ISSUE BRIEF

Predatory Lending: An Important but Often Overlooked ESG Investment Consideration

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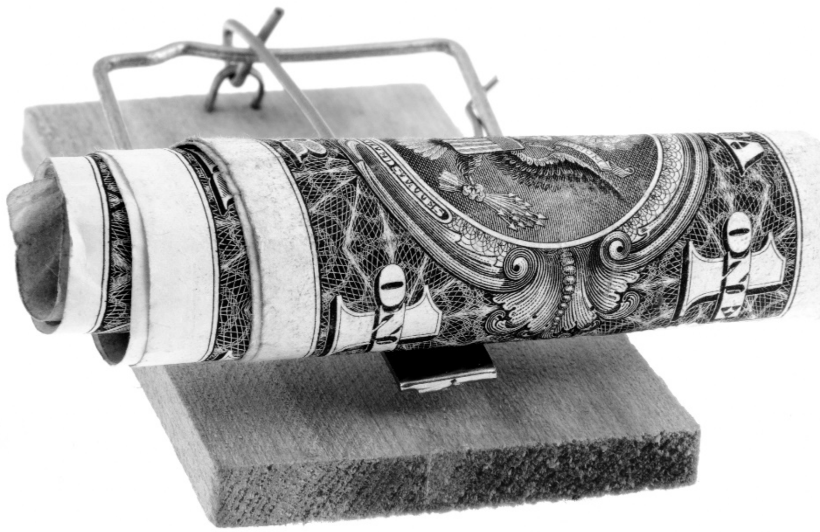

As a result of the pandemic-driven increase in financial vulnerability, the risk of desperate borrowers falling prey to predatory lenders has risen.

More than a year into the COVID-19 public health crisis, it is clear that while lifestyle disruptions were universal, the economic upheavals caused by the virus fell largely on the less financially secure members of society. Anyone unable to work remotely has faced rising odds of layoffs or reduced hours, particularly in lower paying service jobs deemed "non-essential" by authorities.

As a result of this pandemic-driven increase in financial vulnerability, the risk of desperate borrowers falling prey to predatory lenders has risen. At the same time, many predatory lenders have been expanding their operations to better take advantage of current circumstances.

Predatory lending is the practice of using unscrupulous tactics including deception and/or fraud to entice and then assist a borrower into taking a loan with unfavorable terms. Loans of this type typically carry very high interest rates, disproportionately high fees, and often deliberately unclear and confusing terms and conditions. The terms are so onerous that the majority of borrowers have difficulty repaying the loan. Many of these loans are tied to a borrower's next paycheck (payday loans), while others are collateralized with personal property such as a car, or in the case of rent-to-own, electronics, furniture, or appliances, with the borrower risking repossession, foreclosure or even theft charges should they default.

The annual percentage interest rates charged by payday lenders can run as high as 400%, and the cost renting to own something instead of buying it outright can easily be three times as much. While many people initially take out payday loans to address an urgent financial need, most end up becoming serial borrowers. According to a Pew Charitable Trust study, the average payday borrower takes out eight 2-week payday loans of $375 each per year and pays $520 in interest as a result. Most payday loan customers end up paying more in fees than the amount they originally borrowed! [1, 2]

Predatory lending is not a minor problem. According to 2017 surveys by the FDIC and the Federal Reserve Bank of St. Louis, an estimated 8.4 million U.S. households were unbanked, and 24.2 million were underbanked (had a bank account but still used alternatives such as payday loans, title loans, and pawn shops.) It is estimated that 12 million people in the U.S. use payday loans each year, 30 million use pawn shops, 5 million are rent-to-own customers, and 2 million take out title loans. While the latest figures are not yet available, given 2020's record high unemployment statistics, these predatory lending numbers are almost certain to have risen. [3, 4, 5]

Lower income, unsophisticated borrowers are a primary target market for predatory lenders, as are those with urgent cash needs.

Statistics from the industry group Association of Professional Rental Organizations (APRO) indicate that more than 70% of rent-to-own customers have incomes of less than $40,000 per year. Similarly, the average income of payday loan customers is $30,000. [6]

It should not come as a surprise that being separated, divorced, disabled, underemployed, or unemployed increases the odds of someone turning to payday lender.

It is often noted that women and minorities bear the brunt of many societal problems. Predatory lending is no exception. In fact, according to Pew, Black Americans are three times as likely as whites, and twice as likely as Hispanics, to take out payday loans. Payday lenders also disproportionally locate their stores in majority Black neighborhoods to exploit this.

Rent-to-own customer demographics are similarly skewed: Black Americans are rent-to-own customers at a rate almost 2.5x their proportion of the U.S. population. According to APRO, their customer base is 45% Caucasian, 32% Black, and 20% Hispanic. This compares with 2019 U.S. Census estimates of 60% Caucasian, 13% Black and 19% Hispanic for the U.S. population.

