Vol. 9, Issue 11
March 27, 2015

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

On Thursday afternoon, the President was in Birmingham, and outlined some of his Administration's plans to impose greater regulatory oversight on what is known as the "payday loan" industry. Why Birmingham? Well, we have a lot of the places in our metro area and state, I mean a whole lot, an embarrassing amount really. In some sections of town, they are one of the few open businesses, apart from maybe a thrift store and a worn down storefront church.

You don't need a political agenda or in-depth knowledge of household finances to conclude there is a lot of economic desperation wherever there is a large number of payday loan locations. You also don't need a graduate degree in finance to know these places charge an enormous amount in percentage terms. Only someone with a heart of stone or embalming fluid in their veins would look at the Annual Percentage Rates (APR) on these types of loans without shuddering, at least a little.

From what I have read, the average loan in the industry is around $350 with a 2-week term. Let's be honest here: if you don't have $350 in liquidity or available credit elsewhere today, what is the likelihood you will have it 14 days from now? Probably not so great, which is the reason why the average borrower takes out between 10-12 loans each year, again from what I have gleaned over the Internet. The whole situation reminds me of the refrain from the old Tennessee Ernie Ford song "Sixteen Tons":

You load sixteen tons, and what do you get

Another day older and deeper in debt

Saint Peter don't you call me 'cause I can't go

I owe my soul to the company store

Basically, it is a vicious cycle: once you start down this road, for whatever reason, it is hard to get off it. There, but for the Grace of God, go I.

Understandably, a lot of folks are indignant, like the President, and want to severely curtail the industry, and the rates it charges. I mean who can stand behind someone charging close to 400%, right? Particularly with interest rates as low as they are? I mean these places must be out to gouge and take advantage of economically desperate people, and that is despicable. Is it not?

Well, it is more of a numbers game than despicable, and it is expensive for all sides involved. I ran some numbers, and I don't see any real compromise here. There is simply no way to make money lending small amounts for short periods of time without charging a rate that would or should make you blink.

I don't particularly want to reinvent the wheel, so let me cut & paste what I submitted to the Montgomery Advertiser on the subject:

> **This week, President Obama was in Birmingham, and had some words about payday loan places. This industry seems to be under attack, so why don't they just reduce their rates to more reasonable levels?**

Inside this issue:

It's easy to get a loan unless you need it.

Norman Ralph Augustine

Something to Think About Cont.

I don't make it a habit, but I have borrowed money from my teenaged son when I have been short on both cash and time. Without fail, I repay him the next day plus the $1 he requires. Of course, I could give him the old "roof over your head, clothes on you back, and food in your mouth" routine, but the convenience alone is usually worth it.

Now, if I borrow $10 and pay $1 in interest on a 1-day loan, that works out to be an annual interest rate well in excess of 3,500%. As such, my son is something of a predatory lender.

The biggest problem with the industry is the size of the loans involved, as the average appears to be around $350 with a 2-week term. So, just how many loans must a payday lender make in order to turn a profit? A few quick calculations suggests it is a pretty decent number.

Right now, the Prime Lending Rate is 3.25%. What if we decided to lend money out for 14 days at 10%? That would be a pretty decent amount, right? And what if we needed to make $100,000 in order to pay all the associated costs of running the business, and still take home some money besides? It gets fun in a hurry.

You see, a 10% annual percentage rate for 2-weeks on $350 is around $1.34. So, we would have to make 74,627 $350 2-week loans in order to gross $100,000. If we work 6 days a week every week of the year, that would work out to be a little under 205 loans per day. Assuming an 8-hour workday, that means 1 loan every 2 minutes.

I doubt there is enough time in the day for 1 person to do everything that needs to get done with that type of volume. So, what if we can only realistically process 1 loan every 15 minutes? How much would we have to charge then? The answer is around 75%. How about every 30 minutes? Try 100%. In truth, we will probably need some additional help, which will eat into our take home pay.

Basically, this is just an expensive business for both sides due to the small size of each individual transaction, and the short term of each loan. But just what is an acceptable rate, and who should decide such a thing?

Currently, the going rate is around $15 for each $100 borrowed. That works out to be around 390% on a 2-week loan. At $10, the rate shrinks to roughly 260%, and at $5, borrowers will pay about 130%. I won't go any lower than that, because I think it doubtful someone would lend a stranger $100 for 2 weeks for anything less than $5. If nothing else, there are absolute costs associated with processing and servicing the loan.

Unfortunately, I don't think there is a good solution here. Of course, it is hard to stomach people paying close to 400%, or even more, on a short-term loan. However, if you really put the screws to the industry, you will find some folks won't be able to borrow money at any price, and I am not sure that is so good either.

