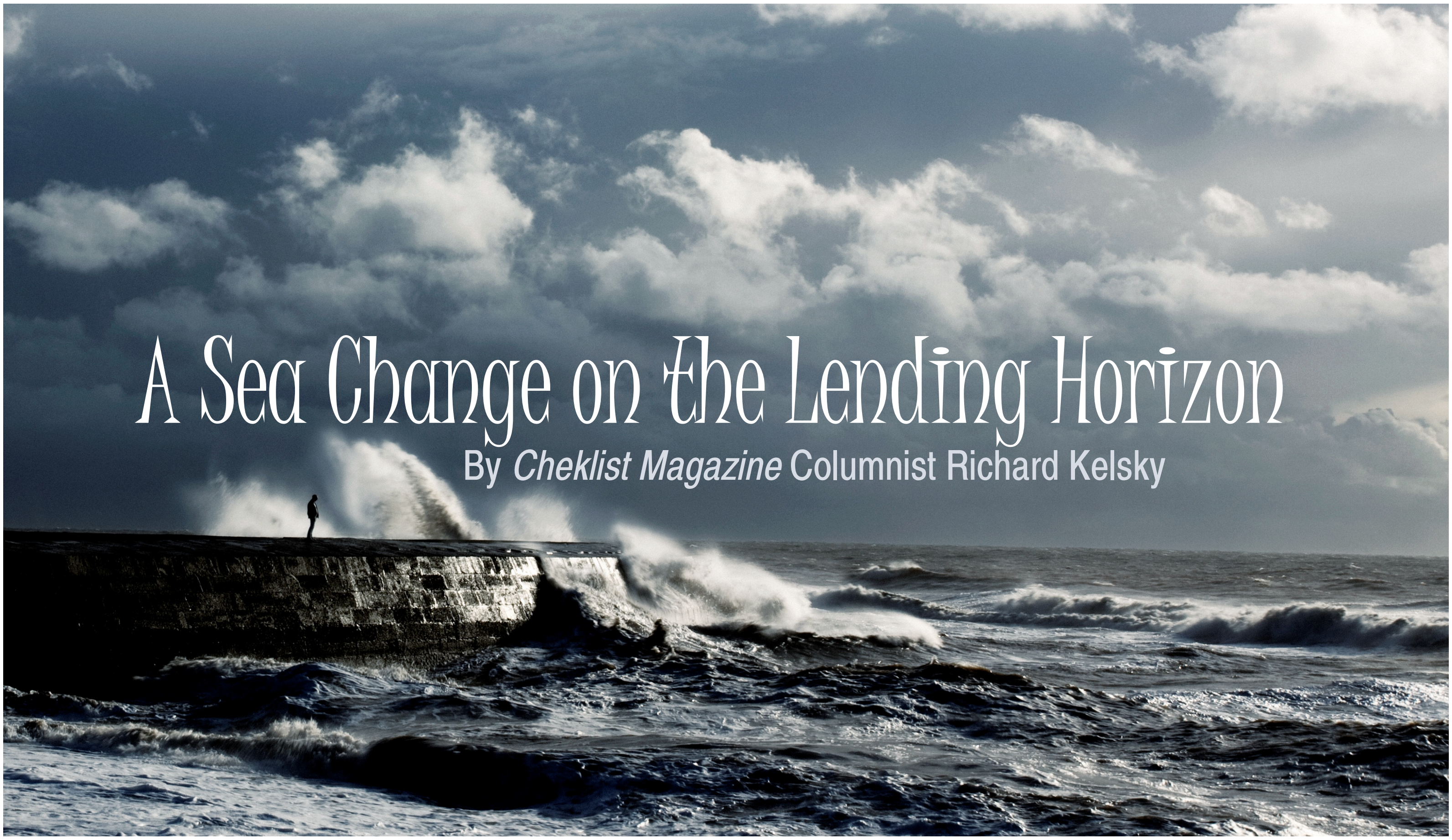

A Sea Change on the Lending Horizon

By *Cheklist Magazine* Columnist Richard Kelsky

If you're not familiar with the term, Webster's defines *Sea Change* as "a marked change: transformation <a *sea change* in public policy>."

As an outspoken supporter of payday lending, I know that properly regulated, payday lending is a completely reasonable vehicle to provide credit to those who have been marginalized by banks or simply need the convenience of a virtually "instant" loan. I also know that as financing vehicles go, payday loans have been more unjustly stigmatized than any other, which is saying a lot given our recent era of interest-only, no-income, no-job and no-assets (NINJA) loans and stealth $30 bank "overdraft privilege" fees.

Unfortunately, in the wake of the mortgage crisis, it's time to recognize where the currents of public opinion are heading. Even with the present need for credit at all levels, the unfair stigma against deferred presentment remains strong. Curiously, that tide runs particularly high in states that have never been willing to adopt payday-ending legislation. Like it or not, it's time to explore alternative horizons. Amid the current sea change, "small-dollar loans" are emerging as the vessel of choice – and everyone (from lender to legislator) needs to get aboard to make them a reality.

While working on this piece, I reread a *Cheklist* column I'd written in the Fall of 2004 titled, "Ending Payday Prohibition" – in which I called upon the states in the Northeast to change their legislative posture. I wanted to see if the logic behind my thinking way back then can be applied to small-dollar loans today. I was happy to see that it most definitely can.

WHAT I SAID THEN: Payday Lending Exists Everywhere. ***"We already have payday lending taking place in all of these allegedly protected states. In most cases, deferred presentment instruments are pitched via the Internet."***

STILL TRUE. What we don't yet have is a properly regulated storefront alternative that gives working class folks ready-access to short and medium-term credit. In the Northeast, and perhaps elsewhere, small-dollar loans are the answer.

