The Brookings Institution

Metropolitan Policy Program

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The Metropolitan Market for Alternative Short-Term Loans

The Consumer in the Financial Services Revolution,
Annual Conference of the Consumer Federation of America

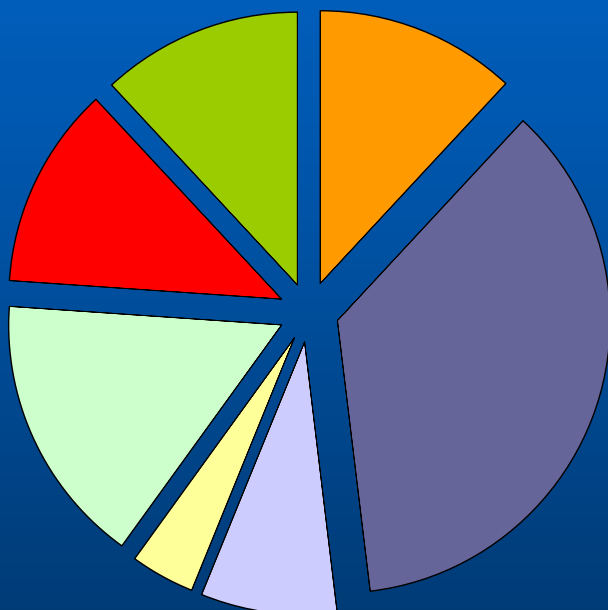

The Metropolitan Market for Alternative Short-Term Loans

I — Why are we asking these questions?

II — What are the major findings?

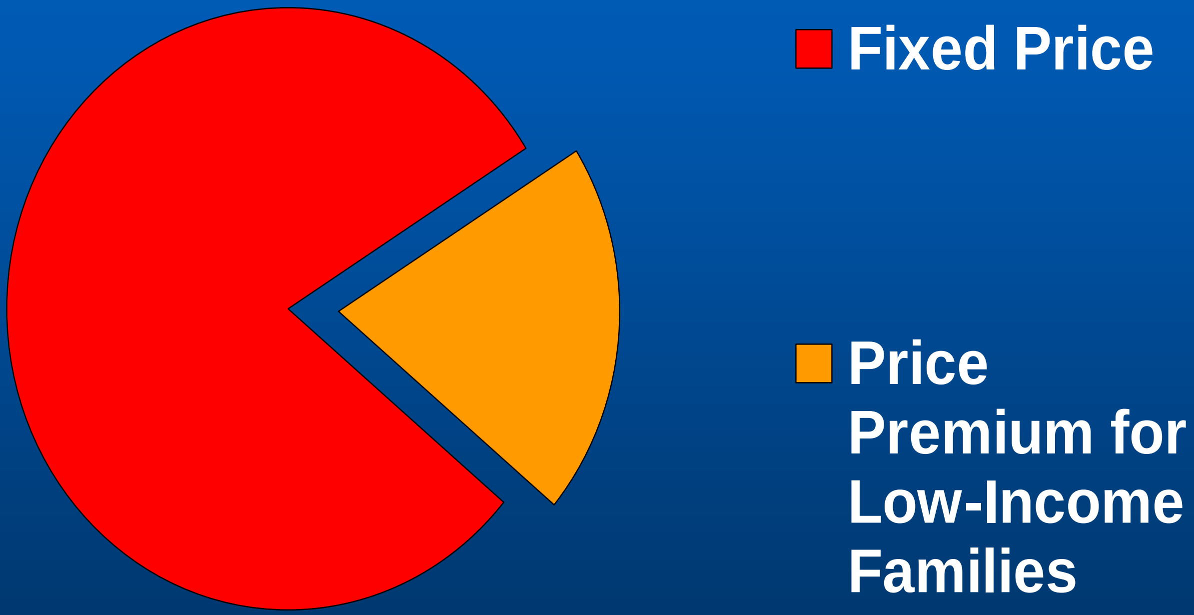
III — How is the market and public policy responding?

We’re in the middle of a multi-year study that is evaluating how prices for basic goods and services vary by income

