Give Me a Little Credit:
Short-Term Alternatives to Payday Loans

Sponsored by:

Table of Contents

- Introduction and Summary
- How Payday Loans Work
- How Pawn Shop Loans Work
- How Car Title Loans Work
- How Installment Loans Work
- How Lines of Credit Work
- Choosing the Best Product
- Conclusion
- References
- Glossary

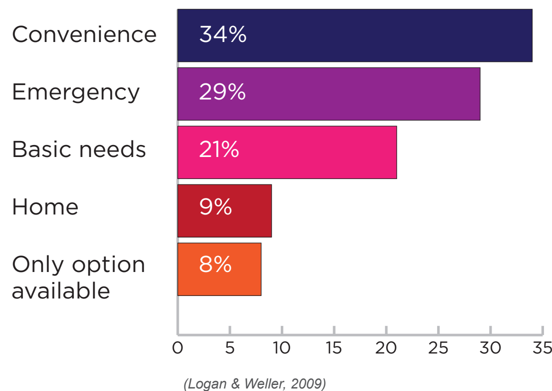
Introduction and Summary

Credit plays an important role in the nation's finances. In 2008, there were close to 177 million credit cardholders in the U.S., which is more than half the population. The average credit cardholder has 3.5 cards with a balance of $1,157 apiece (Woolsey & Schulz, 2011). Since credit is such an integral part of the economy, what happens when people are denied credit, because of bad credit history or other reasons? When unexpected bills come up, these consumers often find themselves in a bind, and they must look to alternative short-term credit products, like online payday loans, for help.

One-third of payday loan borrowers have been denied credit during the past five years.

(Carter, 2011)

There are approximately 19 million payday borrowers nationwide (Logan & Weller, 2009), and one-third of them have been denied credit during the past five years (Carter, 2011). But consumers use payday loans for a variety of reasons, not just as a last resort in emergency situations. Here are some motives, gathered by Logan and Weller (2009), that consumers reported for using payday loans:



(Logan & Weller, 2009)

Interestingly, the least common reason for using payday loans is that they are the "only option available." Actually, there are several alternatives to payday loans — such as pawn shop loans, car title loans and installment loans, to name a few — that give consumers access to cash. But of these products, payday loans may be the most widely used. Before taking out a payday loan, less than 1 percent of customers consider a pawn shop loan as an alternative, and 2.5 percent consider a title loan (Elliehausen, 2006). In fact, households are twice as likely to use payday loans as pawn shop loans (Avery & Samolyk, 2011), so clearly, not all short-term credit products are alike. What works best for one consumer may not be a good choice for another. But by researching the available options and comparing products to one another, consumers who are in need of financial assistance can make educated decisions regarding sources of informal, short-term credit.

Before taking out a payday loan, **less than 1 percent** of customers consider a pawn shop loan as an alternative, and **2.5 percent** consider a title loan.

(Elliehausen, 2006)

How Payday Loans Work

So how do payday loans work? Payday loans are small, short-term cash advances that are typically paid back along with a fee on the borrower's next payday, generally within two weeks. To qualify for these loans, applicants must be 18 or older, a U.S. citizen, employed, and have a valid checking account. When applying through an online payday lender, potential borrowers fill out a secure application over the Internet with their employment, bank account and contact information. If the borrower is approved, the lender deposits the funds directly into their bank account as soon as the following business day. Then when the loan is due, the loan amount and fees are debited from the borrower's account, unless they choose to make a partial payment or extend the loan, which incurs another fee and is only available in some states.

In-store borrowers secure payday loans by writing a postdated check for the loan amount and fee and leaving it with the lender. If the borrower is ready to repay on the due date, they may simply let the lender cash the check, or they may return to the store to pay by another method and get their check back. Borrowers who need more time to repay the loan may request to extend it and incur another fee(Logan & Weller, 2009).

Payday loans are viewed as a convenient way to cover emergency expenses between paydays. But there are other common ways to get small amounts of short-term credit in an urgent situation, such as car title loans, installment loans, lines of credit and the most well-known of them all — pawn shop loans.

How Pawn Shop Loans Work

The decline of pawn shop popularity in the early 2000s is often attributed to the growth of payday lending during the 1990s (Caskey, 2005). Pawn shop loans are different from online payday loans in that borrowers have to give the pawnbroker a possession of worth — such as jewelry, tools or a musical instrument — in exchange for a loan that is typically 50 percent of the item's actual value (Avery & Samolyk, 2011). The borrower gets their item back after full repayment with interest; however, if the borrower does not repay by the due date, they forfeit the item and the pawnbroker can sell it in the pawn shop, usually for more than the value of the loan.

