Undermining Economic Security

Use of Alternative Financial Services in Virginia

By Rebecca M. Tippett

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NUMBERS COUNT
Analysis of Virginia Population

In communities and households across Virginia, families are using multiple strategies to stretch financial resources in the face of the protracted economic recession and rising costs for gas, food, and healthcare. Prior research found:

- A quarter of Virginia households are income inadequate; they do not earn enough to meet their regular monthly expenses.
- Nearly thirty percent of Virginia households are asset inadequate; they do not have sufficient assets to weather a short-term financial crisis.[1]

To get through hard economic times, households may reduce unnecessary expenditures; draw money from their savings; or rely on support from family and friends, charitable organizations, or government programs. For some households, the only way to pay their bills is to borrow money. In fact, nearly ten percent of Virginia's households report relying on short-term loans from alternative financial service providers to make ends meet.[2]

Alternative financial services (AFS) provide short-term, small-dollar loans that some households use when faced with income shortfalls.[3] Compared to loans from mainstream financial institutions, such as banks and credit unions, loans from AFS providers have:

- Smaller loan values
- Shorter loan terms
- Substantially higher interest rates and fees

Most families are already in or near crisis when they turn to these products, and they are using them to pay for basic necessities such as rent, food, and transportation. The immediate consequences of financial crisis—such as eviction—may outweigh the long-term consequences of using these high-cost loans.

This paper examines alternative financial services in Virginia and addresses the following questions:

What alternative financial services exist in Virginia?

Why do Virginians use alternative financial services?

Who uses alternative financial services?

Where are alternative financial services located in Virginia?

What alternative financial services exist in Virginia?

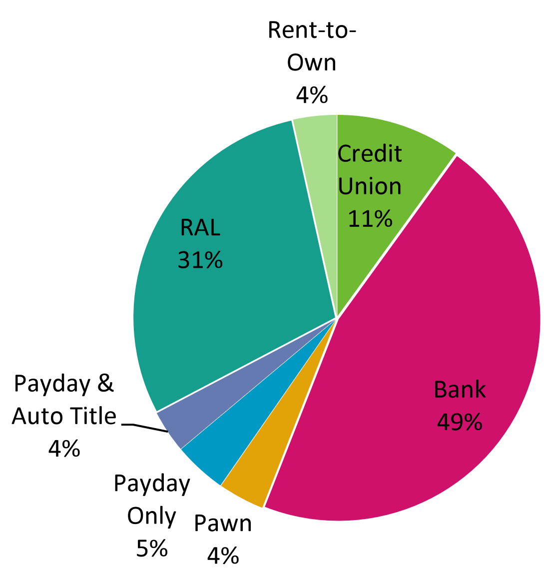
Twenty-two states, including Virginia, allow lending from all types of AFS providers. Twenty-six states and the District of Columbia have prohibited auto title loans. Thirteen states have prohibited payday lending.[4] Households in Virginia have access to five types of short-term, small-dollar loans from alternative providers:

1. **Auto title loans** are for four months to one year and are secured by the borrower's car title. If the borrower defaults on the loan, the auto title lender has the right to repossess the vehicle. Nearly 150,000 Virginia households (5 percent) reported using an auto title loan between 2005 and 2009.[5]
2. **Pawn loans** are typically for a 30-day period and are secured by a personal good of the borrower. The pawn lender takes possession of the item; if the borrower fails to repay the loan, the lender has the right to sell the item. More than 95,000 households (3 percent) have borrowed money from a pawnbroker.[6]
3. **Payday loans** are typically for a two to four week period. The borrower writes the lender a postdated check for the value of the loan plus fees; when the loan is due, the borrower either repays the lender or the lender cashes the check.[7] Nearly 120,000 Virginia households (4 percent) reported using payday loans in 2008.[8]
4. **Refund anticipation loans (RALs)** are typically for a one to two week period, with fees varying substantially between lenders. The tax preparer provides a loan based on the borrower's expected tax refund (minus loan fees and interest) and establishes a temporary bank account into which the IRS refund is directly deposited. Seventy thousand Virginia households (2.5 percent) reported using RALs at least once between 2004 and 2008.[9]
5. **Rent-to-own (RTO) stores** provide borrowers the option to lease big-ticket consumer items such as furniture, appliances, and electronics.[10] At the end of the lease term, the borrower owns the item. Missing a payment can result in repossession of the item and loss of all prior payments.[11] More than 100,000 households (3.6 percent) reported using RTO stores.[12]

Of these, only auto title lenders and payday lenders are regulated by the Virginia State Corporation Commission's Bureau of Financial Institutions.

