VISIONS AND CHALLENGES OF PAYDAY LENDING IN LITHUANIA

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Introduction

Payday lending market had emerged and rose rapidly in Lithuania as the result of sudden increase of liquidity concerns and restricted access to mainstream credit at the peak of overall economic hardship in 2008-2009. Despite the tremendous popularity, payday loans had earned a bad name mostly because of charges on immoral and irresponsible lending, decorated by the horror stories of loans-gone-wrong. As a response to public charges and regulation initiatives, the industry has tried to justified itself with high transaction costs and benefits of having the lender of last resort available to the consumer in need.

In other words, the problem of payday lending arises from the classical and natural tension between The Need of access to credit, with the peak importance to the poor, and The Greed of the financial institutions. The Need and The Greed is (has always been) the *yin* and *yang* of consumer finance. This tension had brought attention not only from media and regulators. Scholars worldwide found many challenging fields for theoretical and empirical research.Yet, the payday lending phenomena, although over-controvercial is well under-explored, especially in the Lithuanian context.

Our motivation for this paper is primarily methodological. To be clear from the very beginning, this paper is intended to provide more questions than answers in the part of the field of consumer credit, which has never been addressed in the Lithuanian academia. Major legal, economic and organizational challenges are left for further theoretical treatment and empirical proving. Our task here is to propose an analytical approach to the credit access issues and briefly describe the Lithuanian context for empirical testing. Therefore this paper contributes to the knowledge, wisdom and understanding of fair balance between The Need of borrowers and The Greed of lenders.

On The Need side of our paper we ask if access to credit should be recognized and treated as The Human Right *per se*. Following the poverty alleviation approach of the Nobel Prize laureate Muhammad Yunus, we look for answers in the well established principle of inviolability of human dignity and guaranteed adequate standard of living. Although not without opposition, we find strong arguments supporting our proposition that poor households has the strong claim to benefit from the credit as the right. Further, briefly describing the situation in Lithuanian households we find a troublesome set of financial situation ratios which, in our opinion, explains the reasons of payday loans popularity and proves that access to credit is more important than its price.

On The Greed side of our paper firstly we extract two sub-issues of responsible lending and usury, and proceed with the discussion of them separatedly. Finding the well recognized problem of definition and measurement of over-indebtedness, we have chosen to adhere the subjective approach to definition and we offer a process mining techniques as a possible measurement solution. With regard to the usury, we find it to be a binary problem too, with the transaction cost on one hand and tolerable rate of interest, on another. Using the logics of transaction cost theory, developed by two Nobel Prize laureates Ronald Coase and Oliver E. Williamson, we briefly describe major variables and approach to measurement of ones. With regard to the tolerable rate of interest, we critique the flat fit-for-all rates and support the procedural fairness approach, although once again ó not without opposition. Further we brief the major financial ratios of the payday lenders, showing on the side of it some insights into the media and regulatory perception. Having it said, the conclusions follow.

The Need

We the People[1] of the market economy, in order to promote general welfare to ourselves and our posterity, have to consume. Globalization, acceleration of consumption and growth of transactions thereof, had resulted in substantial increase in the household debt and decrease in saving ratio[2]. Consumer credit has become a common source of finance for households (Betti, Dourmashkin, Rossi, & Yin, 2007). Therefore being indebted is normal consumer behavior, inevitable for the majority of households (European Commission, 2001, 2008, 2010). The importance of credit on the household welfare had even triggered the discussion if access to credit should be The Human Right[3]. That is, the credit transaction has been elevated to the highest level of social analysis, institutions of which, according to (Williamson, 1998, 2000), are changing õvery slowly ó on the order of centuries or millenniaö[4].

It is worth to explain for ones who donøt have legal training that The Right of one defines The Duty to be obeyed by others, who are in the field of that Right, and *vice versa*. This imports bilateral relationship, as a unit of analysis. Moreover, according to Vaisvila (2004), it imports two major regulatory constrains: (i) the right shall not be denied without sufficient cause and fair procedure, which suggest the necessity of carefull evaluation before restrictive rulemaking; and (ii) the realization of right shall be guaranteed by the force of the State, which suggest the necessity of accessible and error-free enforcement institutions.

From the perspective of borrower it means that the right to borrow defines the duty to lend. Therefore the borrower should benefit from such set of outcomes: (i) access to credit cannot be denied without sufficient cause and fair procedure; and (ii) realization of the right to credit shall be warranted by the force of the State. From the perspective of lender it means that the duty to lend defines the right to claim repayment (plus usury). Therefore the lender should equally benefit from the same set of outcomes: (i) the right to claim repayment shall not be denied without sufficient cause and fair procedure; and (ii) the realization of the right to repayment shall be warranted by the force of the State. From the perspective of the State it means that: (i) it has to make regulatory choices as to ensure the fair and effective balance of rights and duties between the parties in credit transaction, and (ii) to provide equally accessible and error-free enforcement services.