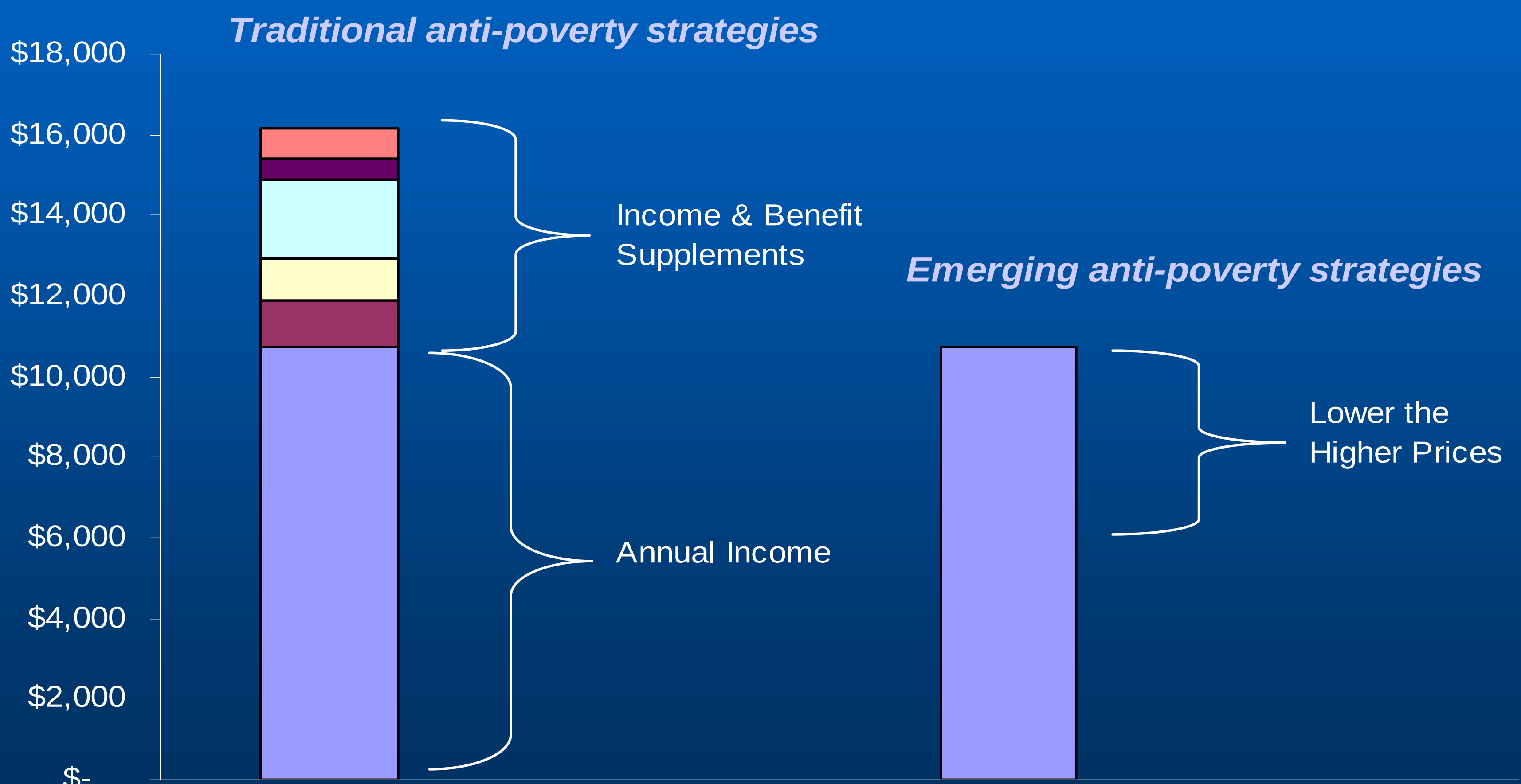


Why?

Low-wage families pay higher prices than higher income households for nearly every basic necessity



The implication is that lowering prices for low-income families is a powerful, and widely underutilized tool to fight poverty



In May ‘06 we will publish our second report in this project, an analysis of prices for necessities within 12 markets

This forthcoming report will provide extensive evidence of these higher prices, along with an agenda for policy and market-based reforms to lower these higher prices

Today, I want to give you a preview of our findings, by presenting some evidence related to the higher prices low-income consumers tend to pay for short-term loans


As has been well documented, low-income consumers tend to utilize higher-priced providers of short-term loans

Examples of <u>Sources</u>	*Monthly Advance*	*Fee*	*Monthly Interest Rate*	*APR*	*Total Monthly Charge*
Credit Union (Payday Loan)	$200	0%	1%	12%	$1.20
Credit Card	$200	0%	1.5%	18%	$3
Credit Card Cash Advance	$200	2%	1.5%	91%	$7
Overdrawn Checking Account	$200	$20	0%	120%	$20
Auto-title Lender	$200	11.5%	0%	300%	$23
Payday Lender	$200	15%	0%	390%	$30
Pawnshop	$200	$1	15%	403%	$31

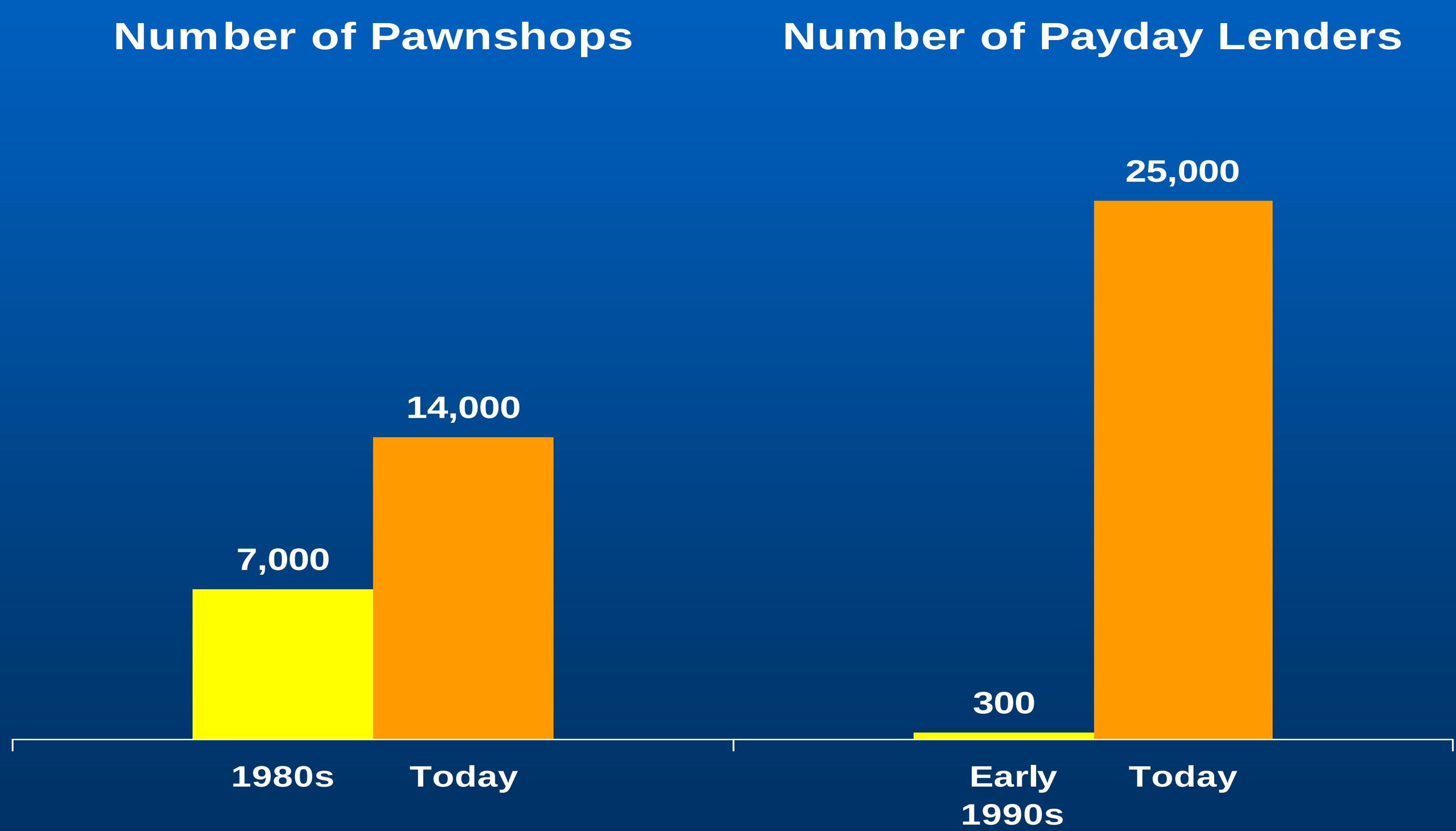
Note: All estimates based on published analyses, but APRs widely vary across both places and companies; the credit union pay day loan is based off of the North Carolina State Employees Credit Union program Also, all sources are assumed to be utilized once per-month.

Among the numerous causes, many have pointed to problems associated with access to short-term loan products

- **Alternative providers of short-term loans** (e.g., pawnshops, payday lenders, & auto-title lenders) **target low-income consumers**

- **Mainstream providers of short-term loans** (e.g., banks, credit unions, credit cards) **dissuade low-income consumers**

But, much of the data that speaks to these issues is out-of-date because this market is rapidly growing. For instance:



Note: Estimates are from John Caskey (*Fringe Lending*) and Sheila Blair (Low-Cost Payday Loans: Opportunities and Obstacles)

This leaves important questions unanswered..

