# WHAT LIES AHEAD IN THE FIELD OF SMALL LOANS

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The amazing growth of consumer credit is one of the outstanding economic facts of our times just as the Uniform Small Loan Law, prepared by the Russell Sage Foundation, has proved to be one of the most successful pieces of remedial legislation enacted in our generation.

This effort to take a look, even a partial look, into the future is necessarily based upon a thoughtful consideration of the past. But, as H. G. Wells once observed, if a student knew *all* the past facts he could, in some fields, foretell the future with fair accuracy.

I do not know all the facts. I believe nobody does because the subject is too vast and complex. Consumer credit, and particularly the small loans field, deals with *people* and no one mind can grasp all their motivations—their plans, ambitions, hopes, and fears.

My own knowledge is strictly limited; but it does extend over nearly forty years. Those of us who can go back that far have this advantage. We have *seen* what consumer credit was when banks frowned on such loans, when there were no licensed small loan companies, when the whole field was the exclusive domain of the loan shark with his usurious rates of interest and his harsh collection methods that forced his victims into a form of peonage.

In 1914 when I became counsel for the Boston Legal Aid Society the most common type of case was the small loan based on a wage assignment.. The typical loan was $10.00; the maximum was $50.00; the security was an assignment of all the borrower's future wages; the one thing the lender did *not* want the borrower to do was to repay the principal of the loan; the "charge" for the loan (politely called an accommodation) was 20 per cent per month. We entered these cases on the Legal Aid records as loan shark cases.

In 1916, the Boston Legal Aid Society backed by all the social welfare agencies in Boston and with the skillful help of Arthur Ham of the Russell Sage Foundation secured legislation that gave Massachusetts one of the earliest well-conceived set of statutes enacted in any state, many of whose provisions were later incorporated in the first draft of the Sage Foundation's Uniform Small Loan Law.

In 1919 I resigned from the Legal Aid Society and entered private practice. After that, and for nearly a score of years, one of my clients was the Massachusetts Association of Small Loan Companies composed of most of the licensed lenders in the state. I have always believed their coming to me was an act of sheer desperation.

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At that time just as no bank would make small loans, so no lawyers knew or cared anything about the small loan problem. The licensed lenders needed help in many ways, particularly in dealing with the legislature. To state their case required an intimate knowledge of the facts about the business. Then the lawyer found that he had the type of case that challenges his best efforts: to defend a party considered guilty by the entire community, but who, on the basis of the lawyer's own investigation, was clearly innocent.

For younger people it will be virtually impossible to realize that in those days a moral stigma attached to *any* small loan and to *both* parties to it. As for the lender, the public did not know the difference between licensed lender and loan shark; partly because the licensed lenders themselves took a defensive attitude, but chiefly because their rate of charge was, and always must be, substantially higher than the conventional bank rate for a commercial loan which, as we all learned in the sixth grade, was 6 per cent per annum. As for the borrower, public opinion generally condemned any borrowing by him as immoral. Even the economists abetted this impression: when a businessman borrowed that was "a constructive loan"; but when the little man made his little loan the transaction was given the rather terrifying title of "a consumptive loan."

Let us now take a long jump forward and arrive at the middle of the twentieth century. The United States Department of Commerce gave us in its "Survey of Current Business" of February 1953 (Table S-16) its carefully checked figures for 1950.

Also let us confine the issue from consumer credit in general to *cash loans*: that means leaving out charge accounts at stores, installment purchases of automobiles, etc., which the law regards as time-sales and not loans.

Total volume of loans outstanding at the end of 1950 was $5,964,000,000.

And who made these loans aggregating nearly six *billion* dollars? Here are the lenders ranked according to volume of their loans:

| | | | |
|---|---|---|---|
| Commercial Banks | $2,510,000,000 | Industrial Banks | $301,000,000 |
| Small-loan Companies | 1,268,000,000 | Industrial-loan Companies | 229,000,000 |
| Insured repair loans | 938,000,000 | Miscellaneous | 176,000,000 |
| Credit Unions | 542,000,000 | | |

You will notice that whereas, at the beginning, the banks frowned on small loans, they now make about 40 per cent of all cash loans in the consumer credit field. That is a revolution in itself. It is a revolution in economic thinking.

