High-Cost Borrowing

Patterns of Credit Use in the Alternative Market

Gregory Mills
URBAN INSTITUTE

Certain household demographics and regulatory policies are associated with greater use of high-cost credit sources. In New England, the states where people use alternative financial services the most are Maine and Rhode Island.

One indicator of the severity of losses in income and wealth during the Great Recession is the extent to which households have turned to high-cost loans in the alternative financial services (AFS) market: mainly payday loans, pawnshop loans, rent-to-own agreements, and refund-anticipation loans. (See "Alternative Financial Services.")

Alternative Financial Services

Payday loans are unsecured short-term loans representing an advance on the borrower's next paycheck. They are typically $250 to $350, with a two- or four-week payback period. The customer writes a check for the advance plus a fee averaging $15 to $20 for each $100 borrowed. The lender holds the check until the borrower's payday. Most borrowers roll over such loans (at an additional fee) in multiple transactions.

Pawnshop loans are short-term loans secured by property, often jewelry or electronics. The loan term is usually one month for amounts under $100. If the customer repays the loan and fee on time, the pawnbroker returns the item. If not, the item is forfeited and the pawnbroker can sell it.

Rent-to-own agreements are self-renewing weekly or monthly leases for merchandise—typically, furniture, appliances, home electronics, or jewelry. A customer making regular payments acquires the item at the end of a 12- to 24-month contract but relinquishes it upon nonpayment.

Refund-anticipation loans are unsecured short-term loans constituting advances on borrowers' anticipated income tax refunds. Customers receive the amount (minus a fee) before they would otherwise receive their federal or state refund. The loans have been largely discontinued.

Use of Alternative Credit Products, 2011

		Used one or more AFS credit products in last 12 months		Used payday loan in last 12 months		Used pawnshop loan in last 12 months		Used rent-to-own agreement in last 12 months		Used refund anticipation loan in last 12 months	
	All households (1,000s)	Households (1,000s)	Usage rate (%)	Households (1,000s)	Usage rate (%)	Households (1,000s)	Usage rate (%)	Households (1,000s)	Usage rate (%)	Households (1,000s)	Usage rate (%)
Connecticut	1,365	49	3.6	2	0.1	27	2.0	18	1.3	9	0.7
Maine	546	41	7.5	2	0.4	16	2.9	26	4.8	5	0.9
Massachusetts	2,614	85	3.3	10	0.4	37	1.4	15	0.6	29	1.1
New Hampshire	526	13	2.5	6	1.1	7	1.3	4	0.8	4	0.8
Rhode Island	423	22	5.1	4	0.9	13	3.1	6	1.4	2	0.5
Vermont	269	10	3.8	4	1.5	2	0.7	5	1.9	3	1.1
New England Region	5,743	220	3.9	28	0.5	102	1.8	74	1.3	52	0.9
U.S. Total	120,408	7,243	6.0	2,063	1.7	3,520	2.9	1,814	1.5	1,449	1.2

Source: 2011 FDIC National Survey of Unbanked and Underbanked Households. See FDIC, September 2012, Table A-33; and FDIC, June 2013, Tables C-26, C-78, C-118, C-158, and C-182.

The increasing use of nonbank credit products is a public policy concern. The interest rates (for payday loans, typically 400 percent annually or higher) make such products expensive. Additionally, borrowers are often using them to meet basic living expenses, not one-time needs, suggesting financial distress that would be better addressed through income support.[1]

Between 2009 and 2011, the percentage of households with one or more members having ever borrowed funds from a nonbank source increased in all six New England states, with the percentage rising from 7.4 percent to 9.7 percent. In proportional terms, the New England rise exceeded the national increase (going from 11.8 percent to 14.2 percent). Maine's proportional rise was 50 percent (from 12.7 percent to 19.0 percent).

Across New England, 220,000 households (3.9 percent) were estimated to have used at least one of the alternative products between July 2010 and June 2011. Although that was well below the national rate of 6.0 percent, the top-ranking New England state—Maine (at 7.5 percent)—was not. Rhode Island was above the regional average at 5.1 percent. The least likely to use alternative services were New Hampshire (2.5 percent usage) and Massachusetts (3.3 percent), with Vermont (3.8 percent) and Connecticut (3.6 percent) somewhat higher. (See "Use of Alternative Credit Products, 2011.")

The Role of Demographics

Why do Maine and Rhode Island households use nonbank credit products so much? A possible answer may be found in a 2013 Urban Institute analysis using data from the 2009 National Financial Capability State-by-State Survey. The analysis identified demand-side factors (household demographics) and supply-side factors (policy) as significant correlates of product use.[2]

Households without a bank account are three times as likely to use nonbank credit, which may partly explain Rhode Island's high usage (highest unbanked rate in New England at 7.0 percent), but not Maine's. Maine actually has a lower rate of unbanked households (3.7 percent) than either the national average (8.2 percent) or the regional average (4.7 percent).

