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Consumer Credit in the Ghetto: UCC Free Entry Provisions and the Federal Trade Commission Study (Business in the Ghetto)

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Like the former speakers, I will not speak on the topic for which I was scheduled. Instead I am going to talk about two things which are not closely related to one another but which are both related to the profitability of the retail sale of goods and credit in the ghetto. I propose to leave the law on consumer credit to Mr. Dostert and Professor Hogan. First I wish to say a word on the so-called “free entry” aspects of the Uniform Consumer Credit Code; then I will comment on the Federal Trade Commission study.

What are the UCCC free entry provisions? What are they designed to accomplish? And how might they affect the profitability of lending in the ghetto? Those of you with experience in the consumer credit industry well know that the industry is subject to a variety of legal limitations which effectively balkanize the market. For example, the usury law often keeps banks out of the bailiwick of consumer finance companies and the maximum loan limitation keeps the consumer finance companies from lending to any of the banks' good customers. One suspects that those in the industry have inspired or at least contributed to the perpetuation of some of these legislative boundaries as a convenient way of holding competition at a comfortable level.

The UCCC would dissolve a number of these boundaries. Specifically, it would largely remove the application of the standard usury law from the installment consumer credit market. It would greatly reduce the licensing requirements which now operate to keep some lenders out of certain markets, and it would remove the maximum dollar amount limitations which currently apply to small loan lending in most of our states.

The UCCC would permit any “supervised lender” to charge the following rates on installment loans: 36% (simple annual interest) on the first $300, 21% on the next $700 and 15% on amounts over $1000. Two significant changes from the current law in most states inhere in these proposed rates. First they will allow a variety of lenders such as banks, non-federal credit unions and others to lend at rates greatly in excess of the standard 7 or 8 or 9% usury rates. Second, they will allow the consumer finance companies who now enjoy statutory exceptions to the standard usury laws in most states, to raise their rates from those presently permitted under the small loan acts of most

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states. In Michigan for example, a consumer finance company can now lend at no more than 30% simple annual interest on the first $300 of the principal balance of the loan; under the proposed law that same company would be able to lend at 36%.

UCCC contemplates licensing of supervised lenders, but it is a licensing of a different sort than that now practiced in many of our states. In many states, one must apply for and receive a license for each physical location at which he plans to do consumer finance business. Moreover he must prove to some administrator that it is in the "convenience and advantage" of the state that such a license be granted. "Convenience and advantage" is not a term of precise definition; in one state it may mean that a new office becomes convenient and advantageous only after one has made an appropriate payment to the proper state official. In another it may mean that no other small loan office may be located within a fixed distance from the proposed new office. But almost everywhere the upshot of all this is that there are fewer offices, fewer credit outlets than would otherwise be the case.

The UCCC would remove the convenience and advantage requirement. It would permit any to enter the market who appear to be above board and economically capable of carrying on the business which they propose. Moreover it would do away with the licensing of individual offices and would require only one license for a company's entire operation in a given state.

Finally, the UCCC would permit the small loan companies to lend any amount upon which it and the customer could agree. The current limitations (e.g., no loan to any one person in excess of $1000 at any one time) were apparently designed to keep low income persons from borrowing too much money at too high rates. The limitation has not achieved that goal and has in fact increased the money cost of the low income consumer. It has not kept the total amount of borrowing of any given consumer down, because it does not prevent the consumer from borrowing more than $1000 by going to two or more loan companies. The consequence of his borrowing an amount greater than $1000 but at two or more loan companies is that he pays a substantially higher rate than he would pay if he borrowed the entire amount at one company. This is so because of the regressive interest rate structure—that is one pays a higher amount on the first $300 than he pays on the next $700 and so on.