As shown in **Figure 1**, three-fifths of lending institutions in Virginia are mainstream financial institutions such as banks and credit unions; the remaining two-fifths are AFS providers.[13] Banks are the most prevalent institution,

Figure 1. Financial Lenders in Virginia, 2011



Sources: Virginia Bureau of Financial Institutions; Credit Unions Online; FDIC; ReferenceUSA reflecting that the majority of households conduct all of their financial transactions at FDIC-insured banks.[14] Among AFS providers, tax preparers offering refund anticipation products and payday lenders are the most common short-term loan services. Although refund anticipation loans can only occur once a year, at tax time, the prevalence of RAL providers reflects the high dollar amount of these loans and nearly guaranteed repayment, as the loan is paid directly from the borrower's federal tax refund.

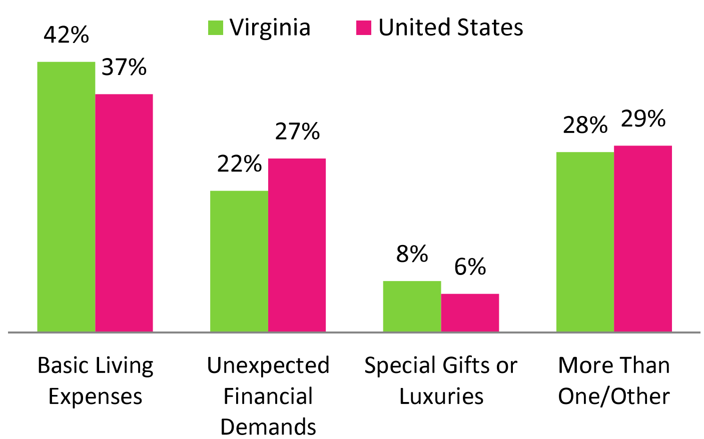
In summary:

- Virginia is one of twenty-two states that allow <u>all</u> types of alternative financial services.
- Forty percent of financial lending institutions in Virginia are alternative financial service providers.
- More than 275,000 Virginia households, nearly 10 percent, use any type of AFS product; payday loans are the most popular.

Why do Virginians use alternative financial services?

People turn to short-term, higher-cost AFS to address chronic income inadequacy or acute financial crisis (**FIGURE 2**). According to 2009 Current Population Survey (CPS) data, more than 40 percent of Virginia households that used AFS did so to meet **basic living expenses**, such as rent, groceries, and child care costs. Another 22 percent of households who used short-term loan products faced **unexpected financial demands**, such as income loss, home and car repairs, and medical expenses. Nearly 30 percent reported multiple reasons for AFS use, suggesting interrelated financial vulnerability.

FIGURE 2. MAIN REASON FOR USING AFS IN PAST 12 MONTHS, 2009 CPS



Some people rely on AFS products because they are unbanked—that is, they do not have a checking or savings account. These individuals are the minority. In Virginia, more than 90 percent of AFS users have a bank account,[15] prompting the question: why do Virginians with access to traditional banking services rely on alternative lenders? Several factors may be relevant. In contrast to short-term AFS loans, personal loans from banks take time to process and require multiple forms of documentation, as well as proof of credit history.[16] Additionally, banks and credit unions typically do not offer extended business hours. These may be barriers to individuals with immediate financial needs or past financial difficulties.

According to the 2009 CPS data, people use short-term loans from AFS providers instead of banks and credit unions for three main reasons:

1. The loans are **easier to get** than loans from banks and credit unions.
2. The AFS providers are **more convenient** than mainstream financial providers.
3. The borrowers **do not qualify for bank loans**, or believe they do not qualify.

Who uses alternative financial services?

