store manager from Spartanburg, South Carolina provides insight on one of many marketing tactics:

You would brochure the projects one week before the [welfare] checks came out so you already had that seed planted in their mind. . . . Then the day the checks came out, you'd go back and knock on doors and fill out the work forms there. Corporate was in on it, the stores were in on it. These people didn't stand a chance.⁶⁰

Comparably, the Rent-A-Center headquarters in Wichita, Kansas uses the six references required to open a rent-to-own agreement for marketing purposes. Individual stores only contact two of the references in determining whether to rent to the customer, using the other four references as marketing contacts to send mailings to. Thus, entire extended families are targeted by advertisements with opening lines like, "Wouldn't you rather watch a big screen TV than the one you have now?"⁶¹

Rent-to-own stores usually emphasize courteous treatment of prospective customers. One industry CEO said that the rent-to-own industry "treats them [customers] like kings and queens." Employees of one firm "are required to greet customers, preferably by name, within ten seconds of their entrance and to conduct payment disputes out of earshot of other renters. Stores are also encouraged to keep fresh coffee brewing."⁶² However, rent-to-own contracts require substantial collection efforts. Stores will generally contact renters/borrowers a day or two after a missed payment. Personal visits to the homes of debtors are standard practice after as few as three days of arrears. Stores generally repossess items after a week of delay. The collection process has traditionally been vulnerable to abuse and misbehavior. A small but significant percent of rent-to-own repossessions are completed by breaking in to the customers' homes. The contracts of one leading rent-to-own company includes a boilerplate provision which attempts to sanction entry into the customer's residence even when the customer is not home. The Federal Trade Commission estimates about 7,000 of these break-in repossessions occur each year. One Nebraska rent-to-own customer mistakenly shot and killed a repossession agent, believing the man was a burglar.⁶³ "Employees handling repossessions have been known to bring along members of a feared motorcycle gang as well as to vandalize customer's homes, extract sexual favors from strapped customers and even, in one instance, force a late payer to do involuntary labor." Particularly infamous are so-

called “couch payments,” or extracting sexual favors at the homes of renters in lieu of repossession or cash payment. The Rent-A-Center CEO

acknowledges that abuses such as couch payments occurred in the past and “are probably going on today.” There are simply “more control problems” in a business where the activity takes place out of the store, he says. But the company stresses that such abuses are “few and far between” and not “in any way condoned by Rent-A-Center.”

However, one reporter interviewed twenty-eight former store managers of Rent-A-Center—six admitted the practice occurred in their areas.⁶⁴

Like payday lenders and pawnshops, rent-to-own operations have grown quickly in the past two decades. Fortune Magazine recently listed Rent-A-Center, the nation’s largest chain with 2,400 stores nationwide, as one of the 100 fastest growing companies in the United States. In one year Rent-A-Center pulled in \$1.7 billion dollars in revenue. Moreover, the highly profitable industry has undergone substantial consolidation with Rent-A-Center and the next largest chain, Rent-Way, owning more than half of the market. Both of these companies roughly doubled in size in 1998 alone. Since 1982 the number of rent-to-own outlets nationwide grew from around 2,000 to approximately 8,000 at the turn of the century. Thus, our nation’s rent-to-own stores have quadrupled in only twenty years.⁶⁵

Car Titles and the “Repo-Man”

There are many different ways to use automobiles as collateral for credit. The most obvious is borrowing the purchase price of a new or used car. Traditionally, car buyers arrange their own fi-

nancing through a bank or credit union. However, car dealers often help buyers avoid the trouble of arranging their own financing by partnering with lenders to offer financing packages to approved customers. In the high-cost credit market, car dealers catering to buyers with problematic credit histories often hold car loans themselves, allowing them to repossess at will and then quickly resell the car. These lenders draw customers in need of transportation with promises such as “good credit, bad credit, no problem,” “no credit check,” “no hassles,” “no money down,” and perhaps more surreptitiously, “low introductory rate.”