In order to grant the access to credit a status of The Human Right, one has to find an authority either in metaphysical absolute or in the will of the regulating bodies. The former would satisfy natural law approach, while latter ó positive law (Weissbrodt, Fitzpatrick, & Newman, 2001). It should be noted, however, that neither of general human rights treaties clearly states that access to credit should be a Right *per se.* One of supporting arguments might be found in the principle of inviolability of human dignity, which is firmly anchored in all major human rights treaties and Constitutions[5] drafted in the spirit of Nuremberg Trials. These documents are held to be an expression of the natural law through the written word of human being (McDougal, Lasswell, &

[1] The phrase "we the people", well known from the preamble of the United States Constitution, is used here to suggest, that the market economy order originates from the People. This pertains the value of individual rights and equality among all family members of so iety and sugests that in order to understand market economy, the unit of analysis shall be a person and drivers of his behavior.

[2] For empirical evidence on the consumption and saving behaviour, see (Bayoumi, 1993) for example.

[3] For excellent review see Hudon (2009).

[4] Although we believe that exponential growth of frequency of transactions, õbig bangö of data and widgets thereof, had made social embeddedness changing not in 10^2-10^3, but exponentially much faster.

[5] See for e.g. Preamble of the Universal Declaration of Human Rights (UDHR); Preamble of International Covenant on Economic, Social and Cultural rights (ICESCR); Preamble of the Convention on the Rights of the Child (CRC); Preamble (a) of the Conventin on the Rights of Persons with Disabilities (CRPD); Article 21 of the Constitution of Lithuania; etc.).

Chen, 1977). That is, inherent dignity of all human family members is a well-accepted right by both approaches to the human rights. Following this string of legal analysis, the issue is whether access to credit is indispensable from the dignity of all human family members?

It is a Nobel Peace Prize honored fact that welfare may be increased (and poverty reduced) directly through greater access to credit (Yunus, 2006). In Yunusø opinion, access to credit is intimately linked with the pursuit of well recognized basic human rights: food, shelter, healthcare, education, work and alike, and therefore provides ša comprehensive set of rightsõ (Hudon, 2009). This argument finds its authority in Article 22 of UDHR, which directly links social security, economic, social and cultural rights with the concept of dignity, and Article 11 of ICESCR which guarantees the right to *„an adequate standard of living for himself and his family"*. Following this string of logics, the core issue is what does šadequateö stand for? Whether a Tarzan has the legal right to the same standard of living as Jane Porter, or maybe the latter is significantly over-consuming? Who and how should determine it? These and many more questions arise from such highly hermeneutical obligation imposed on the society.

Despite the width of the definition, its identification is relatively simpler. First of all one has to form the hypothetical budget of household which is needed for the adequate standard of living, i.e. *minimal rate of consumption*. In our opinion, this budget should mandatory include at least these goods and services which are expressly listed in Article 22 of UDHR, Article 11 of ICESCR, Article 27 of CRC, Article 28 of CRPD: (i) food, (ii) clothing, (iii) housing, (iv) continuous improvement of living conditions, (v) goods and services needed for the child's physical, mental, spiritual, moral and social development (for households with children).

Second step in the analysis is to inquire whether at least such level of õtolerable incomeö (Posner 2003) may be achieved by a household without access to credit? If the regular income or assets of a household are not sufficient to reach the adequate standard of living, the society has to face the issues of poverty and costs of its reduction (Posner, 2003). Having limited scope of alternatives, financially excluded poor have to increase income, use of otherwise dispose the assets, borrow or turn towards opportunistic behavior. Since opportunistic behavior diminishes general welfare and is generally illegal it should not be propoted as an acceptable alternative of action. Therefore under-consumed household should turn to former three alternatives left. Rights to income and control of assets are defined primarily by the well established rights to labor and private ownership. If these two are not sufficient to ensure the adequate standard of living, the access to credit, as a single choice left, should be treated as the right. That is, the bigger gap between adequate standard of living (minimum rate of consumption) and capacity to ensure it through labour or control of assets, the stronger is the case of The Human Right to credit *per se.*

Intuitively the conclusion may be made that the lesser income or assets a household has, the higher is its demand for credit, if the adequate standard of living remains stable. However, households adjust their standard of living to fit their consuming capacity up until some lowest limits below which human dignity is being undermined. That is, facing the decrease in the income or assets, a household may make a decision to lower the level of living. This set of decisions is available only up to some bottom limit of living conditions, below which inability to consume damages personøs dignity. This is the threshold of poverty, i.e. field where restriction of access to credit should be very well and carefull weighted. Households at this threshold have the strongest claim to credit as The Human Right *per se*. Moreover, such poverty alleviation approach makes the access to credit partly a social mission to protect dignity of the poorest households, not only a business mission to expand the consumption.

Of course, this bottom line concept is very context sensitive and may be constructed only after identification of particular society and characteristics of its individual households thereof. Briefing the Lithuanian context, financial situation of 38% households was very difficult or difficult in 2011

(Statistics Lithuania, 2011). It is expressly stated that the income of 56% households was lower than expenses needed to ensure the adequate standard of living. This ratio is 74% for single parent households (one parent and one child) and 72% for single households. Moreover, 42.4% of single households with children, 10.1% of the employed and 53.1% of the unemployed households are at the risk of poverty. More than 60% of households would not be able to cover 830 Lt (240 Eur) of unexpected expenses.