Virginians are less likely to use alternative financial services than Americans overall. Nearly ten percent of Virginia households report ever using short-term loan products from alternative providers, less than the national rate of 12 percent. Patterns of use, however, are similar between the nation and those Virginians who use AFS:[17]

- The majority of households, 71 percent, use only one type of alternative short-term loan.
- Eight percent of households report using three or more types of AFS.
- Payday loans and pawn loans are the most popular form of AFS.

TABLE 1. DEMOGRAPHIC AND ECONOMIC CHARACTERISTICS OF VIRGINIANS BY AFS USE, 2009 CPS

	Any AFS Use	Never Use AFS
Age (median)	38	50
Race[1]		
White	49%	75%
Black	44%	15%
Income		
Less than $25,000	38%	16%
$25,000-74,999	42%	44%
More than $75,000	19%	40%
Unemployed	10%	3%
Education		
Less than High School	23%	9%
High School/GED	34%	28%
Some College	24%	22%
Bachelors or More	19%	41%
Household Characteristics		
Married	44%	57%
Have Any Children	41%	18%
Own Home	40%	78%

[1]The sample size of Hispanic and other race Virginians is too small to provide meaningful estimates.

Households that use AFS products are demographically and economically distinct from households that do not (**TABLE 1**). Compared to households that never use alternative financial services, AFS-using households are:

- Much younger, with lower incomes and higher unemployment.
- Less likely to have a bachelor's degree, be married, or own a home.
- More likely to have children.

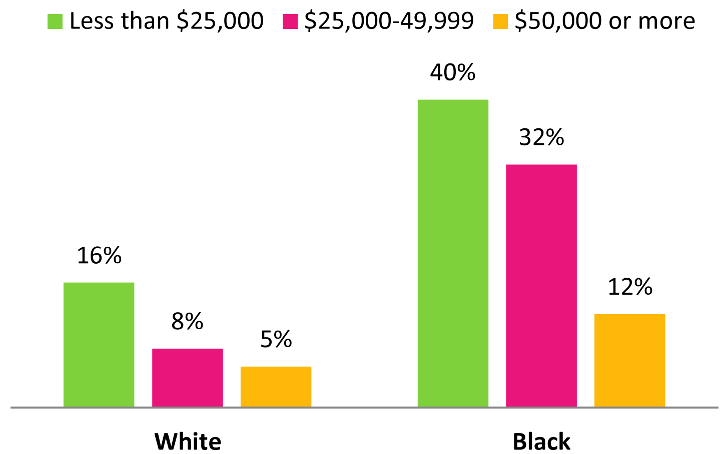
Significant differences in short-term loan use are found between racial and ethnic groups. Nationally, both black and Hispanic households have higher rates of AFS use than whites. Controlling for characteristics associated with need for and use of short-term loans—such as age, income, and education—different findings emerge. Hispanic households are significantly less likely to report any short-term loan use compared to whites. In contrast, black households remain significantly more likely than white households to report ever using short-term loans from AFS providers.[18]

Similar patterns exist in Virginia and are shown clearly in **FIGURE 3** (page 5). Across all income categories, black households are significantly more likely than white households to report ever using short-term loans from AFS providers. Multiple factors may contribute to this differential, and research remains to be done on racial and ethnic preferences and demand for certain types of financial products. Existing research has focused on the importance of geography, with results showing that poor and minority neighborhoods frequently lack access to mainstream financial institutions and are disproportionately exposed to AFS providers.[19]

Where are alternative financial services located in Virginia?

As might be expected, the bulk of both AFS and mainstream providers are located in Virginia's largest urban centers: Hampton Roads and Northern Virginia.[20] One-quarter of all AFS providers and one-third of Virginia's pawn shops and payday-only providers are located in Hampton Roads, the area with the highest concentration of black residents.

