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Rates of Charge

IN THE rates charged on personal small loans the consumer's interest focuses on the cost of money borrowed, the lender's on the relation of rates to profitability, that is, on the income from loans of different sizes and types compared with the average loan expense. The ultimate cost to the borrower is ordinarily simple to determine when the charge is expressed as a percent of unpaid balance for a stated period of time, but it may be difficult to analyze when charges are differentiated by type of loan and are presented in a complicated system of rate quotations. For the lender the relation between rates and profitability may also be difficult to determine exactly, because the cost of making loans may decrease as more loans are made. It is important, however, to analyze personal finance company rates from these two viewpoints. Therefore in this chapter we examine the cost to consumers, both in dollar and in percentage terms, of loans of various sizes and durations under different rate systems, and also the contention made by some representatives of the business that loans of smaller amounts entail higher costs than larger loans and consequently justify higher rates of charge.

FORMS OF RATE QUOTATION

The maximum lawful rates chargeable by small loan licensees in various states were presented in Table 2 (p. 34). These rates may be classified into several general types.[1]

[1] The word "rate" is here used to designate a specific formula from which monthly charges are computed. Unless otherwise qualified it signifies an average or representative monthly percent of charge on unpaid balance.

The first of these may be called the "flat" rate, a straight monthly percentage of the unpaid balance; this form of quotation was specified in the original draft of the Uniform Small Loan Law and remained the general type of rate until about 1932. It is now in effect in 13 states and the District of Columbia. Originally it was considered the ideal method of charge, and certainly it has two great advantages: it is simple to apply and easy to understand.

The second general type of rate, which has recently become popular and is tending to supplant the flat type, is the combination rate; this combines two or more rates, allowing for a higher rate on an unpaid balance up to a specified figure and a lower rate on the remainder of the balance. The latest draft of the Uniform Small Loan Law[2] recommends, as an experimental maximum, 3½ percent a month on an unpaid balance up to $100 and 2½ percent on the remainder. At present 14 states and Hawaii have adopted maximum rates of the combination type.[3]

A special form of the combination rate which might lead to confusion is one which provides for a decreasing rate of charge computed on unpaid balance but graduated according to the original size of the loan, for example, 3 percent a month on loans of $100 or less and 2½ percent on loans of more than $100. Such a rate, graduated according to size of loan, is at present employed only in Missouri. A borrower might easily confuse the two types of charges and regard a rate of "3-2½ percent graduated at $100" as one with a charge of 2½ percent on all loans above $100, whereas it is actually a 2½ percent charge on that part of the unpaid balance above $100. When the rate is graduated according to size of original loan the loans above the dividing line carry a lower rate throughout their duration than do the loans of smaller

[2] The sixth draft, published January 1, 1935.

[3] Table 2 shows 15 states with graduated, or combination, maximum rates of charge. It includes Missouri, however, which is here classified separately.

amount; therefore borrowers may pay different charges on identical balances if originally they had borrowed different sums. The total difference in charge between loans just above and just below the dividing line is not insignificant; under the 3-2½ percent rate, for example, the initial monthly charge would be $3 on a loan of $100, and $2.75 on one of $110.

There is another type of rate, not now in general use, which is referred to in the trade as the "restatement" rate. It provides for a regular interest charge and, in addition, for stipulated fees to recompense the lender for various services rendered. A schedule of this kind has recently been advocated by Jackson R. Collins as a means of circumventing provisions of certain state constitutions regarding legal interest.[4] It would require for each loan an investigation fee amounting to a maximum of 5 percent of the face of the note, but not exceeding $15, and an interest charge of 5 percent per year, both to be deducted in advance from the amount borrowed. Rebates of unearned interest would be allowed if the loan were paid off in full before maturity. There would also be a maximum monthly service fee, graduated according to the size of the loan, as follows: $1 on loans over $75, 75 cents on loans from $51 to $75 inclusive, 50 cents on loans from $26 to $50 inclusive, and 25 cents on loans not exceeding $25. While no rates so complex as that proposed by Collins are to be found in Table 2, there are a few rates that approximate this type. In Colorado, for example, there is an interest

[4] In a few states, including Arkansas, Oklahoma, Tennessee and Texas, the maximum legal interest rate is constitutionally determined and cannot be altered by legislative action; a legal small loan business apparently cannot be successfully conducted under the constitutional rate, but the additional fees proposed in the Collins plan would presumably permit of profitable operation. It is Collins' thesis that a fee for investigation and a monthly service charge represent payment for services rendered by the lender, not interest as such for the use of funds borrowed, and that the courts will generally permit the collection of special fees in addition to the maximum legal rate of interest. See *Report on Conference on Personal Finance Law*, Kansas City, September 28, 1937.

charge of 10 percent per year plus an investigation fee of one-tenth the amount of the note.

