Micro Lending: A Case Study

Feraidoon (Fred) Raafat, College of Business Administration, San Diego State University, San Diego, CA 92182, (619) 594-5685, fred.raafat@sdsu.edu
Massoud M. Saghafi, College of Business Administration, San Diego State University, San Diego, CA 92182, (619) 594-6358, msaghafi@mail.sdsu.edu

ABSTRACT

A US based national bank (ABC) was interested to explore opportunities for personal micro lending programs. This paper researches the target groups conducts a competitive analysis, and explores the means of reaching the target market and comparing traditional methods to partner with organizations that may already have relationships with this target group. Additionally, regulatory concerns were reviewed for the microloan market and alternatives to such programs.

INTRODUCTION

Microloans have gained a great deal of attentions especially in emerging markets. Originally conceived as a method of mobility out of poverty, it has grown throughout the world to offer small loans to those unqualified for a traditional loan to build a small business. These loans used primarily for purchasing small equipment or tools rapidly grew in 1970s and 1980s worldwide, many of which were funded by NGOs using subsidies from public and private sources. These organizations demonstrated that the poor could repay loans even without collateral. Thus, microlending became a potentially viable business and today, more than 8000 institutions provide microfinancing with a total portfolio exceeding $16 billion (Perkins, 2008).

Microlending is not limited to emerging economies. There are programs in British Columbia, Canada that target youth 18-29 for low interest loans of up to $5,000 to start a small business (Ward, n.d.). Since the financial crisis of 2008, microlending has taken off in USA typically of less than $50,000 mostly for entrepreneurs who do not qualify for traditional loans (Dewan, 2013). Some 400 banks currently offer microloans in the USA.

A US-based national bank was interested to explore opportunities for such programs and sanctioned a study to research viability of entry into micro lending market in San Diego, California. A team of MBA students and faculty was formed to conduct a market assessment study, identify target markets and recommend brand-building strategies for ABC Company to pursue. In particular, our team was interested in understanding the needs of current and potential microloan customers in San Diego assess the competitive environment and determine an effective method of reaching the target microloan customers.

COMPETITIVE ENVIRONMENT

Credit Cards. According to Bankrate.com ("Current Credit Card Interest Rates," 2014) the current average 3-month APR trends on fixed credit cards are 13.02%. Rates on cards issued for bad credit ranged from 17.9% to 23.9% including monthly fees up to $10. Allowed borrowing limits on these cards start at $200, but may be as high as $10,000. Pew Research finds that "those with family incomes under $30,000 annually are more likely to report using credit cards when they run out of money at the end of a pay period." Reasons for credit card use amongst this group include:

Table 1 Credit Card Use

Reasons For Credit Card Use	**Income Under $30K**
Pay for unexpected expenses	69%
More Convenient	55%
Pay for things when out of money	48%
Finance major purchases	40%
Earn points in rewards programs	22%
Source: Pew Research 2007	Respondents=236

A listing of top expenses for this group is provided in Table 2.

Table 2 Under $30K Expenses

Expense Type	**Income Under $30K**
Medical or dental bills	58%
Clothing	41%
Eating at restaurants	24%
Vacation travel	20%
Entertain friends & family	19%
Home furnishings	21%
Jewelry	8%
Source: Pew Research 2007	Respondents=481

Payday Loan Centers

A payday loan is a 1-4 week loan of less than $1,000 that costs about $10-$30 per $100 borrowed, which is an APR of 360-780%. These types of loans are only made to individuals who provide a proof of income. (Bhutta, 2013). The average payday loan is $375, but the total cost averages $520 with interest and expenses ("Who Borrow, Where They Borrow and Why," n.d.). Many borrowers also renew their loans several times which drives their costs even higher (Skiba & Tobacman, 2014, p. 7). On average a payday loan borrowers will use eight loans lasting 18 days each a year. Only 5-10% of population uses payday loans with low credit scores. Even worse, the probability of delinquency is over twice the general population. (Bhutta, 2013). According to a Pew Charitable Trust survey in 2010, 69% of respondents used payday loans to cover recurring expenses like utilities, credit card bills, rent or mortgage payments, or food. Only 16% used the loan for unexpected expenses like car repairs or emergency medical costs.
The potential market size of the payday loan industry is presented in Table 3.

Table 3 Payday Loan Market Size

Area	Population Size (18 years +)	% Use Payday Loans	Est. No. of Payday Loan Users
United States	316,128.8k	5% - 10%	15,806.4k - 31,612.9k
California	38,332.5k	5% - 10%	1,916.6k - 3,833.3k
San Diego County	3,211.3k	5% - 10%	160.6k - 321.1k

Source: US Census 2013 Estimates

Pawn Shops

Pawnshops offer another alternative for small sized lending. The average loan size at a pawn shop is $80 and collateral in the form of a personal item is required. No proof of income is required and no credit is checked. Average interest on these loans is 20% and if the loan is not paid within the set terms, the collateral item becomes the property of the pawn broker. Loan durations last around 1 month. These terms translate into an APR of approximately 240% (Avery & Samolyk, 2011). According to an FDIC-sponsored Current Population Survey in 2009 56.1% of pawn consumers borrow for basic living expenses (Avery & Samolyk, 2011).

Online Lenders

A new type of lender has sprouted up on the internet within the last few years. Businesses like Loanme.com offer personal, business, and auto loans. The personal loan products offered by these types of companies range from $2,500 to $25,000 and the loan payback period can last from 12 to 120 months. Interest rates range from 20% to 200% dependent upon the credit worthiness of the borrower and the borrowers payback history.