Cars and trucks are also used to secure credit not related to the purchase of the vehicle. Car title lenders or auto-pawnbrokers loan money to cash seeking consumers who own their cars. Some lenders require the borrower to turn over the car, which is then stored on a fenced lot until repayment. But, the great majority of non-purchase price auto lenders simply hold the car title—and a copy of the keys. The latter strategy is more common because it allows customers to borrow on what may be their only significant asset without losing access to convenient transportation. Typically, car title loans contracts provide that the debtor relinquishes ownership of the car upon a single missed payment.

There is a broad range of interest rates on high-cost car loans. Mainstream bank or credit union car-purchase loans fluctuate in the neighborhood of 10 percent APR, depending on the length of the loan and whether the car is new or used. But borrowers with problematic credit histories typically pay two or three times as much. Average car title and auto-pawn loans cost between 200 percent and 300 percent APR, but can reach as high as 900 percent.⁶⁶ Like payday lenders, car title lenders use creative charades to evade state interest-rate caps, where they exist. For example, some companies claim they are buying cars from the customer and then selling them back at a higher price. One journalist notes, “[t]hey have trouble, however, explaining why the customer con-

tinues to drive the car he just sold.”⁶⁷ Moreover, like other high-cost creditors, car lenders often use contracts with stiff penalties for late payment, repossession, bounced checks, and more.

While interest rates tend to be less for car-secured credit than unsecured credit, such as payday loans, interest rates alone often do not represent the true price debtors pay. Some car title lenders thrive less on the interest rates they charge than upon repossessing cars. Jeanette Greco’s story is not unusual. When Greco’s husband died his estate became tied up in court. The New Port Richey, Florida woman needed cash to pay her son’s tuition, so she decided to take out a title loan on the almost-new car her deceased husband had given her as a present. The lender required Greco to turn over the title to the \$30,000 specially-ordered Dodge Stealth in exchange for her \$1,000 loan. After making faithful payments on what turned out to be a 500 percent APR secured loan for several months, Greco’s father suffered a heart attack in Puerto Rico. Greco missed several of her weekly payments when she traveled to Puerto Rico to take care of him. When she returned the car was gone, along with all of the family Christmas presents she had been storing in the trunk. While she never saw the Christmas presents or her car again, court records indicate the car was sold at auction for \$3,500. The lender did not even rebate auction proceeds in excess of the Greco’s remaining debt. Despondent about her options, Greco observed, “lawyers cost twice as much as what you pawned the car for.”⁶⁸

Title loan contracts often allow repossession after only one day of arrears. Even in states which require the repossessing lenders to rebate the excess value of the car beyond the outstanding debt, lenders may quickly sell the car at less than its fair value rather than find a buyer willing to pay a fair price for the car. Repossessing creditors also have a strong financial incentive to “sell” the car at less than its market value to a subsidiary holding company or to an individual in a financial relationship with the lender. Cloaked

by a nonexistent transaction, the creditor can claim no proceeds are left over to rebate to the debtor, when in reality the creditor keeps both full repayment of the loan and the collateral. In states where there is no rebate requirement, or where the requirement is not vigorously enforced, creditors simply resell repossessed cars at fair market value and keep all of the proceeds. Many car title lenders also have car dealer licenses. Regardless, some lenders loan to title debtors who are *likely* to default, in order to find creative ways to capture the value of the car.

Unsurprisingly, many car title debtors become desperate to avoid repossession. Like all car owners, car title debtors use their vehicles as transportation to and from their jobs, to drive their children to school, or to visit sick family members. Many car title debtors face unemployment if their car is repossessed. When Debra Lusan, a working mother from St. Louis, fell behind on day-care payments for her two children, she took out a \$600 title loan. After paying \$900, she had long since lost track of how much the title lender claimed she owed, but she still kept on paying. "I just want to get my title back," she explained.⁶⁹ Many car title debtors undergo privation, sacrificing food expenditures, utility payments, and health care treatment, rather than lose access to transportation.

Another problem with high-cost automobile credit comes from the rapid depreciation in the value of cars. When consumers purchase new cars with reasonably priced financing, the car is likely to provide reliable transportation long after the loan is repaid. But where working-poor consumers buy used cars with high-priced credit, the loan often outlives the car. Accidents and breakdowns can make cars functionally worthless while the buyer still owes thousands of dollars borrowed at high rates. Because few working-poor families can manage two car payments, the buyer is left without reliable personal transportation.

