

Tightened Credit Standards and Rising Personal Bankruptcy Rate in the U.S.

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Abstract

There has been conflicting literature on the root cause of rising personal bankruptcy. While many researchers (Sullivan, Warrant, and Westbrook, 2000; Himmelstein, Warren, Thorne, and Woolhandler, 2005) conclude that adverse events, such as job loss, serious illness, divorce, are leading cause to rising bankruptcy filings, many others (White, 2007; Zhu, 2008), however, conclude that high level of personal revolving debt as major contributing factor. Although bankruptcy rate fell dramatic in 2007 after it reaches its climax in 2006, a new wave of bankruptcy filing starts to rise again since 2008. To many, banks' tightened credit standards are considered the reason behind such phenomenon. This paper examines if the newly tightened credit standards and consumers' switching to other alternative financial sector in an attempt to find out if they are some of the contributing factors to the new rise in personal bankruptcy rate in the U.S.

Introduction

A recent report by CNNMoney.com confirms that personal bankruptcy filing is on the rise again in the United States shortly after a temporary decline in 2007, especially after the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005 was implemented in 2006. In the meantime, a recent Federal Reserve survey of senior loan officers of the major banks confirms that they have tightened their consumer lending terms to their customers. As the survey data shows, over 60 percent of banks confirm they have been actively lowering credit limits. Many economists and financial analysts wonder if the new lending policies associated with the tightened credit standards may have a negative impact on changes in consumers' borrowing behaviors, which ultimately worsens consumers' financial stability by cutting back or even withdrawing the basic accessibility to relatively low-cost credits. Although there have been debates on the root causes that lead to rising bankruptcy rate in the past, there is a need to uncover some other contributing factors that may help explain the root causes of the on-going surge of bankruptcy rate.

Personal bankruptcy is a not new in the American society. In the early days of lending and borrowing in the US history, consumers typically had to go through a series of complicated procedures before getting consumer loans, such as home loans, car loans, student loans, etc., from banks (White, 2007). With strict screening process in place, a relatively smaller number of consumers could qualify for those loans and a relatively small number of them did file for personal bankruptcies. Since the "Marquette" decision by the Supreme Court 1966, however, the nation started to witness a steady increase in personal bankruptcies when banks were allowed to conduct business across the states with interest rate deregulated by the federal government (see Chart # 1). With credit cards becoming a major means of borrowing from banks, more and more consumers carry revolving debt (credit card debt) in addition to other installment debt such as mortgages loans. Since 1980s, family debt levels have been increasing steadily while the average family income levels have witnessed relatively small increment (see Chart # 2), and the debt to income ratio keeps growing up due to excessive consumptions (see Chart # 3). A survey conducted by the U.S. Census Bureau in 2008 there was a 14.3 percent increase of personal bankruptcy filings between 2007 and 2008 (US Census Bureau, 2008), and more American families are expected to face even higher risk of delinquency in 2009. With the country in the middle of an economic crisis, more and more Americans find themselves unable to keep up with debt payments as a result of job loss or lower income due to organization restructure. As of June 2009, the nationwide unemployment rate has reached 9.4 percent (see Chart # 4), and a fast recovery of national economy is still beyond sight. Many consumers find themselves struggling with their mortgage and credit card loan payments. It is not surprising to see a new round of personal bankruptcy filings, and this trend may go even higher later in the year.

For years, many economists and researchers have serious debates on what actually lead to a rising personal bankruptcy rate in the U.S. Earlier researchers cite adverse events, such as adverse events like loss of job, serious illness, divorce, as the leading causes. Sullivan, Warren, and Westbrook (2000) find that 67 percent of bankruptcy associated with job loss while Himmelstein, Warren, Thorne, and Woolhandler (2005) conclude that 55 percent of bankruptcy filings are the result of illness, injury, or medical bills. Recent studies on personal bankruptcy,

however, indicate that revolving debt, specifically credit card debt, as the primary culprit that causes rising bankruptcy rates (White, 2007). Similar studies carried out in many other countries such as Japan and Australia also confirm such findings (Mann, 2006). Their conclusions reject the previous research findings by pointing out that adverse events do not provide a good explanation for the dramatic increase in bankruptcy filings (White, 2007) when only 21 percent survey respondents cite their job loss as their primary reason for filing bankruptcy (Panel Study of Income Dynamics). Other studies on personal bankruptcy also suggest that gambling is not the major contributor behind rising bankruptcy filings (Barron, Staten, and Whilshuen (2002). Rather, they discover that credit card debt is the root cause of behind the steady increase of personal bankruptcy filings over the years, and they also confirm that typical bankruptcy filers are most likely from low income families rather than middle class families (White, 2007). According to data collected by Panel Study of Income Dynamics (PSID, year), 33 percent bankruptcy files cited high debt and/or misuse of credit cards as their primary reasons for their financial meltdown. In a similar survey by National Foundation for Credit Counseling in 2006, 75 percent of bankruptcy filers claim that poor management and excessive spending ruin their financial stability. They conclude that the high revolving debt increases the probability of bankruptcy filings (Domowitz and Sartan, 1999) and credit card holders are more likely to file for bankruptcy as their credit card debt levels steadily increase (Gross and Souleles, 2002a).

Will the tightened credit standards lead to higher personal bankruptcy filings by increasing revolving debt among consumers knowing that revolving debt increases the chances of filing bankruptcy (Ellis, 1998)? Specifically, how will the new lending policies among mainstream banks impact consumers' decisions in switching to other alternative financial sector to obtain credits under the current financial crisis? What financial options are available in the alternative financial sector? What risks are associated with those financial options? Finally, what role does the alternative financial sector play in personal bankruptcies these days? This study explores the impact of the tightened credit standards on consumers' accessibility to obtaining credits and how consumers' new borrowing behaviors may contribute to higher bankruptcy filings in the U.S. Section 2 discusses the history of credit expansion and bankruptcy in the U.S. Section 3 discusses the relationship between banks' lending practices and personal bankruptcy. Section 4 explores the risks associated with alternative financial sector services and their potential role in leading to rising personal bankruptcy rate. Section 5 concludes findings of this research.

Credit Expansion and Personal Bankruptcy

Credit is the provision of resources (such as granting a loan) between a lender, the creditor, to the borrower, or the debtor, on pre-agreed terms and conditions. Consumer credits, or consumer debt, can be defined as money, goods, or services provided to an individual in lieu of payment. Common forms of consumer credit include credit cards, store cards, motor finance, personal loans (installment loans), retail loans (retail installment loans), and mortgages. One key characteristics of consumer credit is the charge of interest based on the interest rates when a transaction happens between a lender and a borrower. The cost of credit is presented in a number of ways, including interest, arrangement fees and any other charges. The contemporary form of lending and borrowing typically happens between financial institutions, such as commercial banks, and consumers, such as families or individuals.

