A Loan at Any Cost: Obtaining High-Interest Loans and the Roles of Financial Literacy, Financial Hardship; and the Dilemma of Minority Racial/Ethnic Groups

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Objective

Given the recent economic shock brought about during the period of the COVID-19 pandemic, the importance of financial preparedness and financial resiliency among households has again taken the center stage in discussions surrounding the importance of the development of financial capability of households for their financial well-being over time (Anand et al., 2020; Lusardi et al., 2021; Vieira et al., 2021). Garner et al. (2020) found in their study, using data from the U.S. Household Pulse Survey, that during the COVID-19 pandemic younger individuals were more likely to have experienced greater hardship in meeting their expense needs. Thisfinding is also corroborated by another report from Dickler (2020). Similarly, other studies have found that minority racial/ethnic groups were more likely to have experienced financial and material hardship during the pandemic (Fang et al., 2022; Morales et al., 2021). Past research has also shown that during periods of economic uncertainty, the utilization of payday loans and other types of high-interest consumer loans increase during periods of economic crises and uncertainty (Dunn &Mirzaie, 2016).Therefore, it is possible that given the period of economic uncertainty, people facing financial hardship would be more likely to participate in high-interest borrowing than others during the covid-19 pandemic. There is, however, a paucity of emergingliterature examining the association between experiencing financial hardship during the COVID-19 pandemic and utilization of high interest loans. Additionally, very few studies have so far examined the factors associated with younger adults' and minority racial/ethnic groups' borrowing behavior during the period of the COVID-19 pandemic. This study aims to fill this gap in the literature by examining the factors associated with participation in high interest loans such as payday loans, car title loans, and pawn shops. We hypothesize the following:

H01: Individuals experiencing financial hardship are more likely to access high interest loans after controlling for financial literacy, risk tolerance, and other socioeconomic and demographically related factors.

H02: Young adults experiencing financial hardship are more likely to access high interest loans after controlling for financial literacy, risk tolerance, and other socioeconomic and demographically related factors.

H03: Individuals from minority racial/ethnic groups experiencing are more likely to access high interest loans after controlling for financial literacy, risk tolerance, and other socioeconomic and demographically related factors.

H04: Using high interest loans is negatively associated with financial satisfaction after controlling for financial hardship, financial literacy, risk tolerance, and other socioeconomic and demographic factors.

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We expect the findings of this paper will inform consumer policy research and is consistent with ACCI's mission of researching issues that are useful for researchers, educators, consumer policy specialists, and related professionals dedicated to enhancing consumer well-being.

Significance

This study's conceptual framework applies the credit utilization model developed by Elliehausen et al. (2007). According to the seminal studies on demand for consumer loans (Hirschleifer, 1958; Fisher, 1930), consumers utilize the loans to purchase goods and services that either meet their immediate needs or wants or provide them with periodic benefits over an expected period of time. The more frequently a consumer needs to use the goods and services they purchase with credit, the greater the perceived value they assign to the specific good or service (Dunkelberg & Smiley, 1975). According to Elliehausenet al. (2007), using credit to purchase a good or service is therefore viewed as a rational choice by a consumer, who engages in such borrowing behavior when the present value of the expected future benefits of the purchased good or service is greater than the cost they will incur in paying the principle and interests on the borrowed money.

On the other hand, lenders use credit forecasting models to determine the risk of default when they provide a loan to a prospective borrower. As a result, the lenders often regulate the supply of loans to borrowers based on the borrowers' estimated risk of default by assigning higher interest rates or lower loan amounts to the riskier borrowers. As a result, the consumers agree to the credit terms and access the loan when they either need the loan to supplement their current savings or income or when they have a higher rate of time preference (Meier & Sprenger, 2010). Additionally,when consumers experience greater financial constraints or have a higher rate of time preference, they are expected to be less elastic to higher interest rates. However, financial literacy moderates the rate of time preference among borrowers engaging in credit(Meier & Sprenger, 2010).