Equity Predators: The Market for High-Cost Home and Mobile Home Credit

The market for home loans has increasingly become the subject of a widespread national debate over wealth inequality, racism, and exploitation of the elderly. For most families, home ownership is the key to long-term financial stability. Many commentators believe relative disparity in home ownership is essential to understanding contemporary American racial inequality. For example, at the height of the 1990s growth economy, approximately 71 percent of whites were homeowners compared to only 44 percent of blacks.⁷⁰ Moreover, a longstanding dispute exists over whether mortgage lenders discriminate, either intentionally or unintentionally, against minority loan applicants. Because homes are so important and costly, most American families spend their lives attempting to pay off home mortgages. The federal government has provided valuable tax incentives and subsidies to encourage and facilitate this process. State and local governments have also attempted to aggressively regulate the market for home-secured loans, often leading to conflict over which level of government is the appropriate source of homeowner protection.

In the last five years this mortgage lending debate has focused on the subprime market and particularly upon home-secured loans consumer advocates describe as “predatory.” Lenders classify debtors based on their credit histories into categories ranging from “A” to “D.” Prime loans are those extended to customers with “A” credit histories. The subprime market services borrowers with “A-,” “B,” “C,” and even “D” credit histories. The government-sponsored enterprises Fannie Mae and Freddie Mac purchase most prime mortgage loans from lenders who originate the loans. These two companies either hold conventional prime loans themselves or bundle and resell them as securities to Wall Street investors. Although recently Fannie Mae and Freddie Mac have begun purchasing some A- loans, in general, both have strict underwriting

standards and pay similar prices for all the loans they purchase. This, along with front-end competition for borrowers, stabilizes the prices prime-market lenders charge. Subprime lenders, however, resell their loans to many different places and often will hold and service the loans themselves. As an industry insider explains, “[t]hat means subprime originators have much more leeway when it comes to setting rates and underwriting standards. As a result, rates, fees, and program guidelines vary drastically depending on which broker or lender a consumer visits.”⁷¹

The boundaries between legitimate sub-prime loans and predatory mortgages are difficult to draw. California-based Ameriquest Mortgage Co., one of the nation’s leading subprime lenders, exemplifies the conundrum. While Ameriquest has donated generously to consumer education funds and other charitable causes, its credit record is perhaps even more checkered than its customers’. In 1996 Ameriquest paid four million dollars to settle a lawsuit brought by the Department of Justice which claimed its brokers charged higher fees to women, seniors, and minorities than to young white males. In 2000, the community activist group ACORN filed a complaint with the Federal Trade Commission alleging the company consistently misleads its customers about the true costs of interest rates and fees. Recently, company detractors stormed an Ameriquest branch location. While employees hid in a back office behind a locked door, the protestors marched around chanting “people over profits” and “no more loan sharks.” To underscore the point, one protestor wore a shark costume.⁷²

Apologists argue these attacks are undeserved and point to Ameriquest as a relatively progressive leader in the subprime market. For instance, after the ACORN protests Ameriquest adopted a ten-city pilot program which provides home ownership counseling to potential borrowers. The company would even counsel potential customers to shop around for the best deal.⁷³ But consumer advocates remain skeptical. So too does Ward Adams from An-

chorage, Alaska. Last year Adams, an out-of-work carpenter and a veteran, fell behind on his bills and was looking for some way out. Ameriquest offered to pay off his credit card debts if he would agree to refinance his family home with them. Ameriquest mailed all of the necessary documents, which Adams admits he did not understand. An Ameriquest representative who claimed to have lived in Anchorage for eighteen years “would call me up and we’d [small talk] like he was my best friend over the phone. He was calling me constantly, sometimes just to [chat].” Adams was ready to sign the contract, but thought twice when he realized the representative “didn’t know any of the crossroads or anything about Anchorage.” Adams talked to some real estate friends and a non-profit consumer debtor counseling service, both of whom admonished him not to sign. The Ameriquest loan would have nearly doubled the interest rate of Adams’ federally subsidized 7 percent Veterans Administration loan. His mortgage payment would have increased about \$350 a month. “How am I going to pay that? There would be no way,” Adams explained his shock, “It was spooky. . . . I was down to the wire—all I had to do was sign the paperwork and send it back.”⁷⁴

