An Economic Perspective on Subprime Lending

Michael H. Anderson
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INTRODUCTION

The purpose of this essay is to provide an introduction and context to the seemingly ubiquitous subprime financing industry. Subprime financing, while encompassing many mechanisms, refers to non-traditional lending which does not rely on the credit history of the borrower and is typically done by non-depository institutions. The fact that such lending is readily available, and that consumers with no credit or bad credit qualify, makes subprime loans appealing to low income or financially constrained consumers.1 Because of the nature of the customer base and the high cost of the supplied credit, critics of these businesses have long been concerned that these services are exploitive and in need of strong regulation and governmental oversight.2

In looking at subprime financing, we note an interesting historical symmetry. The 1970s and early 80s were a very challenging time for the U.S. economy. The creation of the Organization of Petroleum Producing States (OPEC) and the subsequent quadrupling of oil prices helped create three recessions between 1973 and 1981.3 Participants in the economy discovered that stagflation, defined as high unemployment and high inflation, was possible.4 This period saw the popularization of the “misery in-

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dex,” the sum of unemployment and inflation. High inflation and general economic uncertainty lead to a period of high interest rates unprecedented in modern times. Because lending rates are set at a spread above investment rates, this effectively curtailed most lending, especially to consumers, as few could afford to pay such rates. Additionally, in some states, usury ceilings shut down consumer loan markets. All this created the need for so-called “creative financing.” For instance, in the housing market, new mortgage origination greatly slowed as consumers expended much effort maintaining rather than rolling over older, lower fixed rate mortgages. It also opened the door to the growth of subprime lending as consumers sought ways to finance needed acquisitions.

Today, the market for subprime financing has also been growing significantly. Unlike thirty years ago, however, today our interest rates are too low. As of this writing, we are five years into a Federal Reserve policy, commonly referred to as ZIRP, of keeping interest rates at near zero. The reason the Fed is following ZIRP is to help the economy recover from the so-called Great Recession that officially ran from December 2007 to June 2009. The “misery index” was first coined in the 1960s by Arthur Okun. See United States Misery Index, NPA SERVS. INC., www.miseryindex.us (last visited Oct. 4, 2013).

For instance, the ten year Treasury Bond, a key benchmark rate, was ten percent or higher from October 1979 to November 1985, topping out at 15.32% on September 1, 1981. 10 Year Treasury Rate by Month, MULTIPL.COM, http://www.multipl.com/interest-rate/table?f=m (last visited Oct. 4, 2013).

According to the Federal Reserve, the Prime Rate (the rate offering to the most credit worthy customer and so the lowest borrowing rate) broke ten percent in November, 1978 and stayed above that until May, 1985, peaking at 20.38 percent in July, 1981. Selected Interest Rates (Daily) tbl. Bank Prime Loan: Monthly, FEDERALRESERVE.GOV, available at www.federalreserve.gov/releases/h15/data.htm (last visited Oct. 4, 2013).

Arkansas once had a fixed ten percent usury ceiling on consumer lending, with the result that consumer lending could not be profitable and so largely ceased to exist; this regulation was not changed until 1982. Ark. CONST. of 1874, art. XIX, § 3 (amended 1982, repealed 2010). However, note that Louisiana still has a twelve percent usury ceiling on conventional loans. LA. REV. STAT. ANN. § 9:3500 (2005).


Fed Chairman Ben Bernanke has stated he has a continued commitment to easy-money policies and “that the Fed is better prepared to find and address financial instability than it was before the 2008 crisis.” Victoria McGrane, Fed Chief Stands Pat on Easy Money, WALL ST. J., March 1, 2013, available at http://online.wsj.com/article/SB10001424127887323293704578334803548396628.html.
2009.\textsuperscript{13} Further, the Fed has expressed a commitment to keeping rates low for the foreseeable future.\textsuperscript{14} For individuals and institutions that have traditionally relied on fixed-rate investments, e.g., retirees, and pension and endowment funds, ZIRP is problematic, and this problem is exacerbated by the demographic trend of a rapidly aging U.S. At the same time, lower income consumers are also impacted. Improving one’s economic situation by opening a savings account may not be tenable when the account does not pay any significant interest, and various fees may actually reduce the account balance over time.\textsuperscript{15} Since the recession started, we have seen a significant drop in median household income, and an increase in Social Security Disability rolls and enrollment in the Supplemental Nutrition Assistance Program (SNAP, sometimes referred to as food stamps).\textsuperscript{16} These factors combined, present a growth opportunity to the subprime industry.