This completely explains, in part, the rise and tremendous popularity of the highly accessible[6], but the most expensive and controvercial, payday loans[7]. Sudden increase of liquidity concerns and restricted access to mainstream credit at the peak of overall economic hardship in 2008-2009 had created the perfect market place for third-tier lenders. 17 out of 27 active companies[8] offering payday loans were established during these two years[9]. In 2011 the portfolio of payday loans had expanded by more than 80% (Central Bank, 2012) and the annum was celebrated by the industry with the overall sales income from interest of more than 100 mln. LTL. Growth of the industry has been slowed down in 2012, still the portfolio had expanded by 32% (Central Bank, 2013). In 2012, top 3 payday lenders[10] alone had reported more than 102 mln. LTL of sales income. Although full annual review is not reported yet, the overall market in 2012 might reach 130 mln. LTL.

Although, comparing to mainstream lending, these are relatively small numbers, the frequency of transactions are very high. The price of average credit is approximately 151 LTL (~44 EUR). It means that in order to reach 100 mln. LTL threshold, consumers had to take (or rollover) approximately 667.000 times per year (6 loans every 5 minutes). It is 27 loans (or rollovers) for every 100 persons of legal age (18 and more). With the frequency of more than 861.000 payday transactions (loans or rollovers) per 2012, these rates are accordingly ó 36 transactions for every 100 persons, and 8 loans every 5 minutes.

Moreover, recent survey of payday borrowers, performed by RAIT (2013), had showed that three most popular usages of payday loans were: (i) to pay for household expenses (28%), (ii) to pay utility bills (24%) and (iii) to buy food (21%). That is, the most popular usages are all linked to the most basic human needs. Most of the times, access to this kind of credit is the irreplaceable source of finance for these households, most of which are low income and young households (Central Bank, 2012). 63% of the borrowers are under the age of 35 and this source of finance is common in the households with less than under 1200 LTL (~347 EUR) of monthly income:

[6] Using internet and/or telephone, a full transaction may be completed in less than 15 minutes. Moreover, the industry rapidly expands the network of physical places of access. Ability to provide application in the post stands or lottery terminals in stores makes it bigger network than all mainstream credit offices combined.

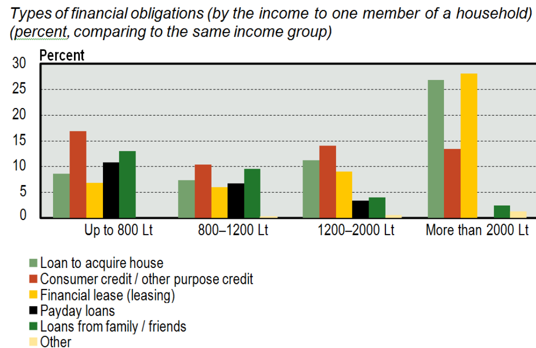
[7] According to the Central Bank (2012), the average loan amount is 653 LTL (~189 EUR), which is borrowed for a 2.2 months term at 216% of APR.

[8] Full list of consumer credit providers is vailable at http://www.lb.lt/viesasis_vartojimo_kredito_daveju_sarasas [visited on 2013-06-03]

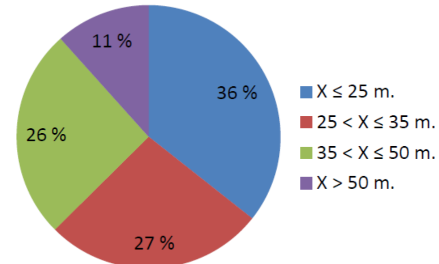
[9] From the records of changes in shareholders or management structure we may also suggest that companies with the establishment date before 2000 have switched previous activities to payday lending in the same 2008-2009 period. It makes 20 of 27 (74,07%) of start-ups in 2008-2009.

[10] UAB õ4Financeö (www.smscredit.lt and www.vivus.lt), UAB õMCB Financeö (www.credit24.lt) and UAB õMoment creditö (www.momentcredit.lt), having approximatedly 80% of the market.

1 pic.: Types of financial obligations (by the income to one member of a household) (percent, comparing to the same income group)*



2 pic.: Distribution of consumer credit users by age*



* *Source: Central Bank (2012, 2013)*

Obvious importance of the access to credit to Lithuanian households seems to warrant the recognition of The Human Right to credit and pressure on the governments to take appropriate steps to ensure and protect the realization of it. In support of this argument it should be noted that there is a clear scientific evidence to support the existence of a liquidity constraint, severer and more widespread over-indebtedness, where consumers have less access to credit market (Betti et al., 2007). Moreover, it is scientifically proven facts that: (i) restricting access to expensive credit harms consumers on average (Zinman, 2010); (ii) limiting access to credit may make some people considerably worse off (European Commission, 2001); (iii) problems of managing debt, and of covering the costs of servicing loans, are likely to increase rather than diminish if there is a cutback in credit (European Commission, 2010); (iv) access to expensive consumer loans helps borrowers smooth negative shocks, better manage liquidity and alleviate financial distress (Morse, 2011; Wilson, Findlay, Meehan, Wellford, & Schurter, 2010; Morgan & Strain, 2008); (v) access to credit makes significant and positive effects in job retention (Karlan & Zinman, 2010); and etc.