While Ward Adams may have narrowly avoided losing his home, horror stories of those not so lucky have come to permeate the nation’s newsprint media and policy rhetoric. For example, in 1990, 71-year-old Lula Mae Rosser owned the small Atlanta home where she had lived for forty years. She agreed to a \$12,500 loan at 16.9 percent APR to finance the repair of her decaying roof. Over the next decade the same lender, Better Homes Co., refinanced the loan two additional times, eventually driving the amount owed up to \$30,000. A disabled former housekeeper, Rosser lived on her \$463-a-month social security income. After the final refinancing, the monthly payments amounted to \$365—almost 80 percent of Rosser’s monthly income. Traditional prime lenders avoid lending to families with income-to-payment ratios

greater than 28 percent. Inexplicably, the loan application forms incorrectly listed Rosser's income at \$664 per month. By January of 2002, she had declared bankruptcy to at least temporarily prevent Bank One, who had purchased the debt second hand from Better Homes, from foreclosing on her only shelter.⁷⁵

Although there is no bright line determining when a subprime loan becomes a "predatory" loan, most agree the distinction turns not only on contract terms but also on the borrower's circumstances. A high interest rate loan might provide a young dual-income family with a needed opportunity, but the same loan could be a devastating financial blow to an elderly widow, such as Rosser, with a fixed social security income. Still, there are many loans and practices which almost all impartial observers agree are predatory. Federal Reserve Board Governor Edward Gramlich has labeled as "predatory" lending to borrowers who have no ability to repay the debt, inducing a borrower to refinance a loan repeatedly, and concealing the true nature of the contract from an unsuspecting or unsophisticated borrower. Other suspect practices include packing loans with excessive single premium credit life insurance, negative amortization, unnecessarily high balloon payments and prepayment penalties, refinancing low-cost or subsidized home loans, inflated appraisal and credit report fees, yield spread premiums, mandatory binding arbitration clauses, and marketing practices targeted by race or age rather than credit history. What victims of predatory lending do not understand until too late is that in a typical high-cost home loan transaction the interest rate is often a relatively unimportant factor in the true price of the loan. The heart of much criticism over high-cost home-secured lending is that many lenders seek to capture home equity rather than a return on their investments.⁷⁶

For instance, multiple refinances—or "flips"—offer high-cost home lenders an unparalleled opportunity to strip homeowners of home equity. At each new refinancing the lender collects another

round of points and other miscellaneous closing charges, almost always including a new credit insurance policy. When a borrower falls behind on payments, many high-cost home lenders will use the situation to flip the loan. The lender might explain, “we see you have been late on your most recent payment. If you could use some extra cash right now, why not refinance your loan and take advantage of our temporary low introductory interest rate.” The sales agent never mentions that refinancing triggers a prepayment penalty and other charges costing thousands of dollars. Because cash-strapped delinquent borrowers are eager to cooperate in order to prevent additional late payment penalties or foreclosure proceedings, they are easy fodder for sales staff paid on commission. Because these charges do not come out of the borrower’s pocket, debtors often do not understand the true cost. Rather, the charges are added on to the total amount the borrower owes on the home. Or—put a different way—these charges are deducted from the equity the borrower has built up in the home over time. Predatory lenders commonly include a small amount of cash as proceeds from the new loan to help encourage borrowers to sign. The unsuspecting but satisfied borrower walks away with a few hundred dollars in his pocket and no idea he has just been taken for thousands. After only a few flips, borrowers can lose a lifetime investment in home equity, never having realized the true consequences of their contracts. A borrower may have spent hundreds of thousands of dollars on the home, but when it comes time to sell—or when foreclosure proceedings begin—the borrower owns nothing.