The nature of lending and borrowing defines that granting credits to consumers also involve risks when the borrowers are not able to repay their debt. Before the Supreme Court's decision on "Marquette" in 1966, the usury law prohibited banks from charging high interest rate on consumer loans such as mortgage loans and car loans. However, the U.S. society started to witness dramatic credit expansion when the usury law was abolished in 1978 as the result of the Supreme Court's decision, clearing the way for many financial institutions to extend large amount of credits to consumers which has led to a rapid increase number of personal bankruptcy filings in the United States (White, 2007). The general-purpose credit card, first introduced to the market in 1966 by Bank of America, made it a means for borrowing. With both credit card debt and mortgage debt increased dramatically, the United States witnessed a rapid, excessive growth in personal debt between 1980 and 2006. Data shows that mortgage debt per household in 2006 has tripled compared with that in 2003 while revolving debt has reached 4.6 times over the same period (White, 2007). The increased debt levels in the past decade is the direct result of Federal Reserve's artificial low interest rate policy meant to promote banks' lending huge sums of mortgage loans, especially subprime mortgage loans, to consumers with relatively low income or credit scores (see Chart # 5). The artificial low interest rates, coupled with U.S. government's financial policies such as the Community Reinvestment Act (RCA), have created a wave of easy-to-get credits that eventually created the economic bubbles today. With US citizens saving less and less and spending more and more on easy credits, many consumers face high risks of delinquency or even bankruptcy when adverse events occur. Statistical data on family debt level in the U.S. between 1990 and 2006 showed that the risk of being bankrupt for U.S. families was at monumental high (see Chart # 6).

High debt levels as a result of excessive consumption has been confirmed by many researches to be the root cause that leads to increasing number of bankruptcy filings in the U.S. (Zhu, 2008). Nearly 1.5 million couples or individuals filed bankruptcy petitions in 2001, a 360 percent increase since 1980 (Himmelstein, Warren, Thorne, and Woolhandler, 2005). The increase in credit card and mortgage debt levels provides the most convincing explanation for the increase in bankruptcy filings in the country (White, 2007). A recent study on debt to income ratio (see Graph # 3) clearly indicates a positive relationship between debt levels due to abundant, easy-to-access credit and increase in personal bankruptcy rates. While the savings rate in the U.S. has reached its lowest point as of 2008, the average debt level has reached its climax in the past few decades (see Chart # 6). As of 2004, households that help credit card debt had an average revolving debt level of \$15,150, and the average bankruptcy filer had credit card debt of \$25,000 (Johnson, 2005; Laibson, Reppetto, and Tobacman, 2003; and Zhu, 2007). For many years, banks and mortgage firms have advertised favorable short-term interest rates for mortgage financing while credit card companies introduce favorable introduction APR to encourage consumers to obtain more debt in order to maximize profits out of those loan transactions. As of 2006, the household debt represents 131 percent of disposable income, up from 95 percent in 2000 and just 65 percent in 1990 (see Chart # 6). The readily available credits in the late 1990s and the first few years in the 21st century, coupled with the low interest rate policy by the Federal Reserve, has brought an illusory prosperity that has misled many consumers into spending beyond their means. Such changes in consumption behaviors have increased the risks of defaults in debt payments, which subsequently has led to higher personal bankruptcy filings in the past two few years. As pointed by White (2007), revolving debt accounts, for the most part, for the

rising personal bankruptcy in the U.S. This is especially true today when consumers lose their income or suffer from other major adverse events under today severe economic crisis.

Bank Lending and Personal Bankruptcy

Credit Expansion and Rising Personal Bankruptcy Filings

Mises (1912) warns against the possible disruption of the financial market when excessive credit is injected into circulation when central banks decide manipulate the demand and supply of the free market—especially when they abolish the gold standard. Unfortunately, many financial institutions on the Wall Street have adopted neo-Keynesian's theory, including the Federal Reserve, in their financial policies by introducing lower interest rates to consumers in the U.S. As shown in Chart # 5, the overnight interest rates for banks set by Federal Reserve were well below the market interest rate. However, such decisions have brought along with them severe consequences when there are any major changes in the macroeconomic condition in national economy, as such adverse events will easily trigger a landslide of delinquency in payments and even lead to bankruptcies when debtors find themselves short of means to borrow additional debt or to refinance their existing loans.

Debt accounts for more than 50 percent of recent bankruptcies (Zhu, 2008). For decades, especially in the past 10 years, many commercial banks, mortgage firms, and insurance companies have issued huge amount of consumer credits, including credit cards. In an effort to maximize profits, many financial institutions have introduced various incentive programs to encourage consumers to borrow even beyond their means. Recent Federal Reserve's data shows that the nation's total mortgage debt has reached \$10.143 trillion while credit card debt has reached \$957.6 trillion as of 2008. Indeed, such debt levels can easily drive heavy-debt borrowers into a tailspin that they find difficult to correct or bailout.

Current research on personal bankruptcies is largely based on analysis of the relationships between consumers' spending behavior, their debt levels, and the factors that trigger their bankruptcy filings. However, little literature has been dedicated to the study on the role of the lenders as a major contributor that helps explain the rising personal bankruptcy rate in the U.S. This paper aims at uncovering some other factors, such as banks' tightened credit standards, that may impact consumers' seeking other alternative financial sector while they are denied access to credits at mainstream banks under the current recession in the U.S. Although previous researches do show the relationship between revolving debt and bankruptcy filings (White, 2008), most of those findings were conducted prior to the economic crisis in 2008. With the on-going economic crisis, it is necessary examine how banks' new lending policies, tightened credit standards in particular, may drive consumers into filing bankruptcies when they have to turn to other alternative financial sector for credits.

Financial Crisis and Tighter Credit Policies

Despite the fact that past researches concluded that revolving debt are the culprit of personal bankruptcy (White, 2007), most recent studies on personal bankruptcy find that adverse events do play a role in personal bankruptcy filings under the severe economic conditions today.

Adverse events such as loss of job or deteriorating health conditions, do contribute to personal bankruptcy filings (Zhu, 2008). With the financial meltdown on the Wall Street, triggered by the subprime mortgage sectors, in the second half of 2008, more and more mainstream banks have taken drastic measures to secure their financial stability and to reduce risk through revamping their lending practices. According to a Federal Reserve survey of senior loan officers at 25 major banks in April of 2009, half of the banks (50 percent) have confirmed that they have tightened their consumer lending terms. Forty-nine percent respondents confirmed that credit standards on mortgage loans as prime residential mortgages have tightened up their lending standards (see Table 1) while sixty-two percent have tightened their credit card application for consumers (see table 2). Crutsinger (2008) points out that banks tightened the spigots further on all sorts of lending, from home mortgage to credit cards, as the worst financial crisis in seven decades took a bigger toll on the U.S. economy. Accordingly to the latest Federal Reserve survey of senior loan officers at major banks in July of 2009, the majority of banks have been tightening their consumer lending terms, with 60 percent of banks reporting lowering credit limits and fewer than 40 percent saying that credit limit have remained unchanged. Nearly 52 percent banks reported having increased the credit score require to secure a line of credit and none of the banks survey said that they were making it easier to get credit.