Honoring the opposition, there are none the less important arguments against elevation of credit into this metaphysical level. First of all, as already mentioned above, the right to credit implies the duty to provide it. Therefore in the society governed under the principle of inviolable private ownership, the issue of fairness and efficiency to demand exchange of cash for mere promise with everybody (especially the poor) is at stake (Hudon, 2009; Nozick, 1974; Sen, 2009). That is, who would be responsible for fulfilling this right? Will the profit seeking credit institutions be willing to voluntary cooperate, or should government force them to credit those that they otherwise would not? Or maybe the right to credit should be implemented by some special government institution? Moreover, as Gershman & Morduch (2011) had correctly pointed out, the questions of price, duration and scale of access are even more contentious. Despite the difficulties, in our opinion, these are procedural issues which shouldnøt quash the existence of the right, if it exists. Members of the *human* society shouldn‑t be able to overrule *divine* will simply because it is too hard to realize.

Secondly, as we have mentioned before, the right to receive credit implies the duty to repay principal and usury (interest). If transaction is voluntary, the profit seeking lender will be willing to lend only if the interest overweight the risks of the transactions. It means that the price of credit for the poor household will be relatively high. Accordingly, the higher is the price of credit, the higher is the risk of default and hence result will be harsh repayment process which is directly linked with the threat of opportunism, over-indebtedness, debt-cycling, rollovers and other events that exacerbates financial distress (Bhutta, Skiba, & Tobacman, 2012; Carrell & Zinman, 2008; Melzer, 2009; Zinman, 2010, and others). If a household made an error either in the valuation of

consumption benefits or the capacity to repay debt with usury, repayment process may be harmful to the household. Since individuals õoften make serious mistakes in deciding important mattersö (Epstein, 2006), the paternalistic intervention restricting access to credit may prevent such household from harming itself and therefore be justifiable. However, ones that are most susceptible to credit exclusion are once again - the poor households. That is, ones that has biggest claim to have right to credit, bear the biggest risks to be harmed by that same right.

The question, however, as correctly pointed by (Bar-Gill, 2007) õis not whether individuals make mistakes. Sure they do. The question is whether these mistakes merit legal interventionö. That is, whether government *a priori* knows better what is best for the poor? Or should the poor be left with a chance to decide by themselves? The borrower may be a loan-short of finding the solution for indignity threat and inevitable harm thereof. The error in preemptive restriction of access to credit for the poor households may be as harmful as over-indebtedness: shadow borrowing, opportunistic activities, crimes, divorces and depression with its extreme suicidal form. If civil society is based of presumption of *bonus pater familias,* the household should have the chance to make mistake, since most of the prudent households will not make one. However, if the regulator thinks of hausehold head as of *stupidus pater familias*, the outcome is of course the opposite.

Thirdly, one may argue that with the same success we may say that credit is intimately linked with the pursuit of all and any of human right. Indeed, there is no single right that may be implemented or protected without any direct or indirect financial support. However, such fit-for-all view does not diminish the importance of credit. On the contrary ó it is the argument that advocates of the right to credit, like Yunus, linking it only with an adequate standard of living, view it too narrowly.

In summary, debt is inevitable part of welfare discourse. Credit has become a normal consumer behavior, common and inevitable source of finance for households. Moreover, at some point of under-consumption, accessibility of credit may be regarded to be The Human Right with the respective duties implied on lender and the State. We find an authority fors such conclusion in the well established concept of human dignity and guaranteed adequate standart of living thereof. If, after the analysis of household needs and meens to satisfy them, it appears that the level of income and assets possess indignity threat, that household has the strongest case to benefit from the Right to credit. The financial situation of most Lithuanian households is exactly at this threshold. In other words, the Need of credit seems to warrant the recognition of The Human Right to credit and pressure on the governments to take appropriate steps to ensure and protect the realization of it. Accordingly, access to credit deserves special scrutiny and very careful regulation in order to avoid unreasonable and severe consequences of legislative error. However, the opposition of this approach rise some important and meaningfull issues which has to be solved. Recognizing the bilateral nature of transaction and bounded rationality of consumer, some restrictions to access of credit may indeed protect the households from over-indebtedness. Having it said, we shall proceed with the discussion on the other side of a coin ó the Greed of lenders.

The Greed

We the People of the market economy also suffer from imperfect rationality, impatience, overoptimism, overconfidence and other behavioral anomalies (Fritzdixon, Hawkins, & Skiba, 2013). Ease of access to credit makes the tradeoffs of the hausehold more susceptible for errors. However, this will usually be appearant to that borrower only after the lapse of that time. Facing the choice to increase the consumption capacity (receive benefits today) and pay later (bear the costs in future), some of the population will inevitably make mistake. The problem, however, lies not in the natural human nature to err. Rather it is in some of the lendersø strategic response to these errors.

Some lenders, infected by the sin of the Greed, knowingly exploit these behavioral anomalies or borrowersø dire need of funds. Excessive profiting on current Needs, disregarding the future consequences, might harm household more than under-consumption or financial exclusion. The surplus of debt burden, i.e. over-indebtedness, seems to mandate the paternalistic intervention into the credit transaction in order to push the household towards the saving or asset management strategy he would never come-up with having the free access to credit. On the other hand, as we have noted before, access to whatever expense credit might be the last chance to buffer the impacts of negative shocks and stabilize the debt servicing capacity of household. Suddenly unemployed Joe may need a tank of gas to go for job interview and hold-on just until payday; or suddenly ill Mary may need some medical intervention in order to recover her working capacity. Therefore paternalistic restrictions of access to credit might harm those, who act responsibly and rationally.

