AN EXAMINATION OF SHORT-TERM BORROWING IN THE UNITED STATES

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ABSTRACT

This paper uses data from the Survey of Consumer Finances to determine the characteristics of people who obtained high-interest loans to meet their short-term financing needs. Results indicate that individuals who were denied credit in the past were one and a half times more likely to borrow from alternative lenders (e.g., payday loan lenders and loan financing companies) than were individuals who had not previously been denied credit. Educational attainment, income, and wealth were negatively associated with borrowing from alternative institutions. The likelihood that, given the current economic downturn, more consumers may have to migrate from conventional credit markets such as banks or credit unions to alternative credit markets for their borrowing needs leads to a discussion of the necessity for more information and education to vulnerable populations.

JEL: D14, H31

KEYWORDS: Household Finance, Debt Management, Alternative Lending

INTRODUCTION

The 2008 economic downturn can be at least partially attributed to relaxed lending standards by financial institutions and the resulting bad debt. Emerging literature on the U.S. financial crisis has indicated that most lenders underestimated the probability of such a catastrophic market collapse (Gerardi et al., 2008). Based on the current market crisis, Krinsman (2007) predicted a tightening of lending standards by financial institutions and the possibility of more government regulation. If this happens, more consumers seeking short-term credit could be forced out of the conventional credit markets (e.g., banks, credit unions, and credit cards) and left with little choice but to resort to non-traditional financial markets (e.g., payday lenders and loan financing companies) for their short-term credit needs. Although alternative institutions may provide needed liquidity, they charge high interest rates and fees with the result that borrowers are even more susceptible to credit default and bankruptcy. Moreover, most subprime consumers lack the knowledge to understand the full implications of high-interest borrowing on their financial well being (Finke, et al., 2005), choosing to focus on the monthly payment instead of the interest rate, payback term or overall cost of the loan. Allen and Kinchen (2009) also find in their study that many Americans who are overextended with debt lack the discipline and the financial knowledge necessary for managing their finances. Alternative financial institutions are more predatory in their lending practices than traditional lending institutions and charge higher fees (Peterson, 2004). For example, interest rates on payday loans can be spectacularly high—over 400% annually in some cases for individuals who cannot pay off their loans and flip them on a regular basis (Caskey, 2001; Corcoran, 2008; Stegman, 2007). Because loans issued by alternative financial institutions are short-term in nature, consumers often face greater difficulty in paying off their debt completely when due (Peterson, 2004; Stegman & Faris, 2003).

This paper uses the 2004 Survey of Consumer Finances to determine the characteristics of borrowers who resort to these high-interest loans to meet their short-term financing needs. The paper also examines

whether denial of credit from traditional lenders increases the likelihood of consumers' borrowing from more expensive, alternative financing channels.

LITERATURE REVIEW

Recent studies have suggested that there is an association between credit denial at mainstream financial institutions and borrowing from non-traditional financial institutions (Dew, 2008; Elliehausen & Lawrence, 2008). The Elliehausen and Lawrence study found that nearly 75% of people who obtained payday loans were more likely to have bounced a check in the past five years. Bond et al. (2005) found that alternative loans are a form of predatory lending that are usually issued to poorly informed borrowers facing income and credit constraints, and Flannery and Samolyk (2005) found that payday lenders located in middle- and lower-income neighborhoods experience higher business volumes and serve more chronic borrowers relative to payday lenders in high-income neighborhoods. A high percentage of income-constrained borrowers end up revolving or "flipping" their loans over a period of time and eventually become chronic borrowers (Stegman & Faris, 2003); consequently, borrowers of payday loans paid between $4 billion and 6 billion in predatory fees annually, and the volume of payday loan industry grew from $8 billion in 1999 to between $40 billion and $50 billion in 2004, with continued prospects for strong growth (King et al., 2006; Stegman, 2007).

Where payday lenders have been banned from operating, credit problems of credit-challenged consumers have increased as a result of their lack of access to organized lending (Morgan & Strain, 2007). Barr (2007) contended that, while alternative financial institutions provide liquidity to resource-constrained individuals, the costs associated with such lending does not make it a socially acceptable or practical alternative. A more traditional financial system is needed that could serve this lower-income segment of society by offering lower-cost credit. There is a paucity of literature examining this emerging area of alternative loan and finance companies and their effects on consumers. This paper adds to the existing literature by identifying characteristics of subprime borrowers who utilize alternative lenders and by quantifying whether past credit denial plays a role in shifting consumers to the alternative financing industry.