In the best of all possible worlds what would be the impact of the new rules in a ghetto neighborhood? They would mean that an indigenous organization such as a development corporation could open its own finance company which would lend at rates lower than those presently prevailing and would use more tender and humane collection procedures. It would mean that the competition from such new entrants in the market would drive the price of money down and that some of those who now borrow at 30% could borrow at 24% and
lower. And, paradoxically, it would mean that some who cannot presently borrow because they are not sufficiently credit worthy under a 30% maximum rate would be able to borrow because the lender could charge 36%.

What in fact will happen in the real world if the UCCC is enacted may, of course, bear no relation to the best of all possible worlds. The market consequences of the enactment of the UCCC is the subject of heated debate both among the self-interested lenders and borrowers and among the presumably disinterested and dispassionate economists. Some creditors (e.g., the banks in Minnesota) are so fearful of the competitive effects that they have lobbied for the removal of nearly all of the free entry provisions from the UCCC; some consumer organizations (e.g., the magazine, Consumer Reports) have so little hope for the salutary consequences of competition, that they characterize the whole thing as a sellout to the creditors.

Doubtless the truth lies somewhere between these viewpoints; I happen to think that the Consumer Reports article is more wrong than is the bankers' position. First, one who talks with the people involved in the consumer finance industry, who is familiar with their current practices, and who observes the advertising in that industry, has a strong suspicion that the consumer finance companies will do almost all, if not all, of their lending at the maximum permissible interest rate. If the rates in Michigan are raised from 30% to 36%, I strongly suspect that all of the consumer finance companies will be lending at 36% shortly thereafter. Certainly that has been their pattern of behavior with some few exceptions and their advertising emphasizes speed, courtesy, and willingness to lend, not the cost of money. Moreover, as retailers of credit, they are surely experiencing significantly higher wholesale money costs than they experienced even a few years ago. For these reasons, it is probably safe to assume that competition would not operate to maintain the consumer finance rates at less than the maximum permissible rate, and therefore that the effective money cost of the customers of such organizations would increase significantly in most of our states.

On the question whether an increase in rates will cause lenders to take risks that they would otherwise reject, the case for the UCCC is stronger. If the retail lender is lending at only one rate to nearly all of his customers (as the consumer finance companies are) and he is losing money, the obvious solution is to discard his lowest stratum of risk—those who have the worst payment record, the most tenuous and uncertain employment etc. Indeed, I am familiar with a small loan company in Chicago who dropped automobile financing altogether after the competing banks had skimmed off their best customers; under the Illinois rate structure they could not make money lending only to the remaining and poorer risks. Thus it seems plausible and even likely, that an increase in the permissible rates will cause additional
money to flow to the consumer lending industry and will cause consumer finance companies to accept classes of risks which they would have rejected had the permissible rates been lower.

Finally, the kind and nature of competition for the current lenders which might spring up under the UCCC is anybody's guess. Indigenous organizations might organize their own companies and such organizations might be moved to lend at rates lower than the maximums. They might use more humane collection procedures, but all of that is the sheerest kind of speculation. It is of course, possible that such organizations would simply fall into the mold of the current lenders.

In arriving at your own judgment upon the merits of the UCCC, each of you will have to balance the presumably detrimental consequences of an increase in rate by some of the current lenders against the presumably salutary consequences of their lending to a wider spectrum of risks and of the consumer protection provisions which Mr. Hogan will discuss. For my own part, after I have weighed all the intangibles and considered all of the arguments, I favor the enactment of the UCCC.

Now I would like to talk to you for a few minutes about the study conducted in the District of Columbia by the Federal Trade Commission. The study's official title is "The Economic Report on Installment Credit and Retail Sales Practices in the District of Columbia"; it is a fascinating document which will amply reward a few hours of study by any of you. It is the only published piece, known to me, which has examined the consumer credit market in a large city ghetto in a systematic way. Its importance is multiplied by the presence of a great deal of firmly held, but totally inaccurate opinion about the consumer credit market in the minds of many of us.

