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### A Reconsideration of Rent-to-Own

Rent-to-own agreements (RTO) are traditionally seen as disguised installment contracts imposed on uninformed consumers at usurious interest rates. After the flaws and omissions in these interest rate calculations are addressed, the implied annual percentage rates (APRs) remain extraordinarily high. It is shown that alternatives to RTO, such as layaway and long-term rental, yield comparable APRs. The appeal of rent-to-own is then attributed to its structure that includes an initial pure rental phase of high value to persons in volatile financial and/or personal situations followed by an installment phase. Should these situations be resolved, the consumer exercises an imbedded option to acquire a perhaps otherwise unobtainable installment agreement at a competitive interest rate.

# A Summer view of rent-to-own

EFFORTS TO EDUCATE CONSUMERS ABOUT THE PITFALLS OF RTO ARE BOUND TO BE UNSUCCESSFUL BECAUSE THESE AGREEMENTS PROVIDE A NECESSARY ALTERNATIVE IN THE MARKETPLACE FOR THOSE WHO CANNOT OR WISELY FEEL THEY SHOULD NOT, SECURE TRADITIONAL INSTALLMENT OR CREDIT CARD FINANCING.

A RECONSIDERATION OF RENT-TO-OWN  
BY MICHAEL H. ANDERSON AND RAYMOND JACKSON  
THE JOURNAL OF CONSUMER AFFAIRS

The excerpt above is the conclusion of a new article in the consumer academic press that offers new insights into the economics of rental-purchase transactions and dispels much of the previous biased and shoddy research into the economics of the industry.

Academics in the field of consumer studies have, over the years, done cursory studies of rental-purchase transactions and concluded, predictably, that the transactions bore high interest rates and were both unfair to and bad for consumers who used them.

One study often cited by industry critics based all of its findings on interviews with 61 rental-purchase customers from West Palm Beach, FL. Another study examined 12 rental-purchase agreements, seven for 19- and 20-inch televisions and five for washers. Much of the consumer advocate condemnation of industry pricing and policies are based on these two articles and others using similarly scanty research methodologies.

BY ED WINN III

**T**he authors of the most recent study had access to a database of hundreds of rental stores and tens of thousands of agreements and customers, which they examined to understand what really happens with rental-purchase agreements in the marketplace.

The authors take pains to debunk the common myths and assumptions about rental-purchase transactions. After reviewing the research to date, the authors conclude that calling rental-purchase transactions installment sales with hidden, exorbitant interest rates obscures the true nature of the



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The earlier Florida study found that 40 percent of those surveyed did not understand what they were doing when they rented. The Massachusetts authors conclude that the early studies “underestimated consumers’ ability to make efficient utility-maximizing decisions.”

Indeed, it is a fundamental precept in economics that people are capable of acting—and in most cases, do act—to maximize their well being by making rational decisions. Liberal consumerist theory maintains that many—if not most—citizens are incapable of making rational economic decisions; thus the need for the state to step in and make those decisions for them. Not so these latest authors who observed the popularity and growth of the rental-purchase industry and concluded that there must be something going on besides unscrupulous rental dealers “doing business with the desperate and uninformed.”

If it were really the case that the industry charged customers 250 percent interest on transactions when credit card interest rates hover at around 20 percent, then the business would not survive. That the industry has not only survived, but also has prospered means that other elements besides a simplistic analysis of the time value of money must be at work.

The Massachusetts authors use a hypotheti-

cal situation to construct an implicit interest rate for going to the Laundromat that is higher than in a rental-purchase transaction for the same washing machine. The authors note that no one is suggesting that Laundromat patrons are exploited and suggest that rental-purchase customers are not being exploited either.

The authors also compare rental-purchase transactions to layaways in order to lay waste to the installment sale comparison even further. In layaways and in RTO there is typically no credit check and both may be terminated without penalty. The authors find a lower implicit interest rate in a layaway transaction, but the lower rate is offset by higher payments over a shorter period of time. Layaway also offers no delivery, no maintenance beyond warranty coverage and, most importantly, no use of the product until it has been paid for in full.

The authors list six benefits of rental-purchase in addition to the bene-

fit of an installment sale, which is essentially the ability to pay over time instead of all at once. Those benefits are:

- ① Provision of all customary retail services such as delivery, set up, maintenance and repair. [The authors do not acknowledge that the use of loaners and other aspects of rental-purchase maintenance are superior to most retail maintenance plans.]
- ② Immediate product availability without a formal credit check.
- ③ Immediate product availability without a security deposit or a large down payment.
- ④ Payments by cash or check scheduled on a weekly or monthly basis.
- ⑤ Ability to secure insurance against damage or theft on the item.
- ⑥ Termination of the agreement by the consumer at any time without further financial liability or damage to his or her credit history.