CHARGES TO CUSTOMERS UNDER VARIOUS TYPICAL RATES

The maximum legal rates shown in Table 2 are not identical with the rates actually in effect, for any licensee is permitted to charge less than the maximum rate. Thus in a state where the maximum legal charge is a flat 3½ percent per month on the unpaid balance, a licensee could, if he wished, charge 3 percent per month, or 3½ percent on unpaid balance up to $100 and 2 percent on the remainder, or 3½ percent per month with a maximum charge of $5, or any of many other rates which might be mentioned. Any rate would be permissible as long as no borrower was charged more than 3½ percent on any portion of his unpaid balance.

It is not possible, and probably could serve no purpose, to present a compendium of all the different rates which are in effect throughout the United States. Instead we present a list of some of the more common rates, the most important of which are naturally the legal maxima in the various states. A schedule of total dollar charges under these selected rates, for various loan sizes and loan periods, is presented in Table 36, the charges being computed on the assumption that the loan is amortized by a fixed capital repayment each month. Table 36 shows also, for the various rates, the average monthly percentage charge for a loan of $300 repaid in 12 months, computed by dividing the total actual dollar charge by the sum of the monthly balances outstanding.

The various rates shown in this table are arranged in order of magnitude, high to low, according to the total dollar charges on a 12-month loan of $200. It is interesting to note that in most cases the rates on loans of other denominations and other durations conform with this ranking; thus the table

allows of certain conclusions as to which rates are relatively higher than others. But rates should be compared only as they relate to particular circumstances. A borrower, if given the opportunity of choosing among alternative rates, would make his choice to fit his own particular case. He needs a certain amount of money, which he can repay in so many months, and perhaps he will need a second loan before he pays out completely. These and perhaps other considerations have to be borne in mind in choosing the best available rate.[5]

The comparison of rates is made more difficult by the fact that there is more than one method of expressing them. Rates may be expressed as total dollar charges, as in Table 36; but they may also be expressed as an average monthly rate of charge, determined by one of several methods, all of which give approximately but not precisely equal results. In most cases, however, it makes no difference which criterion is used. Whether the borrower compares alternative rates by determining an average effective interest rate or whether he uses the much simpler expedient of merely computing the total charges he will have to face, he will usually arrive at the same conclusion.

A question frequently asked concerns the per annum equivalent of monthly small loan rates. When there is a flat percentage charge the annual rate is of course just twelve times the monthly rate. A fixed percentage charge of 3½ percent per month, for example, means that the borrower pays

[5] A single example will serve to show some of the various factors and complexities encountered in the choice of the most favorable rate. If a person has the choice of borrowing $300 at a straight 2½ percent or at a 3-2 percent rate graduated at $100, and if he expects to pay this loan off in 12 or 20 monthly instalments, he would choose the 2½ percent rate, for his charges are then less (see Table 36). But there are circumstances in which the 2½ percent rate would be more costly. Suppose that the borrower agrees to repay the $300 in 12 months; that after making six payments aggregating $150 he encounters some misfortune necessitating reborrowing $150, so that he again owes $300 to be repaid in 12 months, and that after making six more payments he has a windfall which enables him to repay the entire balance, $150, at once. With the straight 2½ percent loan the total interest charge would be $78.75, but with the graduated rate it would be $77.

TABLE 36

TYPICAL RATE SCHEDULES ON PERSONAL FINANCE COMPANY LOANS, CORRESPONDING TOTAL DOLLAR CHARGES ON REGULARLY AMORTIZED LOANS OF VARYING SIZE AND DURATION, AND AVERAGE MONTHLY PERCENTAGE RATE ON $300 LOAN REPAID IN 12 MONTHS