Thus, the task of balancing the Need and the Greed is a twofold. From one side, access to credit shall not be restricted to ones who has priority Needs and borrow in order to avoid indignity threat and to restore consumption capacity. On the other hand, credit access regulation should discipline lenders ro prevent over-indebtedness and ban the immoral profiting. Put it in other words, the questions are ó whether it is fair to deny credit to particular borrower and if credit should be provided ó how much it is fair to charge for it. Accordingly, susceptible for regulation are the fields of responsible lending and usury. Former should ensure the accessibility of data for future projections, while latter ó protect from immoral profiting.

With regard to responsible lending, the issues are how to *ex ante* evaluate the ability to pay *ex post*, and where is the limit separating sustainable amount of debt and over-indebtedness of a borrower. These are tough and challenging issues, since as DøAlessio & Iezzi (2013) notes, there is no a consensus in the literature on the definition of over-indebtedness or, consequently, on how to measure it. Same conclusion has been made by various studies conducted by European Commission (see 2001, 2008, 2010). In this regard Betti et al. (2007) distinguishes main indicators of indebtedness[11] used by various organizations which are mostly devised to compare debt with assets of that borrower either in objective, subjective or administrative models. However, this study aligns with the abovementioned conclusions that there is no methodology for determining the critical level of these ratios and all of them suffer from the information deficit.

Of course, a regulator may take a quick and easy path defining a õfit-for-allö indicator (e.g. debt to income, debt to asset, etc.) and prohibit transactions which are below some flat rate, hoping that on average benefits will outweight harm to the general welfare. However such type of rulemaking unnecessarily restricts access to credit for some borrowers, violates consumerøs freedom of choice, and is a form of hard paternalism (Meade, 2012). Moreover, flat objective rates usually ignore the capacity of younger families to accumulate more debts than it can repay and thus ensure the steady living conditions (Modigliani and Brumberg, 1954, 1990; DøAlessio & Iezzi, 2013). Having in mind that certain level of debt is inevitable for the majority of households, particularly at the earlier stages of their lifecycle, the financial exclusion based on average rates cannot be easily justified. In addition, all of these rates have their individual shortcomings. For example, pure objective debt-to-income ratio (or its variations) ignores assets and savings, which are directly linked with the capacity to service a debt promise. Accordingly, it is well recognized that such ratios do not necessarily reflect the financial position of individual households (European Commission, 2010).

European Banking Industry Committee (EBIC) (2011, 2012) also supports the proposition that there is no ÷one size fits allø figure which could be appropriate to describe over-indebtedness for each and every borrower. According to European Commissin (2001, 2008, 2010), the level of debt at which a

[11] These are: (1) total stock of debt or debt per capita; (2) proportion of households with net liabilities; (3) consumption to income ratio; (4) debt to income ratio; (5) debt to asset ratio; (6) number of bankruptcies/arrears; (7) rate of credit delinquencies; (8) average liabilities per bankruptcy; and (9) number of households self-reporting to be over-indebted.

household becomes over-indebted depends on many factors: the size and structure of the debt, the debt-servicing arrangements, the assets of the household, other personal and economic characteristics of the household, as well as external factors such as the state of the economy. Thus the critical level of debt differs between households and there cannot be objective, single fit-for-all ratio defining sustainable level of debt at all stages of life.

It seems, therefore, that the most straightforward and powerful method of determining the over-indebtedness is to ask the household directly whether or not they are facing debt repayment difficulties (Betti et al., 2007; DøAlessio & Iezzi, 2013). People do not generally attempt to hide their difficulties (European Commission, 2001), therefore Commission had offered the pure subjective definition of over-indebtedness: š[a] person is over-indebted if he or she considers that he or she has difficulties in repaying debts, whether consumer debt or a mortgageõ.

We adhere to this definition, although in recent study European Commission (2010) had recognized that it is problematic when it comes to measurement. In our opinion, if definition is correct, the measurement problems should challenge the creative minds, not quash the definition. The exponential growth of the õdigital universeö and technology makes it possible to record and analyze events at the nano level of objective events and subjective activities. The challenge is to capture the data and extract the knowledge out of the chaos of the event logs. Hawing the detail past and present data on events and activities of the household (e.g. transactions, applications for medical care, browsing history, etc.), credit scoring minght be developed to perfection, by providing subjective evaluation from objective data. This is the wide field of process mining techniques[12], as manifested by Aalst et al. (2012) and extensivelly described by Aalst (2011).

The second part of the Greed problem ó usury - had evolved throughout millennia and had šabsorbed the minds of some of historyøs greatest thinkersõ (Bodenhorn, 2005). Aristotle, Aquinas, Locke, Smith, Bentham, Keynes and many other academic superstars are just a few to mention. Throughout history usury was commonly viewed as intrinsically evil and immoral (Rutherford, 2005; Voth & Temin, 2004). However, as market economies evolved, the notion of usury has changed from whether usury was acceptable to how much was tolerable (Peterson et al., 2008; Rutherford, 2005). Hence, various usury laws came into fashion.