Tighter lending standards was typical in a weakening economy—especially in the consumer sector where banks increased minimum credit scores required on credit cards while restricting card loan limits. As indicated in the survey of the loan officials in 2009, banks have changed their underwriting standards out of concerns on borrowers' ability to repay their debt under current financial crisis. The survey data is typical of the banks practices in the U.S. as they have a total loan amount reaching \$3.6 trillion, which represented over 84 percent of all outstanding loans in the national banking system. In a similar survey conducted in August 2008, Lawder (2008) confirmed that the tightening in credit is being driven by broader weakness in the U.S. economy and is defying efforts by the Fed to boost liquidity in the banking system and keep interest low. Finally, the survey finds that 65 percent of U.S. domestic banks tightened standards on credit cards and other consumer loans, considerably higher than the 30 percent that tightened card standards in the previous survey (Lawder, 2008). In fact, U.S. banks and credit card companies have tightened their credit standards for the second straight year, making it harder for consumers to get or keep a credit card. Such new lending policies by mainstream banks have made it difficult for many consumers to borrow to finance their consumption. When the national economy is sunk into recession, unemployment rate keeps rising, and the dislocated many consumers find themselves badly in need financial assistance in going through the current economic turmoil. With unemployment rate reaching 9.4 percent nationwide, it is very difficult for many consumers to obtain the needed financial services when banks raise their bars for consumers to obtain credits as they did before. After all, banks need to minimize risks in lending under adverse economic conditions by setting higher credit scores for home loans and credit cards, minimum requirements for opening bank accounts, and more stringent screening process.

When mainstream banks raise their bars in lending, many consumers are obliged to choose among the fees associated with bank account ownership or the fees of alternative financial service (AFS) providers. Not surprisingly, the highest fees for basic financial services are concentrated among those least able to pay (Barr, 2007). Like many lower- and moderate-income families, more and more consumers who used to be middle class in income are now

turning to alternative financing sectors (AFS) for financial services when they are denied of access to mainstream banking system. Such alternative financing services typically consist of payday loans, car title loans, refund anticipation loans, pawnshop loans, and many others. What's more important about those alternative financial sector services are the very high risks associated with their short-term loans that typically carry extremely high interest rates, high processing fees, and many stringent terms and conditions for those transactions. For consumers with poor financial management, those alternative financial products are typical traps that can drag them into heavy debt they may never be able to get out. For many consumers, turning to those AFSs for temporary financial relief can turn into a nightmare that eventually leads them to personal bankruptcy instead.

Alternative Financial Sector and Personal Bankruptcy

Today, the U.S. unemployment rate jumped to a 26-year high when many employers continued to slash jobs despite tentative signs that the economic crisis may be easing. The U.S. labor department confirms that 467,000 people lost their jobs as of June 2009, and the unemployment rate now stands at 9.5 percent, up from 9.4 percent in May. With consumer confidence index still remaining low, many businesses continue cutting back their labor force. For many consumers, borrowing from banks will become more and more difficult, especially for those who have either lost their income or have less income than they did before. About 98 percent of banks that tightened their credit standards have confirmed their concerns with the poor economic outlook, their own liquidity, and their capital positions (Nutting, 2009). Their new lending policy is merely a counter measure to lower risks consumer loans.

Unfortunately, the tightening credit standards also carry serious consequences when mainstream banks charging higher interest rates, demanding larger down payments, requiring higher credit scores, lowering existing credit lines, and reducing loan maturity (Nutting, 2009). It is no secret that banks have raised the bar for borrowers who want to get a new home loan. The fact is that today's requirements may be significantly more challenging, whether borrowers want to buy a home, refinance their current mortgage, or take out a home equity loan or a line of credit (Geffner, 2008). This tightening in lending practices could worsen the already weakened economy from job loss and lowered consumer spending. Consumers may have to cut spending as mortgages loans cost and credit card fees increases, and many individuals or families who have recently lost their jobs are forced to choose some short-term financial service provider, such as payday loans, car title loans, and refund anticipation loans, for temporary financial relief when the mainstream banks refuse to give them credit. Not surprisingly, the use of alternative financial services is a common response to the lack of availability of mainstream banking services, either due to proximity, denial of access, or lack of information. Between 2003 and 2005, 26 percent bought on layaway, 11 percent pawned something for cash, and 22 percent received a refund anticipation loan (RAL) form paid tax preparer (Barr, 2006).

Under the current economic conditions today, the alternative financial sector is experiencing tremendous growth than ever before. Rent-to-own stores, for example, thrive during the current economic recession. Aaron's, the second-largest retailer in the \$6.3 billion industry, plans to open 200 stores in 2010 on the heels of an 18 percent increase in same-store sales last year (O'Donnell and Walbaum, 2009). Choosing alternative financial sector for financial services

pose a great threat to the financial stability of specific group of consumers—especially the lower- and moderate-income households and those who recently experience adverse events. Although many of the products associated alternative financial sectors have differences in their operation procedures, policies, as well as terms and conditions, they typically carry some common characteristics: short-term loans with extremely high interest rates and very high processing fees. High level of personal debt associated with excessive spending is the primary factor that leads to high bankruptcy rate. According to a most recent research by Zhu (2008), the following three factors are the major contributing factors in filing bankruptcies: (1) loss of job; (2) losing one's health, and; (3) excessive consumption. The nature of those financial products has high risks for some consumer groups, including the banked and unbanked consumers, low- and moderate-income households,

Loss of job or high medical bills due to poor health belongs to adverse events, some of which are totally beyond the control of consumers. Like most consumers, those who have lost their jobs or have lower income than they did before still have the need to regularly conduct financial transactions: convert income to a fungible medium, make payments, save, borrow, seek insurance, and engage in economic decision-making. However, the tightened credit standards limit their access to relatively low-cost credits in the mainstream banking systems when the financial services system is not designed to serve them well (Barr, 2007). Some of the banked households have recently become unbanked, which makes them more likely to turn to alternative providers than banked households. In fact, even banked individuals often use some alternative financial services providers (Barr, 2007). In a study of job loss and unemployment in Brantford, Ontario from 1991 to 2005, Hoyes (2006) analyzes the data and finds that unemployment rates do exert a significantly negative impact on the bankruptcy rates in Brantford. As soon as people lose their jobs, they may be forced to use credit cards and lines of credit for survival. This, in turn, increases their debt levels. Without a reliable income to pay their debt, they are more opt to turn to the alternative financial sector for financial services which, in turn, increases their debt levels when they have to face more stringent lending terms and conditions. That could probably explain why personal bankruptcy went up all of a sudden in 2008 when compared with that in 2007.