The 'alternative' lenders provide loans at very high-interest rates to consumers who are determined to be too risky to lend to by conventional financial institutions because these consumers are either experiencing extreme financial constraint, have very limited income or have a history of defaulting on prior conventional loans they have accessed (Nam et al., 2019). The alternative or predatory lenders often target vulnerable underserved racial-ethnic minorities when marketing their loans and products, and try to exploit the greater financial constraint and lower financial capabilities prevalent among consumers belonging to these communities (Hardin & Towns, 2019).Moreover, the market for high-cost alternative borrowing credit has grown substantially over the past two decades (Nam et al., 2019; King & Parrish, 2007). Although, the alternative lenders provide access to credit for a segment of the population that has been shut out of the traditional lending markets, these lenders often charge exorbitantly high-interest rates on their loans that sometimes amount to over 100% in interest rates and charges made on these loans (Elliehausen et al., 2007).

Financial literacy has been associated with better financial decision-making, greater financial well-being, and greater financial stability in prior literature (Fan & Zhang, 2021; Goyal & Kumar, 2021; Lusardi, 2019). It is therefore expected that consumers who experience financial hardship, have very lower income, or have lower financial capability are more likely to access high interest short-term loans through alternative loans such as payday lenders, auto title loans, or pawnshops. Financial literacy is expected to play a moderating role in the association between experiencing financial hardship and accessing high interest alternative loans.

Recent literature examining the association between experiencing financial hardship during the COVID-19 pandemic and utilization of high interest loans is relatively absent. Additionally, very few studies have so far examined the factors associated with younger adults'and minority racial/ethnic groups'borrowing behavior during the period of the COVID-19 pandemic. The findings of this study will shed light on the factors that were associated with accessing predatory loans during the period of the pandemic and will have implications for policymakers, scholars, and researchers examining the financial well-being of minorities and young adults.

Methods

Dataset

This study will use the 2021 wave of the FINRA National Financial Capability Study (NFCS) dataset. The NFCS dataset is supported by the FINRA Investor Education Foundation (FINRA.org, n.a.). The NFCS data oversamples economically marginalized minority groups and individuals with lower income and educational attainment. The dataset provides rich information on American's borrowing behavior, financial capability, income, education, and various other socioeconomic and demographic characteristics important for the empirical analyses of this study. Additionally, the 2021 wave also includes information on households' Covid-19 experience that will be included in our empirical model.

Dependent Variables

Alternative Loans

The respondents are asked whether they have used the following types of loans in the past year: "payday loan", "auto title loan", or a "pawnshop" to meet their borrowing needs. All three dependent variables were binary and were coded as '1' if an a specific loan was utilized and as '0' if otherwise. A new variable was constructed with obtained Predatory loan coded as '1' if the respondent obtained atleast one of the above types of loans and was coded as '0' if they obtained no high interest loans.

Financial Satisfaction

"Overall, thinking of your assets, debts, and savings, how satisfied are you with your current personal financial condition?"

Where, 1= "Not at all satisfied"'; 10="Extremely satisfied"

Independent Variables

Objective Financial Literacy

The big-3 financial literacy questions (Lusardi, 2019) are used to measure financial literacy. These were as follows:

1) Suppose you had $100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?

2) Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account?

3) If interest rates rise, what will typically happen to bond prices?

These variables were coded as '1' if the answer was correct, and as '0' if otherwise. The correct answers were totaled up to compute the objective financial literacy score.

Subjective Financial Literacy

The respondents were asked to rate on a scale from 1 to 7, where 1 means very low and 7 means very high, "how would you assess your overall financial knowledge?"

Financial hardship

Spending more than one's income (1=yes; 0=otherwise); difficulty in making payments (1=very difficult; 0=otherwise); and sudden drop in income (1=yes; 0=otherwise). The three responses were summed up to obtain the financial hardship score for each respondent.

Risk tolerance

The responses to this scale also range from 1= "Not at all willing" to 10="Very willing" to take investment risks

Other Factors

Other factors included in this study comprise of age, gender, marital status, race/ethnicity, income, educational attainment, and whether the respondent was laid off during the pandemic, and whether they received stimulus payments.