- Where is all of this growth happening?
- What implications do these trends raise for public policy and the market?

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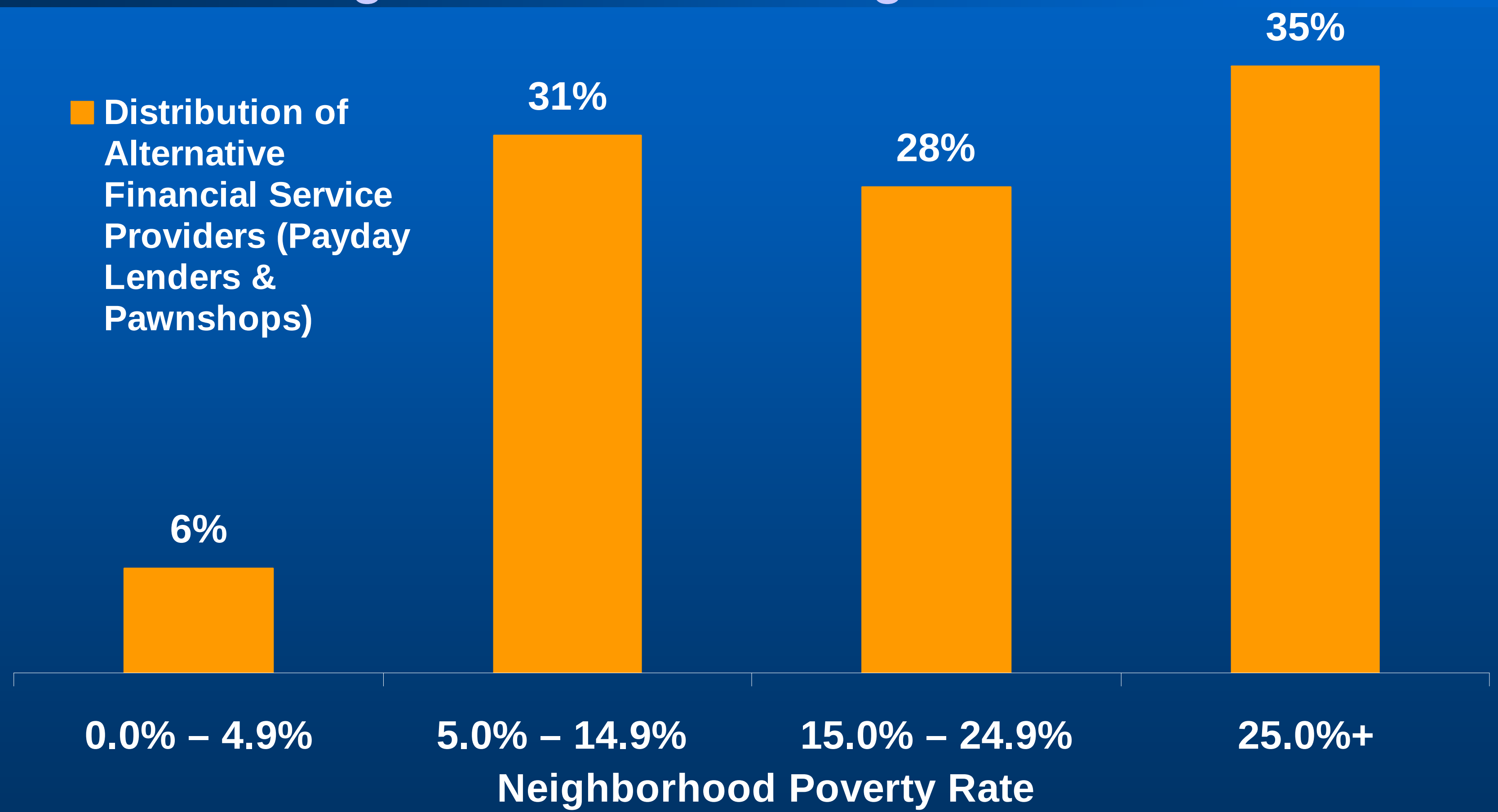
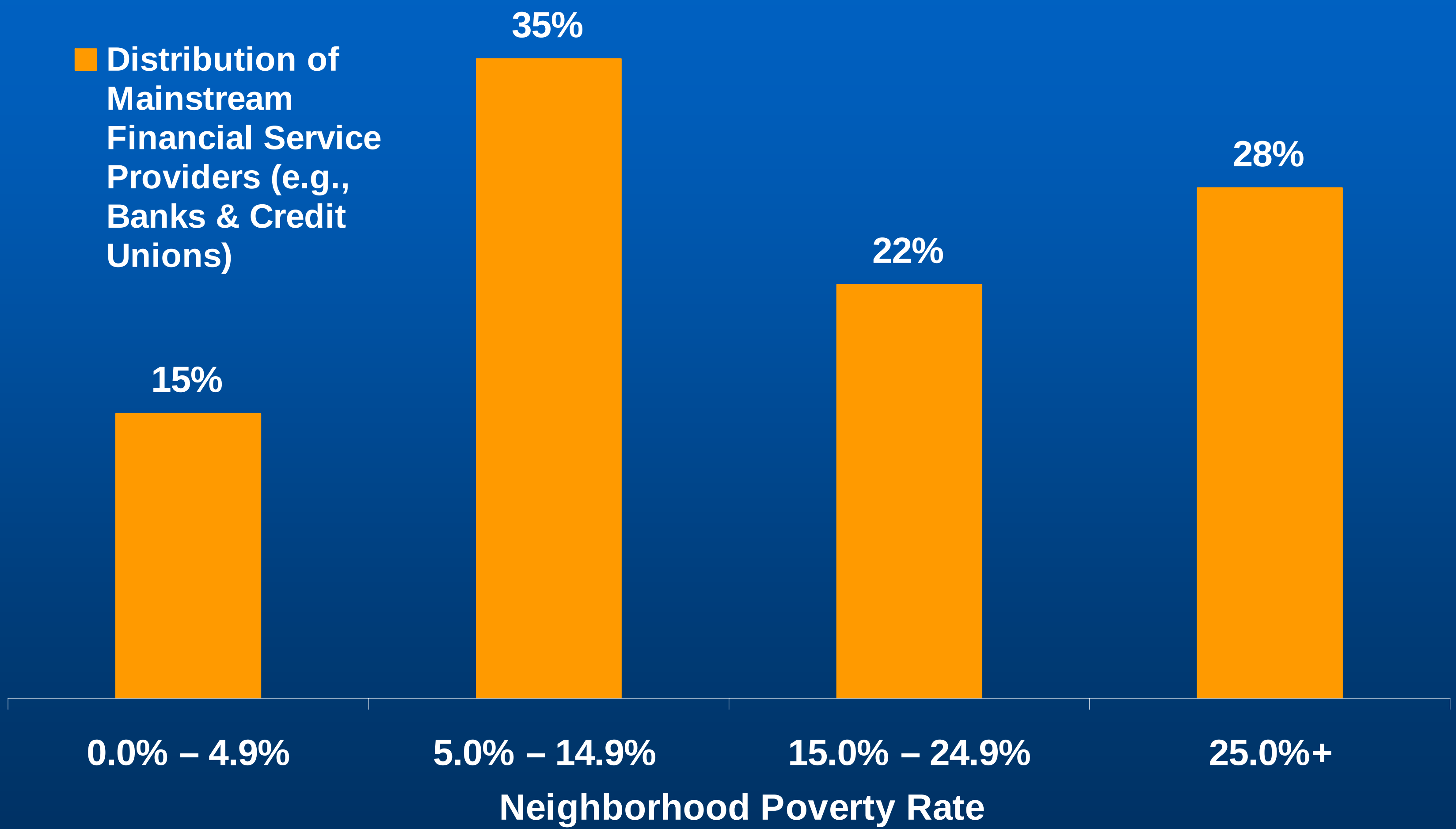
Within cities, the location of these establishments plays into popular perceptions about these industries