For those who have high medical bills due to serious illness, they may find themselves in the similar situations as those who have lost their jobs or have pay cuts. Medically related bankruptcies have been rising steadily for decades. In 1981, only 8 percent of families filing for bankruptcy cited a serious medical problem as the reason while a 2001 study of bankruptcies in five states by the same researchers found that illness or medical bills contributed to 50 percent of all personal bankruptcy filings (Arnst, 2009). In a study of 931 American families in 2001, 50 percent cited medical causes for filing for bankruptcy (Himmelstein, Warren, Thorne, and Woolhandler, 2005). Among those whose illnesses led to bankruptcy, out-of-pocket costs averaged \$11,854 since the start of illness. About 76 percent had insurance at the onset of illness, and medical debtors were 42 percent more likely than other debtors to experience lapses in coverage. Even middle-class insured families often fall prey to financial catastrophe when getting serious ill. In a similar study conducted by Harvard researchers funded by the Robert Wood Johnson Foundation, 62 percent of all bankruptcies in the U.S. in 2007 were caused by health problems and seventy-eight percent of those filers had insurance (Arnst, 2009). More than 90 percent of medically related bankruptcies were caused by high medical bills directly or

medical costs that were so high the family was forced to mortgage their home. The remaining 8 percent went bankrupt because a medical problem caused them to lose income. A 2007 study also found that, of low- and middle-income households with credit-card debt, 29 percent used their plastic to pay off medical expenses. When consumers resort to the alternative financial sector for short-term loans to finance their medical bills, it may potentially turn into a long-term ordeal if they cannot pay back the money they owe. Using short-term financing for long-term purposes will definitely drag those consumers into deeper debt when they find it difficult to pay back loans in time. When circumstances like that do occur, consumers may be obliged to seek personal bankruptcy to bail out the heavy debt incurred as a result of the high interest rates and high processing fees associated with the alternative financial products.

Finally, it is worth noticing that heavy debt due to excessive consumption accounts for the majority of bankruptcy filings in the U.S. In a research study on personal bankruptcy in Delaware during 2003, Zhu (2008) concludes that excessive consumption accounts for more than half of the bankruptcy filings in the U.S. According to him, over-consumption makes households financially over-stretched and more susceptible to adverse events, which reconcile the strategic filing and adverse event explanation.

Excessive debt from the alternative financial sector, like credit card debt, can be a main contributor to a new rise in personal bankruptcy. The rapid credit expansion by financial institutions on the Wall Street since mid-1990s has made each U.S. citizen share an average of \$38,061 as of 2009 (Hall, 2009) and \$668,621 per U.S. household (Indiviglio, 2009). Not surprisingly, as concluded in many previous researches, revolving debt, such as credit card debt, accounts for the majority of bankruptcy filings in the U.S. (White, 2007; Zhu, 2008). Riskier credit-borrowing behaviors also translate into difficulty in acquiring loans from mainstream providers. With more and more mainstream banking system cutting back credit limit through higher requirements for credit application, more and more consumers find themselves being prevented from accessing low-cost, low-interest loans for short-term or long-term financing purposes. With credit card companies and banks tightening their belts, many more consumers will turn to these short-term lenders when they desperately in need of financial services and many of them may become stuck in a cycle of debt that is incredibly difficult to escape. Alternative financial services, such as payday loans, rent-to-own, refund anticipation loans, car title loans, pawnshops, and many others are most likely their top choices when they are in need of temporary financial relief. However, dealing with alternative financial sector (AFS) typically involve high risks of financial perils, characterized by short-term, high-interest rates, which may potentially ruin borrowers' financial stability and force them into bankruptcy if those borrowers do not know how to manage their spending. Those loans bear not only very high interest rates but also very stringent time requirements for repayment schedules. According to the data by Colorado's state's attorney general, for example, the median interest rate on small loans is over 318 percent. This will mean that the average person pays \$800 in interest and principal for a \$300 loan (Boothby, 2009). With high interest paid and potential failure in meeting repayment schedules, borrowers can sink into a financial dark hole that they find it difficult to bail out. A careful examination of that alternative financial sector reveals that the risks are extremely high for some borrowers when compared with borrowing equal amount of credits in the mainstream banks. There is a need to examine how those major financial services of the alternative financial

sector and their associated risks in order to get a clear picture of how those services can potential make more people file for bankruptcy under the current economic crisis.

Payday Loans

Payday loans are small loans consumers can use when they are temporarily out of money. Most often, payday loans are short-term loans (two weeks or so) for a modest amount of money (a few hundred dollars). They are made by payday loan stores, check cashers, and pawnshops. Loans are also marketed via toll-free telephone numbers and over the Internet. Individuals use payday loans to pay for necessities, and payday borrowers generally have few assets and saving, seek loans at a higher rate, and face higher rates of loan denials. They often use payday loans multiple times—with a median between five to six loans (Elliehausen and Lawrence, 2001). At the end of 2006, the Center for Responsible Lending (CRL) reported about 25,000 payday loan outlets in the United States and annual volume of at least \$28 billion, with almost \$5 billion in loan fees paid by consumers. The Industry estimate a 2008 online payday loan volume at \$7.1 billion.

Despite the high cost, customers choose payday lenders over other possible sources of credit because they recently have been turned down by other, low-priced alternatives, and are confident that they will be approved for payday loan. Serving as a “lender of last resort” and filling a critical need, payday lenders can charge high fees to a segment of the population that is in some ways disconnected from the financial mainstream. Borrowers of payday loans are credit-constrained and find it difficult to save regularly. After obtaining a payday loan, many borrowers fall into a debt trap (often paying fees to postpone or “rollover” payments) or borrowing from one payday lender to pay back another. According to the Center for Responsible Lending (CLR) report in 2003, 99 percent of payday loans go to repeated borrowers, the average payday borrower is flipped eight times by a single lender, 91 percent of all payday loans are given to people with five or more payday loans per year, and the average payday loan borrower gets between 8 and 13 payday loans per year. Finally, about five million Americans fall into such traps each year (Skiba, 2009).

Although consumer credit (even with relatively high-interest rates) from alternative financial sector can facilitate consumption by helping customers cope with short-term shocks that arise between paychecks, typical alternative financial services, such as payday loans, can play a role in the rise of personal bankruptcy filings. In fact, there have been hot debates over whether payday loans leads to personal bankruptcy. One such study was conducted by Dr. Stoianovici and Professor Maloney (2008), who found no direct correlation between payday loans and the increase of personal bankruptcy filings based on state level data between 1990 and 2006. However, another study by Skiba and Tobacman (2008) came up with a totally different conclusion: payday loan approvals for first-time applicants increase the two-year Chapter 13 bankruptcy filing rate by 2.48 percentage points. They found a clear correlation between payday loans and bankruptcy and that the cumulative interest burden from payday and pawn loans amounts to roughly 10 percent of the total liquid debt interest burden at the time of bankruptcy filing. Approved first-time payday loan applicants experience a 90 percent increase in bankruptcy filing rates, according to the study. People who take out payday loans are 7 times

more likely to file for bankruptcy than those who don't. Yet each year 10 million American families take out payday loans often at a 450 percent yearly interest rate (Orville, 2008).

