



U.S. Senate Committee on Banking, Housing and Urban Affairs

Hearing on the Department of Defense's Report on Predatory
Lending Practices Directed at Members of the Armed Forces
and Their Dependents

Written Testimony
of
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It is an honor to appear today before this Committee. Thank you for the opportunity to share some thoughts on predatory lending practices directed at military personnel and their dependents. My name is Christopher Peterson and I am a law professor at the University of Florida where I teach commercial law and consumer law classes. I commend you, Mr. Chairman, Senator Sarbanes, and other members of the Committee for organizing these hearings and for providing an opportunity to discuss this important and timely national issue.

As you know, the Department of Defense recently released a large report on predatory lending to military personnel. I have been asked to share my reactions to this report. In short, I believe that deceptive and onerous credit is a significant problem for both the military and for many middle and lower income Americans. The Department of Defense's report does an excellent job of compiling the various predatory lending threats to its personnel and in recommending an appropriate policy response. In this testimony, I will briefly discuss some historical, economic, geographic, and legal considerations which may be of assistance to you in deliberating on the meaning and significance of this report.

Military Personnel Have Historically Been Vulnerable to Oppressive Credit

Predatory lending is not a new phenomenon either in American or world history. Since humanity's earliest recorded history, some creditors have always been willing to

take advantage of desperate, incautious, or naive borrowers by making loans with ruinous interest rates and remedies. While today's borrowers wonder whether they will have sufficient funds in their account to cover a check post-dated two weeks in advance, ancient debtors dreaded "the end of the moon" when their high cost loans came due.

Moreover, government and religious leaders of virtually all complex civilizations have tried to limit the harsh consequences these contracts can have both for borrowers *and* for their communities and institutions. It is no coincidence that humanity's very first recorded comprehensive legal system, the Code of Hammurabi (c.1750 B.C.E.), includes aggressive consumer protection rules. According to legend, the Babylonian Emperor Hammurabi ascended a mountain where Shamash, the Babylonian God of Justice gave him a comprehensive code which was used to govern that civilization for over a thousand years. Included in the statute was a usury law that limited interest rates to 20% per annum for loans of silver and 33% on loans of grain. The text of the code bears a remarkable similarity to interest rate caps adopted thousands of years later, including the interest rate cap purporting to limit interest rates to 18%, which is still in the State code in my home state of Florida. Ironically, the loans offered by companies that surround virtually all of our military bases would have been illegal in ancient Babylon.

History books are full of evidence suggesting military personnel have tended to be especially vulnerable to oppressive moneylenders. For example, violent riots broke out in the early Roman Republic (before they adopted a usury law) when the public learned of

an oppressive credit contract between a military veteran and a money lender. When the veteran was unable to pay his debt the moneylender took his farm and imprisoned him. The resulting riots, usually called the “First Secession” by Roman historians, threatened to undermine the entire emerging Roman Republic. Public resentment of oppressive credit contracts was stabilized when the government adopted an interest rate cap in the twelve tables, a law which served as the foundation of Roman law and still influences civil legal systems in Europe and the state of Louisiana. Throughout most of the Roman Empire and eventually the Byzantine Empire, the government capped interest rates at 12% per annum.

All throughout our national history—with the exception of the past decade or two—we have attempted to protect military and non-military borrowers alike with usury laws. The founding fathers brought over English interest rate caps when they arrived in America. When the U.S. Constitution was ratified, low usury ceilings and a frontier thrift ethic were nearly universally agreed upon by America’s first leaders. It is extraordinarily unlikely that George Washington, Thomas Jefferson, or Alexander Hamilton would have tolerated 500 percent interest rate loans to members of the Continental army. Certainly Benjamin Franklin, who frequently wrote on the subject and was a strong proponent of usury law, would have been outraged at today’s military loans.¹

1. For example, Franklin once wrote:

Think what you do when you run in Debt; *You give to another Power over your Liberty*. If you cannot pay at the Time, you will be ashamed to see your Creditor; you will be in Fear when you speak to him; you will make poor pitiful sneaking Excuses, and by Degrees come to lose your Veracity, and sink into base downright lying; for, as Poor Richard says, *The second Vice is Lying, the first is running in Debt*. . . . Poverty often deprives a Man of all

During America's rise to international power in the twentieth century federal and state governments relied on usury laws to deter, educate, and exercise symbolic moral leadership on predatory lending. During the years when so-called "greatest generation" governed our country, very few states or leaders were willing to depart from our traditional usury laws. Our military, along with our allies (all of which, incidentally, did not tolerate predatory lending to their troops either), managed to win the Second World War without the assistance of triple digit interest rate loans in whatever form those loans might take. In the economic boom years following the war, our country became more comfortable with using credit to finance a middle class lifestyle. But it was not until much later that loopholes in our law, including the Supreme Court's historically dubious interpretation of the National Bank Act, allowed lenders to begin marketing loans with terms that in past generations would have been associated with illegal loansharks.