Traditional Lenders

The primary threat to ABC ′s attempt to enter the consumer microloan market is the way lending is regulated in the United States including the interest rate ceiling. J.P. Morgan Chase is the largest bank in the United States and maintains many of the same strengths as ABC Company, including the ability to finance projects involving microloans and community development. In 2008, Chase invested more than $670 million into certified community development financial institutions. (Nuffer, 2014)

Bank of America currently primarily invests in grant programs that provide loans pursuant to SBA. (Hughes, 2010). Citigroup Inc.′s microfinance strategy supports microfinance institutions (MFIs) and community development financial institutions (CDFIs) that seek to increase the availability of credit and asset building financial products and services. In 2013, Citi Foundation invested $10.5 million to MFIs, CDFIs, intermediary organizations and industry networks (″Site Map,″ 2014. Credit Unions are another entrant into the consumer microloan market and as not-for-profit; they can offer same products as banks at lower interest rates. Some credit unions are currently targeting consumers as microloan customers. These loans are aimed to assist consumers with vehicle repairs, home maintenance, education costs and debt consolidation. (″2013 Year-End Impact Report,″ 2014).

METHODOLOGY

Survey

A survey was constructed to determine the attributes of consumers in the microloan market segment in San Diego. The survey instrument was made up of three sections. The first section related to demographics. The second section asked questions related to individuals banking and credit conditions and the third focused on dealing with respondent's prior experience with microloans. The goal was to collect a statistically acceptable sample of roughly 200 respondents who sought or actively seeking microloans. The survey was administered in payday loan centers through intercept method among actual payday customers and was also sent out electronically to residents in areas within the city where the average household income was under $30,000.

Payday Loan Products

Payday Loan Centers compete indirectly with commercial banks like ABC Company in that they are regulated in a different manner than traditional banking institutions. According to the current legislation in the state of California, payday loans from both online and store front lenders are legal under California Civil Code 1789.30 and the Financial Code 23000. These two pieces of law include all of the relevant regulations for payday loans within California. Maximum length of a loan that Payday Loan Centers are allowed to make is 31 days while fee and finance charges are capped at 17.65% and may not exceed 15% per week. ("Payday Lending State Statutes," 2014) A vital competitive advantage of these loans is that the institutions providing them are allowed to charge an APR of up to 459% on a 14-day $100 loan. The Payday Loan Center service companies in San Diego County that were assessed along with key findings are in Table 4.

Table 4 San Diego Payday Lender Comparison

Company	Products	Amount Provided	14-day APR% ($100 borrowed)	Duration
Moneytree	California Payday Loans	From $50 to $255	460.16%	31 days
Money Hut	No longer available	-	-	-
The Check Cashing Place	Payday Loans	From $50 to $250	460.16%	30 days
Check Center	Payday Loans	From $50 to $255	460.08%	30 days
Checkmate Check Cashing & Payday Loans	Payday Loans	From $50 to $255	460.16%	30 days
Dollar$mart Money Center	Payday Loans	From $50 to $255	460.16%	31 days
Advance America Cash Advance	Loans	From $100 to $255	456.25%	A Month
Check Into Cash	Payday Loans	From $50 to $255	460.16%	30 days

Local Microlending Institutions

Several institutions in San Diego that already service clients with microlending programs: International Rescue Committee, La Maestra and its subsidiary, Generations.

The International Rescue Committee ("IRC") is a national non-profit that responds to the worst humanitarian crises and helps those impacted not only survive, but also rebuild their lives ("Rescue.org/IRC- Our Impact," 2014) IRC offers a wide variety of microfinance programs in areas such as credit building loans, immigration/refugee resettlement loans, career development loans, auto loans and small business loans. The organization manages approximately 250 active loans per month. Its funding comes from private organizations, commercial banks in the form of grants /as well as internal funding.

La Maestra is also a non-profit health center serving the culturally diverse and lowest income communities. A subsection of La Maestra is Generations aiming to improve the well being of culturally diverse individuals in San Diego and offers a microcredit program to help its members to become self-sufficient. The program began in 2008 and at its peak; had over 200 active loans. La Maestra also focuses on consumer education pre-loan training courses, and basic financial education. The program primary focuses on small business loans of less than $1,000 with a flat interest rate 10%, paid off in 25 weekly installments. The program coordinator has expressed interest in partnering up with a bank for purely consumer microloans.

FINDINGS

Survey Analysis

The survey yielded 174 responses; 51 responses from non-profit organizations' customers and 123 responses from intercept surveys at payday loan centers. Figure 1 features proportions of respondents by ethnicity, sex and annual household income level. Of those who answered the question about loan size, respondents in lower income brackets demand smaller value loans than those who responded in the larger income brackets (Figure 2). Larger proportions of respondents in the lower income groups tend to borrow loans with short payback periods (Figure 3).

Borrowing activity declines as income level declines among the respondent group (Figure 4)

Credit card use also declines when income levels decline among the respondent group (Figure 5).

Top sources of debt from the lower income level survey respondents include the following as depicted in Figure 6.

(These graphs are available upon request)

SUMMARY AND CONCLUSION

A microlending program targeted to those who use credit cards, but earn $30,000 or less per year and those who use payday loan centers may help these groups gain affordable access to capital when in need. The research provided paints a profile picture of the users of alternative lending sources across the San Diego County. Our research suggests that in the United States, use of credit cards among households that earn $30,000 or less per year and the use payday loans may lead to problems with debt.

If ABC Company would like to enter the microloan market in San Diego, then the bank should partner with an organization such as the ones highlighted in this paper. These organizations already have the infrastructure in place to reach the target market of lower income individuals. Each of these organizations have also developed or are currently developing personal microlending programs and have learned from past mistakes. A partnership could allow ABC Company to gain rapport with the clientele of each organization which then could lead to potential future clients who could benefit from ABC Company's portfolio of banking and lending services.

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REFERENCES

Available upon request