Pawn shops that operate online are a fairly new phenomenon, but the concept is essentially the same. Borrowers can go to an online pawn shop's website and send them a description or photo of the item being pawned. Within 24 hours, the pawnbroker makes them an offer. If the borrower accepts, often they can mail the item at the pawn shop's expense, and then the loan is funded directly into their checking account. The item is returned once the loan is paid off in full (Pawngo, 2012).

How Car Title Loans Work

Car title loans grew out of pawn shop loans, which is why they are similar products. With a title loan, a borrower puts up their car title as collateral to secure a loan, often for a fraction of the Kelley Blue Book value, and then gets the title back after the loan is repaid with interest. But one key difference is that, unlike pawn shop loans, with car title loans the borrower gets to keep and use their vehicle while the loan is being borrowed. The only item initially surrendered to the lender is the title. These loans can be closed in as little as one day and typically require proof of income, identification and vehicle ownership before the transaction can be completed. Repayment periods on title loans can be as long as a

With a title loan, a borrower puts up their car title as collateral to secure a loan, often for a fraction of the Kelley Blue Book value.

few years or as little as 30 days, depending on the lender and state regulations, and they are usually paid off in installments. If the borrower misses a certain number of payments, the lender — as the legal title holder — has the right to repossess the borrower's car (Zywicki, 2010).

Online title lending follows the same model, but calling these companies "online" lenders is a bit misleading. They almost always require an in-person meeting before the loan can be closed. This is because the lender has to inspect the vehicle and the borrower has to show certain paperwork, as well as hand over their title. However, numerous online title lenders are willing to send a specialist directly to the applicant's home or office, so those borrowing through online lenders have the added convenience of not having to leave their house.

How Installment Loans Work

Another source of short-term credit is installment loans, which are like payday loans on steroids. Installment loans are medium-term loans that are generally made for larger sums of money than payday loans. They are also repaid gradually instead of all at once — a typical repayment schedule lasts several months to a year, not two weeks. And unlike payday loans, which charge a flat fee, installment loans can be interest-based.

To apply online, a potential borrower provides some basic information, such as employment status and bank account number, through the lender's website. The borrower then waits for approval, which may take minutes or days, depending on the lender. Some companies also require borrowers to fax in extra documents, such as a recent pay stub, before evaluating the application. After getting approved, the borrower is funded the loan through a direct deposit into their bank account. Installment loans can be a good alternative to payday loans for people who need more money and more time to pay it back.

How Lines of Credit Work

Consumers who foresee an ongoing need for cash advances might consider opening a line of credit. This product is similar to a credit card, only without the card. Approved customers are issued a credit limit — which can range from $100 to $1,800 with companies such as CashNetUSA (2012) — and the customer may continuously borrow money up to their limit as long as their account is in good standing. These advances can be requested by phone, email or logging in to their online account with the lender, and typically the money is funded into the borrower's checking account by the following business day. Most lenders issue a transaction fee after each advance, at a rate similar to a payday loan fee.

Just like with a credit card, the balance on a line of credit does not need to be paid in full right away. At the end of each billing cycle, borrowers have the option of paying the minimum balance, the entire balance or an amount in between, while the unpaid principal accrues interest daily. Borrowers may choose from numerous payment options, such as cash, check, money order, credit card, debit card and automatic withdrawals from their bank account. The application process for lines of credit resembles that of payday and installment loans — the borrower must show that they have an income and an active checking account. Many companies do not even run a credit check. And unlike most traditional credit cards, lines of credit only charge interest and fees when the account has a balance, meaning there is no penalty for non-use. Lines of credit are distinct from the other short-term credit products because they offer continual access to loans without having to reapply every time.

Choosing the Best Product

Consumers have a wide selection of short-term credit products to choose from, and they all offer speedy access to necessary cash. But before potential borrowers can choose the best option, they must understand how these products compare to each other. While they have some similarities, they are actually very different products that fulfill different consumers' needs. Here are just a few of the differences between these products:

First is the amount of money received. Loan amounts vary widely across these products for a number of reasons, like state regulations, value of collateral, amount needed, and so on. The average payday loan is roughly $245 (Caskey, 2005), but some payday lenders can offer as much as $1,000 per loan, depending on the state's lending laws. The online pawn shop Pawngo (2012) says it can offer up to $100,000 on one loan, but since a pawn shop loan is secured by a valuable item, one would need to have an object worth over $100 grand in order to borrow that much money. The average pawn shop loan is actually $75, according to Caskey (2005). Title loans are a similar animal. The average title loan, according to the American Association of Responsible Auto Lenders, is $700 for AARAL members. But these loans also depend on the value of the collateral — one's vehicle. In general, title loans stay in the range of $250 to $1,000 (Zywicki, 2010), but some companies, like Auto Title Factory (2012), advertise as much as $50,000 to residents of California. Again, the loan amount hinges on state law and how much the car is worth. For borrowers seeking unsecured loans — which require no collateral — lines of credit can be as much as $1,800, and installment lenders may offer up to $2,250 (CashNetUSA, 2012), both of which are higher amounts than what is typical of online payday loans.