A long term historical perspective suggests that the Department of Defense's recent report on predatory lending is actually quite conservative in substance and modest in proposals. Any responsible look at our national history reveals that at no other time would the Pentagon have been forced to implore the Congress to protect its personnel from triple digit interest rate loans. In every previous American generation, the Department of Defense's substantive legal recommendations would have been accepted

Spirit and Virtue: Tis hard for an empty Bag to stand upright The Borrower is a Slave to the Lender, and the Debtor to the Creditor, disdain the Chain, preserve your Freedom; and maintain your independency: Be industrious and free; be frugal and free.

DAVID M. TUCKER, THE DECLINE OF THRIFT IN AMERICA: OUR CULTURAL SHIFT FROM SAVING TO SPENDING 9-10 (1991); 7 THE PAPERS OF BENJAMIN FRANKLIN 342-49 (Leonard W. Labaree ed., 1963).

with little or no debate.

The Department of Defense Report is Economically Sound

Free and competitive enterprise is one of the backbones of American society. And, no institution is more responsible for preserving our freedom to conduct business than the Department of Defense. However, I would respectfully counsel the Senate to recall the great difference between a competitive market and market anarchy.

In a competitive market, self-interested, autonomous commercial behavior creates better policy outcomes than government intervention, because each individual can be trusted to make their own resource allocation decisions. As each individual makes decisions about where to invest their time, services, and funds, competitive markets naturally evolve into a result that is better than could have been achieved had government intervened. Adam Smith famously compared this process of individual, self-interested decision making to an “invisible hand” that guides social policy to the optimal outcome.

Unfortunately, sometimes the invisible hand alone does not work. Responsible leaders uniformly agree that the government must intervene in the market for some goods and services. We can all agree that the U.S. government should ban free markets for weapons grade plutonium, child pornography, or heroin. These products have characteristics associated with them that make an unregulated market unacceptable. The sale of plutonium to terrorists would likely impose the highest externalities on those killed

by a bomb made as a result of the contract. We ban child pornography because contracts to purchase it create an incentive to assault our children, and because we refuse to recognize economic demand for that product as morally legitimate. We ban the sale of heroine because buyers of this product tend to make non-rational decisions by virtue of the product's addictive characteristics. Our ancient (and only recently relaxed) laws against predatory loans are evidence of analogous market imperfections associated with credit contracts.

At least three market imperfections prevent the market for high cost short term loans from resolving to an efficient equilibrium: (1) imperfect information, (2) behavioral distortion, and (3) externalities. First, consumers have great difficulty comparing the prices of credit. Despite the best efforts of our educational system, many people in our society still have (and likely will *always* have) difficulty learning to read or make simple mathematical calculations. The "invisible hand" cannot create efficient outcomes when individual borrowers do not compare the price of a loan to its opportunity cost. In markets that are targeted by predatory lenders, it is likely that a large percent of the served population have little or no idea how to compare credit prices. Moreover, because creditors can hide and obscure those prices through inaccurate disclosure, hidden fees (including contingent charges such as late fees, over-the-limit fees, attorney fees, etc.), and worthless add-on products that even *rational* borrowers will not attempt to shop,

since doing so is likely to be an unproductive use of time.²

Second, Consumers, including military personnel, do not always make economically rational decisions. As the nobel prize winning research of Daniel Kahneman and Vernon Smith demonstrates, people often fail to match their estimation of the value of the a product to the utility they actually receive from it. For example, consumers often unreasonably discount the value of future income. Sometimes, for better or worse, people want today, what they *should* wait for until tomorrow. That is why it is difficult to save for retirement and it is one reason why many people borrow more money than they should. Similarly, consumers tend to overestimate their own ability to control financial outcomes and underestimate factors outside their control, such as unexpected car repairs, illness, payroll mistakes, job loss, etc. This common tendency leads borrowers into believing they can quickly repay high cost loans, when in reality, they cannot. Predatory lenders understand how these behavioral distortions operate in the credit market, and intentionally exploit them. This is why advertisements for “fast cash” or “easy credit” can tempt people, including soldiers, sailors, airmen, and marines, into making unreasonable financial decisions.