Analyses

The likelihood of obtaining a high interest loan is estimated using a logistic regression model:

PL=f (YA, OFL, SFL, FH, RTL, OSD)

Where,

PL=Obtaining a predatory loan

YA= Respondents who were 36 or younger

OFK=Objective Financial Knowledge

SFK=Subjective Financial Knowledge

FH=Financial Hardship

RTL=Perceived risk tolerance

OSD=Other socioeconomic and demographic factors.

The second part of the analysis examines the association between financial satisfaction and accessing predatory loans. Given the limited nature of this dependent variable, an ordered logit model was used as follows:

FS=f (PL, YA, OFL, SFL, FH, RTL, OSD)

FS=Financial Satisfaction

PL=Obtaining a predatory loan

YA= Respondents who were 36 or younger

OFK=Objective Financial Knowledge

SFK=Subjective Financial Knowledge

FH=Financial Hardship

RTL=Perceived risk tolerance

OSD=Other socioeconomic and demographic factors.

Both models were run for a) overall sample, b) younger adults only, c) minority racial ethnic groups only, and d) younger adults from minority racial ethnic groups

Results

The results from the regression analyses of this study reveal that financial hardship, being African American,having an income less than $25,000,and having educational attainment of lower than high school were positively associated with obtaining a predatory loan. Although no significant differences were found in the association between being younger adults and utilization of predatory loans, our results indicate that African American and Hispanic younger adults were positively associated with obtaining a predatory loan. Conversely, objective financial literacy, educational attainment, and income were negatively associated with obtaining a predatory loan. Additionally, financial literacy when interacted with financial hardship was negatively associated with obtaining a predatory loan.

The results show no difference between obtaining a predatory loan and financial satisfaction in the overall model and in the younger adults sample. Financial literacy was positively associated with financial satisfaction, as were income and educational attainment across all models. However, obtaining a predatory loan was positively associated with financial satisfaction in the younger adults model with minority respondents, and financial literacy when interacted with obtaining a predatory loan was negatively associated with financial satisfaction in the overall population.

A detailed summary of the significant variables are presented in tables 1 and 2 below.

Table 1: Predatory Loans: Summary of Significant Associations

Predatory Loans				
Variables	Overall	Young Adults	Minorty	Minority Young Adults
Obj. FK	-	-	-	-
Sub. FK			+	
Fin Hrdshp	+	+	+	+
Obj. FK*FinHrdshp	-			
Young Adults				
Black	+	+		
Hispanic		+		
Other				
<High School	+	+	+	+
High School		+	+	+
Income<$25K	+	+		+
Inc 25K to 35K			+	

Table 2: Financial Satisfaction: Summary of Significant Associations

Financial Satisfaction				
Variables	Overall	Young Adults	Minority	Minority Young Adults
Obj. FK	+	+	+	+
Sub. FK	+		+	
Fin Hrdshp	-	-	-	
Predatory Loans			+	+
Young Adults				
Black	+	+		
Hispanic				
Other				
<High School	-	-	-	-
High School	-		-	
Income<$25K	-			+
Inc 25K to 35K	-		-	

Conclusion and Relevance

The findings of this study support the first hypothesis that financial hardship is associated with obtaining predatory loans. The findings also support the third hypothesis that individuals from minority racial-ethnic groups are more likely to obtain predatory loans. Interestingly, the association between obtaining predatory loans and financial satisfaction was not clear from the analyses of this study. While the association was not significant in the overall model, the association was positively associated with financial satisfaction for younger adults belonging to minority racial-ethnic groups. Although more research is needed to understand this association, the significant association between obtaining predatory loans and financial satisfaction in the minority younger adultssample should be of concern from a financial stability and wellness perspective. It is possible that younger adults belonging to minority racial/ethnic groups lack adequate access to conventional banking channels, and hence, obtaining predatory loans maybe the only recourse for them when experiencing severe financial constraints. The silver lining in the findings of this study was the moderating effect of financial literacy on the association between financial hardship and obtaining predatory loans, indicating the continued need for building financial literacy and capability in the population for developing greater financial resiliency among minority and underserved racial ethnic communities. Additionally, as the economy begins its phase of recovery greater focus should be on providing easier access to conventional loans for the minority racial ethnic groups who are likely to benefit most from such loans.

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