High-cost manufactured home credit poses special problems for vulnerable debtors. Manufactured home loan interest rates are generally two or three percentage points higher than conventional home loans for borrowers with comparable credit histories. Moreover, the value of manufactured homes tends to depreciate, more like an automobile than conventional housing. But unlike car loans, which typically last no more than five years, manufactured

home mortgages last fifteen, twenty, or even thirty years. Also, manufactured home buyers tend to lease rather than buy plots for their homes, leaving any appreciated value in the real estate itself for the landlord. Soon after the contract is signed, many borrowers find their manufactured home is worth nowhere near as much as they owe. The homeowner becomes trapped not only in the loan, but also within a manufactured home park. Because it typically costs around \$7,500 to move a “mobile” home even a short distance, park owners can dramatically increase plot rental fees or require expensive lot improvement charges after a homeowner has moved in. Manufactured homeowners have a median household income of only \$23,000 per year and an average age of 52.7 years. Typically, they live check-to-check lifestyles, forcing them to accept monthly rent increases since they cannot afford the one-time up front cost of moving their homes. Manufactured homeowners may alternatively seek refinancing to relocate, subjecting them to another round of points and probably a prepayment penalty, all of which leave them even deeper in debt.⁷⁷

Furthermore, recent investigations and studies have exposed widespread fraud, inflated pricing, and a variety of other unscrupulous practices throughout the manufactured home finance market. One study analyzed more than 400 manufactured home consumer complaints filed with the Texas Attorney General. The study found sales staff commonly falsify loan application information in order to qualify eager buyers who cannot realistically afford homes. Alternatively, many dealers will lend the borrower nearly all of the down payment, which is then incorporated into the home loan. These practices lead to high default rates. But, because many lenders are affiliated with home manufacturers, they share an interest in high sales volume as well as economies of scale in repossession proceedings. Moreover, if a debtor tries to assert her rights in court, the lender may hamstring the borrower’s legal position by claiming the borrower committed fraud against the

lender. These dealer practices drive responsible lenders out of the manufactured home finance market and secondary market since these lenders cannot accurately measure the quality of their investments. Moreover, because manufactured home buyers are usually locked into a contract before their home is delivered, dealers have little incentive to carefully install the home—leading to substandard housing. Many manufactured home buyers complain their homes are never set up properly, lack specially ordered features, or are even different models than those displayed by the dealer. And, if a borrower refuses to accept the delivered home, dealers sometimes retaliate by reporting or threatening to report the borrower to credit bureaus. Many manufactured home lenders and dealers conduct scrupulous businesses. But with approximately 8 percent of the United States population residing in around 9 million manufactured homes, unfair manufactured home lending is a surprisingly large and neglected problem.⁷⁸

The market for subprime and manufactured home mortgages grew rapidly in the 1990s. Federal Reserve Board researchers explain that between 1993 and 1998 “subprime and manufactured home lenders’ share of conventional purchase mortgages extended to lower income and minority borrowers tripled (quadrupled in the case of Hispanic borrowers) . . . reaching levels of one-fifth to one-third.” In the same five-year period the annual shipments of manufactured homes grew about 47 percent, as compared to annual increase of only 24 percent in conventional site-built homes. While this increase is in part due to growing variety in manufactured housing styles and amenities, it is also due to a growing proportion of the American population groping for financial solutions for lives on the edge of solvency. For instance, African Americans are increasingly turning to manufactured homes instead of conventional homes. Between 1993 and 1998 the proportion of African Americans applying for home purchase mortgages from manufactured home lenders rather than conventional home

lenders more than doubled from 20 percent to 42 percent.⁷⁹ No data exists which casts light on the proportion of subprime and manufactured home loans fairly considered predatory. However, if interest rates and other credit charges do provide a fever chart of economic health, recent trends both in the home mortgage market as well as the market for other forms of high-cost credit suggest a significant threat for many vulnerable Americans.

THE SYMPTOMS OF DEBT FEVER

High-cost debt can have a devastating impact on the lives of debtors and their families. While the consumer credit industry in general accounts for nearly 87 percent of debt listed in bankruptcy, no reliable data estimates what proportion originates from alternative finance lenders.⁸⁰ Generally the more disposable income is spent on debt, the greater a household's chances of bankruptcy are. Therefore, it is not surprising that bankruptcy has grown in step with increases in consumer debt.⁸¹ Bankruptcy is intended by law as a last-resort method of discharging unpayable debts. It is also intended to give debtors a fresh start to allow them to continue to function as productive members of society.⁸² However, a great deal of stigma and moral judgment are attached to declaring bankruptcy. It is the legal and moral equivalent of declaring oneself a financial failure, and undoubtedly shatters the self image of many who take the option. As the nation's leading bankruptcy scholar explains, "everyone wants to be a success in the American competition for prosperity; bankruptcy singles out those who did not make it. . . . We should be haunted by questions of why so many Americans are losers in the great financial game of life."⁸³