This essay will discuss four common subprime mechanisms: rent-to-own, payday lending, pawn shops, and title pawn lending, respectively. Some conclusions on these industries are then stated in the final section.

I. RENT-TO-OWN

Rent-to-own (RTO) has been described in fuller detail in “An economic investigation of rent-to-own agreements” in an accompanying article in the symposium. RTO is a mechanism allowing consumers immediate access to merchandise—most commonly appliances, electronics, or furniture—with neither a credit check nor down payment. Instead, consumers agree to a series of payments. One interesting aspect of RTO is that consumers can choose their payment periodicity: monthly, semi-monthly, bi-weekly, or weekly.\textsuperscript{17} Thus, consumers can choose to have a payment frequency in sync with their paydays, or in line with their planned contract

\textsuperscript{13} See US Business Cycle Expansions and Contractions, supra note 3.
\textsuperscript{14} For instance, the Fed has said it will keep short-term interest rates low until the unemployment rate slips below 6.5\%, which is projected to be reached in mid-2015. Carolyn Cui, Fed Seeks More Control Over Rates, WALL ST. J., August 22, 2013, at C4.
\textsuperscript{15} The rise in fees is another consequence of low rates as banks try to replace lost interest revenue with higher consumer fees.
usage. The agreement is for a fixed time period, usually twelve to twenty-four months. At the same time, the customer maintains the ability to terminate the arrangement at any point either by returning the item or by making a final lump sum payment. If all payments are made or the early purchase option is utilized, the customer takes ownership of the merchandise. However, no adverse credit action occurs if the consumer decides to terminate payments early. Adding to the value of the transaction, merchandise delivery, set-up, and service (as well as pick-up, if required) are all included.\(^\text{18}\)

Since its beginning in the 1960s, the RTO industry has grown to over 9,800 stores in the U.S., annually serving over six million customers, and generating over $8.5 billion in revenue.\(^\text{19}\) The industry consists of two publicly traded companies—Rent-A-Center (RAC) and Aaron’s—and a number of privately owned businesses. RAC (and its subsidiary ColorTyme) is largest with thirty-two percent of the RTO stores in the U.S.,\(^\text{20}\) Aaron’s, along with its franchises, is second with twenty one percent,\(^\text{21}\) RAC and Aaron’s taken together generate sixty percent of the industry’s revenue.\(^\text{22}\) RAC encourages weekly schedules, while Aaron’s prefers monthly, and the privately owned companies generally offer a blend of payment frequencies.\(^\text{23}\)

RTO is not regulated at the federal level; however, forty-seven states have passed laws regulating RTO.\(^\text{24}\) State regulations can generally be organized into rules that require various disclosures, and rules that place

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19. ASS’N OF PROGRESSIVE RENTAL ORGS., supra note 18.


22. RAC’s 2012 revenue was $3.082 billion in 2012. RENT A CENTER, INC., 2013 PROXY STATEMENT: 2012 ANNUAL REPORT Form 10-K 13, available at http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MTE5MjEwEwEwSUQ9LT8VHlwZT0z&t=1. Aaron’s 2012 revenue was $2.222 billion. AARON’S, INC., supra note 21, at 5.

23. For instance, of the over 180,000 Rent-A-Center transactions examined, 8.5 percent were monthly, 19.6 percent were bi-weekly and 71.9 percent were weekly. Michael H. Anderson & Raymond Jackson, Managing High Risk in a Retail Operation: The Rent to Own Business, 29 THE SOUTHERN BUSINESS & ECONOMIC JOURNAL 87, 89, 97 tbl. 4 (2006). Of 6,000 transactions examined from an independent RTO chain in the southeast, 18.5 percent were monthly, 25.8 percent were bi-weekly and 55.7 percent were weekly Michael H. Anderson & Sanjiv Jagjia, An Empirical Look at Low Income Consumers and the Rent To Own Industry, in LOW INCOMES: SOCIAL, HEALTH, AND EDUCATIONAL IMPACTS 245, 248 (Jacob K. Levin ed., 2009).