Rate Schedule	TOTAL DOLLAR CHARGE BY SIZE AND DURATION OF LOAN							*Average Monthly Rate on $300 Repaid in 12 Months*[a]	*States in Which Rate Is Legal Maximum*
	$50	*$100*		*$200*		*$300*			
	10 Mo.	12 Mo.	20 Mo.	12 Mo.	20 Mo.	12 Mo.	20 Mo.		
5/6% + fee[b]	$.....	$23.14	$.....	$46.28	$.....	$69.42	$.....	3.55%	Colo., Neb., N. M.
3½% flat	9.63	22.75	36.75	45.50	73.50	68.25	110.25	3.50	Ariz., Fla., La., Md., Va.
3½–2½% at $150	9.63	22.75	36.75	44.50	72.00	63.00	101.91	3.23	Ky., W. Va.
3½–2½% at $100	9.63	22.75	36.75	42.00	68.00	59.25	95.91	3.04	Hawaii
3% flat	8.25	19.50	31.50	39.00	63.00	58.50	94.50	3.00	Minn., Ohio,[c] Ore.,[d] R. I., Utah
3–2½% at $150	8.25	19.50	31.50	38.50	62.25	55.88	90.38	2.86	Ill., Me.,[e] N. Y.
3–2% at $150	8.25	19.50	31.50	38.00	61.50	53.25	86.25	2.73	Ia., Mass., Pa.[f]
3–1½% at $150	8.25	19.50	31.50	37.50	60.75	50.63	82.13	2.60	Ind.[g]
3–2½% at $100	8.25	19.50	31.50	37.25	60.25	54.00	87.33	2.77	Mich.
3–2% at $100	8.25	19.50	31.50	35.50	57.50	49.50	80.15	2.54	Conn.
3–2–1% at $100 & $200	8.25	19.50	31.50	35.50	57.50	47.00	76.30	2.41	None
Collins Rate[b]	10.56	23.11	.....	34.22	.....	43.67	.....	2.24	None
3–2½% at $100[h]	8.25	19.50	31.50	32.50	52.50	48.75	78.75	2.50	Mo.
2½% flat	6.88	16.25	26.25	32.50	52.50	48.75	78.75	2.50	N. J.
2½–2¼% at $125	6.88	16.25	26.25	32.01	51.70	47.00	75.98	2.41	Vt.
2½–2% at $100	6.88	16.25	26.25	30.75	49.75	44.25	71.58	2.27	Calif.
2½–2–1% at $100 & $200	6.88	16.25	26.25	30.75	49.75	41.75	67.73	2.14	Wisc.
2% + fee[i]	7.50	15.00	23.00	28.00	44.00	41.00	65.00	2.10	N. H.
2% flat (no fee)	5.50	13.00	21.00	26.00	42.00	39.00	63.00	2.00	None
1½% flat	4.13	9.75	15.75	19.50	31.50	29.25	47.25	1.50	Ga.

annual charges equal to 42 percent of his average outstanding balance; it means further that a small loan company will receive a gross income of approximately 42 percent per year of its loan volume employed in the business, provided it collects 100 percent of its charges on the due date.[6]

The per annum equivalent of combination rates is not so obvious and may be determined only for loans of given size and duration. It may be approximated, however, from the figures in Table 36: a rate of 3½-2½ percent graduated at $100, for example, is lower than (or the same as) a 3½ percent and higher than a 3 percent straight rate for all regularly amortized loans, and therefore the per annum rate on such loans is somewhere between 36 and 42 percent. Since the

[6] It has been alleged that since interest on small loans is paid monthly there is a possibility of monthly compounding and that therefore a rate of 3½ percent a month is not 42 percent a year but 51 percent. This, however, is not very reasonable. If the personal finance company could reinvest each month 100 percent of its gross earnings, representing 100 percent collections on employed assets, it would indeed show a return of 51 percent per year on the capital invested at the beginning of the year; but no personal finance company can operate on these terms. Again, lenders are usually forbidden by law to add interest charges to principal in case of default. They can, of course, plough back each month any excess earnings that are not needed to pay expenses or meet dividend payments; but the portion of monthly receipts that may be so utilized is small; and, in practice, monthly receipts amount to substantially less than the 3½ percent of assets which is theoretically to be expected.

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[a] Computed by dividing the total dollar charges by the sum of the monthly balances outstanding—equivalent to dividing the total dollar charges by the product of number of months outstanding and the average balance outstanding.
[b] A 10 percent discounted service charge renewable semi-yearly in addition to the 10 percent per year interest. This rate and the proposed Collins rate are not directly comparable with the other rates shown in the table. In both cases the quoted charges should be considered as only approximations; they are based on the actual amount of cash advanced to the borrower, not on the face amount of the note. For a description of the Collins rate see p. 123.
[c] In Ohio there is an additional charge of $1 on loans of $50 and less.
[d] In Oregon there is a minimum charge of $1 per month on secured loans.
[e] In Maine there is a minimum charge of 25 cents per month.
[f] In Pennsylvania there is a rate of 6 percent per year on balances outstanding after 18 months.
[g] In Indiana there is an additional fee of 50 cents on certain loans.
[h] Note that rate is graduated according to original amount of loan rather than according to unpaid balance.
[i] A fee of $1 on loans of $50 or less, and $2 on loans over $50.

rates on individual loans vary considerably, there is no justification for attempting to obtain a more precise figure for the per annum rate.