Overall, individuals seeking and using other types of credit are also likely to use payday loans (Barr, 2006). Financial difficulties are common among payday loan users, and hardships appear well correlated with choosing to use payday loans. Payday borrowers may have a greater need for borrowing than non-users as they do so for myriad reasons, including greater hardships, poorer financial planning ability, uncontrollable spending habits, or less access to more mainstream and less costly source of credit. In fact, numerous studies have shown that people who use payday loans are twice as likely to declare bankruptcy when compared with those who don't—those loans can tip the balance for people who are already financially distressed. The main pitfall with payday loans is that they don't help debtors solve the problem at hand. If they are experiencing financial difficulties, payday loans can only make the problem worse. Borrowers are paying a really high rate of interest which means that their expenses and debt are just going up. As a long-term strategy, payday loans will pull them under as payday borrowers have a history of credit problems which make it difficult for payday borrowers to acquire short-term credit elsewhere. Also, the higher rate of credit problems among payday borrowers also suggests that this group exhibits riskier borrowing behavior (Barr, 2006). Finally, payday loans also bear other serious consequences if borrowers do not handle them properly. Failure to repay leads to a bounced check fees from the lender and the consumer's bank. Returned checks cause negative credit ratings on specialized databases and credit reports. Borrowers can lose their bank accounts or have difficulty opening new bank accounts if they develop a record of "bouncing" checks used to get payday loans. Other previous research studies indicate that payday loan users are almost twice as likely to file for bankruptcy as borrowers who are turned down for a payday loan. When more and more consumers resort to payday loans for temporary financial reliefs, it won't be surprising to see more and more of them file for bankruptcy in courts.

Refund Anticipation Loans

Refund Anticipation loans (RAL) are loans that consumers get based on their expected tax refund. When consumers file their taxes, the tax preparer might offer to give them immediate refund money which most taxpayers may have their refund in two weeks or less even without the costly loan. Used mostly by low and moderate income consumers, RALs are extremely high-cost bank loans secured by the taxpayer's expected refund – loans that typically last 7-14 days until the actual IRS refund repays the loan. Aggressively marketed by income-tax preparation companies that advertise "instant refunds" or "quick cash" for their cash-strapped customers who need money in a hurry, RALs are disguised advance loans on anticipated tax refunds.

The refund anticipation loan borrowers have grown dramatically—to an estimated 12 million households nationwide. This growth is occurring despite the fact that the advantage of these short-term loans is highly questionable, especially since the IRS has significantly expedited its turnaround time for sending out people's tax refunds. The risk involved in the RALs is not difficult to see. According to the NCLC/CFA 2009 Refund Anticipation Loan Report (Wu, 2009), RAL volume remained high and steady from 2006 to 2007. Tax preparers and their bank partners made approximately \$8.7 million RALs during the 2007 tax-filing season compared to \$9 million in 2006, and a high of 12.4 million in 2004. Consumers paid an estimated \$833

million in RAL fees in 2007 to get quick cash for their refunds--borrowing their own money at extremely high interest rates. Consumers paid another estimated \$68 million in “application”, “administrative”, “e-filing”, “service bureau”, “transition”, or “processing” fees. For example, the APRs for RALs can still range in the triple digits, and the effective APR for RALs based on 10-day loan period ranges from about 50 percent for a loan of \$10,000 to nearly 500 percent for a loan of \$300. Pay stub RALs, loans that are made prior to the beginning of the tax filing season and repaid by the tax refund or RAL during tax season, are very risky for borrowers (Wu, 2009) as they may also increase the cost of tax-related loans for some borrowers and require them to return the same preparer for tax preparation.

Risks associated with consumers’ using RALs are typically very high as they continue to represent a huge drain on the tax refund of almost 9 million consumers with hundreds of millions of dollars from the pockets of consumers and the U.S. Treasury. They target the working poor, and especially those who receive the Earned Income Tax Credit (EITC)—a refundable credit provided through the tax system and intended to boost low-wage workers out of poverty. According to IRS data, 85 percent of taxpayers who applied for a RAL had adjusted gross income of \$38,348 or less. Industry data similarly shows that most RAL borrowers are low to moderate income taxpayers. A 2005 survey by CFA also found that the majority of RAL borrowers (58.7%) earned below \$40,000. Many consumers may be pushed to the edge of filing bankruptcies if they ignore some of the important facts associated with borrowing RALs. For example, a RAL must be repaid if the taxpayer’s refund is denied, is smaller than expected, or is frozen. If the taxpayer cannot pay back the RAL, the lender may send the account to a debt collector. In some cases, the unpaid RAL will show up as a black market on the taxpayer’s credit record. Another example is the significant risk if the IRS denies or reduces a taxpayer’s refund, leaving consumers with unpaid RAL debt. If taxpayers with unpaid RAL debt apply for a RAL or subsequent year’s refund, they will get seized to repay the prior unpaid RAL debt. It is not difficult to see how dangerous if consumers are not well-informed of the high risks associated with borrowing RALs when they file for tax returns with some brand name tax preparers, such as H&R Block, Johnson Hewitt, HSBC, and JPMorgan Chase. It appears that RALs continues to flourish in 2008 and into 2009, and consumers can easily be victims of those predatory lending and be forced into bankruptcy when they have no other choices.

Rent-to-Own Survey (RTO)

The rent-to-own industry (also known as the rental-purchase industry) consists of dealers that rent furniture, appliances, home electronics, and jewelry to consumers. Rent-to-own transactions provide immediate access to household goods for a relatively low weekly or monthly payment, typically without any down payment or credit check. Consumers enter into a self-renewing weekly or monthly lease for the rented merchandise, and are under no obligation to continue payments beyond the current weekly or monthly period. The lease provides the option to purchase the goods, either by continuing to pay rent for a specified period of time, usually 12 to 24 months, or by early payment of some specified proportion of the remaining lease payments.

Terms for rent-to-own customers are attractive to many who cannot afford a cash purchase, may be unable to qualify for credit, and are unwilling or unable to wait until they can save for a purchase. Some consumers also may value the flexibility offered by the transaction which allow

return of the merchandise at any time without obligation for further payments or negative impact on the consumer credit rating. Other consumers may rent merchandise to fill a temporary need or to try a product before buying it. The rent-to-own industry trade association estimated there were 7,500 rent-to-own stores in the United States that in 1998, serving nearly three million customers, and producing \$4.4 billion in revenues. The U.S. rent-to-own (RTO) business has grown from a fledgling industry 25 years ago to a \$4 billion industry serving 2.8 million customers in 1996. Some 7,500 RTO stores offer appliances, furniture, computers, and other goods for “rent”, with an option to own, or purchase. Consumers make weekly or monthly payments that typically require 18 months to complete and acquire ownership.