controls on permissible fees and prices. Eighteen states have mandated in-
store price tag disclosures. This typically requires the tag hanging on the
merchandise on the store floor to disclose the cash price, the rental pay-
ment, number of payments and total dollar amount required for owner-
ship. All states that have passed legislation also mandate agreement
disclosures—very much akin to requirements for consumer loan disclo-
sures. Generally speaking, the contract must speak to whether the mer-
chandise is new or used, the cost of ownership, the customer’s rights, the
terms of the options, if a manufacturer’s warranty will apply after owner-
ship, and other related information. Most states also have limits on fees,
such as whether the store can charge an in-home collection fee when a store
employee is be dispatched to a residence to collect payment. The fee
restrictions also address the length of any grace period for late payments
that must be given and whether or not a reinstatement fee may be assessed
if a transaction is resumed after having been temporarily suspended. Finally, five states have placed caps on cash prices and total payment-to-term
RTO prices, expressed as multiples of the store’s wholesale cost.

II. PAYDAY LENDING

Payday lending, or check advance loans, involves small dollar amount
loans made for short periods of time. They typically are for $100 to $500
(up to $1,000 in some jurisdictions) lasting for two to four weeks. The
borrower instigates the loan by writing a post-dated check for the loan
amount plus fees of $15 to $20 per $100 of principle. At the due date,
often the consumer’s next payday, the customer may redeem his or her
check with cash or simply allow it to be deposited. Due to the small loan
size, this is necessarily a high volume business. For efficiency, the under-
writing process is very streamlined: essentially verifying identity, income,

25. Id.
26. Id.
27. See Anderson & Jaggia, supra note 23, at 238 n.3 (of 136,275 analyzed payments, over 8,000
were picked up at the customers home).
28. See Winn III, supra note 24 add. (Specifications on Fees and Payments).
29. California, Hawaii, Maine, New York, and West Virginia have statutory caps. See Winn III,
supra note 24 add. (discussing in-store price tag disclosures).
30. See, e.g., Payday Lending Statutes, Nat’l Conf. of St. Legislatures, www.ncsl.org/issues-
research/banking/payday-lending-state-statutes.aspx (last visited Oct. 4, 2013) (providing a comprehen-
sive, state-by-state list of payday lending statutes).
31. The precise fees vary by state. See Cash Advance Rates / Fees, Cash Am. Int’l, Inc.,
(providing a state-by-state listing of fees).
and the existence of a bank account. In states that regulate the transaction, the firm may additionally have to verify loan eligibility by checking a central database. While the presence of the post-dated check provides an easy collection mechanism, it cannot guarantee that there are sufficient funds; for example, loan loss rates between eight and fourteen percent of gross revenue have been recorded.

The payday lending industry began in the early 1990s and has seen significant growth. There are currently 20,600 payday advance locations in the U.S. providing $38.5 billion in short-term credit to some 19 million households. Six large companies control about twenty percent of the payday industry. The largest firms in the industry are Advance America with over 2,500 locations; and Cash America with over 1,000 locations. The other major firms are ACE Cash Express Inc., Check ‘n Go, Dollar Financial, and Check Into Cash; all four of which are publicly traded. The rest of the industry is composed of smaller local and regional firms. In addition, a few banks, including U.S. Bank and Wells Fargo & Co., offer a comparable product.

The annual percentage rate (APR) on a payday loan can easily exceed 400 percent. Such APRs would normally be considered usurious; however, a commonly offered justification is that such loans are a cheaper alternative then the costs associated with overdrawing a bank checking account.

34. Lawrence & Elliehausen, supra note 33, at 302.
addition to high rates, consumer advocates are also concerned about a potential credit trap due to the financially constrained borrower’s need to roll over these loans.41

While there are no federal regulations, a total of forty states and the District of Columbia have payday lending laws, which generally limit permissible fees, maximum loan amounts, and the number of such loans a consumer can have outstanding at any point.42 Two states, Arizona and North Carolina, have allowed their payday loan regulations to sunset.43 The remaining eight states either have no explicit regulations, or require payday lending to comply with consumer loan caps thereby effectively prohibiting payday lending.44

III. PAWN SHOPS

The pawn business is the making of secured loans to individuals using that individual’s personal property as collateral. The pawn transaction is one of oldest financial transactions in existence. Pawning can be traced back three thousand years to ancient China, and was also present in early Greek and Roman civilizations.45 The word pawn itself traces to the fifteenth century from a root word meaning “pledge” or “security.”46 The pawn business has become more visible in recent years. For instance, there are several reality-television shows set in pawnshops that are currently on the air.47 There were an estimated 6,389 pawnshops in 2007,48 and there are an estimated 10,000 shops as of January 2012.49 The high price of pre-