Another way these products differ is in application requirements. For payday loans, installment loans and lines of credit, applicants typically need to be at least 18 or older, a U.S. citizen, have an active checking account and have a source of regular income. But pawn shop loans from a brick-and-mortar store require none of these things — all that is needed is an item of value that can be pawned. For this reason, storefront pawn shop loans would be a better choice

Application Requirements

	Payday Loans (online)	Pawn Shop Loans (in-store)	Car Title Loans (in-store)	Installment Loans (online)	Lines of Credit (online)
18 Years or Older	✓	✗	✓	✓	✓
U.S. Citizen	✓	✗	✓	✓	✓
Regular Income	✓	✗	✓	✓	✓
Valid Checking Account	✓	✗	✗	✓	✓
Valuable Item	✗	✓	✓	✗	✗
Insurance on Valuable Item	✗	✗	✓	✗	✗
References	✗	✗	✓	✗	✗

for borrowers who are either unemployed or do not have a bank account. Online pawnbrokers, however, usually require borrowers to have a checking account so that the loan can be made through direct deposit, which is typical of any online loan transaction.

Title loan applicants have to provide numerous items to supplement their applications, including pay stubs, recent bills, a social security card, an insurance card and a valid driver's license, among other things. And of course, they must have a car with a clear title. By comparing application processes alone, the least is required of in-store pawn shop applicants, who only need an item to pawn, and the most is required of title loan applicants, who need to show proof of residency, income, identification and vehicle ownership. However, it is important to keep in mind that both of these types of loans require collateral. Borrowers must have an object of worth, such as a car title, to put up as security in case they cannot pay the loan back. Those who are hesitant to part with a valuable item — or do not own anything valuable — should consider online payday loans, installment loans or lines of credit instead. These products require no collateral, but they do require some form of income, so borrowers can keep their possessions while the loan is out.

Another distinction between payday loans and alternative products is the loan term. Payday loans are short-term advances intended to tide people over during an emergency until their next payday, and thus they are typically repaid within two weeks. Pawn shop loans generally have a term of about 30 days (Avery & Samolyk, 2011), as do title loans (Zywicki, 2010), but the exact length varies from lender to lender and state to state. Installment loans, which are usually for higher amounts of money than payday loans, have an average repayment period of about a year. The term on a line of credit is more complicated. Since lines of credit are open-ended credit options, there is not a fixed repayment plan — it depends on how the borrower decides to use the product. They are only required to pay a minimum balance each month, which is determined by how much money they have been advanced. It is up to the borrower whether to pay the minimum balance or the full bill. So payday loans typically have the shortest terms, at two weeks, and lines of credit could have the longest, depending on borrower behavior.
Borrowers who do business with any online lender have the extra advantage of closing the deal with more privacy. Unlike title loans and storefront pawn shop loans, which require face-to-face interactions, online payday loans, installment loans and lines of credit can be closed discreetly over the Internet. All legitimate online lenders use McAfee SECURE™, VeriSign Secured™ or other data security software on their websites, to protect a borrower's information from identity theft. A person who chooses to get a payday loan online can keep their personal information secure by dealing with an online lender instead of a brick-and-mortar lender.

Finally, consumers shopping around for short-term credit should always consider what the overall cost of the loan will be. Each type of loan has its own rates and interest charges, and it is important to understand them before making a final decision.

Payday loans, for instance, have a fee for every $100 borrowed (Logan & Weller, 2009), and are typically borrowed for two weeks. But if the customer needs more than two weeks to pay back the loan, a line of credit might be cheaper than rolling over a payday loan in states that allow extensions, which would incur another fee in this instance. Like payday loans, lines of credit also have a transaction fee attached to them. Typically, every time a customer requests an advance, they incur a fee for every $100 borrowed. If the loan is out more than 14 days, an interest rate is assessed on the current principal balance outstanding.