These benefits are, of course, well known to rental dealers. It is nonetheless nice to see them recited in the academic press.

Instead of being merely an installment sale with unconscionably high “interest rates,” the authors borrow the economic concepts of “puts” and “calls” from the world of corporate finance to explain how consumers employ rental-purchase transactions in their own best interests.

A *put* is an option to sell something at a fixed price at or within a certain time. If the put is exercised by the holder, the other party, the buyer, must purchase the item from the put holder at the strike price. A *call* is an option to buy something at a fixed price at or within a certain time. If the holder exercises the option, the other party, the seller, must sell the item to the call holder at the strike price.

In the rental-purchase context, the authors find that for each rental payment the customer makes, the dealer is providing a bundle of services and financial instruments:

- ① Use of the product and maintenance service for the rental period.
- ② A put option with a zero strike price.
- ③ An option to acquire a call with a zero strike price when the final payment is made.

If a customer returns the property, it means that he is exercising his put

option and abandoning the third option. Over time, as the transaction progresses, the value of the put option declines while the value of the third option increases.

According to the authors, “unlike conventional put and call options whose value to the investor increases with the volatility in the market price of the underlying asset, the value of the imbedded options to an RTO customer increase with the possible future volatility in her or his financial or personal profile.”

The authors then acknowledge that consumers with uncertain financial or personal futures will be particularly drawn to rental-purchase transactions because the value of the put and call options is higher for them.

The authors also offer an alternative analysis of rental-purchase transactions as first a rental agreement with multiple optional rental periods and finally an installment purchase with competitive interest rates. This is so because most rental-purchase customers who terminate do so fairly early on in the transaction. Once a customer has been renting for 12 months, it is likely that he or she will rent long enough to obtain ownership. The authors offer the example of a washing machine to demonstrate that even during the final installment purchase phase of the transaction, the implicit interest rate is not higher than for a traditional credit sale.

In this model, the original third option to acquire a call transforms into an option to secure an installment purchase at a competitive rate.

The authors identify three separate categories of consumers for whom rental-purchase transactions have high value:

- ① Short-term renters.
- ② Financially tentative buyers.
- ③ Denied buyers.

Short-term renters are, as the name suggests, only interested in the first and second elements of the transaction. They want immediate use of the property without any hassle and they want to be able to return it later. Financially tentative buyers want to purchase the property, but have volatile personal or financial circumstances and do not want to be dunned by debt collectors, have their wages garnished or suffer the other unpleasant results of defaulting on an installment sale in their future. For them, too, the first and second elements of the transaction have high value.

Denied buyers are those who have bad or no credit histories and cannot make an installment purchase, even though that is their goal. For them, all elements of the transaction have value because they can use the multiple period rental phase of the transaction to get to the installment phase.

“This consumer is effectively given the opportunity to establish or restore a record of financial responsibility,” write the authors. If “denied buyers” make timely rental payments, they can become buyers whom the credit market previously has denied. If they fail once again and cannot make timely payments, they are no worse off than they were before they rented and can keep trying.

The Massachusetts authors attempt to

demonstrate with a thorough economic analysis of what the marketplace has recognized all along—that rental-purchase transactions offer a valuable choice to consumers in a variety of circumstances. RTO is not intended to supplant credit sales, but to suggest that it is a harmful choice for consumers to make in all circumstances “may be detrimental to consumer welfare,” as the authors put it.

It is rare that the academic community will take a realistic look at how ordinary people live and analyze carefully and objectively the economic decisions that they make. Here is a piece that does just that and rental dealers everywhere will be gratified to read about themselves and their businesses portrayed in such a positive light. A limited number of copies of the article are available to APRO members through the APRO office. To view online, visit [www.consumerinterests.org/public/articles/details.html?id=16](http://www.consumerinterests.org/public/articles/details.html?id=16).

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## Puts and Calls and Courts

**t**he Massachusetts authors are not the first academics to analyze rental-purchase transactions using *puts* and *calls*.

A Yale law and economics professor was hired as an expert witness and was paid by the plaintiffs in a New York lawsuit brought against a rental company. This professor testified that rental-purchase transactions were not really rental transactions at all. Instead, they are really credit sales with a *put* option granted by the merchant. The professor had the temerity to assert that the rental company was loaning rental customers money for the purpose of purchasing both product and a *put* option. While it is true that the transaction could be structured that way and in some environments likely is (some real estate sales give the buyer the option of *putting* the land back to the seller under certain circumstances), that is not how rental-purchase transactions are structured, since the title to and ownership of the property remains with the dealer as a legal matter. The facts, however, did not deter this expert from reaching the conclusion that the client paid for. The rental company won the case and, among other things, the judge ruled that the testimony of the expert was irrelevant to the specific question before the court.

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