42. See NAT’L CONF. OF ST. LEGISLATURES, supra note 30.
47. See, e.g., Hardcore Pawn (TruTV 2009), Hardcore Pawn: Chicago (TruTV 2013), Pawn Stars (History 2009).
48. NAT’L PAWNBROKERS ASS’N, supra note 45, at 7.
49. Id.
cious metals has led to an increased interest in pawning or selling one’s jewelry and in the growth of the related “cash-for-gold” stores. In addition to jewelry, electronics, collectibles, musical instruments and tools are commonly pawned. In some jurisdictions, firearms can be pawned. Additionally, there has been some growth in Internet pawning, which can circumvent state and local regulations. The vast majority of the industry is composed of independently owned stores or small regional chains; there are also three publicly traded companies. These represent less than thirteen percent of the industry.

One reason for the popularity of a pawn loan is that it is independent of a customer’s credit history and his or her ability to pay: as long as one has items to pawn, one has quick access to cash. Furthermore, unlike a conventional loan, defaults do not damage the credit history of the customer. Additionally, customers also have the option to simply sell their items instead of pawning the merchandise. Handling the items bought outright and the collateral taken in is one thing that makes this business interesting. The possibility of default is part of the basic business model, with the pawnbroker being allowed to sell the collateralizing item to recoup their loan outlay plus interest and fees. It is incumbent on the pawnbroker to carefully value the item in question as well as to manage the quantities and mix of items in inventory to avoid losing on any particular item or class of item.

According to the National Pawnbrokers Association (NPA), the national average loan amount is under $150 and is for less than thirty days. Over eighty-five percent of the pawn loans are repaid. The transaction

51. Should a pawnshop choose to accept firearms, they are subject to the Gun Control Act § 922(t), the so-called “Brady Act.” See Brady Law, BUREAU OF ALCOHOL, TOBACCO, FIREARMS, AND EXPLOSIVES, www.atf.gov/firearms/faq/brady-law.html#pawn-redemption (last visited Oct. 4, 2013). These pawnshops must then use the National Instant Criminal Background Check System. See Id.
52. For example, Pawngo offers a loan application that can be processed entirely online. About Pawngo, INTERNET PAWN, LLC, https://pawngo.com/about (last visited Oct. 4, 2013). As the National Pawnbrokers Association points out, such firms may avoid regulation if they are based off-shore or on tribal reservations. See NPA Policy Statement: Internet Pawn Loans and Providers, NAT’L PAWNBROKERS ASS’N, www.nationalpawnbrokers.org/internet-pawn (last visited Oct. 4, 2013).
53. These publicly traded companies are Cash America International, Inc., EZCORP, Inc., and First Cash Financial Services, Inc. NAT’L PAWNBROKERS ASS’N, supra note 45, at 7.
56. Id.
itself is conceptually simple. The pawnbroker gives cash for a pawned item. Within a set period, typically a month or two, the customer can reclaim the item by repaying the loan plus the specified interest. The length of time and interest rate are set by the pawnshop, though most jurisdictions have regulation limiting on the permissible interest rate. Most states also have regulations requiring record keeping and reporting due to concerns that items being pawned are stolen property.

Like other subprime financing, using a pawnshop is expensive. Shackman and Tenney considered the maximum interest on an $80, two month loan in all fifty states and Washington D.C., finding permissible rates as high as twenty-five percent a month: translating to an APR of 300 percent. Further, they found that only ten jurisdictions had a requirement for the store to return any excess proceeds upon the sale of the collateral.

IV. TITLE PAWN LOANS

A title pawn loan, or title loan, is a loan against the equity in one’s vehicle. These loans range from small amounts borrowed for short periods of time, for example, $300 for thirty days, to much larger and longer term loans such as, $5000 for a year or more. For regulatory purposes, these loans may be classified as pawn loans; however, while a pawnbroker takes possession of a pawned item, here the borrower retains the use of the pawned vehicle, adding another element of risk to the transaction.