Preference for high-interest borrowing may be explained by the rational choice theory (Coleman, 1990; Hetcher, 1994), wherein individuals make choices to maximize their benefits and reduce their losses based on the information to which they have access. In keeping with this theory, people will try to obtain credit at the least possible cost. Since conventional financial institutions offer credit at the lowest cost, rational consumers are more likely to seek credit from these lenders first to meet their long-term and short-term credit needs. However, those who are denied credit because of poor credit history, a lack of credit history, low income, or excessive debt may be more likely to participate in high-interest borrowing to meet their credit needs relative to individuals who have not been denied credit from low-cost lenders. One assumption of this hypothesis is that people who seek credit will obtain it in almost any way they can, including obtaining a high-interest loan if the less expensive options are not available. It is also possible that these borrowers are not fully educated about the high expenses associated with short-term loans through alternative lenders and that they may overestimate their ability to pay off the loan when it is due. Therefore, they end up making a decision based on incomplete information.

This study expands on the previous studies in this area (Dew, 2008; Elliehausen & Lawrence, 2008) by focusing on possible predictors of obtaining high-interest loans for short-term usage and by examining the role of recent credit denial within the context of rational choice theory. More specifically, the hypothesis for this study is that individuals who were denied loans from traditional lenders during the previous five years are more likely to have accounts with alternative lenders after controlling for other socioeconomic, demographic, and credit-related factors.

METHODOLOGY

Data was obtained from the 2004 Survey of Consumer Finances (SCF). Sponsored by the Federal Reserve Board, the SCF is a comprehensive national dataset providing detailed information on financial characteristics of U.S. households (N = 4,519). The descriptive data is weighted to reflect the characteristics of the U.S. population (Kennickell & Woodburn, 1999), and all dollar values are represented in terms of 2004 dollars based on the Consumer Price Index.

The dependent variable is coded as 1 if the individual had an account in an alternative lending institution, such as a financing or loan company that did not offer depository services, and as 0 otherwise. Finance companies such as automobile finance companies and mortgage brokers were excluded from the study. The main independent variable was also a binary variable based on whether respondents had been denied credit during the five years before 2004. Other control variables included the covariates that had been found to be predictors of credit denial in earlier studies, such as not applying for credit in the past for fear of rejection, attitude toward credit, number of individuals in the household, gender, age, educational attainment, race or ethnicity, marital status, and total family income (Crook & Hochguertel, 2007; Dew, 2008). The log value of income was used in the model, and net worth quartiles were controlled for in the model.

A descriptive statistical analysis was initially performed to examine the demographic characteristics of respondents who utilized alternative financing companies compared to those who used conventional lenders (Table 1). After controlling for other socioeconomic, demographic, and credit-related factors, we used logistic regression was performed to estimate whether denial of credit over the previous five years increased the likelihood of obtaining high-interest loans for short-term needs. The specific model under analysis is as follows:

Having alternative loan accounts = *f (credit denial, credit attitudes, age, income, net-worth, education, marital status, race, children, family size)*

RESULTS

The descriptive statistics (Table 1) reveal that the average age of the borrowers who obtained high interest short-term loans (45.2 years) is lower than that of the borrowers who obtained loans at lower costs from the traditional financial institutions (51.3 years). Borrowers of loans from alternative financial institutions have larger family sizes, although a higher percentage of these borrowers are not married. The average household income for the borrowers of high-interest loans was $28,805, while the average income for the borrowers utilizing traditional financial institutions was $71,046, and those who borrowed from regular financial institutions had higher educational attainment. In addition, 49.5% of those who obtained high-interest, short-term loans had a net worth in the lowest quartile, while 46.5% of those who were able to acquire loans from the traditional financial institutions were in the highest quartile of net-worth. A higher percentage of respondents who were denied credit over the previous 5 years or who felt discouraged about approaching regular financial institutions for credit and had bad credit obtained short-term loans from the alternative financing institutions.