The core providers of alternative short-term loans in central cities tend to target low-income neighborhoods



Note: Estimates are an average of distributions within 13 cities: Atlanta, Chicago, Denver, Hartford, Indianapolis, Hartford, Indianapolis, Los Angeles, Louisville, New York, Oakland, Pittsburgh, San Francisco, Seattle, & DC. “Core” refers to those businesses that declare these services as their primary or secondary business service.

On the other hand, retail mainstream financial services tend to be clustered in more middle-income neighborhoods



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Findings such as these have contributed to concerns about access to short-term loans in low-income markets – there's too many alternative lenders, too few mainstream lenders

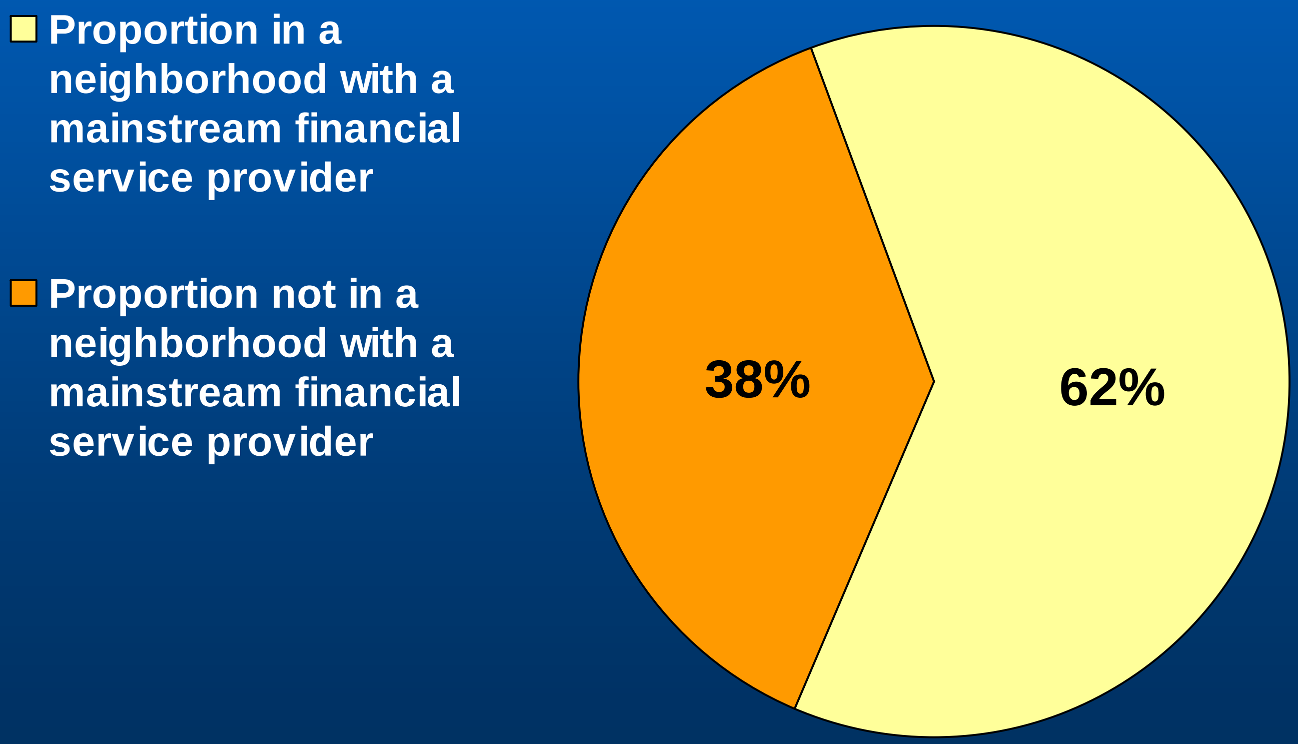
But, just looking comparatively at these overall trends in the location of these urban establishments misses a number of points with important policy and market implications

First, there actually is more of a “product desert” than a “retail desert”

Most neighborhoods with an alternative financial service provider also have a bank or credit union

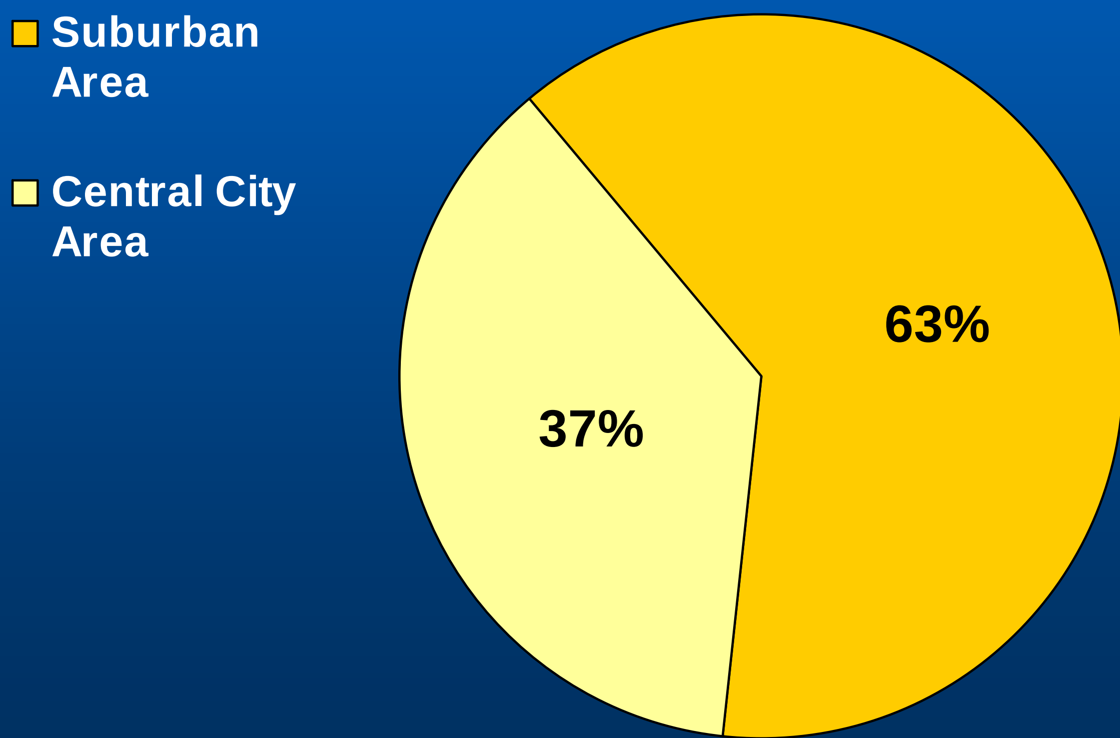
- We examined 6,911 neighborhoods
- Of these, 3,086 had an alternative financial service provider (45%)
- Of these, 57% also had a mainstream financial service establishment