FIGURE 3. RACE, INCOME AND SHORT-TERM AFS USE IN VA, 2009 CPS



The relationship between concentrations of racial and ethnic minorities and prevalence of alternative financial services is brought into focus at the Census tract level. An examination of the racial and ethnic composition of Virginia's 1,907 Census tracts reveals that alternative financial service providers are disproportionately located in higher concentration black neighborhoods.[21] Among Census tracts with any financial service providers,[22] analysis shows:

- Seventeen percent of black Virginians live in a Census tract with only alternative financial institutions, compared to 11 percent of white and 13 percent of Hispanic Virginians.
- Only 18 percent of black Virginians live in a Census tract with access to banks or credit unions and no alternative financial service providers, compared to 23 percent of white and 21 percent of Hispanic Virginians.
- In Census tracts with both alternative and mainstream financial services, the ratio of AFS relative to banks and credit unions increases as the population proportion of black residents in the tract increases.

Even after accounting for population density and socioeconomic factors such as median household income, black Virginians remain more likely than white Virginians to live in a Census tract with only AFS providers.[23] When living in tracts with both alternative and mainstream services, black households are more likely to live in neighborhoods with a higher proportion of AFS providers relative to banks and credit unions. Whether this reflects differences in demand for services or specific targeting by financial institutions is beyond the scope of this analysis.

Discussion and Policy Implications

In the face of inadequate income and assets, nearly ten percent of Virginia's households report relying on short-term loans from alternative financial service providers to help make ends meet. Most families are already in or near crisis when they turn to these products, and are using them to pay for basic necessities such as rent, food, and transportation.

Providers of alternative financial services argue that they offer a legitimate option to individuals who may be risky borrowers with poor credit histories and few borrowing alternatives. Opponents of AFS contend they offer predatory loans disproportionately targeted at low-income and minority households with costs not reasonably justified by borrower characteristics. Although it is difficult to define predatory or abusive lending, many characterize alternative financial services as predatory due to their high fees and interest rates, as well as lack of concern regarding the borrower's ability to repay the loan.

Use of short-term loans poses serious threats to the economic well-being of already vulnerable families. Because of this, policy makers at the local, state, and national levels have focused on effective regulation of alternative financial services, along with the development of products that might reduce need for AFS products. For example, government officials are particularly concerned about the potential for refund anticipation products to undermine tax assistance targeted at the working poor. Nearly two-thirds of RAL users in 2009 qualified for the Earned Income Tax Credit (EITC), a federal anti-poverty program targeted at low-income households that work.[24]

Multiple changes at the federal level are anticipated to reduce the volume of **RALs** in the future:

- While RALs provide nearly immediate access to tax refunds, the proliferation of electronic filing has reduced demand for RALs by substantially reducing the amount of time it takes for individuals with bank accounts to receive their full refund.
- In 2010, the IRS changed its reporting guidelines to make it more difficult for RAL providers to assess the risk of potential borrowers.
- For households that may not have a bank account, the U.S. Treasury Department introduced a pilot program in 2011 that quickly deposits tax refunds onto a prepaid debit card.[25]

At the state level, Virginia implemented regulations on January 1, 2009, that led to a substantial decline in the volume of **payday lending** between 2008 and 2009. Compared to 2009 payday borrowers, the average 2008 user had significantly more payday loans with both higher APR and shorter loan terms, yet concerns remain. In 2009, the average borrower used 2.7 payday loans over the year, with an average loan amount of $371. The total value of all loans made in 2009 was more than $170 million, with interest and loan fees totaling more than $40 million.[26]

Although Virginia payday loans were capped at an annual interest rate of 36% in 2009, the true cost of borrowing remains significantly higher. Lenders can charge additional fees of:

- Up to 20 percent of the value of the loan (e.g., $20 per $100 borrowed).
- $5 to register the borrower in Virginia's statewide database of payday loan users.

Multiple bills proposing repeal of the allowable loan fees, such as HB188 and SB138, have been proposed in the General Assembly.

Conclusions

Reliance on AFS is a sign of economic insecurity and a need to build income and asset adequacy. This paper also points to the need for other critical steps toward economic security, including:

1. Improved financial literacy for individuals and their families. This might help households avoid the need for AFS, or at least better understand the costs of the loans.
2. Development of alternative short-term loan products through mainstream institutions that meet the needs of low- and moderate-income households while providing a mechanism for developing savings, for example, a version of Individual Development Accounts (IDAs) that rewards saving for emergencies.[27]

Economically secure households can meet their day-to-day expenditures, plan for the future, and cope with temporary financial emergencies such as illness or job loss. Nearly a quarter of Virginia's households are at risk of economic insecurity, and more than 275,000 families have used AFS products that further undermine their economic position. While alternative financial services offer short-term relief from immediate financial demands, use of these products may exacerbate a household's already challenging financial situation.[28] Reducing need for AFS products by promoting saving and developing alternatives will improve long-term economic outcomes for both Virginia's families and the Commonwealth.