Yesterday Burt Griffin seemed to say that anyone who was inspired by the lucre motive to do business in the ghetto had rocks in his head. Now I have been a friend of Burt's since we were in college together fifteen years ago, and periodically since that time I have accused him of operating under the motto "Often wrong, but never in doubt." Here Burt may be right; it may not be possible to sell goods or credit at a reasonable price in the ghetto and make money. But at minimum the study shows that he ought to be in doubt; certainly there are people making a handsome living from selling goods in the ghetto and the study offers some hope that others could sell at lower prices than those currently prevailing and still make money there.

I will first outline the scope of the study and summarize its findings on net profit, return on investment and costs of doing business. Then I will give you some suggestions about the study's meaning to those who are considering retail selling in the ghetto.

The study reports figures for the calendar year 1966 in the District of Columbia. The Federal Trade Commission surveyed all of the retailers of "hard goods" in the District who had estimated annual sales
of more than $100,000. They believe that they covered more than 85% of all the furniture sales in the District. Ultimately, the FTC limited the study to 65 retailers among their original sample of 96 because only 65 sold on installment credit. These 65 were divided into "low income" sellers and "general market" sellers. One became a low income seller only if his store was located in or near the ghetto and he did not advertise to the general market. (Thus if one were located in the ghetto but he advertised in the newspapers or on the radio to reach those living outside the ghetto, he was not regarded as a "low income" seller.) The general market retailers were further divided into three categories: (1) appliance, TV and radio outlets, (2) furniture stores and (3) department stores.

To avoid any mistake, let me emphasize those who were not included in the study, those about whom the study says nothing. First, it did not deal with any sellers of services or sellers of food or soft goods. Nor did it deal with the group of sellers of goods who have recently caused trouble all across the United States, namely the sellers of house siding and other home improvements, and of goods such as encyclopedias. Since the study dealt only with those who had fixed places of business in or near the District of Columbia, such transient sellers of goods were not included. Since the study was limited to the sellers of goods, it of course did not deal with banks, finance companies or others who are engaged solely in lending.

The most relevant and interesting information obtained in the study is that dealing with gross margins and net returns. The gross margin (the difference between the total revenue from the sale at retail and the wholesale cost) of the low income seller was far greater than that enjoyed by the general market retailer. The low income seller marked up his wholesale price by 100 or 200% whereas the general market retailer typically marked up his price 50% or less. Consider the following example: both the low income and the general market retailers purchased a specified type of portable Motorola television set for approximately $109 wholesale. In some cases the general market retailer sold that television set for as little as $129.95 (almost certainly a cash sale); the low income seller sold it for $219.95. The study reveals several other identical items on which the discrepancy between the gross margin of the low income seller and that of the general market seller was even greater.

One notes in passing that there is almost certainly some interest charge imbedded in that $219 price. Despite the fact that he will add a time-price differential or an interest charge on top of the $219, the low income retailer would likely sell that TV at somewhat less than $219 cash if we bargained with him. The study shows that more than 90% of the low income sellers' sales are on credit; it reports that only 25% of the general market retailers' sales were on credit.

One would naturally assume that the gigantic markup the low in-
come seller charges would result in an outrageous net profit. Contrary to this expectation, the study shows that the low income sellers' net profit on sales after taxes is only 4.7%. This compares with 2.1% for the general market television and appliance stores; 3.9% for the furniture stores and 4.6% for the general market department stores. So the low income seller makes a better profit per dollar of sales than anyone else, but it is not a radically better profit.

Moreover the low income seller earns the lowest net return on investment of any of the groups studied. His return is only 10.1% whereas the television and appliance seller reaps approximately 20% on his investment, the furniture store 17% and the department store approximately 13%. These differences in the return on investment are partly a function of the amount of leverage in the various businesses. Apparently, the television and appliance stores are the most highly leveraged; it appears from the study that they sold 98% of their paper and they undoubtedly held their inventory on consignment or floor plan. The low income seller sold only 20% of his paper. Why he did not or could not sell more of it does not appear from the study.