WHAT I SAID THEN: Credit Can be Abused by Rich & Poor. ***"Economic standing has no bearing on whether a consumer will be responsible or reckless in handling credit. Those with wealth sufficient to qualify for credit cards appear no less inclined to run up debt at double-digit interest than the non-credit-card-eligible are to let payday loan rollovers get away from them. And, with the right regulation, the latter scenario could be prevented."***

STILL TRUE. These words seem eerily prophetic in light of how the middle-class has since gorged itself on credit card lines and debt sourced through phantom home equity, and how many sophisticated investors leveraged to the hilt to buy commercial real estate and stocks on margin.

WHAT I SAID THEN: The Need Exists. ***"Demand in this country demonstrates payday loans address a financial need currently unmet where they are prohibited."***

STILL TRUE. But no matter how I felt then, and how I feel now, the payday lending industry is navigating some very rough waters. Despite payday opponents' reliance on one negative payday loan story out of ten thousand (as if the same story does not exist for TENS OF MILLIONS of users of credit cards, overdraft privileges and mortgage debt), they do have a following. As a result, the real question is what form of grassroots lending will evolve along side payday lending?

Everyone acknowledges that something needs to fill the gap between traditional banking products (loans, credit lines and credit cards – which are not available to many typical payday borrowers and certainly not to the unbanked), and the underbelly of street lending – which in my day was known as loan sharking. Will payday lending vanish? Absolutely not – because it fills a need and it works. Will new forms of lending emerge? They already are.

The Answer is Blowin' in the Wind…And it's a Nor'easter! So where is the ideal place for this change to begin? The Northeast. Yes, the very same Northeast that has traditionally prohibited payday lending. For all of its conservative views on lending the Northeast remains the center of the American financial world. And residents of Northeastern states have been crying out for a lending vehicle for the common man for decades.

The time has come.

What can you expect? Look for a "hybrid" small-dollar loan that has the convenience of a payday loan, and some of the features of a traditional loan. Compared to a payday loan, no doubt the term will be somewhat longer, default more demure, and collection more constrained.

Will everyone be 100 percent happy? Not a single person – except the borrower. And that, my friends, may be a perfect situation. One of the advantages of the no payday-lending environment of the Northeast is that *any* small-dollar lending would be an improvement – and a brand new credit vehicle for consumers. There is no entrenched industry to resist the change, no payday poster-children to oppose it.

For small-dollar loans to become a reality, legislators must let go of the idea of using commercial loan or credit card APRs. Mind you, I am not suggesting payday loan APRs. But small-dollar loan rates do need to reflect the fact that these loans are going to be VERY RISKY for the lenders. By comparison, people need their credit card every day, so they have to make the minimum payment. And unlike payday loans, a post-dated check on an existing account does not exist. These loans will be cash-and-carry. Once made, the money is gone – without either the continuing need of a credit card or the dependence on a bank account. Indeed, the only thing actually securing borrower to lender on a small-dollar loan would be a desire to remain creditworthy. But that's a farsighted concept with lots of frontloaded risk, and loan rates would have to reflect as much.

The risks undertaken by these small-dollar lenders will far outstrip those of credit card issuers and even payday lenders. With the anticipated restrictions on default rates and collection activity, the risk will be multiplied. Loan volume will no doubt be contained by a limit on outstanding loans - supported by a loan database - and extensions and rollovers will most likely be similarly restricted.

In small-dollar lending the underlying economic model and expectations for payday lending will go the way of the buggy whip. High volume, high return, moderate uncollectability will give way to managed-volume, lower return, and questionable collectability – collectability which is highly dependent upon loan issuance standards. As a result, non-traditional methods of measuring creditworthiness will also emerge – based upon transaction history and other measures. In order to avoid a lending free-for-all, the loans would best be available only through entities that have an ongoing licensed, regulated and government audited financial services business.

The Perfect Outlet for Small-Dollar Loans. As registered MSBs, check cashers are already serving the un-banked and under-banked communities, and are accustomed to complying with numerous and detailed state and Federal regulations. That makes them uniquely suited to be the outlet for these new small-dollar loans. Check cashers – most of which are highly automated - already have transaction histories which can serve as an information source for credit decisions. Moreover, given the high-risk and limited profitability of these small-dollar loans, they will be best suited as incremental business, not a sole source of revenue. Check cashers are the obvious, existing, and appropriate regulated source for this new small-dollar loan.

In order to get this hybrid loan through the various state legislatures compromises will have to be made. These will include lenders accepting lower fees and rates than traditional payday lending, as well as some limits on default rates and recovery methods. At the same time, legislators have to be realistic in what they insist upon, or the loans will never be made. They cannot be so unprofitable – or worse, so uncollectible – that loss levels drive credit standards to where these loans are generally unavailable. On the other hand, the legislators cannot afford to be seen as supporting politically incorrect lending practices. A delicate balance must and will be struck.

My conclusions haven't changed since my '04 article went to press: "When crafting a regulatory framework," I noted, "the end result must recognize the genuine consumer need for such financial products. It must also shield those same consumers from the specter of potentially predatory lending practices and help consumers understand the terms of the loan. Finally, it has to permit a reasonable financial return to the lender commensurate with the unsecured risk." The worthy goal of making credit available remains, and is all the more important in the wake of a Great Recession. If your state association has an ongoing effort to support small-dollar lending, get behind it and get involved. With a consumer need, and a cooperative legislative process, this is one small idea with the potential to make it very big.

> Compared to payday loans, **SMALL DOLLAR** terms will be somewhat longer, default more demure, collection more constrained. Rates will also need to be higher than credit cards to reflect much higher risk. Will everyone be 100% happy? Not a single person – except the borrower. And that, my friends, may be a perfect situation.

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