Usury caps are established to curb power of lenders, to protect naive borrowers, to discourage profligacy and to influence the allocation of resources (Bodenhorn, 2005). On the other hand, it is argued that usury laws actually make high-risk or low-wealth borrowers worse off because they are either excluded from regulated credit markets, deprived of the ability to build a credit history, or they are driven into the hands of loan sharks with questionable methods of providing or enforcing credit (Reifner, Clerc-Renaud, & Knobloch, 2009; Rigbi, 2009). Moreover, access to cheap credit gives no incentive to save and restricts development of the financial infrastructure (Hudon & Sandberg, 2011). In our opinion, policy decisions with regard to tolerable rate of usury should fairly balance between the welfare of the customers on the one side, and the imperative of building strong institutions on the other. That is, the interest rates should maximize the overall utility, be mutually *fair* (in legal terms) or[13] *effective* (in economic terms). The issue, however, remains ó how much is too much?

Yunus, as observed by Hudon & Sandberg (2011), has a straightforward and simple approach to this issue. He separates the costs of credit transaction from its premium and argues that interest rate is reasonable if it is not more than 15% above the necessary cost of funds. Following the logics of separation costs from premium, the task for the regulatory seems to be the development of the

[12] Realizing that the field of process mining is far bigger than the space we have to explain it, we should stop with proclamation of the name, without any deeper insights into it, leaving this task for further researches.
[13] Most of the times fairness and efectiveness coincide (™Ýma–ius, 2002).

transaction so as to economize on its costs as much as possible. Reduced transaction costs would result in decreased price of credit, if premium stays capped.

The logics of transaction cost analysis and economization thereof is still under development in the field of Transaction Costs Economics (Williamson & Tadelis, 2012). Started and developed mainly by Nobel Laureates - Ronald Coase (see 1937, 1960 for example) and Oliver Williamson[14] (see 1975, 2000 for example), the Transaction Cost Economics have become an õempirical success storyö (Williamson, 2000) and one of the dominant economic theories of the XXI century (see Carter & Hodgson, 2006; Geyskens, 2006; Macher & Richman, 2008; Ruester, 2010, and others). According to this theory, as we interpret it, the state of zero transaction cost may be reached only if all promises (including implied promise of good faith and fair dealing) are kept, i.e. when ownership is perfect.

However, it is not a case in the market economy, highly infected by the sins of malice. A promisee is always at risk that a promise given to him/her will differ from the true will or the true actions of the promisor. That is, there is always a risk of asymmetry between the *ExAnte* promised and *ExPost* received value of the promise. Protecting him/her from the perils that the promise will be breached in the future, the promisee invests in pre-contractual research, drafting of contract and the protective means thereof. That is, some costs of transacting are suffered *ExAnte.*

However, all of the means employed at this stage are based on assumptions about future events, which are impossible or too costly to determine with certainty. Of course, the more investments are made at the pre-contractual stage, the less is the risk of post-contractual breach. However, human body and mind has their limits, which together with future uncertainty make it impossible to determine all the sources of risk and employ preemptive means to avoid them. Moreover, pre-contractual investments are inevitable and future risks are only probable. Besides, every symbol used in drafting has its own hermeneutical risk, which might be the source of misinterpretation and hence ó error in the enforcement procedure. Due to these shortages, parties may šagree to disagreeõ (Ben-Shahar, 2004). Thus, contracts are incomplete (see: Eggleston, 2000; Hart & Moore, 1999; Hill, 2009; E. Posner, 1999; R. Posner, 2004; Rasmusen, 1995 for egzample).

Therefore, since all transactions have their gaps and are subject to uncertainty, opportunistic behavior of promisor and enforcement errors, the fair balance of rights and duties between parties might be breached. If *ExAnte* means of protection fails, parties are forced towards the process of adaptation, compensation or litigation. However, promises to adapt, to pay damages and to litigateare all promises, susceptible for breach *per se*. Moreover, neither of these procedures is costless. In any of the scenarios parties suffer from asymmetry in the timing or value of the expected fruits of trust. These are *ExPost* transaction costs.

Adapting the famous formula of Richard A. Posner (2004), where Transaction Costs (*TC*) are the sum of *ExAnte* costs (x) and risk (y) that *ExPost* costs might occur, this might be expressed as simple as:

$$TC = x + y * z.$$

In the ideal world, everybody keeps his/her promises ($y = 0$). In this case $y * z = 0$. Accordingly, there is no need of safety measures. Accordingly, $x = 0$ and $TC = 0$. Hence, transactions are self-enforcing; the demand for regulation and enforcement services disappears. The market is perfect. However, in the real world, promises are sometimes breached ($y > 0$), and transactions are not self-enforcing. The promisee is always at the mercy of promisor. Accordingly, $y * z > 0$. At the face of

[14] Williamson is admitted to be one of the most cited schollars in the social science (Pessali, 2006; Pessali & Fernández, 2012)

threat, the demand for protective measures arises. Thus and $x > 0$ and $TC > 0$. It follows that the difference between the ideal and real world is the costs of trust failure.