On May 4, 1953, The National City Bank of New York used large advertisements to point with pride to the twenty-fifth anniversary of its personal loan department as "the first Personal Credit Department established by any large commercial bank in the United States. Since then, more than six million people have borrowed 2½ billion dollars. These loans are for a wide variety of useful purposes, such as: medical, dental, hospital, household, educational expenses. . . ."

That illustration will enable you to understand the significance of these words in the long-established Boston financial weekly, "United States Investor." In its issue for November 29, 1952 (Vol. LXIII, No. 48) the leading article was titled "Successful Consumer Credit!" Here are the relevant words:

> Here is what is described as the major development in American bank operations in the next decade, and here is a new bank service for more and more people.
>
> Of course we all remember something about consumer credit—even if only the "folly of installment buying" school of thought. Because consumer credit, you know, is by and large responsible for the success of mass production in the United States and has held out a helping hand to millions of people in their struggle to improve their standard of living, consumer credit has played its part in giving Americans the highest standard of living in the world.

Before moving on to a scrutiny of the figures for small loan companies let us make a digression (which will turn out not to be a detour after all) to ask how the transaction of lending-borrowing deemed almost immoral not so many years ago is now considered a potent factor in our standard of living.

If you or I want something that costs $300 and we do not have $300 we could (a) borrow $300 to be repaid over a year and at once buy the desired object or (b) save $25 a month for a year and then buy the object for cash, thereby saving ourselves all interest and carrying charges. If the American people had followed the latter course, would we be where we are now (with a lag of one year) or would the pump never have been primed? This sounds like the ancient riddle of whether the hen or the egg came first. I lack the wisdom to give a definitive answer; but the pragmatic conclusion is clear enough.

*For psychological reasons the American people want the incentive to save which they get by first obtaining possession of their object—be it a home, household furnishings, an automobile, or just to be clear of a lot of bills.*

In my opinion, this psychological law will continue far into the future.

The clearest proof I can submit is as follows: A person with a savings bank account of $1,000 wishing to purchase something costing $300 will borrow $300 from the savings bank, using the bank book as collateral; but will *not* withdraw $300. I have come to the conclusion that is psychologically sound.

If any of my readers in higher income brackets are disinclined to agree, let me ask them to ponder this question. Should you need $3,000 to add on to your home or to meet a pressing obligation, do you honestly prefer to borrow from a lending institution or to borrow on your life insurance? Do you not have a deep-rooted feeling that to borrow on your life insurance is the first step towards losing it? Your feeling is not wide of the mark. Life insurance statistics show that loans all too commonly result in forfeiture of the policies.

We have seen earlier that the volume of cash loans made by licensed small loan companies and outstanding on December 31, 1950, totalled in the aggregate $1,268,000,000. The essential fact is this: *The small loan business at the end of 1950 was at least a thousand times greater than any of the pioneers in the field ever dreamed of.*

In my opinion, what the small loan companies have won they will hold and continue to expand. This will be true in spite of apparent competition by banks. The competition is more apparent than real.

Competition as to rates of charge the small loan companies have faced for years. First it was the credit unions. Next the Morris Plan Companies now denominated Industrial Banks. Government has made loans of many types. All these have carried rates of charge lower than what the small loan licensed lenders must charge. The reason they have survived and grown is that they—by and large—deal with a different group of borrowers and render a different type of loan service.

The licensed small loan companies make the *small* loans. For that reason they deal with far more American families. Their customer is the average citizen on Main Street. They understand him and they have won his confidence.

The great test came in the depression that began in 1929 and continued through 1932. While big banks found many big loans uncollectible, the small loan companies found that the small loans owed by the average American family were being steadily repaid. Defaults were due, not to unwillingness to repay, but to unemployment. Even so, the reserve for losses set aside by well-run companies did not exceed 10 per cent of outstanding loans and that reserve proved to be more than ample.

On sober reflection, the reason is plain. There is no mystery. We are now speaking of borrowers who come from the income groups that constitute a majority of our people. We trust them to elect the President of the United States, the members of Congress, our Governors, members of our State Legislatures. Why not trust their judgment, family by family, when they decide that it is prudent for them to borrow $100 or $200 or $300.

*The record of the American people for integrity in honoring their debts was superlative.*

In my opinion, this record will continue and on this score I have no doubts whatsoever.

The banking epigram attributed to J. P. Morgan is that "The only worth-while security for a loan is character." In lenders' terminology that means "the desire to repay."

After the demonstration of character by the American borrowers of small loans the lenders reacted and began asking for no other security than character.