Over 60% of the 5,010 alternative financial service establishments in our sample are located in a neighborhood with a bank or credit union

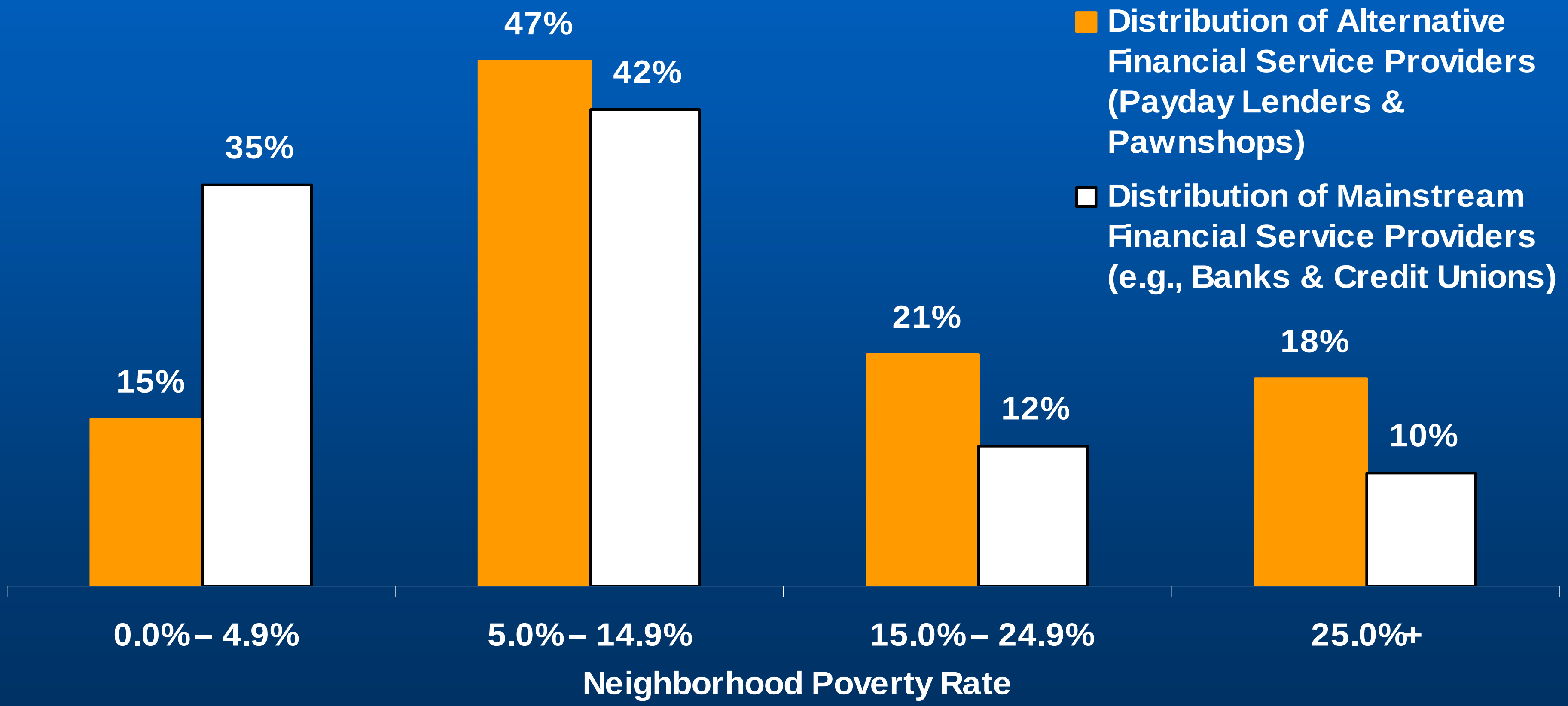


Second, alternative providers of short-term loans have become suburbanized

Location of Alternative Financial Service Provider



In fact, within *metropolitan areas*, the market penetration looks much more similar between alternative and mainstream providers



Note: Estimates are an average of distributions within 13 metro areas: Atlanta, Chicago, Denver, Hartford, Indianapolis, Hartford, Indianapolis, Los Angeles, Louisville, New York, Oakland, Pittsburgh, San Francisco, Seattle, & DC.

Finally, market penetration by these providers widely varies across markets.

To see this consider:

The alternative financial services market in *Atlanta and Denver*

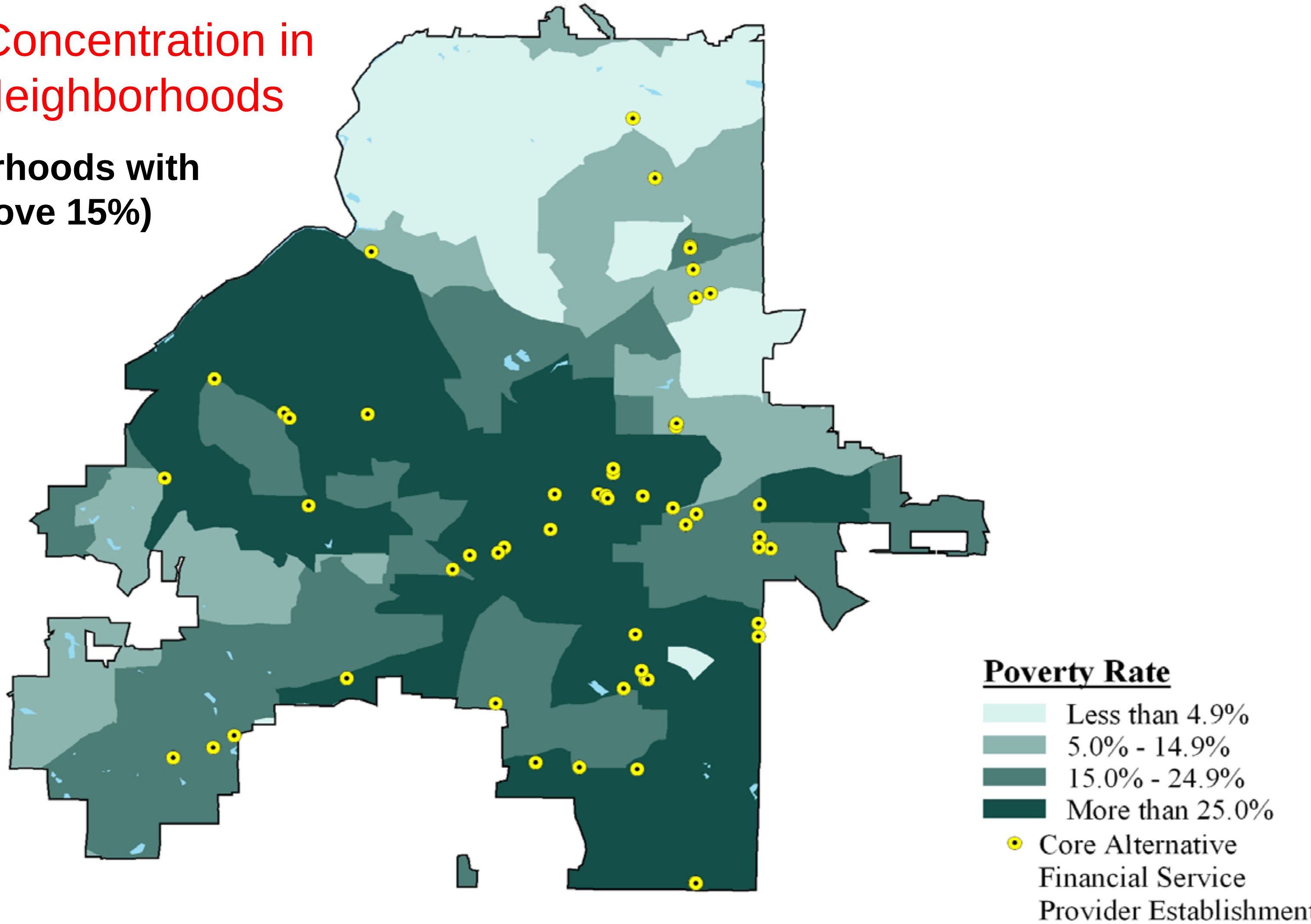
The mainstream financial services market in *Chicago and Pittsburgh*

CORE ALTERNATIVE FINANCIAL SERVICE PROVIDERS IN ATLANTA CITY

by Neighborhood Poverty Rate (2005)

Bottom Line: Concentration in Low-Income Neighborhoods

(84% in neighborhoods with poverty rates above 15%)



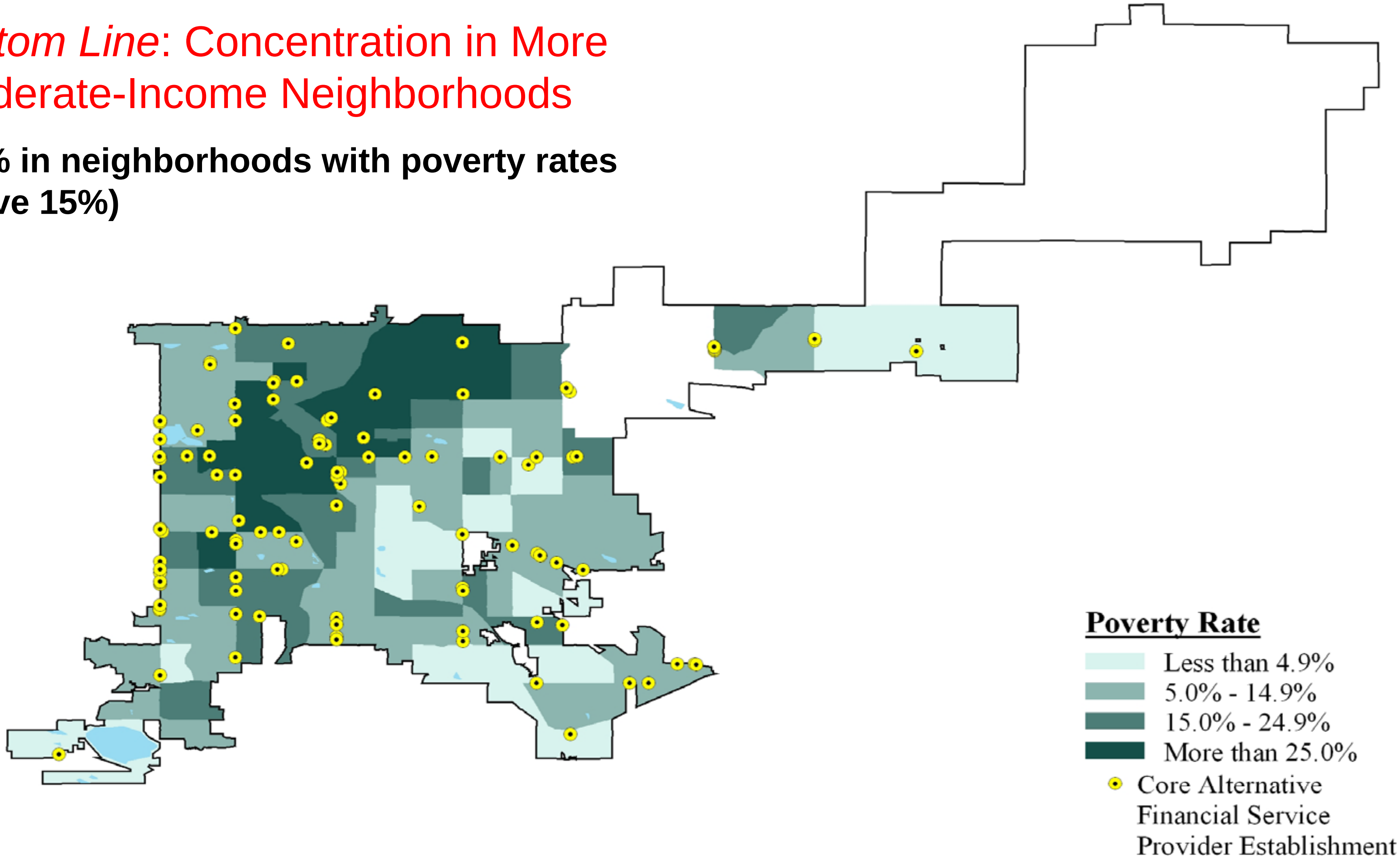
Source: The Brookings Institution

CORE ALTERNATIVE FINANCIAL SERVICE PROVIDERS IN DENVER CITY

by Neighborhood Poverty Rate (2005)