How can one markup his goods by one or two hundred percent and still make only a five percent net profit on sales? The answer, of course, lies in his costs, and it is here that the potential entrant into the ghetto consumer credit market will wish to look most closely at the FTC study. If one cannot avoid some of the costs which the low income seller experiences, then Burt is probably right, for few will wish to adopt the selling and collection practices of the low income seller. Yet any who wishes to make a profit in the ghetto will either have to adopt those practices or avoid some of the costs which the current low income sellers are experiencing. Unfortunately, the study does not give as much detail on the type and amount of costs which the low income sellers experience as one might wish. It does suggest at least three areas for investigation: bad debt losses, employee selling and collection expenses, and legal expenses associated with collections.

First consider the low income sellers' bad debt losses; the low income seller lost approximately 6.7% of his sales in bad debts, whereas the general market retailer lost only .3%. Note that not all of this very substantial difference is attributable to the fact that the low income sellers dealt with poor credit risks. A substantial part of the difference is surely attributable to the fact that more than 90% of the low income sellers' business was credit business whereas only 25% of the general market retailers' business was credit business. Thus even if the credit worthiness of the low income sellers' clientele had been identical to that of the general market retailer, he would still have had to have written off a substantially higher percentage of his total sales.

Secondly, the low income retailer spends approximately 28% of his total sales revenue on employee salaries and commissions; the general market retailer spends only 17% of his sales for that purpose.
Why did it cost more to sell in the ghetto than elsewhere? The answer lies partly in the mode of selling. At Sears, Roebuck, one or more salesmen man a sizeable department and handle a large volume of sales. The low income seller sends his men door-to-door in his neighborhood and these salesmen receive a percentage on the sales. Moreover, they also go door-to-door to collect and they also often receive a percentage of the collections.

The study shows that the low income seller experiences substantially higher "miscellaneous costs" (21% of sales) than does the general market retailer (11% for him). The study does not specify the nature of these expenses in any detail, but it is clear from some of the data that at least a part of these expenses are legal fees and the costs of filing and conducting law suits. Eleven of the low income retailers in the study procured 2,690 judgments, 1,568 garnishments and 306 judicial repossessions in the court of the District of Columbia in 1966. Eight general market furniture stores doing a volume apparently equal to or greater than that of the eleven low income sellers procured only 70 judgments by comparison. Moreover, eighteen low income sellers instituted 3,030 suits in 1966 (roughly 1 for every $2,600 of sales); 47 general market retailers instituted 1 suit for each $232,000 of sales. These figures may be a little fishy because some of the suits and judgments by either or both groups may have been instituted or taken in the names of the collection agencies and thus not reported in the study. Still it would take a massive error in these figures to wipe out the difference in the use of the courts between the low income sellers and the general market retailers.

The final group of data which I will not go into, but which is important to one who contemplates entry into the ghetto consumer credit market is that dealing with the profile of the low income consumer. The study reports the kinds of jobs which the ghetto consumer held; whether the head of the household was male or female; the size of the family and so on. These data are of obvious importance but I have no time to summarize them here.

Let us turn now to an analysis of the data. What do the data tell us about Burt's suggestion of yesterday that one cannot sell at a reasonable price in the ghetto and make money? What conclusions should we draw from the massive data which the FTC has made available to us? A threshold and obvious question in such analysis is to ask the breadth of application of the study's findings. Are there factors present in the District of Columbia ghetto which would render the study's findings invalid with respect to the Detroit or Los Angeles or St. Louis ghetto? Well, Vice President Agnew has told us that if you've seen one ghetto you've seen them all. Now I think one ought to view that proposition with a bit of skepticism. Yet from my comparatively uninformed vantage point, I can see no good reason why the main findings of this study would not also apply to similar transactions in other American
ghettos. I say that with some hesitance for I cannot claim real familiarity with even one ghetto, and even my assertion (that I see no differences) falls short of a positive statement that the findings are applicable elsewhere. Let me suggest some investigation which one might wish to undertake before he accepted the study as a reliable indicator of the state of the consumer credit market in his own ghetto. For one thing he would want to compare the ethnic backgrounds of his own people with those of the residents of the District of Columbia ghetto. It may be that poor blacks are better or worse creditors, are more or less careful buyers or otherwise behave differently from low income whites or Mexican-Americans or Indians. One would also want to examine the occupational and familial status of his own people and compare those findings to those contained in the FTC study. Obviously the ADC mother who is living without a husband but with three or four children may behave differently and have different needs than an aged couple who have no children.