Households whose head was younger than 45 were generally more likely to use AFS credit products than those aged 45 to 54, but that, too, fails to explain Maine's high rate. Maine ranks lowest in New England in the percentage of householders under age 45 (at 33.4 percent). The percentage for Rhode Island is higher (at 36.1 percent) but not as high as for Massachusetts (at 38.4 percent) or Vermont (at 37.4 percent).[3]

Another risk factor is low educational attainment. Maine is again surprising, as the percentage of householders without a high school diploma (8.4 percent) is second lowest in New England. But low education may be contributing to AFS use in Rhode Island, which has New England's highest rate for lacking a high school diploma (16.0 percent).

The Urban Institute found that African Americans are significantly more likely than whites to use AFS credit products, adjusting for other factors. That pattern is relevant to Rhode Island, with the region's second-highest share of African American householders (7.0 percent). But race does not provide an explanation for Maine, with the region's second-lowest percentage of African Americans (1.5 percent).

Household income also was associated with AFS credit use. Households most at risk were those with incomes of $15,000 to $50,000. Income seems clearly related to both Maine's and Rhode Island's high AFS usage rates. Regionwide, Maine had the highest percentage of households in the $15,000 to $30,000 range (at 44.5 percent). The next in rank were Vermont (38.6 percent) and Rhode Island (35.4 percent). One policy implication is that households with limited incomes should be encouraged to access all forms of income support for which they qualify. Participation in programs such as food stamps is low in qualifying income ranges above the poverty level, where the monthly benefit amount may be limited but where households nonetheless need assistance.[4]

The Role of Policy

The Urban Institute found that less restrictive state policies on payday loans, pawnshop loans, and rent-to-own agreements also were associated with greater AFS use. States regulate those three options through prohibitions, interest-rate caps, maximum loan amounts, required disclosures of the terms, and the like.

Maine and Rhode Island's high AFS usage results primarily from pawnshop loans and rent-to-own agreements. Both states have fairly lenient policies on pawnshop loans. Although New Hampshire has no cap, Maine's policy is the second least restrictive in the region, with an interest rate cap of 25 percent. Rhode Island has a rate cap of 5 percent.

The influence of policy is less clear for rent-to-own. The study found lower usage rates among states with rent-to-own price caps. Maine's high usage runs counter to the pattern, as Maine has a price cap. Consistent with Rhode Island's high rent-to-own usage rate, the state's policy is relatively lenient, with no rent-to-own disclosures of any type.

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New England households tend to use high-cost nonbank credit products at lower rates than elsewhere in the nation, but regionwide, Maine and Rhode Island have high usage rates. Among the most significant demand-side factors suggested by the Urban Institute analysis is the share of households in the income range $15,000 to $50,000. On the supply side, Maine and Rhode Island's somewhat less restrictive pawnshop loans and rent-to-own policies may explain the prevalence of such loans in those states.

The use of these high-cost credit products has policy implications. To the extent that consumers may be making ill-informed choices, greater transparency may be achievable by requiring stricter product disclosures. And if customers are more creditworthy than such high pricing suggests, they should be able to get loans from mainstream financial institutions. Regulatory policies for such institutions should seek to encourage innovation in risk pricing within the small-dollar credit market.

Gregory Mills *is a senior fellow at the Urban Institute in Washington, DC. Contact him at gmills@urban.org.*

Endnotes

1 This article examines the patterns of use of alternative financial services products as measured in the Federal Deposit Insurance Corporation (FDIC) surveys of unbanked and underbanked households. The findings are from the January 2009 and June 2011 Current Population Survey supplements. For the 2011 survey, see Susan Burhouse and Yazmin Ozaki, "2011 FDIC National Survey of Unbanked and Underbanked Households" (report, FDIC, Washington, DC, 2012) and Susan Burhouse, Yazmin Ozaki, and Anirudh Sarna, "Addendum to the 2011 National Survey of Unbanked and Underbanked Households: Use of Alternative Financial Services" (report, FDIC, Washington, DC, 2013). For the 2009 survey and addendum, see "FDIC National Survey of Unbanked and Underbanked Households" (report, FDIC, Washington, DC, 2009) and "Addendum to the 2009 FDIC National Survey of Unbanked and Underbanked Households: Use of Alternative Financial Services" (report, FDIC, Washington, DC, 2010).

2 Signe-Mary McKernan, Caroline Ratcliffe, and Daniel Kuehn, "Prohibitions, Price Caps, and Disclosures: A Look at State Policies and Alternative Financial Product Use" (report, Urban Institute, Washington, DC, 2010). See also the data documentation in Nancy Pindus, Daniel Kuehn, and Rachel Brash, "State Restrictions on Small-Dollar Loans and Financial Services, 2004–2009: Summary, Documentation, and Data" (report, Urban Institute, Washington, DC, 2010).

3 The state-by-state economic and demographic characteristics of households are tabulated from Burhouse and Ozaki, "2011 FDIC National Survey of Unbanked and Underbanked Households," http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf.

4 For the most recent analysis of participation in the Supplemental Nutrition Assistance Program, which shows lower participation rates among eligible households with above-poverty income, see Esa Eslami, Joshua Leftin, and Mark Strayer, "Supplemental Nutrition Assistance Program Participation Rates: Fiscal Year 2010" (report, Mathematica Policy Research, Washington, DC, 2010).