Similarly, home foreclosures associated with high-cost mortgage credit can tear families and communities apart. One congressional representative persuasively explained, "[i]f owning a home is the American dream, then the threat of losing that home is the Amer-

ican nightmare. . . . The human costs of mortgage is startling. A family's life savings and a major part of its earnings, understandably, is often tied up in its home. For many, losing their home is an event from which they will never recover."⁸⁴ Foreclosure uproots the social links between people. Children are usually forced to change schools. Commuting to and from places of employment often becomes more challenging. New living arrangements are almost always less convenient, healthy, safe, and emotionally satisfying. Many families are forced to bounce from home to home of families and friends until a new job or apartment can be found. Because home ownership defines "social personhood," home foreclosure destroys the self image and social embedding of families. In the worst cases, new living arrangements are found only in a homeless shelter, in a family car, or on the street.⁸⁵ Statistics for the causes and numbers of homelessness are notoriously difficult to establish, but few see that problem as independent of home foreclosure, and foreclosure is certainly not independent of high-cost lending. What we do know is that increases in home foreclosure have tracked the "explosive" growth of the high-cost lending market. U.S. Census Bureau data shows that in the past twenty years, the number of home foreclosures has increased by more than 384 percent—almost *quadrupling*—despite two decades of fast aggregate economic growth.⁸⁶

However, defaulting high-cost debtors do not always face events that culminate in a single crisis point such as foreclosure or bankruptcy. For many the collection process and worry over the impending risk of these more cataclysmic events are the sources of great suffering. One study asked debtors in default on mortgage payments how they felt when they realized they had missed a payment and could not make it up. The nearly universal response was shock and fear. Some of the typical answers were: "I panicked, cried." "We worry sick about it. It scares us to death." "Well, it was a shock . . . I went a bit berserk really. . . ." "I felt ill, I remember

the shock. I thought ‘where the hell are we going to find the money from?’”⁸⁷ These concerns are mirrored in dramatic increases in the number of support and therapy groups dedicated to helping those living in debt. For example, Debtors Anonymous, a support and therapy system based on Alcoholics Anonymous, first appeared in 1968 in New York. By 1998, twenty separate weekly Debtors Anonymous meetings were listed in the Washington, D.C. area alone. As the high-cost credit industry has exploded so too has Debtors Anonymous, which now lists at least 500 therapy groups in the United States, as well as additional groups in thirteen other countries.⁸⁸

In high-cost lending, where default is dealt with as a matter of course, the tactics used by creditors are often aggressive and the stakes for debtors high. Often creditors use pressure collection techniques which involve frequent calls, demand letters, threats, manipulation, and intimidation. Moreover, federal legislation regulating debt collection has a relatively narrow scope, in addition to enforcement problems. But its chief drawback is that it only covers third-party debt collection agencies. This creates a significant incentive for lenders to collect debts themselves rather than selling the debt at a reduced price to secondhand collectors. Thus, in the high-cost credit market, it is common practice to keep collection activities “in house.” In an industry where profit revolves around how much money can be collected, rather than predictions of credit risk, the incentive to use high-pressure tactics, regardless of the consequences for debtors’ personal lives, is difficult to control. Checks on abuse, either through government-sponsored rules or the good intentions of well-meaning creditors, tend not to overcome this incentive. A culture of disregard for debtors’ emotions and suspicion of debtors’ motivations can gradually build up in even well-meaning high-cost credit organizations.

