

## Something to Think About



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This week, a reporter friend of mine asked my thoughts on the prospects of traditional banks and credit unions getting into, what can only be called, the payday lending space IF the Administration's regulatory reform proposals get through the Congress. It seems some banks have made overtures about doing just that, but this is very anecdotal and far from the norm. Frankly, I am kind of professionally ambivalent on the matter, but I still gave these bullet points to him:

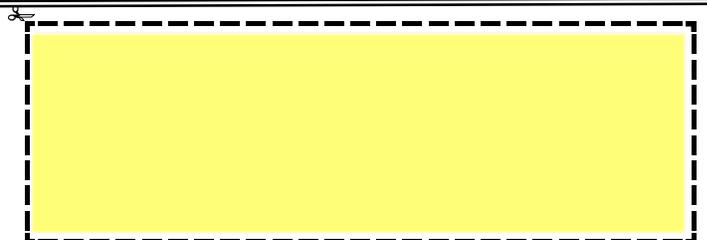
- Due to the costs associated with extending credit, it is hard to imagine banks falling over themselves to start making a bunch of \$300 two week loans for business purposes.
- There is a difference between making a small, short-term loan for an established client and making one to a stranger off the street.
- At a 10% annual rate, a \$500 two-week loan generates about \$2 in interest for the lender. Can they originate, underwrite, and service the thing for that of money, let alone overhead? Candidly, it makes more business sense to let people bounce checks.
- There is a difference between what the company spokespeople say and the what the CFO offices think. Guess who normally wins that argument.
- Those banks which enter this lending arena will do so up to the point where they maximize their Community Reinvestment Act rating, and probably not much more than that. That is cynical but honest, and better than nothing.
- Once the payday lending imbroglio reaches an acceptable conclusion, consumer advocacy groups will target overdraft charges and ATM fees. Depending on the average balance in an account, these can be even worse than payday loans.
- Imagine a local ATM charges \$3 for non-customers. If you take out \$20, that one day loan, for all practical purposes, as an annual rate of about 5,475%, using a 365 day count basis. Where is the outcry over that?
- Listen, if this were truly a profitable business line for traditional banks, there wouldn't be a payday lending industry or loan sharks in the first place.
- Traditional banks want back in the business? If you say so.
- Hmm. I can pay \$35 to the payday lender so I can pay my \$200 utility bill or I can bounce a check and pay \$35. What should I do?

Yep, that about sums it up. Frankly, it is just math.

How many \$300 2-week loans must a bank make in order to gross, say, \$1 million in revenue? That is relatively easy to answer, as the 'processing and financing' on something like that is around \$15 per \$100, or thereabouts, given current business practices. So, 1,000,000 divided by 45 equals 22,222 and change. But that \$45 on a 2-week \$300 loan is equal to annual rate of around 391%, which is usurious given the current zeitgeist.

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From what I have read, the various powers that be seem to think 36% is an acceptable ceiling for these short-term loans. To be sure, that rate is a great deal more than a traditional loan from a traditional lender. But what is the math on that? Well, that turns out to be around \$4.15 on that \$300 2-week loan. As such, to GROSS \$1 million, a lender would have to physically process 240,964 of the things including rollovers (\$1 million divided by \$4.15).

The issue here isn't whether the bank can make a great spread on committed capital: it can, since roughly 80% will/can be rollovers/extensions at any given time. Still, the numbers start to boggle a little bit. What if it is 'only' 50,000 new loans and 190,964 extensions? How about 60K and 180K? What if 10% default or even 20%? Heck, I have seen numbers as high as 46% (in North Dakota).

Under current practices, the lender gets their \$300 back if a borrower extends 7 times, roughly a quarter. Done. At \$4.15, it would take 72 extensions to make back the \$300, or about 2.75 years. Do you think the likelihood of a default will go up or down over that time period?

In truth, on one side, this business just doesn't pass the proverbial smell test, does it? On the other, why would a traditional lender really want to get into this morass at a capped rate of 36%, understanding the sheer volume of loans and extensions necessary? Shoot, they would have to build out the necessary capacity to generate the efficiencies, and guess who has already done that? That's right, the payday loan industry.

Further, from what I can tell from looking at income statements and Internet stories, the net profit margins at payday lenders ain't what you might think....the over/under line seems to be around 10%. This means the following: yeah, the payday lenders are making money, just not as much as you might think they are. After all, there is overhead; there are charge offs, and there are employee related costs, etc. It is a business, with business related expenses.

To that end, two of the largest publically traded pawn shop/payday loan companies in the US are EZCORP and FirstCash. Neither of these two companies has had an annual net profit margin in excess of 15.35% going back to 2001. Certainly, the CFO's offices can tweak here and there for any given time frame, but for 15+ years? Consistently? Further, the current, reported fiscal year profit margin for both companies are 4.30% and 7.84% respectively.

So, decent money making unsavory short-term loans? You bet. As much as you thought, at least as far as these publically traded companies are concerned? Probably not.

As a result, I go back to the bullet points I gave my friend. What do I think are the chances traditional lenders will enter (or reenter) the so-called payday lending industry in a meaningful way given some type of regulatory reform?

If I were a betting on such things, I would say you could reasonably anticipate traditional lenders to absorb about 10%, maybe a smidge more, of the current industry if & when various government industry effectively run it into the ground. This will likely come in the form of additional overdraft lines for borrowers with a minimum FICO score and proof of some household income threshold. In short, they will cover those people who probably didn't really have to go to the payday lender in the first place, but for the fact they didn't want to bounce a check...or something along those lines.

Banks and credit unions will NOT get into the business of making, rolling over or extending loans for borrowers without those minimum criteria. As a result, you could sensibly argue significant reform and/or restrictions upon the payday lending industry will deny the poorest among us access to credit, at least through somewhat official channels. Admittedly, the current access is pretty darn hard to swallow at times.

Therein lies the rub.

You can outlaw or otherwise be indignant about payday lending, but that won't stop the underlying problem. This being: there are a lot of people who don't make enough money to make ends meet, regardless of their monthly budget. As a result, they need short-term funding sources. THAT is the problem. Payday lenders are a symptom of it. But what are the alternatives?

Frankly, if states like Alabama effectively prohibit the industry, I would fully expect the use of pawn shops to grow exponentially. At first blush, that sounds like a bad thing, but it isn't, really. The reason is simple: when people get a pawn

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loan, it is generally for the amount needed or very close thereto. After all, they are putting up something of some value as collateral on the loan, and they ordinarily would like to get it back. For this reason, from what I have read, pawn loans are typically smaller than payday loans AND the default rate seems to be significantly less. Shoot, if you keep rolling a \$300 loan, that \$45/fortnight payment becomes a part of your monthly budget. If you hock your television to pay the \$150 cable bill, strangely enough, hot doggit, you want your TV back and will make more prudent financial decisions moving forward.

As a result, perhaps unintended, the recent push to effectively price the payday loan industry out of business will be a boon for pawn shops....not for traditional lenders. This will simply shift the problem from the realms of the pernicious to merely the unfortunate. This, I assume, is a step in the right direction, even if it isn't what politicians and the indignant would like or have imagined. So, those are my real thoughts on the matter.

That is about it for today....good week, but a SLOW Friday.

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