THE RELATIONSHIP BETWEEN RATES AND LENDERS' COSTS

There has been much controversy among small loan experts on the ideal form of rate schedule. The Russell Sage Foundation and many others originally favored the flat percentage rate because of its simplicity. Others have held that the flat rate charge is unfair, since two classes of customers, the borrower of very small amounts and the borrower who repays his loan long before contractual maturity, do not pay enough to meet the costs of extending them service, and that therefore the flat rate should be replaced by one whereby each class of borrowers pays the actual costs incurred in extending the service received.

In view of this controversy it is surprising that there is no adequate information available on the actual costs of making loans of various sizes and durations. The few cost accounting studies that have been made are not sufficiently detailed for the purpose. One available study, made by the Household Finance Corporation, is based on the operations of 8 New Jersey offices over eight months of 1931.[7] Although the company has since abandoned this method of analysis we present it here as one possible approach to the problem of determining relative costs by size and duration of loan.

The Household computation involved three steps. First, the cost of making loans, including all expense that could directly or indirectly be allocated to investigation and to opening and closing the account, was divided by the total number of loans made during the period; this resulted in a cost per loan of $5.1688, hereafter called investigation cost, and

[7] Brief submitted by the Household Finance Corporation to the New Jersey Small Loan Commission, November 23, 1931, pp. 5 ff.

dividing by 12.35, the average number of months during which all loans were outstanding, gave $.4185 as the average investigation cost per loan per month. Second, a carrying cost was determined by dividing the total cost per month of carrying and collecting all loans by the average number of loans on the books at the beginning of each month; in this way $.9071 was obtained as the average cost per month of carrying a loan. Third, a percentage capital cost was computed by totaling bad debts and similar losses, federal income taxes, and a profit allowance at the rate of 12 percent of the amount of capital funds employed, and dividing this sum by the amount of capital employed; as a result, 1.5061 percent per month of the average outstanding balance was found to be the cost of providing capital.

TABLE 37

AVERAGE COST PER MONTH OF MAKING AND OF CARRYING A PERSONAL FINANCE COMPANY LOAN, JANUARY–AUGUST 1931, BY SIZE OF LOAN[a]

Size of Loan	*Operating Cost per Month*[b]	*Capital Cost per Month*[c]	*Total Cost per Month*	*Necessary Rate Charge per Month*	*Average Balance Outstanding During Life of Loan*[d]
$ 30	$ 1.3256	$ .3021	$ 1.6277	8.11%	$ 20.06
50	1.3256	.5035	1.8291	5.47	33.43
100	1.3256	1.0071	2.3327	3.49	66.87
200	1.3256	2.0142	3.3398	2.50	133.74
300	1.3256	3.0214	4.3470	2.17	200.61

[a] Based on brief submitted by the Household Finance Corporation to the New Jersey Small Loan Commission, November 23, 1931, p. 6; the data cover the operations of 8 New Jersey offices of this company. The duration of the loans is assumed to be 12.35 months, which is the average for all loans during this period.

[b] Investigation cost of $.4185 plus carrying cost of $.9071, irrespective of size.

[c] Amounting to 1.5061 percent of average balance outstanding.

[d] These figures computed from a sample of loans of all sizes paid off during the period; the sample probably includes loans that were renewed before being paid off.

In this threefold classification of costs the investigation cost is independent of the size and duration of the loan; the cost for the expenses of carrying and collecting is independent of the size of the loan; and the capital cost varies directly with the amount of the outstanding balance. On the basis of such a threefold classification it would be possible to estimate the cost of making a loan of any size and any duration. In the study carried out by the Household Finance Corporation, however, computations were made for loans of various sizes but of only one duration, 12.35 months—the average for all loans during the period specified. The results of this study, as they apply to loans of several sizes, are presented in Table 37, which also indicates the necessary rate charge per month to cover these costs.

Jackson R. Collins[8] recently reported a study comparable to that of the Household Finance Corporation. The results are summarized in Table 38, with average annual cost itemized in four categories, for the period 1929-36. It is interesting to note that credit investigation and acquisition expense, plus expenses incidental to closing transactions, is here $6.77 per year, as compared with the Household estimate of $5.17. The difference may be explained partially by the fact that Household had no advertising expense in New Jersey in 1931. The Collins estimate of average carrying cost of $10.49 per year, or $.87 per month, is almost identical with Household's $.91 per month. In the Collins study the item for bad debts is strictly a variable cost that should properly have been combined with the total costs of providing capital, and the lack of any treatment of capital costs is a decided shortcoming.