Accordingly, the major task of regulation is to protect the promisee from the uncertainty and opportunistic behavior in all stages of transaction. With regard to *ExAnte,* it implies duty to foster access to data and process mining technology to process it (thus diminishing perils of uncertainty and bounded rationality), and with regard to *ExPost* ó duty to foster accessibility to enforcement system and technology to process the claims (thus diminishing the perils of opportunism and asset specificity).

Having it said, we may turn to the surplus of transaction cost, that is, price of credit. In our opinion, straightforward application of Yunus usury cap may have a diminishing effect to the accessibility of credit, especially to the poor. Naturally, a poor borrower bears higher risk of default. Creditors, therefore, will be willing to accept high risk either through higher premium, or through distribution of risk among bigger number of borrowers. If the former is capped and capacity to lend stays the same, the latter may be achieved only by lowering the sum of credit and/or shortening its term. However, the administrative and transactional costs associated with management of a large amount of small loans may be immense. Therefore even if the demand will be high, there may be no lenders who would be willing to supply a high risk small loan to ones that has the biggest needs.

Besides, according to the law of diminishing marginal utility, poor people may accept higher interest rates than non-poor, since one monetary unit has more intrinsic value to the poor than non-poor (Hudon & Sandberg, 2011). Accordingly, some would-be borrowers might be willing to pay higher price which would be treated reasonable, fair and Pareto efficient. Moreover, an over-indebted consumer could still keep up with his promises by reducing the level of consumption, selling his assets or improving his income rates, i.e. solving the liquidity constrains during the time bought for the price of credit, or revising its property management strategies. Despite the reasonableness of the decision to borrow at the high margin, willingness and ability to pay, the credit transaction will never commence if there will be no one willing to lend. Therefore we argue, that the price of credit should cover the transaction costs and should provide premium that is based on the principle of fairness and subjective willingness to pay, not on flat õfit-for-allö rate.

Under the procedural approach to fairness[15], the price of credit should be held fair if parties have full knowledge of their options and a free choice between the alternative ways of action (or inaction). Therefore the fairness depends primarily on the free will of the parties, which should be formed and expressed without any unlawful coercion or deceit, through the full disclosure and bargain of equals. Free will should be bilateral and persist throughout all stages of the transaction. The role of regulators, therefore, is to smooth bargaining inequalities and perils of opportunistic behavior between parties in transaction. Usually this is achieved using mandatory disclosure requirements, bans of unfair contract provisions, rights of premature withdrawal and other.

In critique of this approach Hudon & Sandberg (2011) assumes that õborrowers are forced by their impoverished situation as such to do something, well *anything*, that can bring food to their tableö. Supposedly it means the will of the poor most of the time is not free and genuine. However, are there some, well *any*, borrower who genuinely desires to be enslaved by the ties of debt? Or any other person who would in general prefer obligation over right? The credit transaction arises out of the *need of*, not *love for*, the debt. Therefore the desirability of credit shouldnøt be a threshold criterion in accepting or denying the free will approach. The real issue with regard to impoverished is whether such borrower has something, well *anything,* in alternative? If any better alternative is available, the task for regulation is in the field of bounded rationality, if not ó in asset specificity.

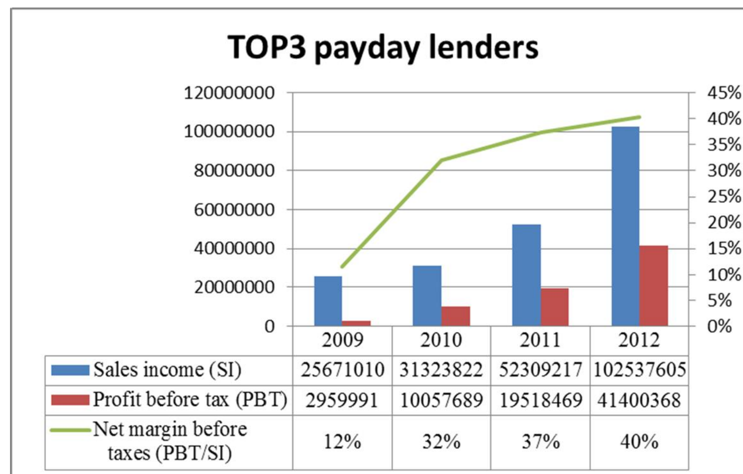
[15] We adhere to the procedural approach to fairness, since it is in line with the proposition by Williamson (1985) to analyze transaction as a process when a good or service is transferred across a technologically separable interface.

That is, even if there would be a single lender in the market, the borrower should be able to decide freely to borrow or not, relying on the understanding of the intrinsic value of credit he applies for.

Therefore together with Meade (2012) we believe, that the best judges of the capacity to service debt are the households themselves. They know better their time preferences, earning, saving and spending plans, liquidity constrains and motives for borrowing. Therefore objective indebtedness assessment might be inaccurate. It might help to guess *whether* the borrower is more likely to repay, but they will not answer *why* he will do so. And the latter is the main issue in evaluation of price fairness (Hudon & Sandberg, 2011). Hence, the data of subjective reasoning should also be taken into account and added to the scoring models. Without holistic evaluation of objective and subjective variables, the paternalistic intervention into the liberty of consumer might be unjust, since it will ignore those who act rational but are desperate (Meade, 2012).

