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Hinkle: Storefront lending - Convenient service or evil incarnate?

By: A. BARTON HINKLE | October 24, 2012

Four years ago, Virginia lawmakers cracked down on payday lending. They limited borrowers to one payday loan at a time, and doubled the length of time they had to pay the money back. It worked. Payday loans plunged more than 80 percent. A few lenders left the state completely.

But it also didn't work. The reforms created a vacuum being filled by a new form of short-term lending: car-title loans.

In a payday loan, the borrower writes a post-dated check to cover the loan amount, plus fees. In a car-title loan, the borrower puts up a vehicle as collateral. Since 2010 the number of car-title lending companies in Virginia has more than doubled. Last year, they made more than 128,000 loans, worth an aggregate $125 million. They also repossessed nearly 8,400 vehicles.

Legislation to cap interest rates on payday and car-title loans died last year. It likely will come up again. But some localities don't want to wait. Officials in Chesterfield want to ban such lenders from the county entirely. This is probably a fool's errand; shutting down lenders won't make demand disappear. Borrowers in need of quick cash may just cross jurisdictions — or turn to even more risky sources, such as the Internet.

It's easy to understand Chesterfield's position when you hear stories like that of Manassas resident Brenda Ann Covington. A while back she borrowed $1,500 and put up her 2005 Chevy Silverado as collateral. Somehow she ended up owing $4,100 — and could have lost a vehicle worth much more. On the other hand, there is no shortage of horror stories about commercial banks, either — as anyone burned in the recent housing bubble can attest.

What's more, defaulting on a mortgage can destroy your credit rating. Defaulting on a payday or car-title loan won't touch it. That's one reason borrowers like

storefront lenders: They "keep my payday borrowing separate from my other banking."

There are other reasons: According to the financial-services journal American Banker, "borrowers may prefer to pay higher rates for small, short-term loans than to participate in credit union programs that have strings attached, such as a savings component. . . . Borrowers also dislike that credit unions generally have shorter operating hours." As a recent article in Regulation magazine — a publication of the libertarian Cato Institute — puts it: Storefront loans have "non-price benefits" that make up for the higher interest rates.

Yet those higher interest rates lead many to believe such "predatory" lenders are little better than leg-breaking loan sharks. Is that charge sustainable? Again, comparison is instructive. The banking industry's profit margin is 5.2 percent. Payday lenders' profits are only 2.4 percentage points higher. Both traditional banking and storefront lending are less profitable than pharmaceuticals, railroads, mining — or even regulated gas and electric utilities.

But wait: If, as critics allege, storefront lenders charge ridiculously high rates, then why aren't they raking in money hand over fist? For one thing, they endure much higher rates of default than banks do. Just as hospitals must charge paying customers more to cover charity care, payday lenders must charge more to cover the welshers. (Banks avoid this problem by simply refusing to lend to bad credit risks. How does that help poor people?)

Still, critics insist the interest rates charged by storefront lenders are so high they're immoral. But it's the critics, not the lenders, who are being dishonest. Here's why:

Suppose Milton borrows $250 from a storefront lender and pays it back two weeks later. The lender charges a standard $15 fee to pay his employees, his utility bill, and so on. That is 6 percent of the loan amount. Yet critics want to express that as an annual rate — which, in this case, would be 156 percent. This sounds outrageous. What it really tells us is not that the lender's greed is huge — but that the loan amount is small. A $15 charge on a two-week, $10,000 loan has an APR of only 3.9 percent, even though the transaction charge is exactly the same.

Banks and credit unions don't usually offer the sort of financial services storefront lenders offer. When they do, they end up charging similar sums. StretchPay, an

Ohio-based credit-union alliance, charges an annual fee of $35 for loans up to $250. That's an APR of 364 percent on a two-week loan.

Then there is microcredit — a Third-World financing revolution that began with the Grameen Bank in Bangladesh. The idea is to lend very small amounts to poor people so they can start businesses. Microlenders have been criticized because, given the small loan amounts, the effective interest rates they charge also turn out to be pretty high — anywhere from 70 to 125 percent. But they don't ask for collateral, either. That makes them look a lot like payday lenders.

There's one big difference, though: While payday and similar lenders are reviled for preying on the poor, Grameen Bank and its founder, Muhammad Yunus, were awarded the 1996 Nobel Peace Prize.