Hey, those are numbers I generated on a spreadsheet. How would you like to see the income statement for Cash America (CSH), one of the largest publicly traded payday loan companies which has 9 locations in Alabama? This is from its most recent publicly available annual report, and audited by PricewaterhouseCoopers. You can go their website and pull the same stuff, and, yes, they charge 390% on a $350 2-week loan….which is as plain as day on their calculator.

Disclosure

Something to Think About Cont.

Look at that. For all the noise about usurious interest rates in the industry, the company has had a net income margin of less than 10% for the last 3 years….comfortably less.

CASH AMERICA INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(dollars in thousands, except per share data)

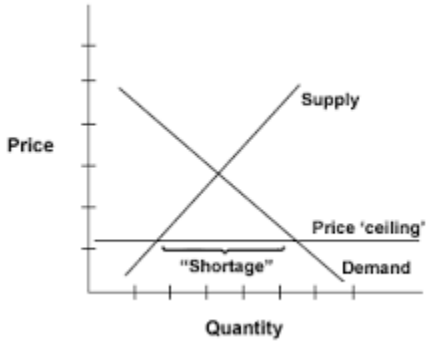
	Year Ended December 31,		
	2013	2012	2011
Revenue			
Pawn loan fees and service charges	$ 311,799	$ 300,929	$ 282,197
Proceeds from disposition of merchandise	595,439	703,767	688,884
Consumer loan fees	878,183	781,520	598,646
Other	11,805	14,214	13,337
Total Revenue	1,797,226	1,800,430	1,583,064
Cost of Revenue			
Disposed merchandise	410,613	478,179	447,617
Consumer loan loss provision	351,255	316,294	225,688
Total Cost of Revenue	761,868	794,473	673,305
Net Revenue	1,035,358	1,005,957	909,759
Expenses			
Operations and administration	750,304	714,614	611,268
Depreciation and amortization	73,271	75,428	54,149
Total Expenses	823,575	790,042	665,417
Income from Operations	211,783	215,915	244,342
Interest expense	(36,317)	(29,131)	(25,528)
Interest income	72	144	81
Foreign currency transaction loss	(1,205)	(313)	(1,265)
Loss on extinguishment of debt	(607)	-	-
Equity in loss of unconsolidated subsidiary	(136)	(295)	(104)
Income before Income Taxes	173,590	186,320	217,526
Provision for income taxes	30,754	84,656	82,360
Net Income	142,836	101,664	135,166
Net (income) loss attributable to the noncontrolling interest	(308)	5,806	797
Net Income Attributable to Cash America International, Inc.	$ 142,528	$ 107,470	$ 135,963

So, what would happen if the government said: "you can no longer charge $15 per $100. You can only charge $10." Well, obviously, that is still a 260% rate on a $350 2-week loan. Further, it would consumer loan fees would fall 33.33%, right? That is just math. So, the new 'consumer loan fees' would now be $585,455, a reduction of close to $293 million, which is twice as much as the company dropped to the bottom line in 2013.

Clearly, something with the business model would have to change. The low hanging fruit? Well, the company would likely start paying less on the dollar for pawn loans; that was easy. Second, it would likely reduce the number of employees in the company, which would reduce the firm's capacity to make, process, and service loans. Third, the company would HAVE to make large loans for longer terms. Finally, it would have to reduce its loan loss provision, meaning it would have to make higher quality loans, which would require tightening credit standards (if there really are any). *Hey, that is just looking at the income statement.*

All told, what would that mean? Clearly, it would mean a reduction of available credit in some form or fashion. So, who gets the rook in this scenario? You guessed it: the most economically desperate and disenfranchised.

This is basic economics. Capping the amount payday loan providers can charge on small, short-term loans is effectively setting a price ceiling. And what do price ceilings cause? That is right: shortages, unless virtually everything I have ever read or seen with my two eyes on the subject is completely and utterly wrong. To the left is the accepted supply/demand graph with an imposed price ceiling.



In the end, we might hate the rates these places charge, and perhaps there could be some greater scrutiny. However, significant regulations and price controls come with a cost, namely shortages, in some form or fashion. These shortages will happen primarily in the most economically depressed areas, effectively shutting them out of the formal (if somewhat unsavory) credit and liquidity markets and into the willing and waiting arms of the underground economy. That is a fancy term for, you guessed it, loan sharks, who won't be charging $15 per $100, and who probably take a much more dim view on defaults.

On a separate note, the sun will rise in the east tomorrow.