According to these estimates a rate schedule which would insure that each loan pay its share of costs should include: a fee of about $7, regardless of the size or duration of the

[8] *Report on Conference on Personal Finance Law,* Kansas City, September 28, 1937.

TABLE 38

AVERAGE COST PER YEAR OF MAKING AND OF CARRYING A PERSONAL FINANCE COMPANY LOAN, 1929–36[a]

Item	*Cost*
Credit investigation and acquisition expense	$ 5.77
Expenses incidental to closing transactions	1.00
Bad debts charged off	3.38
Carrying charges	10.49
TOTAL	20.64

[a] Based on J. R. Collins, *Report on Conference on Personal Finance Law*, Kansas City, September 28, 1937, p. 30. Each figure represents an unweighted average of annual averages.

loan, to cover the costs of opening and closing the account; a monthly service fee of about $1, regardless of the amount of the unpaid balance; and an interest fee of about 1½ percent per month on the unpaid balance. Such a rate is somewhat similar in form to the restatement rate discussed above.[9] The restatement rate, however, would provide for an investigation fee graduated according to size of loan, and for an annual rather than a monthly interest charge.

Such divisions of costs serve to show why the lender often considers very small loans, or loans repaid in a month or so, to be unprofitable under the flat-rate method of charging; but as a meaningful treatment of costs they have definite shortcomings. Some costs cannot be allocated to any of these categories, but must be charged against the general conduct of the business; such costs are license fees, and probably managers' salaries, auditing, at least part of rent and part of advertising, and it is probable that these are by no means negligible. If such general costs are to be fitted into a threefold, or a fourfold, classification, they must be allocated by some arbitrary method. They might be divided equally among all loans regardless of size; they might be apportioned

[9] See p. 123.

according to size; or they might be distributed according to loan duration, as so much general cost per month. In fact, any arbitrary cost accounting basis might be used, or even some preconceived standard of social justice.

Moreover, even if it were possible to classify all costs according to four categories—investigation, carrying, capital and general—such concepts as average investigation cost per loan made, average carrying cost per loan carried, and average capital cost per month per dollar outstanding, are somewhat misleading. These per-unit costs may vary with size or duration of loan, size of the establishment, type of borrower or nature of the security.

With regard to size of loan, it has already been shown that, other things being equal, charge-off losses are relatively higher for large loans than for small loans;[10] this would seem to necessitate a more exhaustive investigation of the borrowers of large amounts, or else the setting up of more than proportional reserves against losses from this source. In either case the larger loan is relatively more costly on this account than the small loan.

It is difficult to generalize about the variation of unit loan costs among offices of different sizes. We have already presented evidence showing that the net rate of return increases as size of office increases;[11] one would naturally conclude from this that unit costs are less for the larger offices.

Similarly, it cannot be assumed that the cost of investigation is as great for present and former borrowers as it is for new borrowers; and also other items of cost, particularly risk, may be expected to vary among old, present and new customers. Moreover, a loan secured by a chattel mortgage on household goods, on which it is necessary for an "outside" man to investigate the home, is doubtless a more costly undertaking than a schoolteacher loan, an unsecured or note loan,

[10] See Table 29, p. 104.
[11] See Tables 33 and 34, pp. 116-17.

or a wage-assignment loan, for which the nature of the credit investigation is quite different.

The main significance of such studies of loan costs as those reviewed here is that they distinguish the principal cost components. As guides to operations in the business they may be quite misleading. The estimates of cost that have been presented are estimates of average costs, computed by distributing the total of a particular kind of cost equally among all loans made. But in attempting to achieve maximum efficiency the loan office manager must consider much more than these average costs. If his facilities are not fully utilized additional business may be handled for a very small additional expense, and he may profitably take on loans of a type that might be considered unprofitable at existing rates if average costs were the only criterion. In particular, he might be glad to make loans of less than average size, or loans of shorter than average length, even though he could show that such business did not pay enough to cover the average cost, for the average cost might be reduced by the additional volume of business.

These considerations merely suggest that the criterion of average cost as the basis for discriminating in charges as between smaller and larger loans, or shorter or longer note lengths, is subject to many difficulties from the standpoint of actual lending operations. The employment of average costs for such purposes ignores too the social and regulative aspects of personal loan charges, but with these the present study has not been directly concerned.