Table 1: Descriptive Statistics

Variables	Type	Alternative Accounts	Regular Accounts
Demographic Characteristics			
Age	Continuous	45.2	51.3
Female	Equal to 1 if yes; 0 otherwise	40.00%	20.44%
Family size	Continuous	3.77	3.14
Have children<18	Equal to 1 if yes; 0 otherwise	20.95%	10.05%
Marital Status			
Married	Equal to 1 if yes; 0 otherwise	38.03%	61.80%
Partner	Equal to 1 if yes; 0 otherwise	4.92%	3.13%
Non-couple	Equal to 1 if yes; 0 otherwise	57.05%	35.07%
Race			
White	Equal to 1 if yes; 0 otherwise	56.07%	79.97%
Black	Equal to 1 if yes; 0 otherwise	26.89%	9.52%
Hispanic	Equal to 1 if yes; 0 otherwise	14.75%	6.75%
Others	Equal to 1 if yes; 0 otherwise	2.30%	3.77%
Socioeconomic Characteristics			
Education			
< 12 years	Equal to 1 if yes; 0 otherwise	29.81%	9.75%
12 years	Equal to 1 if yes; 0 otherwise	35.10%	23%
13-15 years	Equal to 1 if yes; 0 otherwise	21.64%	19.96%
16 years or more	Equal to 1 if yes; 0 otherwise	13.45%	47.29%
Mean Family income	Continuous	$28,805	$71,046
Networth			
Networth Q1	Equal to 1 if yes; 0 otherwise	49.51%	17.58%
Networth Q2	Equal to 1 if yes; 0 otherwise	23.28%	18.10%
Networth Q3	Equal to 1 if yes; 0 otherwise	7.54%	17.81%
Networth Q4	Equal to 1 if yes; 0 otherwise	19.67%	46.51%
Credit Related Characteristics			
Denied Credit in past 5 years	Equal to 1 if yes; 0 otherwise	24.59%	14.52%
Felt discourage with credit	Equal to 1 if yes; 0 otherwise	31.15%	12.26%
Bad Credit	Equal to 1 if yes; 0 otherwise	21.31%	7.74%

This table shows the socioeconomic and demographic distribution of alternative and regular borrowers and their credit related characteristics

The logistic regression results (Table 2) indicate that, even after controlling for other demographic and socioeconomic factors, those whose past credit requests had been denied were more likely to borrow from the alternative financial institutions than were those who had not been denied credit. The log odds for this association was slightly higher than 1.5, indicating that individuals who had been denied credit over the previous five years were one and half times more likely to have accounts at alternative financial institutions than were individuals who had never been denied credit. Among demographic variables, age was negatively associated with having account at alternative financial institutions, and women and those who had children less than 18 years of age were more likely to borrow from the alternative financing

companies. When compared with the married respondents, single and partnered (but not married) borrowers were more likely to borrow from the alternative financing companies. Compared with the reference group of Caucasians, African-Americans were more likely to borrow from the non-traditional lending companies. The socioeconomic variables show that those with an educational attainment of high school or lower were more likely to have accounts at the alternative financing companies. Income was negatively associated with having accounts at the alternative financial institutions, and being in the bottom two quartiles of net worth was positively associated with having alternative accounts.

Table 2: Logistic Regression: Borrowing from Alternative Financial Institutions

Variables	Coefficient	St.Error	Log Odds
Credit related Characteristics			
Denied Credit in past 5 years	0.421***	0.135	1.523
Felt discourage with credit	0.047	0.163	1.048
Bad Credit	0.244	0.230	1.277
Demographic Characteristics			
Age	-0.014***	0.004	0.986
Female	0.614***	0.227	1.85
Family size	-0.078	0.051	
Have children<18	0.615***	0.164	1.85
Marital Status (Ref. Married)			
Partner couple	0.778***	0.276	2.18
Non-couple	0.906***	0.120	2.48
Race (Ref. White)			
Black	0.606***	0.150	1.83
Hispanic	0.093	0.196	1.09
Others	-0.083	0.388	0.920
Socioeconomic Characteristics			
Education (16 years or more)			
<12 years	1.509***	.208	4.524
12 years	1.099***	.184	3.003
13-15 years	0.809***	.203	2.248
Family income	-0.138*	0.074	0.872
Networth (Networth Q4)			
Networth Q1	0.768***	0.260	2.154
Networth Q2	0.584**	0.231	1.793
Networth Q3	0.057	0.275	1.059