Third, predatory loans have significant costs—usually referred to as

2. Although the government has attempted to assist in this respect by passing the Truth in Lending Act, most people agree that there are serious problems with this statute as it is currently written. TILA disclosures are difficult to understand, come far too late in negotiations (after a loan applicant has already decided to borrow), and are riddled with exceptions that distort the usefulness of disclosures. Moreover, inflation has outdated the dollar limits to the scope of the statute and the remedial damage awards that deter non-compliance. Besides, predatory lenders consistently disregard and obscure TILA disclosure rules anyway. *See generally* CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH COST CREDIT MARKET (U. Akron Press, 20034)

externalities—born by those not privy to the contract. For example, when a predatory loan does not only hurt the borrower, it can also lead to deprivation of resources that would have otherwise gone to the borrower's children or other dependents. Neighborhoods that host predatory lenders often suffer from lower property values. Utilities, hospitals, landlords, and mainstream financial service providers all have greater difficulty obtaining timely payment from consumers who become mired in high cost debt. Because they tend to be more aggressive than other creditors, predatory lenders frequently skip to the head of the line obtaining payment before others with less questionable debts.

The Department of Defense report should be seen as an emphatic example of the externalities associated with predatory loans. Military leaders are speaking out, explaining that predatory lending is eroding the military readiness of our armed forces. Who better to know whether this is true than the Pentagon along with the many generals, admirals, and other officers who have spoken out on this issue? By trapping military borrowers in high cost predatory loans, lenders are disrupting the family lives and emotional well being of those who are protecting us in a complex and dangerous world. The evidence cited by the Pentagon on the thousands of service members who have suffered revoked security clearances as a result of predatory lending should be seen as concrete, unimpeachable evidence of a market distorting externality associated with high cost consumer loans.

The Department of Defense Report is Empirically Sound

A previous study conducted by Professor Stephen Graves, of California State University, Northridge, and myself examined the location patterns of one type of predatory lender in relation to military installations around the country.³ In our study we examined 20 states, 1,516 counties, 13,253 ZIP codes, nearly 15,000 payday lenders, and 109 military bases. We found high concentrations of predatory lending businesses in counties, zip codes, and neighborhoods in close proximity to military bases. Our study controlled our observations by comparing the density of payday lender locations in military areas to statewide averages and also by comparing payday lender locations to bank locations. We could find no statistically reasonable explanation for these location patterns except for the presence of military personnel living on or in close proximity to military bases.

This pattern existed in every state we looked at, except for New York, which had consistently and aggressively enforced its 25 percent per annum interest rate cap. Unlike every other major military installation we studied, Ft. Drum (home to the Army's 10th Mountain Division) in upstate New York was not surrounded by payday loan outlets. While other credit options were available, including finance companies, credit unions, banks, thrifts, and pawnshops, there was not a large on the ground force of triple digit interest rate lenders surrounding the base. In contrast, voluntary trade association guidelines, or so-called "best practices" agreements, did not create any demonstrable

3. Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653-832 (2006).

influence on the geographic patterns associated with payday lenders and military installations. Similarly, a variety of ancillary state consumer protection rules, such as roll-over limitations, internet databases, and licensing requirements, did not deter payday lender clustering around military bases. We concluded that usury laws—the time tested, conservative, historical American response to predatory lending—appeared to be the best legal tool for addressing concerns about predatory lending to military personnel.

The Department of Defense report further corroborates our findings. It uses a variety of quantitative and qualitative data to establish the existence of a significant predatory lending problem. The report makes realistic estimates of the percent of service members using payday loans. The report also accurately summarizes a variety of other potentially predatory credit products used by military personnel. The report accurately describes Department of Defense financial education efforts, as well as the inherent limitations to this approach. The report accurately summarizes the many better alternatives to predatory loans available to military borrowers, and pragmatically explains that these alternatives are not likely to prevent service members from falling into predatory debt traps. The report persuasively presents compelling qualitative narratives of service members and their families who have suffered real personal, financial, emotional, and professional losses as a result of predatory lending. And the report compiles a useful list of suggestions for policy reform—all of which would meaningfully improve the lives of military service members.

In conclusion, I do have one reservation with the Department of Defense report. I am afraid the comprehensive nature of the report might be used as a tool to prevent immediate reform of credit laws. While I believe comprehensive reform is necessary, reestablishing our traditional, time-tested usury law should be a necessary first step on the path to comprehensive reform. Accordingly, I strongly urge Congress to take the opportunity presented by the Talent-Nelson amendment to this year's defense authorization bill. This amendment reasonably re-establishes a cap on allowable interest rates charged to military personnel at a generous 36 percent per annum. Loans in excess of this amount have proven historically dangerous, economically inefficient, and geographically targeted at the military. For additional information on these issues I invite the Committee members and their staff to review my prior published writing.⁴

4. A bibliography of my research is available at <http://www.law.ufl.edu/faculty/peterson/>.