How Do Borrowers Use Alternative Forms of Credit to Fill in the Gaps?

Interactions between Alternative and Mainstream Credit Product Use

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Alternative Financial Services are financial services provided outside of traditional banking institutions. These typically include short-term small-dollar loans (such as payday loans**),** loans where personal property is used as collateral (such as **pawn shop** and auto title loans), and transactions under which property is leased in exchange for a weekly or monthly payment with the option to purchase (rent-to-own).

How do we define alternative financial service (AFS) borrowers? Adults who obtained loans from a nonbanking institution including **online and storefront small-dollar lenders, online installment lenders, and lenders providing single payment, line-of-credit, auto title, and rent-to-own products.** According to our data, 4.5 percent of adults had used any form of AFS credit in **September 2019.**[1]

What is mainstream credit use? We classify adults as using mainstream credit if they have an **open credit card or other revolving debt.**

We know little about how people who borrow from alternative financial service (AFS) providers interact with mainstream credit providers, yet this knowledge has important policy and program implications. If adults turn to AFS because they cannot access mainstream credit, then increasing such access could be important. If adults who turn to AFS already have mainstream credit access, then other options, such as **information disclosure interventions**, may help people avoid high-cost AFS products.

This fact sheet is based on a unique combination of AFS loan (Clarity) and credit report (Experian) deidentified data that include about 1.2 million US adults who obtained their first AFS loan between 2015 and 2016. Clarity is a credit-reporting agency regulated by the Fair Credit Reporting Act, and its unique data source is derived from various alternative financial service providers, including online and storefront small-dollar lenders, online installment lenders, and lenders providing single payment, line-of-credit, auto title, and rent-to-own products. We identified first-time AFS borrowers in the Clarity data and obtained their detailed credit record from Experian—a major credit-reporting agency—in the 4 quarters before and 11 quarters after they got their AFS loan. Using these data, we explored the extent to which adults who used AFS credit had used traditional credit products before obtaining their first AFS loan. We also investigated how their level of financial distress changed after they obtained their first AFS loan.

FIRST-TIME AFS CREDIT USERS ARE NOT WHO YOU THINK

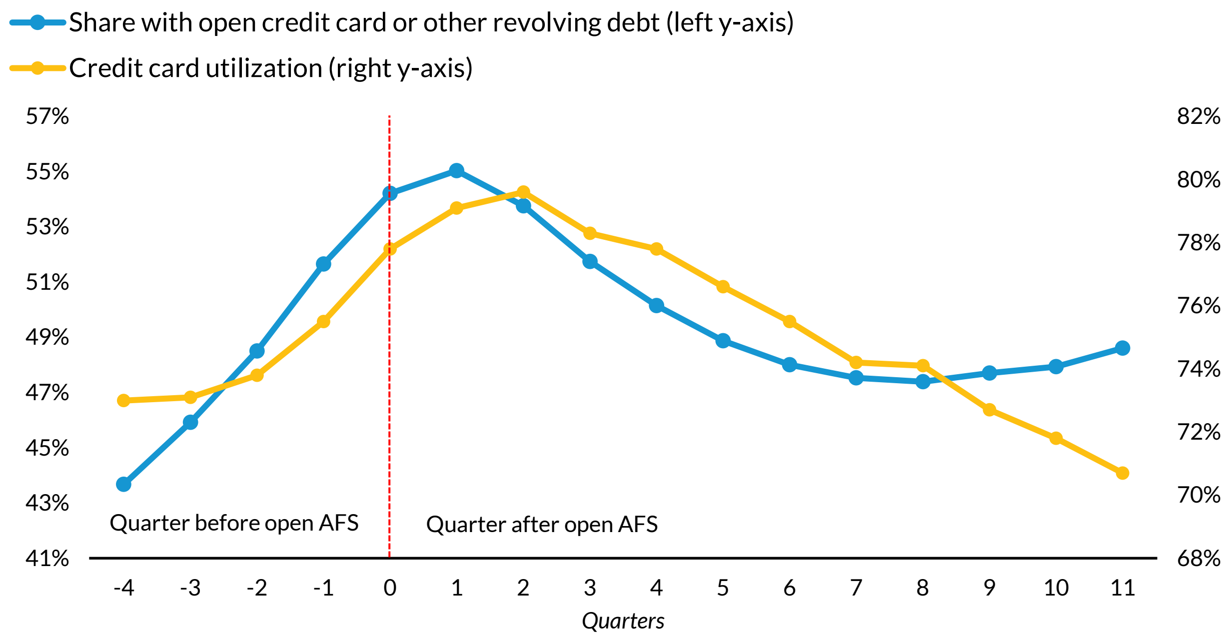
The majority of first-time AFS users had interacted with mainstream credit before using AFS credit. About 52 percent of these adults had an open credit card or other revolving debt in the quarter before they opened their first AFS loan. In addition, about 78 percent of adults who first used AFS credit had a subprime credit score before obtaining their first loan. Finally, most people were in financial distress before they obtained their first AFS loan. **About 75 percent of first-time AFS borrowers had debt in collections reported in their credit history in the quarter before they obtained their AFS loan.**

[1] This is comparable with the 5 percent of adults who reported using any alternative financial sector borrowing service (payday loan, paycheck advance, pawn shop, auto title loan, or tax refund advance) **over the past 12 months** in the **Federal Reserve Board's 2019 Survey of Household Economics and Decisionmaking**.

HOW DO AFS BORROWERS PERFORM WITH MAINSTREAM CREDIT PRODUCTS *BEFORE* THEIR FIRST AFS LOAN?

Our data refute the potential explanation that adults use AFS credit because they are losing access to mainstream credit. **An increasing share of adults had access to mainstream credit in the months before obtaining their first AFS loan** (see figure). **However, borrowers' average credit utilization increased from 73 percent four quarters before their AFS loan to 78 percent the quarter they obtained their AFS loan.** A low credit utilization rate of 30 percent is typically recommended for a strong credit score. AFS borrowers may feel like they are headed toward maxing out their mainstream credit lines and that AFS loans are their only alternatives going forward. This mainstream credit is likely high cost because most adults who use AFS have a subprime credit score.

Share of Adults with Mainstream Credit and Credit Card Utilization Increases before AFS Borrowing



Sources: Clarity and Experian credit records data.
Note: The figure includes adults who obtained their first AFS loan between 2015 and 2016.

HOW DO AFS BORROWERS PERFORM WITH MAINSTREAM CREDIT PRODUCTS *AFTER* THEIR FIRST AFS LOAN?

AFS borrowers are less able to pay their mainstream debts after obtaining their first AFS loan. The credit card delinquency rate among first-time AFS borrowers increased from 18 percent in the quarter they obtained their first AFS loan to 34 percent five quarters later. Although AFS borrowers were already in financial distress before obtaining their first loan, their financial health deteriorated even further after they obtained their initial AFS loan. The increased delinquency rate of mainstream loans could be caused by either pressure to pay the high-cost AFS loan or a negative life event, such as a job loss, which is also associated with AFS use.

DISCUSSION

We find that a growing share of AFS borrowers had access to mainstream credit in the months before opening their first AFS loan, and first-time AFS borrowers experienced increased financial distress after obtaining their AFS loan. Both descriptive results point in a different direction than **regression discontinuity results based on data from a single payday loan provider**. **Programs that help consumers rebuild their credit to reduce future credit costs** and **set aside emergency savings** so they do not need high-cost credit in the future might benefit potential AFS users.

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