High-cost creditors focus on pressuring customers into paying, regardless of the consequences payment might bring. The *Con-*

sumer Credit Collector, a monthly newsletter published for debt collectors and often distributed by credit companies to their employees, reflects industry standards in the collection process. The cover page article of one issue entitled: “Pressure As a Collection Tool: Turn Up the Heat to Get Paid,” quotes a typical collector who is having trouble “turning up the heat.” “My manager says I’m too nice to our debtors and don’t know how to get tough when I need to. Actually, I could become much more forceful in my collecting, but I never know when the time is right.” The article goes on to explain what “pressure” in the high-cost credit industry means:

You must convince your customer that you have taken a personal interest in this account and that you won’t be satisfied until the delinquency is remedied. Your customer must realize that this balance is the most important account you have. Once the debtor has accepted these two points, you have applied the necessary pressure that will enable you to get paid.⁸⁹

No room is left for the possibility that debtors simply cannot pay. The culture instead classifies any attempt by the debtor to take this position as merely making “excuses.” Another article in the same issue entitled, “Set Deadlines to Create Urgency,” is illustrative:

It is important for collectors to set deadlines when collecting. Deadlines stress to debtors the urgency of the situation and your seriousness in collecting the account. A deadline also forces debtors to search for sources of repayment immediately and not delay further. . . . every conversation with a debtor should include some type of deadline.⁹⁰

The stresses associated with high-cost debt often lead to serious emotional and psychological trauma. A whole range of depressive

symptoms are part of the normal cycle for those in credit trouble, including sleeplessness, anxiety, aggression, frequent crying, increased alcohol intake, and weight loss. Moreover, “[d]efault debtors blame themselves rather than society for the circumstances they find themselves in, and attribute these circumstances to bad luck rather than any structural aspect of society.” In the words of one debtor, “I feel I’ve let them [the creditors] down, I feel guilty about that; my reliability is not there.” Even debtors who do not blame themselves are still controlled by their fear that others will make harsh judgements against them. Borrowers in credit trouble rarely discuss their financial problems with others. The senses of shame and embarrassment, combined with decreasing financial ability to maintain a normal social life, cause debtors to retreat into social isolation from both friends and family. This retreat deprives them of normal means of emotional coping and support that allow individuals to deal with life problems, thus magnifying the emotional crisis.⁹¹ A debtor persuasively explains in her own words:

[Collection Agents] talked to me as if I were a child, not letting me speak. They didn’t speak about facts, only me as a person—me as a bad person. One told me that people collecting welfare paid them more monthly than I was offering to pay. I was neither on welfare, collecting unemployment, nor employed, but it made no impression on them. They asked why I didn’t have a job, what had I been doing about it. They insinuated that there was something definitely wrong with me, and they wanted to know what it was. Shame and hopelessness set in. They called a lot, never allowing much peace between their verbal batterings. The collection agency switched me from one representative to another, so no history, rapport or empathy could develop. They were just doing their job.

There is no debtors prison but after a few of these relentless, harassing phone calls I wished there were. Maybe then I could escape the verbal and psychological abuse. I didn't discuss the problems with my friends, because their disdain would be too demoralizing. The fear, shame and pressure from others, and especially myself, was paralyzing.

It was a nightmarish descent into debtor's hell. I already know I was a social misfit because I no longer had a credit card, but now I had to experience degrading humiliation because I couldn't pay my monthly minimum. So what could I do? Commit suicide? Declare bankruptcy? Leave town and change my name, leaving no forwarding phone number? . . . When I was younger and saw old newsreels of people jumping to their death because of the 1929 stock market crash, I couldn't believe it. "Just for money?" I wondered. But now I understand it.⁹²

Many of the symptoms associated with debt trouble, including anxiety, feelings of helplessness, aloneness, self-contempt, anger, and terror, are also counted by medical, psychological, and legal professionals as risk factors for suicide.⁹³ Debtors have even been known to sell their organs on the transplant black market to pay off their debts. But in the high stakes collection of second-tier debts, mortal danger does not come merely from debtors themselves. For example, Henry James Hubbard III borrowed \$300 from Georgia Auto Pawn in Macon, Georgia. Although the loan was secured by the title to Hubbard's car, Georgia Auto Pawn nevertheless charged interest and fees amounting to about 300 percent APR. About five months later Mr. Hubbard fell behind on his payments. When a collection agent came to repossess the car, Hubbard understandably protested. When both men drew guns, the collection agent shot Hubbard three times while his wife looked on. In court, a medical examiner testified that based upon the angle of Hub-

bard's wounds, he died from a bullet to the chest suffered while lying on his back.⁹⁴