Installment loan costs are trickier to calculate because they are entirely interest-based. Depending on the amortization schedule, the total interest charges on these loans often exceed the initial loan amount. However, this might be

preferable for a consumer who needs more time to repay, since installment loans typically have a one-year term. Loan fees at pawn shops are approximately 20 percent of the loan amount (Avery & Samolyk, 2011). But another cost to consider when using secured loans at pawn shops and title lending firms is the chance of losing one's collateral if the loan is not paid back on time. Potential borrowers must contemplate whether a title loan or pawn shop loan is worth the risk of losing their car or valuables in the case of nonpayment. The important thing is to research the charges and costs associated with each type of loan and decide which is the most preferable — and affordable — option.

Conclusion

Payday loans, pawn shop loans, car title loans, installment loans and lines of credit are all unique products with their own benefits and drawbacks. When deciding on the best product to suit one's needs, consumers should ask themselves these questions:

- What types of loans do I qualify for?
- How much money do I need?
- How much time will I need to pay it back?
- Do I own something valuable that I am willing to part with? Does my car have a clear title?
- Is the privacy of the transaction important to me?
- How much will this cost me overall?

By keeping these things in mind, borrowers can choose the right type of lender to match their needs.

Although having a variety of options can be overwhelming at times, in the case of short-term credit, extra options create extra advantages. Rather than settling for whichever lender happens to be willing to extend a fast loan, consumers can compare rates and decide for themselves which product they want to use. Comparing prices is not just for the grocery store — it is also an important part of shopping for a loan. Above all, the decision-making process does not need to be stressful. With just a bit of investigation, potential borrowers can settle on a fitting credit product with little difficulty.

Comparing prices is not just for the grocery store — it is also an important part of shopping for a loan.

References

Auto Title Factory. (2012). Auto title loan rates and terms. Wilshire Consumer Credit. Retrieved February 21, 2012, from https://www.autotitlefactory.com/rates-and-terms

Avery, R. B. & Samolyk, K. (2011, May 13). *Payday loans versus pawnshops: The effects of loan fee limits on household use.* Federal Reserve System. Working paper. Retrieved from http://www.frbsf.org/community/conferences/2011ResearchConference/docs/2-avery-paper.pdf

Carter, S. P. (2011, October 28). *Payday loan and pawnshop usage: The impact of allowing payday loan rollovers.* Vanderbilt University. Retrieved from https://my.vanderbilt.edu/susancarter/files/2011/07/Carter_Susan_JMP_website.pdf

CashNetUSA. (2012). Payday loan fee schedule at CashNetUSA.com. Retrieved from http://www.cashnetusa.com/fee-schedule.html

Caskey, J. P. (2005). Fringe banking and the rise of payday lending. In P. Bolton & H. Rosenthal (Eds.), *Credit markets for the po*or (pp. 17-45). New York: Russell Sage Foundation.

Elliehausen, G. (2006, May). *Consumers' use of high-price credit products: Do they know what they are doing?* Networks Financial Institute. Working paper. Retrieved from http://www.frbsf.org/community/research/assets/DoHighPriceCreditCustomers.pdf

Logan, A. & Weller, C. E. (2009, March). *Who borrows from payday lenders? An analysis of newly available data.* Center for American Progress. Center for American Progress. Retrieved from http://www.americanprogress.org/issues/2009/03/pdf/payday_lending.pdf

Pawngo. (2012). How does an online pawn shop like Pawngo work? Retrieved from https://pawngo.com/how-does-pawngo-work

Woolsey, B. & Schulz, M. (2011, July 14). Credit card statistics, industry facts, debt statistics. *CreditCards.com*. Retrieved from http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php

Zywicki, T. J. (2010). *Consumer use and government regulation of title pledge lending*. Mercatus Center. Retrieved from http://www.luc.edu/law/activities/publications/clr_vol22_issue4/pdfs/zywicki_title.pdf

Glossary

Payday loans – small cash advances that are typically repaid along with a fee on the borrower's next payday

Pawn shop loans – cash advances that are secured by a possession of value, which is left at the pawn shop until the loan is repaid along with a fee

Car title loans – cash advances secured by a car title; in the case of nonpayment, the title lender may repossess the borrower's car

Collateral – assets a borrower will give to a lender if he or she fails to pay back the loan

Installment loans – cash advances that are repaid gradually, with interest, over the course of months or years

Kelley Blue Book value – the average price a vehicle sells for at a dealer or between private parties, which is calculated and published by the Kelley Blue Book

Line of credit – a credit limit that is extended to a borrower, who may borrow as often as desired up to that limit while accruing interest on the principal balance

McAfee SECURE™ – software intended to keep website content secure from hackers

VeriSign Secured™ – software intended to keep website content secure from hackers

Amortization schedule – a table showing the details of each payment, including the amount of interest paid and the amount of principal paid