*This table shows the likelihood of borrowing from the alternative lending institutions after controlling for various socioeconomic and demographic characteristics. ***, ** and * indicate significance at 1%, 5% and 10% levels*

DISCUSSION

The results of the empirical analysis confirm the hypothesis that individuals who have been denied credit in the past are more likely to have accounts with alternative financing companies, even after controlling for other socioeconomic, demographic, and credit-related characteristics. Consistent with rational choice theory, the results demonstrate that individuals who are constrained by the denial of conventional, low-cost loans are more willing to pay a higher premium for borrowing from alternative financing companies. The results of this study are consistent with the findings of previous studies (Dew, 2008; Elliehausen & Lawrence, 2008).

Denial of credit at conventional financing institutions such as banks or credit unions indicates that the traditional lending industry views the borrower as risky in terms of his or her ability to repay loans. As a result, the borrowers who have previously been denied credit make themselves even more vulnerable to credit defaults by opening accounts at alternative institutions that lend money at much higher rates. This situation is exacerbated by the fact that many of these high risk borrowers lack the financial skills necessary for managing their finances (Allen & Kinchen, 2009). Among other control variables, the negative association between age and having accounts with alternative financing companies indicates that younger individuals are more likely to be customers of these lending institutions. An increasing proportion of respondents with alternative accounts had lower educational attainment, lower income and lower net worth. Clearly, these associations of education, income, and wealth with the likelihood of having accounts at the alternative lending institutions point to the increased vulnerability of these borrowers. Some adverse selection of participation may apply because individuals who are more likely to have trouble paying off the loans borrow from the expensive alternative financing sources. The results also show that single households and African-American households are more likely to participate in this type of borrowing. The analysis reveals the groups that consumer economists and financial educators should target with information that clearly presents the consequences and risks associated with subprime borrowing and utilization of alternative financing institutions.

CONCLUSION

This study uses data from the Survey of Consumer Finances to examine whether denial of credit at traditional financial institutions is a predictor of individual borrowing from alternative lenders. The results indicate that individuals who were denied credit by the traditional financial institution were one and half times more likely to have accounts with the alternative financing institutions. This study also finds that the likelihood of borrowing from the alternative financing companies is higher for younger individuals, individuals with larger families, and for individuals with younger children. In addition to this, the study reveals that African Americans, individuals with lower educational attainment, and women are more likely to borrow from these high cost lenders. Conversely, being married and having higher income and net worth are negatively associated with alternative borrowing. Therefore, people experiencing financial instability are choosing to borrow from alternative sources, without the income, wealth, or human capital necessary to protect them against the high cost of such borrowing. If these choices are rationally made by weighing the risk of such borrowing against the benefits of expenditures that are essential or opportunistic, then the results may not represent a problem. If, however, borrowers are unable to assess the consequences of such borrowing correctly, then they may be exposing themselves to a larger threat of financial disruption than they should rationally be willing to accept.

This study did not objectively measure the credit-worthiness of borrowers. It could be that even one denial of credit to otherwise credit-worthy individuals directs these individuals into the alternative lending markets. As a result, borrowers who might qualify for lower interest rates subject themselves to much higher interest rates than necessary because of perceived barriers to low-cost credit. This choice has the potential to reduce credit-worthiness in the long-run as a result of dealing with the cost of unfavorable lending terms. Future research should consider this possibility. Characteristics of the borrowers who obtain loans from the alternative financing institutions are similar to those of subprime borrowers over a long-term horizon (Hogarth & Hilgert, 2002). The popularity of these alternative finance and loan companies reflect a growing trend towards catering to resource-constrained consumers. Unfortunately, as the credit markets tighten and the traditional financial institutions raise their lending standards even higher, these alternative financing companies are likely to see even more business in the near future. The findings of this study, especially those related to creditworthiness, educational attainment, income, and wealth, provide evidence that increased financial constraints lead individuals to obtain alternative loans while adding to borrowers' financial leverage and exposing them to greater interest-rate burden. Economists and financial professionals should target these vulnerable groups with specific information

and education related to the risks associated with short-term, subprime borrowing, because it is in the broader national and global interest to ensure informed choice and prevent another financial debacle that results from information asymmetry.

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