

the
journal
of
consumer
affairs

Winter 2001

volume 35 number 2

MICHAEL H. ANDERSON AND RAYMOND JACKSON

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.

Recent economic studies have portrayed rent-to-own (RTO) agreements as disguised installment contracts detrimental to consumers by their imposition of undisclosed, usurious interest rates (Hill, Ramp, and Silver 1998, Renuart and Keest 1999, Swagler and Wheeler 1989). Correspondingly, RTO agreements are also purported to yield startlingly high rates of return to the dealer-owner even after deducting reasonable business expenses (Walden 1990). It is asserted that firms in the industry are able to prey on the fears of those who have had credit problems and to exploit their customers' short-term time horizon and lack of understanding of the true cost of rent-to-own.

This paper suggests that a straightforward casting of a rent-to-own agreement into the mold of an installment sales contract obscures the actual benefits and costs to the consumer and yields misleading public policy recommendations. In reality, a rent-to-own contract offers consumers a series of valuable services and options unavailable in an installment purchase agreement. Implied interest rate calculations that discredit or simply ignore these services and options distort the nature of rent-to-own agreements while underestimating consumers' ability to make efficient utility maximizing decisions.

Michael H. Anderson is Assistant Professor, Department of Finance, and Raymond Jackson is Professor, Department of Finance, both of University of Massachusetts, Dartmouth.

The authors gratefully acknowledge the contribution of three anonymous referees for their insightful and constructive reading of a previous draft. The views expressed herein remain solely those of the authors.

The first section examines important omissions in the traditional Swagler and Wheeler (1989) consumer analysis and discusses critical theoretical and empirical flaws in Walden's (1990) widely cited economic model of dealer-owner yields. The second section examines market alternatives to rent-to-own and is followed by a section that examines a rent-to-own contract from the perspective of the consumer. The consumer's perspective views the monthly or weekly rental payment as a fee for service, the purchase of a number of options including the option to cancel and, eventually, a payment toward building equity.

TRADITIONAL ANALYSIS OF RENT-TO-OWN

The traditional view of rent-to-own is that RTO contracts are fundamentally installment credit contracts with the desperate or uninformed consumer vulnerable to exploitation. The resulting implied interest rates imposed on the consumer from these calculations are truly excessive. Renuart and Keest (1999) refer to an apparently hypothetical case where the RTO agreement on a television set yields an APR of 254 percent. Swagler and Wheeler (1989) use a sample of five actual RTO contracts on a 19-inch portable color television set with a retail value of \$362 to generate APRs as high as 150 percent for monthly payments and 193 percent for weekly payments. Zikmund-Fisher and Parker (1999) calculate the rent-to-own APR on a 31-inch television at 229.7 percent compared to a credit card rate of 19.8 percent.

In this negative perception of RTO, services provided by the rental agency during the term of the contract are given little weight. For example, Swagler and Wheeler (1988) claim the repair service included in an RTO agreement is of minimal value because most items are new and covered by the manufacturer's warranty. Consumers following this advice on the length of the manufacturer's warranty regarding the portable television set would be misled. An online survey of the warranty period on parts and labor for all brands of midsized televisions currently sold by Sears, Best Buy, and Circuit City is three months while the RTO agreements listed by Swagler and Wheeler (1988) all have a duration of eighteen months. The value of the service agreement implied in RTO exceeds that of the typical manufacturer's warranty and is comparable to the optional service contract offered by traditional retailers for an additional fee at the time of purchase. A consumer who makes an installment purchase would have to choose this optional service contract to have the same expectations for service as an RTO customer.

RTO contracts also include prompt delivery—a high value service to renters lacking ready access to an automobile or those dependent on public transportation. Swagler and Wheeler do not explicitly include delivery in their calculations of the cost of RTO. By adding Sears' standard delivery charge of \$35 and a two-year \$79 service contract to the retail value of the 19-inch color television, the calculated implicit APRs are somewhat lower. Using Swagler and Wheeler's (1988) approximation formula, the APR on monthly payments declines from 150 percent to 104 percent, and the rate on weekly payments falls from 193 percent to 146 percent.