Although there is little evidence the relationship between personal bankruptcy filings and consumers’ borrowing from rent-to-own stores, a recent survey conducted by the PIRGs among 124 rent-to-own stores (RTO) in 17 states and D.C. in spring 1997 shows that consumers using rent-to-own business typically pay much higher price when they select to purchase products or services they have signed with the rent-to-own stores. For example, RTO stores typically charge an average effective APR of 100 percent and RTO stores charge effect APRs ranging from 16 percent to 275 percent for television and refrigerators. About 48 percent of the RTO stores surveyed charged effective APRs of over 100 percent on one or more items (which is five times as prevailing credit card rates). Finally, purchasing items via rent-to-own at RTO stores costs 2-5 times as much as purchasing the same items at department and discount stores. The high cost of interest only increase consumers’ debt levels and potentially make their already over-stretched financial condition even worse.

Car Title Loans

Car title loans, or the so-called short-term emergency loans against borrowers’ automobiles, are also part of the alternative financial services that may potentially drive borrowers into bankruptcy proceedings. When consumers get a car title loan, they pledge their auto as collateral in order to get cash. Car title loans are expensive and risky as borrowers may lose their cars and subsequently make them lose their ability to get to work and earn income. Time constraint is another challenging task for most borrowers as they will have to repay the car title loan within 30 days—they can lose their vehicles if they don’t repay as agreed. Last, but not least, very high interest rates are one of the biggest drawbacks to car title loans. Much like payday loans, they can end up paying extremely high rates for car title loans.

One of the biggest issues with car title loans are their high interest rates. Although car title loans are in a different category than credit card companies or banks which allow them to work around usury laws, this does not prevent them from ripping people off using very strict terms on those loans to charge triple digit annual percentage rates (APRs) on borrowers. The interest rate is usury as it is usually the maximum allowed by law. Car title loans are often renewable and depending how they are set up, so like payday loans they can go on as long as you continue to pay. Just like payday loans and pawn shops, borrowers can sometimes become very dependent on car title loans once they start the process, and they oftentimes end up taking one loan after another. When they encounter financial difficulty or set back and desperately need money they turn to whatever is quickest and easiest. Eventually, they come to a point where what started out as a simple \$250.00 short term loan on their cars has turned into a debt of \$1,000.00 or more in a

very short period of time and they still don't have their title back. Ultimately, they are unable to pay the money back, and all too often these people will end up losing their vehicle. When they can't repay the debt, their vehicle gets repossessed and their financial world quickly comes crashing down. It's not uncommon to end up paying \$5000.00 for your \$1500.00 vehicle. With such high risk involved in getting car title loans, the chances of those low-income consumers entering bankruptcy court may be the rise.

Another characteristic of car title loans are a number of fees that add up quickly, including processing fees, document fees, late fees, origination fees, and lien fees. Some lenders have even gone so far as to make the roadside assistance mandatory. In addition to the high interest rates and mountains of fees, car title loans lenders also give borrowers the option of interest-only payments for a set period of time. In these cases, the loans are usually set up for a longer period of time and the borrower can pay the interest only on the loan which the borrowers pays the interest of the loan each month and at the end of the term they still owe the full amount of the loan.

Finally, car title loan lenders target low-income borrowers who are not able to pay back their loans in the 30-day period. When this happens, it is referred to "rolling over" the loan whose terms are crafted to keep borrowers in a cycle of debt and bring customers either to the verge of repossession or to actually repossession. Not being able to pay off the initial loan and then renewing it the next month cost borrowers more money in interest, on top of the original amount they've already borrowed. In a report by CFA on the people they interviewed in 2004 study, 75 percent had to give the title loan lenders a copy of their car keys. The concerns of having their cars repossessed are obvious: if the cars are taken away, so goes the money they are worth. If consumers cannot pay back the loan, car title loan lenders may be able to sell your car and keep 100 percent of the profit. Some lenders even take the consumers to court for money and tack on court costs and finance charges on top of the existing loan amount.

Car title loans have been lumped into the "predatory lending" category by many consumers, and non-profit organizations as Consumer Federation of America (CFA) and the Center for Responsible Lending have issued detailed reports outlining some of the title loan issues that the public should leery about. More studies are definitely needed in car title loans in order to find out if they do play a role in bankruptcy filings in the U.S.

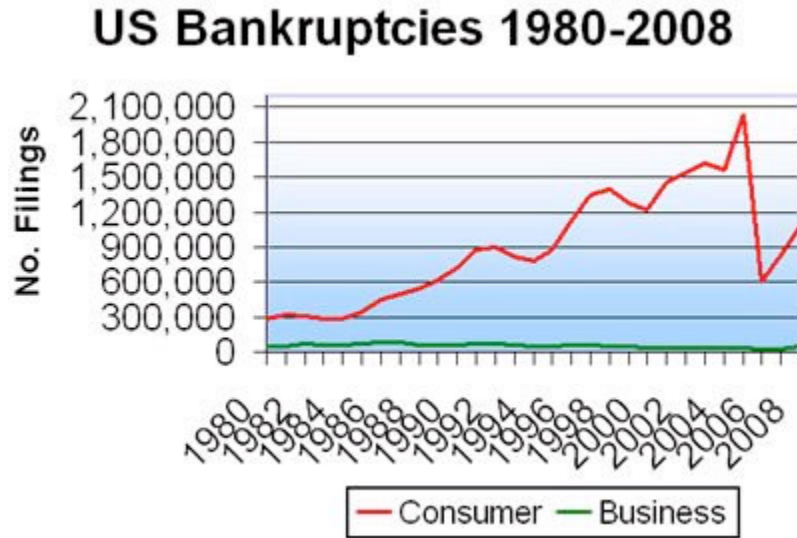
Conclusion

Tightening credit standards by mainstream banking system as a result of the economic recession in the U.S. to prevent risks in lending will definitely bring along with it negative impact on consumers' ability to borrow and to manage their debt. High debt levels among U.S. households associated with excessive consumptions are the fundamental cause of high personal bankruptcy rate in the country. When many lower- to moderate-income consumers, banked or unbanked, are cut off the relatively low credits from mainstream banking system, they tend to turn to other financial sectors to finance their daily needs for credits. Unfortunately, most of the financial services provided by the alternative financial sector, such as payday loans, tax refund anticipation loans, rent-to-own store, and car title loans, are predatory lenders who typically charge high interest rates in addition to other fees. Additionally, most of those loans come along

with stringent clause or terms that are crafted to maximize lenders' profit while leaving the consumers facing increased debt due to outrageous high interest rate charges. For many consumers who are not familiar with the alternative financial sector, this could mean their final chance of survival before turning to court for personal bankruptcy filings.