Beyond race, women comprise the majority of payday loan borrowers (52%) and more than two-thirds (68%) of rent-to-own customers.[7, 8, 9]

In April of 2020, Progressive Leasing, a private company that markets rent-to-own payment plans to retailers across the country, agreed to pay a $175 million fine to the Federal Trade Commission (FTC) to settle charges that it deceived consumers about the true prices paid for items purchased using its services. Consumers were told that the company's

[1] https://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf

[2] https://www.pewtrusts.org/-/media/assets/2016/06/payday_loan_facts_and_the_cfpbs_impact.pdf

[3] https://www.fdic.gov/householdsurvey/2017/2017execsumm.pdf

[4] https://research.stlouisfed.org/publications/page1-econ/2019/04/10/fast-cash-and-payday-loans

[5] https://www.rtohq.org/wp-content/uploads/2019/06/APRO-Flipbook-About-Us.pdf

[6] https://www.bondnbotes.com/could-your-rent-to-own-store-send-you-to-jail

[7] https://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf

[8] https://www.rtohq.org/wp-content/uploads/2019/06/APRO-Flipbook-About-Us.pdf

[9] https://www.responsiblelending.org/payday-lending/research-analysis/rr006-Race_Matters_Payday_in_NC-0305.pdf

rent-to-own plans were the "same as cash" or "no interest" when, in fact, the true costs were as much a twice the retail price.

Undeterred by these fines, other rent-to-own companies have begun rapidly expanding their third-party financing options, sensing greater opportunities as a result of the pandemic. One rent-to-own company views "Providing LTO (lease-to-own) solutions to national retailers (as) a significant untapped opportunity."

In fact, there were more strategic acquisitions and spinoffs in the rent-to-own industry in the last quarter of 2020 than there had been in several decades, all in an attempt to capitalize on the growing base of potential customers forced into non-bank financing solutions due to economic difficulties.

A common rent-to-own misconception is that it is a form of financing, but in fact, the transfer of ownership, if it occurs at all, only happens after all lease payments have been made. As a result, if the renter misses a payment or fails to return the item in a timely fashion, he or she could subject to legal prosecution.

Many states, including Florida, Pennsylvania, Colorado, Washington, Oregon, Arkansas, and others, have "Theft of Rental Property" laws with potential felony charges awaiting customers should the rent-to-own companies decide to pursue them.[10]

With continued high unemployment and unprecedented stress on small businesses due to forced COVID-19 shutdowns, the number of people susceptible to the siren song of payday loans and rent-to-own contracts remains near all-time highs.

Successful predatory lenders understand human nature, and they exploit it unabashedly. Most people struggle with temporal discounting, a fancy term that quantifies a person's preference for satisfying their desires now versus at some point in the future. Individuals who find it difficult to delay gratification would be expected to have very high discount rates, and the higher the discount rate, the more open to predatory lending they are likely to be.

Temporal discounting can be exploited to a lender's advantage even in normal times. Predatory lenders are experts at framing, or biasing, how their offerings are presented. Benefits are emphasized while costs are obscured or ignored entirely. Just as it is tougher to stick to a diet when presented with a plate of freshly-baked cookies, predatory lenders focus on immediacy and ease of access to make their offerings more tempting. "Get Cash Now", "Instant Approval", "Hassle-Free Fast Cash" and "1 Minute Application" are just some of the phrases used to lure borrowers.

Temporal discount rates also vary depending upon individual circumstances. Uncertainty and stress, both of which have skyrocketed during this pandemic, increase people's discount rates and make borrowers even more susceptible to deceitful lending practices.

Predatory lenders often present themselves as lenders of last resort. Most of their customers have low or no credit scores and limited access to traditional banks or finance companies. While it is true that predatory lenders are providing a service, the full costs of that service are often glossed over at

[10] https://theappeal.org/rent-to-own-companies-are-turning-the-criminal-justice-system-into-their-debt-collector/

best and deceptively or even fraudulently portrayed at worst. If borrowers fully understood what they were signing up for, many might choose not to take the money or rent the product.

Predatory lending concerns often fly under the radar of even sophisticated ESG investors, as all publicly traded predatory lenders are small or micro cap companies. However, an increasing number of large nationwide retailers, including Best Buy, Lowes, GameStop, Kay Jewelers and others are now contracting with Progressive Leasing and its publicly traded rent-to own competitors. All these rent-to own companies are providing traditional retailers with third party, expensive purchase options (often 2x to 3x the cash price) for their higher credit risk customers.

The social costs and negative externalities created by predatory loans are substantial, and avoiding companies engaging in these practices should be a high priority on any ESG investor's list.