momentum

Summary Brief: High-Cost Alternative Financial Services

Many Albertans turn to high-cost alternative financial services when they need a short-term fix for a financial issue. Though these services are expensive[1] and unsafe, they are often the only option for low-income individuals, particularly those who struggle to obtain credit at mainstream financial institutions. High-cost alternative financial services contribute to a two-tiered banking system, in which the poor often pay more for inferior services. Without more stringent regulation, and in the absence of safe and affordable short-term credit options, Albertans living on lower-incomes will continue to experience financial exclusion and take on heavy debt loads – both of which are major contributors to long-term poverty.

"We need better options. They are often the only option."

What are high-cost alternative financial services?

Recent regulatory changes at the provincial level have considerably reduced the cost of borrowing from a payday lender. In an attempt to build upon this success, Momentum has shifted its focus to the variety of high-cost alternative financial services that exist in addition to payday loans. They are described below.

Rent-to-own financing	A financing option that allows consumers to lease furniture or a household appliance for a weekly, bi-weekly or monthly fee over a set period of time (e.g., 130 weeks). If the consumer makes all payments over the duration of the contract, they will own the item.
Instalment loans	High-interest loans between $500 and $15,000 that are paid back in instalments over a set period of time (up to 60 months).
Pawn loans	Short-term loans secured against personal property. The amount loaned is determined based on the value of the pawned product. To buy back an item, the borrower must pay the cost of the loan plus interest.
Cheque cashing	A service that allows individuals to, for a fee, cash cheques and receive funds instantly (i.e., without the account holds often applied by banks and credit unions).
Title loans	High-interest loans between $1000 and $50,000 that are secured against a borrower's vehicle. Contract lengths range from 30 days to five years.
Auto loans	Sub-prime auto loans offered at a high interest rate to individuals with low credit scores. Extended term loans often result in lower monthly payment amounts but a higher overall cost of borrowing.

Like payday lenders, providers of high-cost alternatives are located primarily in lower-income neighbourhoods. Research indicates that people access these services for the same reasons they obtain payday loans, and fit within similar demographic groups.[2] Through consultations and interviews with borrowers,[3] Momentum has learned that many struggle to access credit from banks and credit unions, and cannot afford to purchase basic items upfront or cover unexpected expenses. For many, a high-cost service is their only option.

1. Examples of interest rates include 46.93 per cent for an instalment loan, 60 per cent for a pawn loan, and a median APR of 79.8% for rent-to-own.
2. Joe Fantauzzi, Predatory Lending: A Survey of High Interest Alternative Financial Service Users (Toronto: Canadian Centre for Policy Alternatives Ontario Office and ACORN Canada, 2016), 9.
3. See: Momentum, High-Cost Alternative Financial Services: The Customer Experience (Calgary: Momentum Community Economic Development Society, 2017) http://www.momentum.org/files/Publications/Part%202%20Experiences%20with%20High%20Cost%20Financial%20Services.pdf

Areas of concern

High cost

- High interest rates that can exceed 60 per cent, often with added fees and lengthy terms.
- Borrowers often extend a loan's term or obtain multiple loans to keep up with payments.
- Delinquencies and late payments are costly: borrowers end up having to pay additional fees and often see their assets repossessed.
- The cost of financing a product using rent-to-own or an auto loan can greatly exceed its retail value.

"I probably spent more on interest than on the actual loan."

Inadequate disclosure

- Total cost of borrowing is often unclear: fees and add-ons are not disclosed upfront, and are instead buried in lengthy contracts.
- Information provided is misleading: optional fees are often included automatically, and services are presented as free when there is actually a cost.

Unfair and unreasonable practices and conditions

- Product valuation: pawn shops undervalue items; rent-to-own stores and auto lenders inflate prices.
- Used products are sometimes represented as new.
- Conditions on pawn loans make it difficult for a borrower to buy back a pawned item.
- Charges are applied for the installation of starter disablers (devices that allow lenders to disable a vehicle if a loan is in arrears).
- Lenders engage in direct soliciting to re-borrow, borrow more and sign up friends and family.

Willingness to lend to vulnerable borrowers

- Many lenders accept Income Support, Assured Income for the Severely Handicapped (AISH), Employment Insurance cheques and disability insurance as proof of income.
- High-cost lenders make a profit by lending to people who may be better served through basic needs assistance, credit counselling, debt consolidation or other supports.
- To account for the risk of lending to those with poor credit, lenders increase interest rates and other fees to exorbitant levels.

Impact

The availability of high-cost loans, particularly in the absence of safe and affordable alternatives, results in a banking system that reinforces financial exclusion among vulnerable individuals, contributes to perpetuating cycles of poverty, and can have significant physical and mental health consequences for borrowers struggling with debt.

"I have pawned items to buy food and make ends meet between social assistance cheques."

The existence of high-cost alternative financial services in a neighbourhood places it at higher risk of poverty and disinvestment due to economic leakage.[4] Often, money that could have been spent in the community by households is used to service high debt costs.[5] The clustering of high-cost lenders in lower-income neighbourhoods also affects how the community is perceived. The presence of these businesses reinforces harmful narratives about the area, driving away desirable businesses, preventing those that do exist from thriving and eroding investment.

Next Steps

The above summary exposes several possibilities for reform, such as reducing the maximum allowable cost of borrowing, strengthening disclosure requirements and mandating better assessment of a borrower's ability to repay. For more information on high-cost alternative financial services, please refer to the following Momentum reports: Issues and Impact and The Customer Experience. A third report (forthcoming) will outline a series of policy options.

4. Charis E. Kubrin et al., "Does fringe banking exacerbate neighborhood crime rates?" Criminology & Public Policy, 10, no. 2 (2011): 437–466.
5. Jerry Buckland, Blair Hamilton, and Brendan Reimer, "Fringe Financial Services, Inner-city Banking & Community-based Solutions," Canadian Journal of Urban Research, 15, no. 1 (2006): 109-128.