For additional information, please contact Rebecca Tippett, Demographics & Workforce Group, Weldon Cooper Center for Public Service, University of Virginia, at (434) 982-5861 or by e-mail at rebecca.tippett@virginia.edu.

References and Notes

[1] For a detailed discussion of income and asset adequacy in Virginia, see: Tippett, Rebecca M. 2011. "Building Economic Security for Virginia Families: Income and Asset Adequacy." *Numbers Count*, February. Charlottesville, VA: Weldon Cooper Center for Public Service.

[2] Author's analysis of January 2009 Current Population Survey (CPS) supplement: FDIC Survey of Unbanked and Underbanked Households.

[3] Alternative financial services (AFS) exist to serve a variety of financial needs, from check cashing to subprime mortgage lending. For more information, see: Bradley, Christine, Susan Burhouse, Heather Gratton, and Rae-Ann Miller. 2009. "Alternative Financial Services: A Primer." *FDIC Quarterly*, 3(1).

[4] Additional details on state restrictions on AFS lending can be found in the following report: Pindus, Nancy, Daniel Kuehn, and Rachel Brash. 2010. "State Restrictions on Small-Dollar Loans and Financial Services, 2004-2009: Summary, Documentation, and Data." Washington, DC: Urban Institute.

[5] Estimates on auto title lending are from the author's analysis of data from the 2009 FINRA Investor Education Foundation's National Financial Capability Study (NFCS). To receive an auto title loan, borrowers are required to provide a driver's license or photo identification, a clear vehicle title, the car (to be inspected), and proof of income. In Virginia, auto title lenders are regulated by the State Corporation Commission. This regulation places interest rate caps on loans (e.g., 22% monthly interest cap, or 264% APR, on the portion of the loan under $700).

[6] Author's analysis of January 2009 CPS supplement.

[7] To receive a payday loan, borrowers must have a checking account and are required to provide identification and proof of regular income.

[8] Author's analysis of January 2009 CPS supplement.

[9] Author's analysis of January 2009 CPS supplement. Question was worded to ask about any RAL use in the "past 5 years" (covering 2004-2008).

[10] Purchasing items under rent-to-own agreements typically costs consumers two to four times the cost of purchasing the items outright at a mainstream store. For more information, see: Rothstein, David, and Mike Stanek. 2009. "Paying More, Renting Debt: Why Rent-to-Own is a bad deal for Ohio consumers." Cleveland, OH: Policy Matters Ohio.

[11] Virginia law allows for reinstatement of an RTO agreement following missed payments, provided that the borrower pays all of the missing payments and necessary fees within 2 to 5 days of missing the payment. If the borrower voluntarily returns the RTO item to the lender before the 2 to 5 day grace period is over, they have an additional 21 to 45 days to reinstate the item, depending on the percentage of total payments made to date. See Virginia Lease Purchase Agreement Act of 1988 for additional details.

[12] Author's analysis of January 2009 CPS supplement.

[13] Data on financial lenders in Virginia were retrieved April 2011. Data on credit unions, payday lenders, and payday and auto title lenders were retrieved from the Virginia Bureau of Financial Institutions. Data on credit unions were supplemented with data retrieved from Credit Unions Online. Data on banks were retrieved from the Federal Deposit Insurance Corporation (FDIC). Data on pawn shops, refund anticipation loans, and rent-to-own stores were retrieved from ReferenceUSA.

[14] Unlike banks and credit unions, AFS providers are not federally-insured because they provide no deposit accounts.

[15] According to the 2009 CPS data, five percent, or more than 150,000 Virginia households, reported being unbanked in 2009, significantly lower than the national unbanked rate of 8 percent. While more AFS-using households are unbanked—8 percent—and unbanked households report greater use of AFS products (21 percent), most unbanked households never use short-term loans from alternative service providers.