Bottom Line: Concentration in More Moderate-Income Neighborhoods

(50% in neighborhoods with poverty rates above 15%)



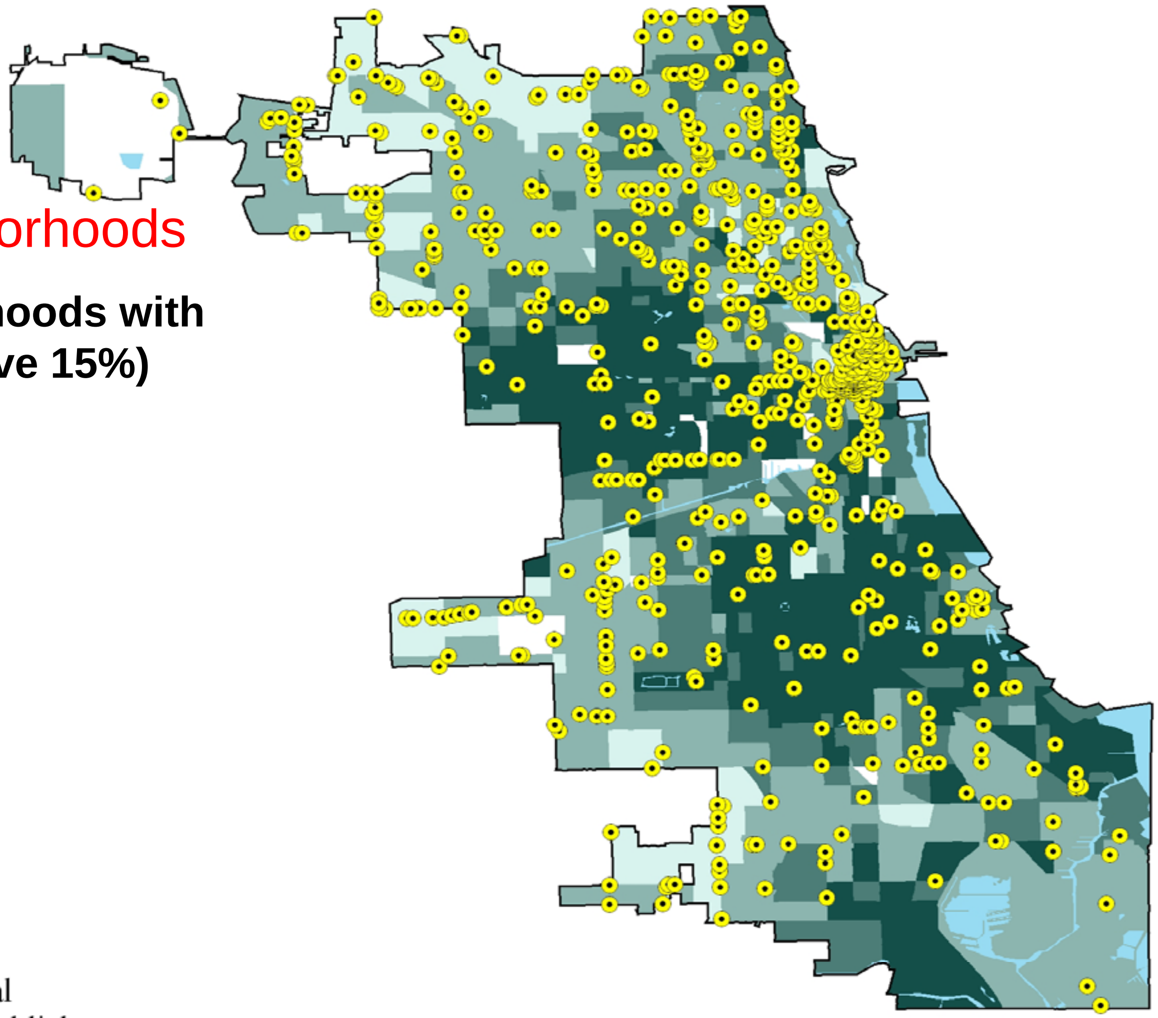
Source: The Brookings Institution

MAINSTREAM FINANCIAL SERVICE PROVIDERS IN CHICAGO CITY

by Neighborhood Poverty Rate (2005)

Bottom Line: Concentration in Middle-Income Neighborhoods

(34% in neighborhoods with poverty rates above 15%)



Poverty Rate

- Less than 4.9%
- 5.0% - 14.9%
- 15.0% - 24.9%
- More than 25.0%
- Mainstream Financial Service Provider Establishment