There has been notable growth in title lending in recent years. A significant portion of loan providers are independent operators, and a fair number are offering title loans as an offshoot of being engaged in a related

57. Id. at 5.
60. Id.
61. For instance, Georgia defines “pledged goods” to include “any motor vehicle certificate of title.” GA. CODE. ANN. § 44-12-130(5) (2010).
subprime financing business. While there are no public companies in the business, there are several large private companies. For instance, TitleMax is a privately owned company, which started with one store in 1998 and currently has over 1,000 stores in twelve states. Another is Auto Cash USA, which represents a network of lenders at over 500 locations. These loans require neither a credit check nor much documentation as they are, in essence, collateralized by the title to the borrower’s vehicle. Consequently, the proceeds can typically be obtained in one or two days, much faster than a conventional bank loan. Generally, all that is needed for the loan to proceed is for the lender to examine the vehicle to verify that it is worth enough more than the desired loan amount, net of expected repossession and auction costs, and to determine if the borrower has a clear title to the vehicle.

For many financially constrained individuals, their car may be their most valuable possession. The value of that potential collateral to a title loan lender is created by the very large, active and liquid secondary market for vehicles that exists in the U.S. The sizable secondary market gives lenders the ability to lend to a customer without proof of income or a conventional credit analysis. While this is a positive in terms of having access to credit, it is problematic in terms of ability to repay. The possibility of losing one’s vehicle is very serious, especially for those in rural areas, and puts access to employment, health care and other essentials at risk.

Title pawn loans are unregulated at the federal level, although the Consumer Financial Protection Bureau is considering doing so. State regulations vary widely: some states such as Connecticut, Maryland, and

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63. For instance, Tennessee reports 179 lenders representing 762 locations, twenty-four percent being proprietorships or partnerships, and the top ten lenders having seventy-nine percent market share. 2012 Report on the Title Pledge Industry, supra note 62, at 5.
67. See Michael H. Anderson, Title Pawn Loans, in CONSUMER SURVIVAL, supra note 18.
68. 9.7 million used vehicles were sold in the first quarter of 2013. See Arlena Sawyers, U.S. Used-Vehicle Sales Drop 6% In First Quarter, AUTONEWS, (May 14, 2013, 4:41 PM), www.autonews.com/article/20130514/RETAIL/130519945#:; see also Mike Ramsey, Amid New Car Boom, Used Cars are Gold, WALL ST. J., February 21, 2013, available at http://online.wsj.com/article/SB10001424127887323511804578300650170654978.html (noting a strong demand for used cars).
Maine have banned title loans outright, while others have capped either the maximum interest that can be charged or the loan size.\textsuperscript{70} For instance, in Illinois the maximum loan amount is $4,000,\textsuperscript{71} while in Mississippi and Tennessee it is $2,500.\textsuperscript{72} As a practical matter, the lender may be able to exploit a looser usury ceiling than would apply if the loan were classified as a consumer loan. For instance, in Georgia, the maximum permissible interest rate on a title pawn loan is twenty-five percent per month for the first three months of the loan after which it is capped at 12.5 percent per month—thus, loans up to three months can legally carry a 300 percent APR.\textsuperscript{73} This is despite Georgia’s consumer loan usury ceiling of sixteen percent on loans under $3,000 and five percent per month for larger loans.\textsuperscript{74}

\textbf{CONCLUSION}

This essay surveyed some common types of subprime financing. It is striking just how small and short most of these loans are. It is hard for most of us to imagine how financially constrained an individual must be to need such a loan. Given the constraints placed on these consumers, it is often difficult for them to repay. Indeed, a very real concern is that many fall into a credit trap, wherein the only way these consumers can cover their expenses is to rollover their subprime loans, possibly repeatedly. A common anecdote about payday and title pawn loans is that they are two-week loans that take months or even years to pay off. The cost of subprime financing, expressed as an APR, can easily be 200 to a 1000 percent or more. Given the very short time frame on some of these loans, the APR may not be that useful a measure, but it is certainly clear that these loans can be very expensive.\textsuperscript{75} Regulation and oversight of these businesses to prevent abuse is important. Product disclosures and consumer education are also essential. At the same time, from a policy standpoint, the best actions would be ones that provide or improve the safety nets available for low income individuals.

\textsuperscript{71} ILL. ADMIN. CODE tit. 38, pt. 110.370(a) (eff. Apr. 1, 2009).
\textsuperscript{75} For instance, a $10 fee to lend $100 for two weeks is an APR of 260 percent—but, instead of focusing on that APR, it would be more meaningful to disclose to consumers the loan’s cost and, if it is rolled over, how exactly that loan can quickly get both expensive and difficult to payoff.
as well as encourage economic growth, so that consumers experience sub-prime financing as a transitional mechanism, if they have to experience it at all.