Innovations for Poverty Action

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Timeline
2014-2015

Study Status
Results

Study Type
Other

Sample Size
1,531 credit union members interested in receiving a credit-building loan

Research Implemented by IPA
Yes

The Impact of a Credit-Building Loan Product on Credit Scores and the Credit Market in the United States

Abstract

Credit-building loan products (CBLs) have begun to proliferate in the U.S. marketplace, but there is little evidence on the effects of these products on consumers and lenders. Researchers evaluate the impacts of a CBL offered at a credit union in Missouri, both alone and coupled with financial education. Researchers also evaluated whether CBL take-up revealed information about a consumer's future credit score. On average, CBLs did not affect the likelihood of having a credit score, and they had precisely no impact on credit scores among consumers who had credit scores at the start of the intervention. However, the CBLs' impact varied by consumer—consumers without prior loans experienced credit score improvements, while those with loans experienced declines. At the market level, CBLs attracted consumers who were improving their financial capability, suggesting that lenders could use CBLs to identify consumers whose creditworthiness is about to start improving.

Policy Issue

Policymakers, financial institutions, and consumer advocates are increasingly pointing to the importance of having a credit history as an asset. Consumers with nonexistent or poor credit scores typically face limited access to credit and high prices for loans. Yet building credit is a duality: credit is needed to build a credit history, but it is hard to get access to credit without a credit history. In response to this challenge, many financial institutions have begun to offer credit-building loans (CBLs). These loans invert the typical sequence of payment for a loan, in which the lender sets aside the funds in an escrow account and gradually disburses the loan as the borrower makes their contracted payments.

Despite increased marketing and usage of CBLs, there is little evidence on how much these products boost credit scores and for whom. Moreover, there are questions around the long-term effects of CBLs: if consumers improve their credit scores through a CBL, are they then equipped to use credit to their benefit? Are clients who voluntarily choose a CBL better equipped to use credit to their benefit, compared to those who don't choose such products? Do these products distort otherwise accurate credit scores?

Context of the Evaluation

Millions of Americans have poor credit scores or little credit history. According to credit bureau Experian, an estimated one-third of Americans had "subprime" credit scores in 2021,[1] particularly affecting low-income individuals. For this evaluation, researchers worked with the St. Louis Community Credit Union (SLCCU), a credit union in the St. Louis area that provides financial education and products (including CBLs) designed to improve the financial stability of its members. Among participants—all of whom indicated interest in improving their credit—nearly 20 percent did not have a credit score when the evaluation began. Those who did have a credit score had an average FICO Score of 560, below the national average of 700 and below the traditional cutoff score of 640 for "prime" borrowers.

Details of the Intervention

Researchers partnered with IPA, RAND Corporation, and the SLCCU to evaluate the impact of SLCCU's CBLs on consumers' credit scores. A total of 1,531 SLCCU members across seven branches who were interested in a CBL were randomly assigned to be offered a CBL immediately or to complete a financial education course prior to opening a CBL.

In addition, researchers evaluated the market-level impact of CBLs, particularly whether CBLs provided lenders with enough information about a consumer's credit worthiness.

The intervention took place between October 2014 and February 2015. To measure outcomes on credit scores and use of financial products, the research team used credit report data from the beginning of the study and after 6, 12, and 18 months; credit union administrative data; and surveys of participants.

Results and Policy Lessons

Results show that, on average, CBLs had no impact on the likelihood a borrower had a credit score. Moreover, CBLs had precisely no impact on improving a borrower's credit score among borrowers who had a credit score at the outset of the intervention. At the market level, CBLs were attractive to borrowers who were increasing their financial capabilities, signaling that CBLs could help lenders identify potential creditworthy borrowers.

Take-up: Approximately 30 percent of those offered an unconditional CBL took up the CBL within 18 months of entering the intervention. Meanwhile, only 12 percent of those who were required to take the course beforehand opened a CBL within 18 months. This suggests that the financial education component acted as a deterrent.

Impact on Credit Scores: On average, CBLs had no impact on the likelihood of a consumer having a credit score and precisely no impact on the credit score itself. However, impacts varied depending on a consumer's borrowing activity. For instance, a consumer with low existing borrowing activity experienced increases in credit scores by 15 points six months after the intervention started and by 13 points twelve months after the intervention started. In contrast, consumers with high borrowing activity did not benefit from the CBLs, experiencing decreases in credit scores by 17 points and 15 points, respectively, in the same period.

Impact on non-CBL Loan Default: CBLs increased non-CBL delinquency among borrowers with the highest installment activity at the outset of the intervention. Researchers found that this is not due to the CBL itself because CBL payments provide less liquidity demands. Furthermore, CBL delinquency only shows up officially within 30 days of nonpayment—after which the SCCLU cures the escrow balance and closes the account—making any effects of opening a CBL on CBL delinquency small to measure. When accounting for CBLs' 40 percent delinquency, however, evidence suggests that their requirements are too much for borrowers to handle along with another, standard loan.

Impact on Market Information: CBL borrowers were 11 percentage points more likely to have a credit score and had credit scores 11 points higher than nonborrowers. Because there was precisely no impact on credit scores, this increase suggests advantageous selection: CBLs attracted borrowers who were already improving their credit and financial capability. Consequently, lenders may be able to use CBLs to identify future increasingly creditworthy borrowers.

Sources

1. Stefan Sombo, "Fewer Subprime Consumers Across U.S. in 2021," Experian, June 7, 2021, https://www.experian.com/blogs/ask-experian/research/subprime-study/

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