Before I give you statistics let us go back once more to the beginning. The loan shark liked the wage assignment for security. It gave him a vice-like grip on his borrower. As if that were not enough, most employers made it worse because, believing that small loans were immoral, they threatened to discharge any employee who had a loan. Hence the lender merely had to threaten to enforce the assignment —which meant notice to the boss—and the borrower would do anything in his power to prevent being fired.

When the licensed lenders entered the field they relied on chattel mortgages on the household furniture. At the time this was as good a security as could have been devised. It worked well both ways. The lender never wanted to foreclose and repossess the furniture because second hand furniture is almost worthless. Yet, from the borrower's point of view, it had a high going value not only because one becomes attached to one's own things but also because it would be quite expensive to replace.

*Today a majority of small loans are made on character and without any security.*

For statistical evidence I submit the figures for Massachusetts because the Bank Commissioner's figures go back in detail to 1937 and because I have worked enough with these figures to believe there are no substantial "catches" or inaccuracies in them. These figures come from Official Document No. 95 and are based on the license year which, in Massachusetts, ends on September 30.

| License Year | Total Loans Made $300 or Less | | Unsecured Loans | |
|---|---|---|---|---|
| | Number | Amount | Number | % of Total |
| 1937 | 236,066 | $35,000,503 | 41,186 | 17.61 |
| 1938 | 205,228 | 29,743,192 | 37,839 | 18.43 |
| 1939 | 262,911 | 37,599,085 | 63,917 | 24.31 |
| 1940 | 282,723 | 40,750,287 | 83,832 | 29.65 |
| 1941 | 312,442 | 46,892,693 | 114,680 | 36.70 |
| 1942 | 271,985 | 41,668,089 | 124,891 | 45.92 |
| 1943 | 228,103 | 33,796,398 | 114,509 | 50.20 |
| 1944 | 233,817 | 35,359,623 | 123,145 | 52.67 |
| 1945 | 231,748 | 36,544,117 | 130,593 | 56.35 |
| 1946 | 259,843 | 42,706,182 | 146,844 | 56.51 |
| 1947 | 265,155 | 46,014,185 | 147,330 | 55.56 |
| 1948 | 267,196 | 49,229,525 | 141,079 | 52.80 |
| 1949 | 250,443 | 47,506,393 | 128,388 | 51.26 |
| 1950 | 243,598 | 47,154,980 | 122,161 | 50.15 |
| 1951 | 234,266 | 45,342,471 | 125,246 | 53.46 |
| 1952 | 229,259 | 45,077,696 | 126,135 | 55.02 |

So far so good. Now, however, we come to a problem which gives me real concern but which, so far as I can learn, has received almost no attention in the literature on this subject.

In this article, the term "small loan" has been used to mean a loan of $300 or less. That is the limit used in almost all of the small loan laws. The banks have always preferred loans *over* $300. The licensed lenders, until recently, confined their loans to $300 or less.

My concern is about the "little loan" and by that I mean a loan of $50 or less.

Bear in mind that $50 was the *maximum* loan-shark loan. The loan shark domain is loans of $10 to $50. If the licensed small loan companies abandon that territory the loan shark will return. The law that nature abhors a vacuum operates without fail in this territory.

Because in the great majority of our American states the licensed small loan companies have operated effectively and decently for so long, there is a disposition on the part of the general public to think that the loan shark is as dead as the dodo and is now utilized only as a ghost to freighten legislative and other bodies.

The truth is otherwise. Look, for example, at the October 5, 1953, issue of

*Newsweek* which on page 21 under the heading "Shark Hunt" reports on prosecutions in Georgia resulting in 15 convictions. In two of the cases the facts were: "A man borrowed $10 from a loan company in Atlanta. Every two weeks for nine years he paid back $1. Then he died. The company tried to force his widow to repay the original $10." In the second case "A laborer reported that 46 months ago he borrowed $25. After paying $3.75 each month since December 1949 and a total of $168.75 the laborer, who was supporting a sick wife and two grandchildren, still owed the full $25."