Tables, Charts, and Diagrams

Chart # 1:



Source: BankruptcyAction.com

Chart # 2:

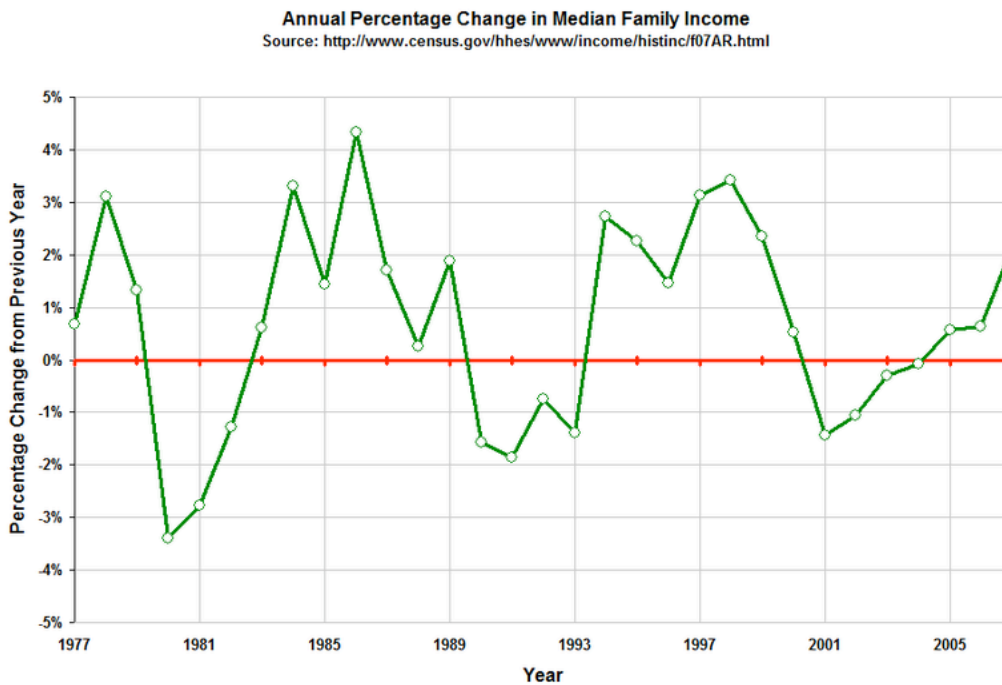


Chart # 3:

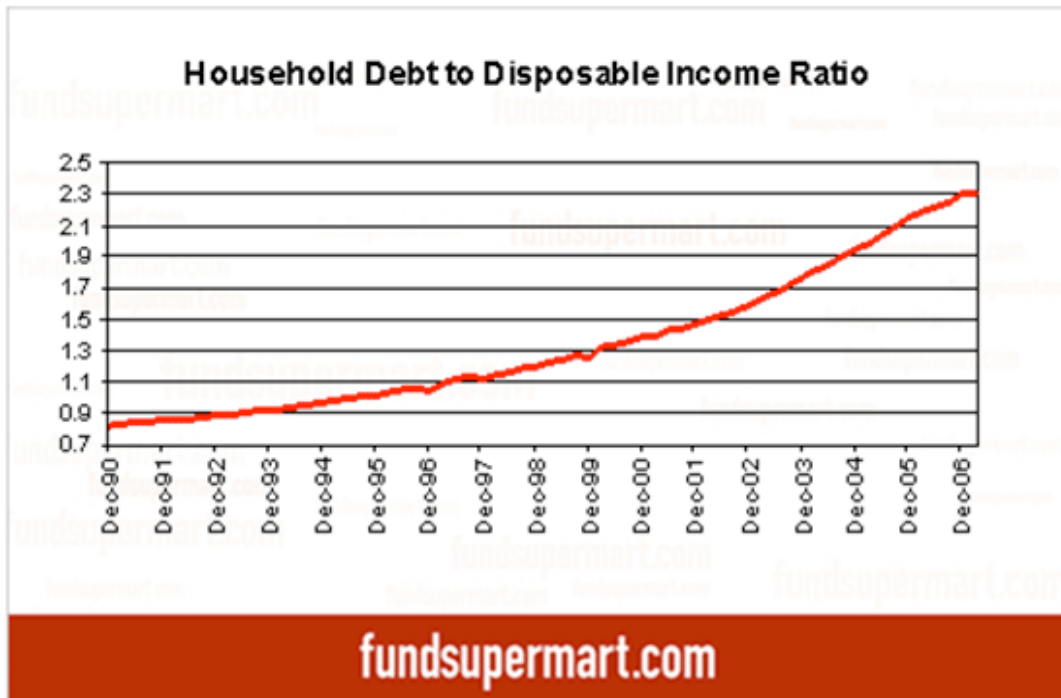


Chart # 4:

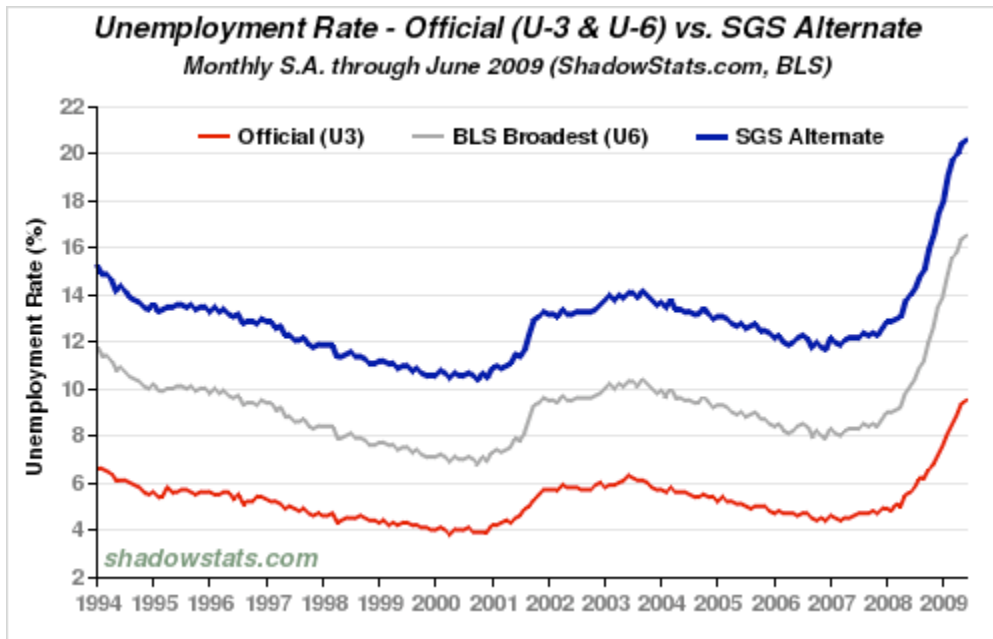
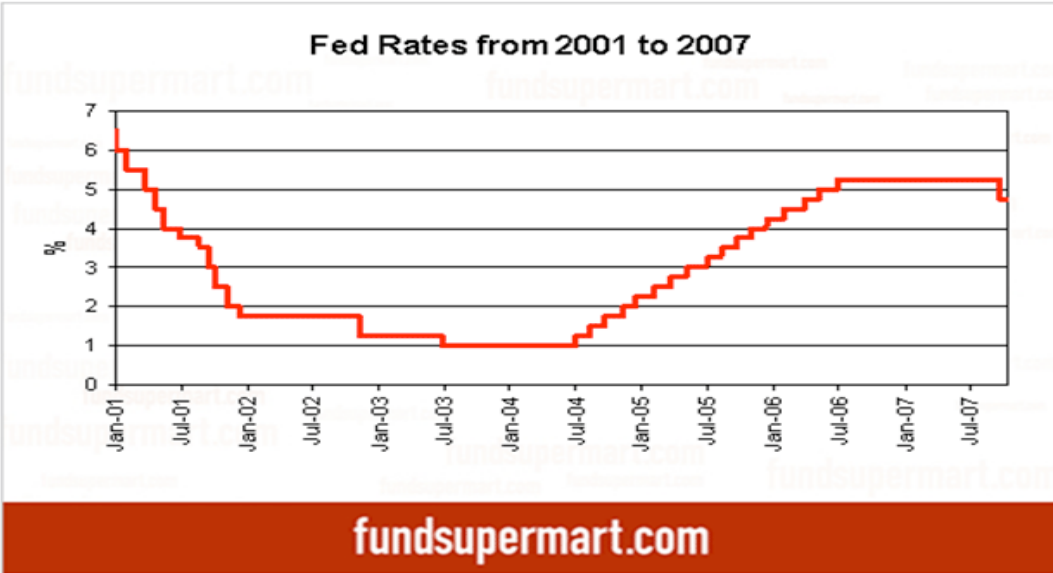


Chart # 5:



Source: US Federal Reserve

Chart # 6:

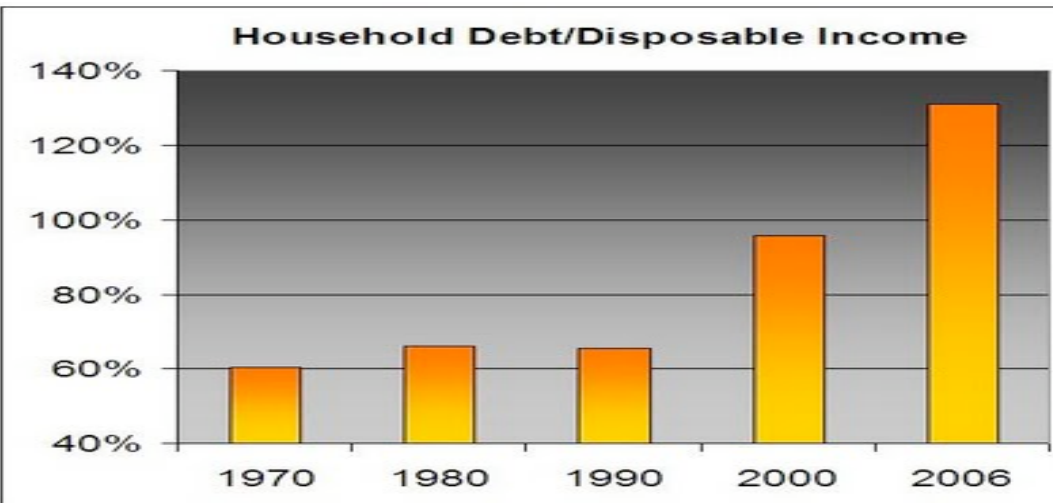
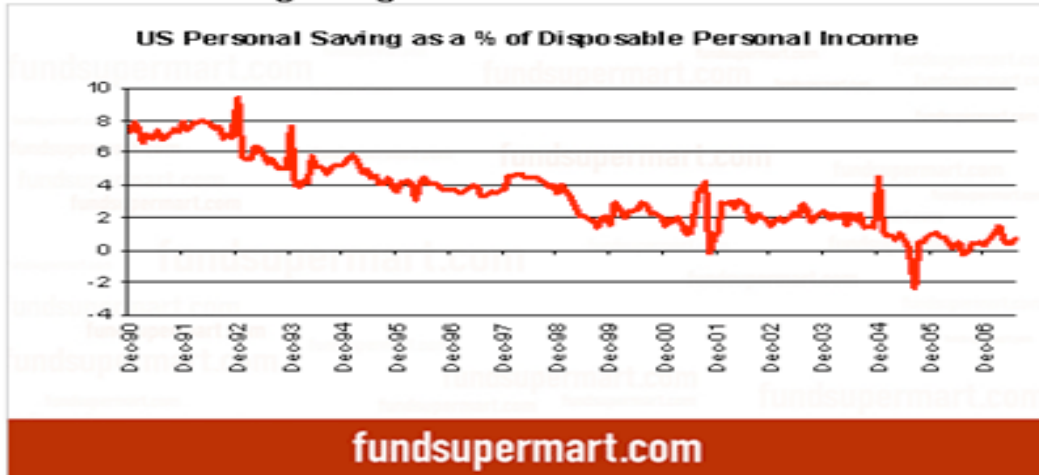


Chart 3: Decreasing Savings In the US



Source: Bureau of Economic Analysis, US

Chart 4: Rising Debt Levels In The US



Source: US Federal Reserve

Tables

Table # 1: Credit standards on mortgage that banks categorize as prime residential mortgages

	All Respondents		Large Banks		Other Banks	
	Banks	Percent	Banks	Percent	Banks	Percent
Tightened considerably	3	6.1	2	7.4	1	4.5
Tightened somewhat	21	42.9	12	44.4	9	40.9
Remained basically unchanged	25	51	13	48.1	12	54.5
Eased somewhat	0	0	0	0	0	0
Eased considerably	0	0	0	0	0	0
Total	49	100	27	100	22	100

Table # 2: Bank's approving applications for credit cards from individuals or households

	All Respondents		Large Banks		Other Banks	
	Banks	Percent	Banks	Percent	Banks	Percent
Tightened considerably	2	6.5	2	10.5	0	0
Tightened somewhat	16	51.6	11	57.9	5	41.7
Remained basically unchanged	13	41.9	6	31.6	7	58.3
Eased somewhat	0	0	0	0	0	0
Eased considerably	0	0	0	0	0	0
Total	31	100	19	100	12	100

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