THE DEBT FEVER IMMUNE SYSTEM: FREE MARKETS

While clearly horror stories such as Mr. Hubbard's do not represent typical high-cost debtor experiences, hearing the tragic stories of high-cost debtors and observing recent credit trends, it is easy to wonder what has gone wrong? These stories and data do not easily cohere with the traditional liberal economic world view which today permeates our policy-making, legal jurisprudence, and economic theorizing. Rooted in the ideas of Adam Smith, Jeremy Bentham, and other Enlightenment thinkers, the default American explanation of market behavior leaves little room for these relatively unclean stories of contemporary high-cost debt. In our default worldview every individual, abstracted as *homo economicus*—the economic man—makes self-interested decisions which collectively create the best possible policy outcomes we can reasonably expect. Adam Smith described the phenomenon of self-interested individual decisions creating collective welfare as “an invisible hand” guiding the allocation of resources to an optimal outcome. Smith's description lies at the heart of the American presumption against government interference in individual market decision-making. Traditional economic reasoning suggests free market forces should act as a sort of natural defense mechanism, or immune system, against feverish credit prices.

This persuasive and elegant account of market decision-making imbues the public relations, legal advocacy, and government lobbying of the high-cost credit industry. High-cost lenders rely on arguments about the beneficial effects of their products, the inevitability of a high-cost credit supply, and the patronizing motives of government regulation. For instance, subprime mortgage lenders argue their home loans give low-income borrowers a

chance to enter mainstream society which they would otherwise never possess. To their credit, home ownership rates have shown impressive gains despite the vast increase in home foreclosures. Similarly, payday lenders explain their loans help families navigate short-term financial crises. They insist it is arrogant for legislators to presume they know which loans are in a borrower's best interests better than the borrower herself. One North Carolina payday lender persuasively explains:

“Thank you for being here,” “Thank God you were here for me when I needed you.” These are very common quotes heard in my lobbies. I’m sure it’s easy for you to sit in your office and tell your readers how “bad” payday lenders are. We offer a service, plain and simple. . . . Our customers like our service. If they didn’t, they wouldn’t use us, plain and simple.⁹⁵

Indeed, who are legislators to tell a struggling mother she should not borrow money to feed her children, pay her rent, or purchase costly prescription medication? Lenders and their supporters accuse their detractors of clinging to archaic Puritan debt phobia to the disadvantage of real people with real needs.

Many high-cost creditors and industry groups report favorable customer satisfaction. High-cost creditors argue payday loan rollovers, repeat pawning, widespread rent-to-own growth, and reiterate home and manufactured home refinancing are all evidence of—not desperation-based borrowing—but contentment. In this view, high-cost debtors, like all consumers, vote with their feet. High-cost creditors merely respond by supplying legitimate services to this natural demand. Moreover, high-cost lenders emphasize that their customers often have no other credit choices. Regulation which impedes this natural market function will only dry up a necessary and beneficial market. If markets persist despite the regulation, the costs of regulation are passed on to borrowers

in increased prices which hurt consumers more than no regulation at all. Lenders assert most consumers would prefer a lower price to added regulatory protection. High-cost lenders argue their services are inevitable, explaining that if government regulation shuts down our current high-cost lenders, a black market will rise from their ashes. Lenders argue the same services will be provided, but consumers would pay an additional premium to insure illegal lenders against the risk of getting caught. Moreover, an unregulated black market would attract lenders specializing in corruption, fraud, and violence.

Much of the controversy over high-cost lending exists because of our well-founded faith in the simple free market principles which ground these compelling creditor arguments. To be sure, free market competition, along with a strong democracy, has been the backbone of American economic and political success in the twentieth century. But as many economists, sociologists, political scientists, journalists, judges, and legislators have recognized, these market principles have not always produced for us the optimal outcomes Adam Smith's allegory of the invisible hand has led us to hope for. This book attempts to reconcile traditional micro-economic reasoning with an interest rate fever chart that suggests many Americans are suffering. This book also examines the way the state interacts with the high-cost credit market, hoping to distill lessons which might help us better close the gap between our traditional economic predictions and reality. This book hopes to help us move towards a cure for our feverish high-cost credit market.