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Usury Incorporated: Some Lending Practices Are Simply Defective

by Stephen Stetson

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Product recalls happen all the time. A Wisconsin company just issued a recall on 2,500 pounds of ground beef possibly contaminated with E. coli. Car seats, cribs, and strollers are frequently recalled for shoddy manufacturing or simple failure to consider the ingenuity of infants. And everyone remembers the recent high-profile recalls of peanut butter (for salmonella) and Toyotas (for faulty accelerator pedals).

But two defective products on the market in Alabama won’t ever be recalled by the companies that make them: payday loans and automobile title loans. Instead, it’s going to be up to the Alabama Legislature to rein in these faulty but perfectly legal products that are damaging the Alabama consumers who use them.

I know what you’re thinking: A loan isn’t a product; it’s a practice. But that’s not how the lending industry thinks about it. Banks, credit unions and finance companies actually talk about loans as products, each with its own varying characteristics: amounts, target audiences, repayment plans, etc. And of the “loan products” on the market, payday and title loans are the ones with the most glaring design defects.

If you’ve got a financial emergency, maybe you’d like to take out a loan using another famously defective product, your Ford Pinto, as collateral. Alabama law allows you to pawn your car title in exchange for a loan (which will vary in size depending on how much you need and the value of your vehicle). This transaction is legally the same as pawning Granny’s wedding ring, but if you don’t pay back the loan secured by the ring, you’ll still be able to get to work the next day. On the contrary, defaulting on a title loan results in repossession of your vehicle, which puts your paycheck in jeopardy.

Repossession risk aside, there’s also the matter of the cost of these title loans. Anyone desperate enough to pawn the title to their vehicle is punished for that vulnerability by being charged a staggering 300 percent annualized percentage rate (APR). If you just think about the APR you pay on other kinds of consumer loans, you’ll realize the absurdity of triple-digit interest – which is why a number of states (and the U.S. military) have capped rates on these types of loans at a reasonable 36 percent. Nobody wins when borrowers get pulled into inescapable financial quicksand – well, except for the lender and the owner of the used car lot where the repossessed car will be sold.

But a title loan's 300 percent APR looks like minor league gouging compared to the 456 percent legal interest rate on payday loans. These loans are for very short terms but come laden with astronomical interest rates and hefty fees each time the loan is rolled over. Purporting to throw borrowers an emergency life-line, these loans actually throw them an anchor. The average borrower takes out eight or nine such loans a year, spending most of the calendar year indebted. Instead of solving emergencies, borrowers often use payday loans for recurring regular expenses – a recipe for destitution.

These facts are not accidents of circumstance. Payday loans are designed to encourage repeat borrowing. Barring some kind of windfall, someone in desperate need of funds for an unexpected expense is unlikely to have the money a few weeks later. They simply roll the loan over, get the deadline extended and repeat the cycle – with another round of fees, of course.

Only a handful of borrowers pay off the payday loan as soon as they reach their next pay period – and industry documents show that lenders recognize the vast profitability of cultivating repeat borrowers. In fact, payday and title loans may be the only defective products that work exactly as designed.

Fortunately, the Alabama Legislature will consider bills this spring to curb these lending practices. Alabama could join other states like Arkansas, Georgia and North Carolina in capping interest rates on small-dollar consumer loans. After all, usury isn't just unethical. It strips wealth out of communities at a time when elected officials have been adamant about protecting working families from economic distress.

Outcry from consumer advocates won't be enough to move Alabama's political machinery – especially when a well-funded payday and title loan lobby is pushing in the opposite direction. But many folks who don't even use payday loans still decry usury and hate the blight of payday storefronts clustered along Alabama roadways. And plenty of folks who have personally used these "Ford Pintos of lending" know first-hand what a bum deal such products are. United, those voices should be sufficient to push Alabama into leveling the lending playing field and taking these defective loan products off the market once and for all.

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