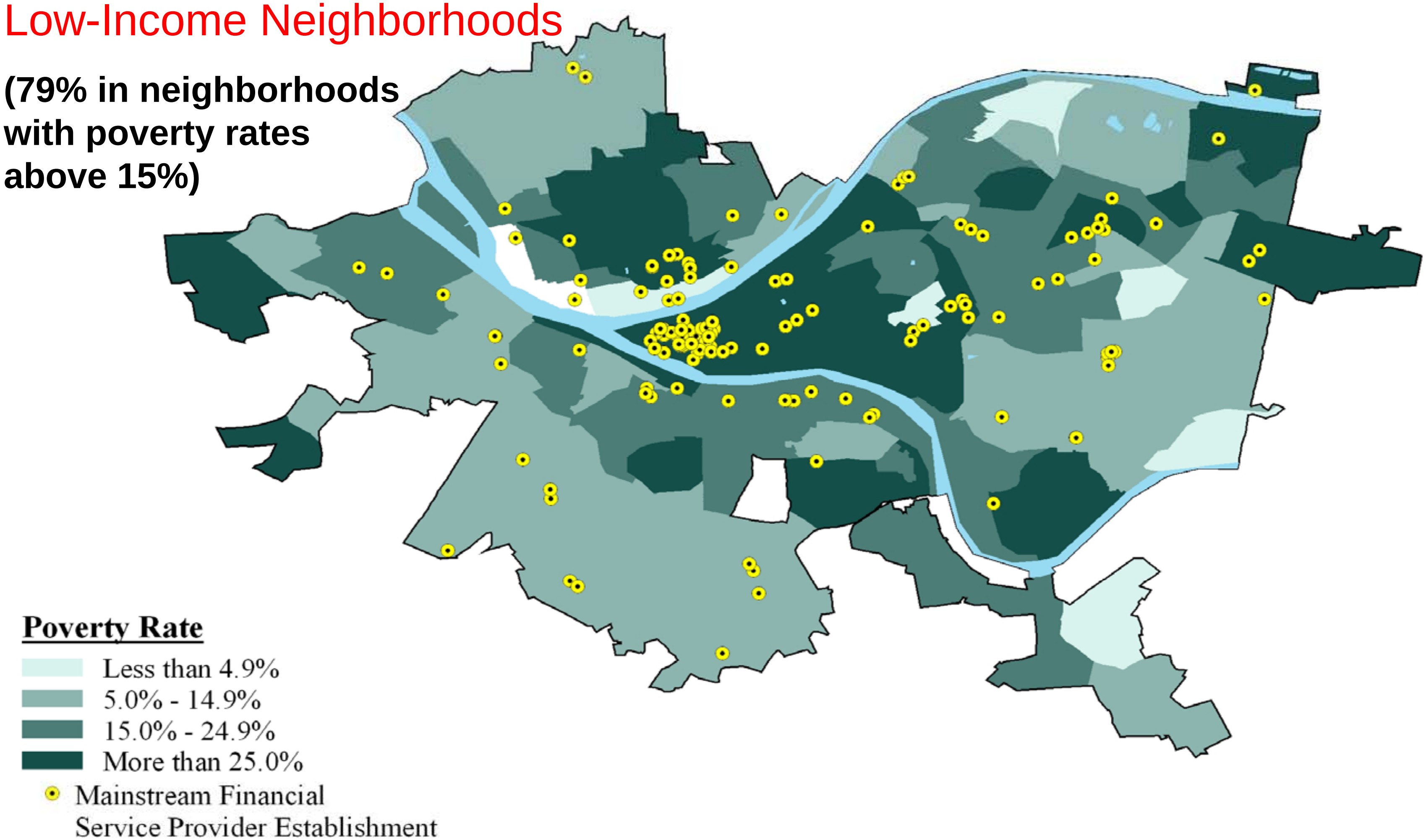
Source: The Brookings Institution

MAINSTREAM FINANCIAL SERVICE PROVIDERS IN PITTSBURGH CITY

by Neighborhood Poverty Rate (2005)

Bottom Line: Concentration in Low-Income Neighborhoods

(79% in neighborhoods with poverty rates above 15%)



Source: The Brookings Institution


All of this adds up to a few central conclusions:

1. **Mainstream financial service companies have a substantial infrastructure in place to reach low-income consumers, if not yet the product line**
2. **The alternative short-term loan market has suburbanized**
3. **There are overall trends, but each area has its own challenges**

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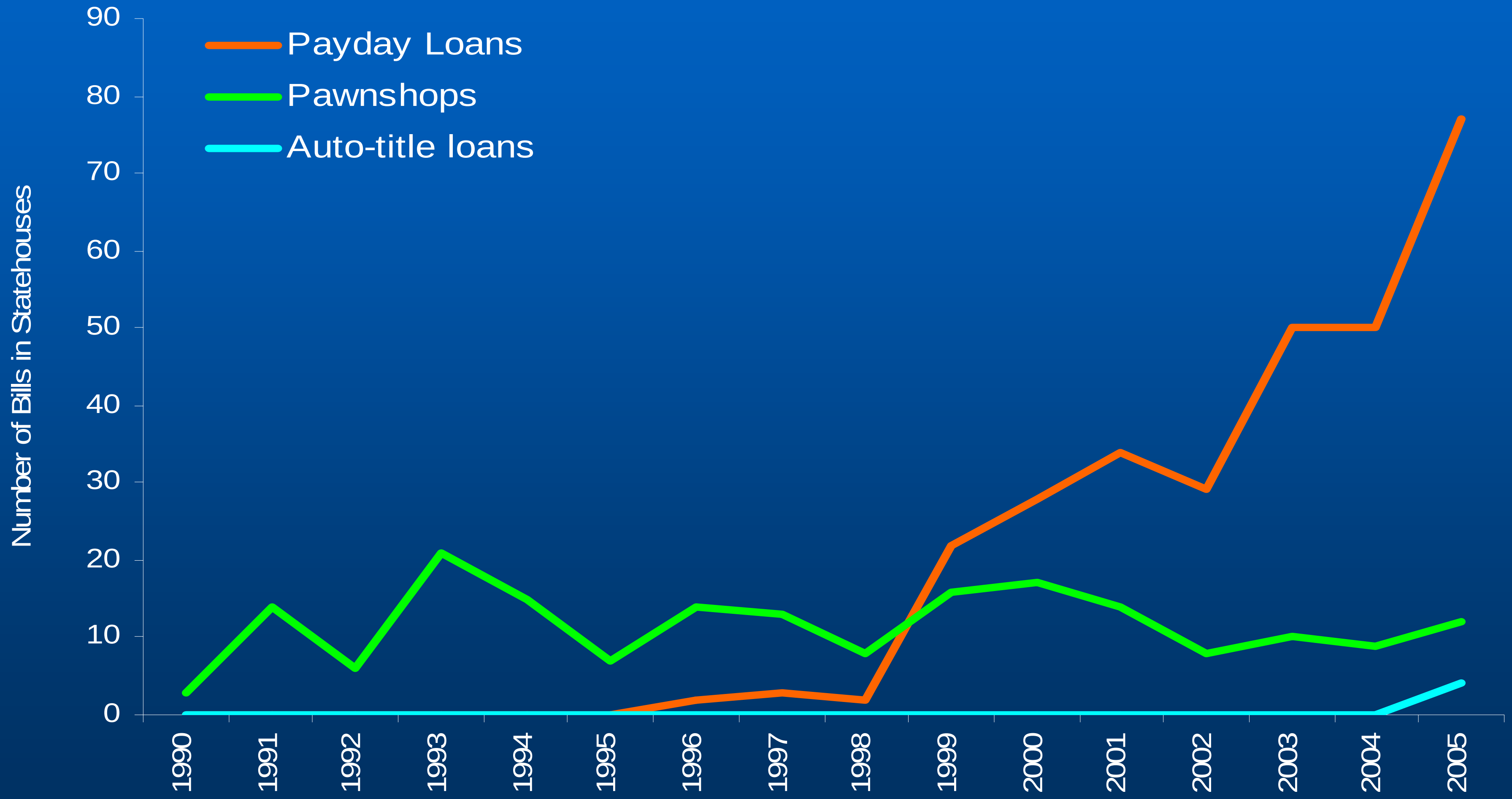
The massive expansion in the alternative short-term loan market has caught the attention of state policymakers



Source: Matt Fellowes (Laboratories of Capitalism)


It has also caught the attention of mainstream providers of financial services

Credit unions are entering the payday loan market

Banks are exploring new, competitively-priced short-term loan products


Going forward, this means that the alternative lending market may actually become a victim of its own success

Policymakers can encourage this by:

1. **Continuing to challenge the business model of alternative providers of short term-loans**
2. **Curbing market demand for high-priced, short-term loans from mainstream providers**
3. **Fostering incentives for market innovation and competition in this market**

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