Continuing the application of these rules in Lithuanian payday market context, it should be noted, firstly, that despite the high price, only 7% of payday loan agreements end in default (Central Bank, 2012). Low rate of default makes to believe, that the cost of credit is compensated by the value of accessibility. Secondly, the administrative costs associated with management of large amount of small loans are immense. Although top 3 companies[16] are based on advance technologies, the average net margin (before taxes) was 30% during 2009-2012, although the average APR, charged per loan, is close to 200%:

3 pic.: Basic financial data of Top 3 payday lenders*



	2009	2010	2011	2012
Sales income (SI)	25671010	31323822	52309217	102537605
Profit before tax (PBT)	2959991	10057689	19518469	41400368
Net margin before taxes (PBT/SI)	12%	32%	37%	40%

**Source: own description*

Recalling the findings in the Need chapter that payday loans are used very frequently by high risk low income and young Lithuanian households, 30% net margin does not seem to be unfair on its face. Such conclusion is supported by the fact that these hight risk households are fulfilling their obligations properly most at the time (93%).

In summary, we agree undisputedly that people suffer from behavioral anomalies, which are susceptible for exploitation by the greedy lenders. This mandates paternalistic intervention to prevent over-indebtedness and immoral profiting from the Need. With regard to former issue of responsible lending, the major problems seem to be the definition of over-indebtedness and accessibility to subjective data and technology to measure it. With regard to latter issue of tolerable usury ó economization on transaction costs and fair surpluss of lender profit. Brief analysis of these issues allows us to agree with the subjective definition of over-indebtedness and offer process mining techniques for extracting knowledge out of the chaos. Applied technology would also

[16] See note 10

benefit in diminishing perils of uncertainty and bounded rationality, thus solving part of *ExAnte* transaction costs issues, leaving the regulators with the *ExPost* costs, deriving from the opportunism and asset specificity variables. Finally, we believe that the profit cap above transaction costs should not be a fit-for-all ratio. The market is susceptible for self-regulation and this seems to be proven by the numbers of top 3 companies in very concentrated payday market. Despite the numerous charges on greedy lending and immoral profiting, straightforward analysis of financial data shows the average net margin of just 30% above the costs. Accordingly, this leads to discussion on rationality and dangerousness of current legislative initiatives, brought by Lithuanian regulators.

In lieu of conclusions

As we have seen from the above, access to credit for households who are under the adequate standard of living deserves special scrutiny and very careful regulation in order to avoid unreasonable and severe consequences. Error in preemptive restriction of access to credit for these households may be as harmful as over-indebtedness: shadow borrowing, opportunistic activities, crimes, divorces and depression with its extreme suicidal form.

The situation in Lithuanian households, in this regard, is unenviable. The lack of the most basic human Needs has driven them into the hands of payday lenders, who grew rapidly in Lithuania since 2008-2009. The obvious importance of emergency credit to Lithuanian households, illustrated by the numbers above, leads us to conclusion that the payday loans might indeed serve as a last chance to survive the financial shocks and indignity threat thereof. This, in turn, seems to warrant the pressure on the government to take appropriate steps to ensure and protect the realization of The Human Right to accessible credit for the poor households.

Despite the high frequency of payday transactions and lack of objective empirical studies of the phenomenon, the industry is suffering from very poor public perception and rather strict legislation. The media is overfilled with horror stories of payday loan gone wrong and surveys show (RAIT, 2013) that the attitude of the respondents towards payday loan services are very negative. 34.3 % percent evaluated them as very negative, 34.9 % ó rather negative and only 2.4 % responded very positively. Presumably, because of such public pressure, the exceptions provided in the Consumer Credit Directive 2008/48/EB for loans up to 200 EUR; loans payable in 3 months term, or free of charge[17] has not been transposed into the Law on Consumer Credit. Failure to harmonise law with directive is not that harmfull as current legislative initiatives. Application of 40% fit-for-all debt-to-income ratilo, below which the lending is prohibited; initiative to lessen the usury cap from 200% to 36%, which covers only ¼ of the operating costs, threatens to leave emergency credit market without lenders. That is, the poorest part of Lithuanian households, ones that has strongest claim to benefit from The Human Right to credit, will inevitably be excluded from the credit market.

Of course, recognizing the bilateral nature of transaction, bounded rationality of consumer and the Greed of lenders, some restrictions to access of credit may indeed protect the households from over-indebtedness. However, this has to be done with the punctilio of attention to the impact of such restrictions to ones that are on the cliff of poverty. Government does not *a priori* know better what is best for the poor. At least not without carefull holistic evaluation of the effect that access to credit has on the general welfare.

Finding fair balance between the Need and the Greed is extremely challenging, demanding time, resources and visionary insights into future. But the harshness of the legislative procedure shall not excuse state institutions from their Constitutional duty to serve the people. What is needed, as we have suggested, is the subjective evaluation techniques, measurement and means to diminish the

[17] Most of payday loan companies in Lithuania provides major discounts (up to 100%) on interest for the first loan.

transaction costs and fair process of transacting. However, we have to admit here that the field of discourse we have barely scratched above is far bigger than the space we have to present it. Accordingly, much has been left for future theoretical development and empirical testing.

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