[16] The speed with which AFS loans are processed is a main selling point of their advertising: "The process is easy, fast, and dignified. Most loans are completed within minutes" (Snooky's Pawn); "We understand your financial needs and always treat our customers like the friends and neighbors they are…You can have cash in as little as 15 minutes!" (Fast Auto Loans).

[17] Author's analysis of January 2009 CPS supplement.

[18] Results from weighted multivariate logistic regressions are available from the author upon request.

[19] See, for example: Graves, Steven M. 2003. "Landscapes of Predation, Landscapes of Neglect: A Location Analysis of Payday Lenders and Banks." *The Professional Geographer*, 55(3): 303-17.

[20] Northern Virginia and Hampton Roads are the most populous regions in the state, with populations of 2.6 million (32 percent of state total population) and 1.6 million (21 percent), respectively. Northern Virginia has the largest share of the state's banks and credit unions, 30 percent, and the second largest proportion of the state's AFS providers, 22 percent. Hampton Roads has the largest share of the state's AFS providers, 25 percent, and the second highest proportion of the state's banks and credit unions, 18 percent. The ratio of AFS providers to mainstream providers is significantly higher in Hampton Roads than it is in Northern Virginia, reflecting differences in population composition between the two regions. The distribution of financial service providers among the other six regions of Virginia is available from the author upon request.

[21] Analysis was done using the Census 2010 redistricting data file on race and ethnicity for the population 18 and over. Longitude and latitude coordinates of all financial service providers' addresses were found using BatchGeo (www.batchgeo.com) and each financial provider was geocoded to its appropriate Census tract using ArcGIS 9.1. Tracts with total population of less than 300 people (n=32) were coded to missing.

[22] Twenty-five percent of all white, black, Asian, and other race Virginians live in a Census tract with neither mainstream nor alternative financial service providers. A smaller proportion of Hispanic Virginians (22%) live in Census tracts without any financial services, reflecting the lower proportion of Hispanics throughout rural Virginia.

[23] Analysis was done using 2005-2009 ACS data (with Census 2000 tract boundaries). Logistic regression results indicated that increasing proportion black was significantly associated with increased likelihood of a given Census tract having only AFS providers. Additionally, among tracts with both alternative and mainstream financial service providers, linear regression analysis showed that increasing population proportion black was associated with more AFS providers relative to mainstream providers (AFS to mainstream ratio). These relationships persisted even after controlling for demographic and socioeconomic characteristics such as population density, median household income, and the proportion of the adult population with a bachelor's degree or higher. Results are available from the author upon request.

[24] Wu, Chi Chi, and Jean Ann Fox. 2011. "End of the Rapid Rip-Off: An Epilogue for Quickie Tax Loans." Boston, MA: National Consumer Law Center. See also: Gerber, Sandy. 2009. "Strengthening the Earned Income Tax Credit: Alternatives to refund anticipation loans." *Community Dividend*: March.

[25] See www.myaccountcard.gov for more details.

[26] Virginia Bureau of Financial Institutions. 2010. "Report on Virginia Payday Lending Activity For the Year Ending December 31, 2009." Compared to 2009 payday borrowers, the average 2008 user had significantly more payday

loans (7.7 vs. 2.7), a smaller loan value ($340 v. $371), with a higher APR (363% vs. 290%), and a shorter loan term (16 vs. 38 days). Estimated loan loss for 2009 was $10.7 million, or slightly more than one-fourth the total value of interest and fees.

[27] At present, there is a dearth of policies that promote and reward saving for short- or medium-term expenses; most savings programs are focused on promoting retirement savings or long-term investments, such as home ownership, business startup, or college, and are unable to address the types of economic shortfalls commonly faced by households. See also: Lopez-Fernandini, Alejandra. 2010. "Unrestricted Savings: Their Role in Household Economic Security and the case for Policy Action." Asset Building Program Working Paper. Washington, DC: New America Foundation.

[28] See, for example: Melzer, Brian T. 2011. "The Real Costs of Credit Access: Evidence from the Payday Lending Market." *The Quarterly Journal of Economics*, 126(1): 517-55.