Passing then the problem of comparing the District of Columbia ghetto to others, and assuming for the sake of the argument that the results of such a comparison would show no significant differences, what does the study tell us about making money as a seller in the ghetto? First, it shows that there are those who do make money there. It also shows that they do so by charging prices and using means which most would not wish to employ. Second, it shows that there is a sizeable and concentrated market. The study estimates that there are 88,000 "poverty" families in the District of Columbia; that they make 260 million dollars per year and that they spent 18 million dollars on furniture and other hard goods in 1966. Moreover, the study estimates that the low income sellers captured between 35 and 45% of that furniture market.

The study quite clearly shows one cannot simply take a carbon copy of a suburban store and make the same profit on the same operation in the ghetto. It indicates that one must be ready to engage in substantially more credit selling in the ghetto that he would have to do in the suburbs and that one must find a way to attack and reduce many of the costs which were experienced by the ghetto seller if he is to make a decent profit without charging outrageous prices.

One who seriously contemplates a ghetto selling operation should first examine the selling and collecting costs of the ghetto seller with a critical eye. If he could find a way to break the door-to-door syndrome and somehow train the customer to come to the store to buy and to pay, he would have taken a giant step toward profitable ghetto selling at reasonable prices. I can offer nothing more than the most speculative kind of suggestions for attacking this syndrome. One might be an education campaign conducted through block clubs and such other indigenous organizations as may be available. Surely the door-to-door bill collector and the door-to-door seller must have accumulated a
large balance of bad will as a result of prior sales of very expensive and sometimes unmerchantable merchandise. Such clubs and organizations could perhaps build upon this bad will as a basis for attacking their door-to-door selling technique. A second thought is the enactment of legislation which would bar or severely limit door-to-door selling. Some few suburbs now absolutely prohibit door-to-door selling and the "give back" provisions in the UCCC may inhibit it somewhat.

A second cost which one who is considering entrance into ghetto selling should not accept as a given is the bad debt loss experienced by the low income seller. The study gives no clue on the care with which the low income seller checked the credit of his customers nor does it make any attempt to correlate customer dissatisfaction with the product and failure to pay. It may well be that a more sophisticated credit analysis and a less frequent sale of unmerchantable or unwanted goods would substantially reduce the credit losses which were experienced by the low income sellers.

Finally, the study tells nothing about the reasonableness of a variety of other expenses which the low income seller suffered. One may find, for example, that a larger and more sophisticated store would enjoy certain economies of scale which the low income sellers did not enjoy. He may also find that the salaries which those stores paid were, in fact, disguised dividends to the owners of the enterprises. And he may find that the substantial expenses which must have been associated with the large number of lawsuits which were filed did not pay for themselves or could be avoided by a more careful selection of the credit risks.

In summary, then, the proper conclusion which one should draw from the FTC study concerning the profitability of selling on credit in the ghetto is that the jury is still out. The study shows that those currently engaged in ghetto selling make a handsome profit but it suggests that they do so only in the face of very large costs and by the use of prices and techniques which would render such business repugnant to most. On the other hand, the study gives no evidence that one must take all of these costs as givens and it does show that there is a sizeable and concentrated market in the ghetto which is now inadequately served. In short, it shows the presence of that kind of market which has historically encouraged the entry of new and aggressive business. Nothing would please me more than to have one of you prove by doing it that one can make a good profit in ghetto consumer credit without resort to unreasonable prices and unconscionable practices.