Prohibitions, Price Caps, and Disclosures: A Look at State Policies and Alternative Financial Product Use

Signe-Mary McKernan
Caroline Ratcliffe
Daniel Kuehn
The Urban Institute

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Alternative Financial Service (AFS) Products

- **Auto title loan**: small loan secured by a borrower’s vehicle
- **Payday loan**: small loan secured by a borrower’s next paycheck
- **Pawnshop loan**: small loan secured by a borrower’s property
- **Refund anticipation loan (RAL)**: loan secured by a taxpayer’s anticipated income tax refund
- **Rent-to-own transaction**: self-renewing weekly or monthly lease for merchandise (e.g., furniture) with the option to purchase
Research Questions

1. What is the relationship between state-level alternative financial service (AFS) policies and AFS use?

2. Are restrictions on one AFS product associated with increased use of other AFS products?
Literature on AFS Products

• Some AFS suppliers circumvent state laws
• Binding price caps and prohibitions are likely to reduce supply
• AFS consumers have relatively few alternatives
• Consumers are not necessarily better off without AFS products
• Well designed and timed disclosures can affect consumer behavior
• Fee disclosures may be better than APR disclosures on AFS products
How Might State Policies Affect AFS Use

• State policies can affect both the supply of and the demand for AFS products and thus consumer use of the products.

• The state policies we examine fall into three categories: prohibitions, price caps, and disclosures.

• Overall, we expect prohibitions decrease consumer use, price caps either increase or decrease use, and disclosures decrease use.
## State AFS Policies

<table>
<thead>
<tr>
<th>Product Type</th>
<th>Number of States</th>
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<tbody>
<tr>
<td><strong>Auto Title Loan</strong></td>
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<td>Product Prohibited</td>
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<td>APR price cap</td>
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<td><strong>Payday Loan</strong></td>
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<td>Product Prohibited</td>
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<td>APR price cap</td>
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<td><strong>Pawnshop Loan</strong></td>
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<tr>
<td>Monthly interest rate price cap</td>
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<td>Return requirement</td>
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<td><strong>Refund Anticipation Loan</strong></td>
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<td>Disclosure requirement</td>
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<td><strong>Rent-to-Own</strong></td>
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<tr>
<td>Price or APR cap</td>
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<tr>
<td>Total cost label disclosures</td>
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<tr>
<td>Contract disclosures</td>
<td>47</td>
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</tbody>
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Data and Approach

- Point-in-time information about respondents’ demographic and financial characteristics
  - Age, educational attainment, financial literacy, race/ethnicity, gender, living arrangement, number of financially dependent children, income, banked status, presence of car insurance, region.
- Use of AFS products over the last five years
  - Auto title, payday, pawnshop, RALs, and rent-to-own
- Estimate separate regression models for each product
  - Own policies
  - Own policies plus policies of other AFS products
What is the relationship between AFS policies and AFS use?

- More stringent price caps and prohibitions are associated with lower AFS product use
  - Payday, auto title, pawnshop loans, and rent-to-own
  - Suggests that supply falls as price is restricted

- No evidence that disclosure requirements are associated with lower AFS use
  - Disclosing how payday loan costs can add up over time and the total cost of rent-to-own purchases have been found to reduce product use (Bertrand and Morse 2011; McKernan et al. 2003)
Restrictive AFS Policies are Associated with Reduced AFS Use

- Payday: Product Prohibited: -32%
- Auto Title: No Cap to 36% APR Cap: -28%
- Pawnshop: No Cap to 3% Monthly Interest Rate Cap: -23%
Are restrictions on one AFS product associated with increased use of other AFS products?

- No evidence that prohibitions and price caps on one AFS product lead consumers to use other AFS products

- Our result is consistent with a recent study that finds no evidence that payday restrictions in Oregon led to increased use of auto title loans (Zinman 2010)
  - Zinman does find evidence of a substitution between payday loans and both checking account overdrafts and late bill payment
  - Theodos et al. (2010) do find restrictions on one AFS product led to increases in another
    - Restrictions on RALs by the military lead to large increase in RACs
How are demographic and economic characteristics related to AFS Use?

- AFS users tend to be:
  - Young
  - Less educated and have lower levels of financial knowledge
  - African American
  - Living in a cohabiting relationship or living with others (but not parents)
  - Financially responsible for more children
  - Lower income
  - Unbanked (pawnshop and RAL)
Summary and Conclusion

- Stringent price caps and prohibitions are associated with reduced use (consistent with reduced supply)

- Restricting supply can increase consumer well-being when it restricts high-priced suppliers but can reduce consumer well-being if consumers turn to inferior products or options to deal with credit needs

- Encouraging mainstream alternative products may improve consumer well-being

- Standard, clear, and timely disclosures of the total cost

- Facilitate and incentivize saving among low-income families