The Massachusetts figures show a decided trend away from the "little loans." Here are the figures, year by year, from Public Document No. 95.

| License Year | Total Loans Made $300 or Less | | Loans Made $25 or Less | | | | Loans Made $25.01 to $50 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Number | Amount | Number | % of Total | Amount | % of Total | Number | % of Total | Amount | % of Total |
| 1937..... | 236,066 | $35,000,503 | 4,402 | 1.86 | 94,886 | .27 | 32,593 | 13.80 | 1,500,642 | 4.29 |
| 1938..... | 205,228 | 29,743,192 | 5,482 | 2.67 | 127,514 | .43 | 28,453 | 13.86 | 1,308,114 | 4.40 |
| 1939..... | 262,911 | 37,599,085 | 10,407 | 3.96 | 247,449 | .66 | 39,299 | 14.95 | 1,810,915 | 4.81 |
| 1940..... | 282,723 | 40,750,287 | 10,352 | 3.66 | 246,278 | .60 | 42,449 | 15.01 | 1,972,772 | 4.84 |
| 1941..... | 312,442 | 46,892,693 | 11,782 | 3.77 | 284,813 | .61 | 44,848 | 14.35 | 2,101,522 | 4.48 |
| 1942..... | 271,985 | 41,668,089 | 9,005 | 3.31 | 216,984 | .52 | 33,858 | 12.45 | 1,555,397 | 3.73 |
| 1943..... | 228,103 | 33,796,398 | 7,198 | 3.15 | 172,929 | .51 | 26,937 | 11.81 | 1,238,212 | 3.66 |
| 1944..... | 233,817 | 35,359,623 | 5,508 | 2.36 | 133,847 | .38 | 24,686 | 10.56 | 1,148,867 | 3.25 |
| 1945..... | 231,748 | 36,544,117 | 4,350 | 1.87 | 105,244 | .29 | 20,916 | 9.02 | 977,751 | 2.67 |
| 1946..... | 259,843 | 42,706,182 | 3,330 | 1.28 | 81,133 | .19 | 21,254 | 8.18 | 999,625 | 2.34 |
| 1947..... | 265,155 | 46,014,185 | 1,818 | .68 | 43,420 | .09 | 13,875 | 5.23 | 658,195 | 1.43 |
| 1948..... | 267,196 | 49,229,525 | 1,315 | .49 | 29,393 | .06 | 9,449 | 3.53 | 441,864 | .89 |
| 1949..... | 250,443 | 47,506,393 | 744 | .29 | 17,773 | .04 | 6,024 | 2.41 | 278,502 | .58 |
| 1950..... | 243,598 | 47,154,980 | 530 | .22 | 15,739 | .03 | 4,733 | 1.94 | 215,298 | .46 |
| 1951..... | 234,266 | 45,342,471 | 545 | .23 | 12,974 | .03 | 5,159 | 2.20 | 236,178 | .52 |
| 1952..... | 229,259 | 45,077,696 | 446 | .19 | 10,623 | .02 | 5,306 | 2.31 | 246,510 | .55 |

Two factors have accelerated this trend away from the "little loans." It is unquestionably true that inflation has converted many a $50 loan into a $100 loan simply because the object the borrower wanted to acquire had increased in price.

The second factor is the disquieting one. There is a steady legislative pressure to reduce rates of charge on loans under $300. The rates of charge have always been stated awkwardly and so are peculiarly vulnerable. If rates are reduced unwisely, the lender must *increase* the average size of his loan if he is to survive.

In the rate structure—even in that advocated by the Russell Sage Foundation—there has always been an uneasy compromise resulting in a disequilibrium.

When you mix sociology with economics to produce a statistic to be embodied in a law you may expect trouble.

Stated as simply as possible, the root difficulty in this. The "little loans" are the necessitous loans. They are the loans that justify the state in using its police power to prevent the lender from overreaching and thus they constitute the ground on which all courts have held the Uniform Small Loan Law constitutional.

But it costs just as much to make, service, and collect a loan of \$25 as one of \$250. Except for pure interest, the costs are identical. Yet on any flat rate of charge the income to the lender on the \$250 loan is ten times that on the \$25 loan.

What the Sage Foundation decided to recommend and what—within limits—may well be the best practicable solution was to let the larger loans carry the "little loans." The uneasiness of this equilibrium is self-evident after a moment's reflection. It assumes that there must be actual losses on the "little loans" but that those losses should be compensated by a little extra on the larger loans.

To make this plan work, two things are essential. First, that the legislatures thoroughly understand the facts and realize that they must authorize rates that will make the "little loans" possible. Second, the licensed small loan companies must continue to make the "little loans" which means that if they are to continue to be successful in the small loans field they must continue to render a full loan service.