The model developed by Walden (1990) focuses on the implicit rate-of-return earned by an RTO dealer-owner on a specific agreement. His computed APRs for rent-to-own contracts, though generally lower than previously cited, are not strictly comparable because the focus is on dealer-owner revenues, costs, and yields rather than consumer financing. For example, in Walden's (1990) model, required maintenance is the dealer's expense rather than the cost incurred by the consumer. He also includes the administrative expense of collecting and processing payments, a cost relevant to a dealer-owner but irrelevant from a consumer perspective.

Fundamental theoretical and empirical issues, however, make this model and results suspect. From an empirical standpoint, Walden's calculations assume that a television and a washing machine both have an expected life of three years when survey data indicates the useful life of a color television is nine years and a washing machine eight years (Consumer Reports 2000). His estimates of the dealer-owner's depreciation cost per year using straight-line depreciation are, therefore, far above the real cost. It is unlikely that appliances and furniture with useful lives approaching ten years would have zero market value after three—particularly to an ongoing RTO firm with specific expertise in the sale and rental of previously used merchandise.

In addition, Walden's (1990) estimates of the appliance purchase price are likely overestimated because he uses the RTO dealer's offer price to consumers rather than the cost of purchase from a conventional appliance retailer. His choice of consumer purchase prices themselves is puzzling since he is estimating dealer-owner yields. One would expect that the relevant figure is the dealer-owner's acquisition cost of the television or washing machine at wholesale rather than any estimate of the retail cash purchase price.

There are two serious theoretical flaws in Walden's (1990) model. In the complete version that includes the probability of an RTO customer canceling prior to the final payment, Walden assumes a constant proba-

bility for the duration of the contract. This assumption is unrealistic because the probability of cancellation during each of the first few months may be quite high but should logically decline as the consumer's perceived equity increases. For example, the probability that a consumer cancels just prior to the eighteenth payment must be near zero because this final payment entitles the consumer to assume possession of the rented good. The Federal Trade Commission (FTC) found that 50.8 percent of those consumers who cancelled did so within the first three months while the cancellation rate beyond one year of payments was less than 10 percent (FTC 2000). Walden's model should incorporate the probability of customer cancellation as a decreasing function of time rather than as a constant.

The second theoretical flaw in the model is also related to an appropriate modification of the economic variables through time. For each time period, Walden (1990) includes as a dealer-owner cost the depreciation of the rented good and the opportunity cost of the firm's investment. Using the straight-line method, Walden computes a constant depreciation cost per period but then fails to adjust the opportunity cost to reflect the declining value of the owner-dealer's investment. In the eighteenth month of the RTO contract, for example, the firm's investment is only half the original amount due to Walden's use of a three year straight-line depreciation schedule, but the opportunity cost is still based on the value of the good at time zero. It is incorrect for the model to include the annual depreciation of the television or washer as an economic cost in the rental fee and then continue to calculate the firm's opportunity cost on its investment through time as if the appliance were brand new.

By underestimating the useful life of the asset, overestimating the opportunity cost through time, and inflating the original investment by the dealer-owner, Walden (1990) is able to produce lower APRs on RTO contracts than previously reported. Using his complete economic model, the implied interest rates are still high ranging from 32.7 percent to 124.8 percent on televisions and from 88.3 percent to 116.8 percent on washers and would be even higher if the model's theoretical and empirical shortcomings were addressed.

In summary, the traditional treatment of rent-to-own as a disguised installment sale will always generate extraordinary APRs for the consumer and extremely high rates-of-return for the dealer-owner. This holds true even when the value of customary retail services, such as delivery and extended warranties, are considered and even when an economic model systematically overestimates dealer-owner costs. Given the continued and

growing consumer acceptance of the rent-to-own alternative in the market, the key favorable attributes of RTO are not fully captured by an APR derived from a straightforward application of the installment sale model.

THE APR OF MARKET ALTERNATIVES TO RTO

The inability of APR to be a valid measure of the cost of market alternatives to RTO can be demonstrated by applying the same installment sale approach to the consumer's choice of using a coin-operated laundromat rather than purchasing a washing machine. Assume a hypothetical consumer with a large family takes eight loads of wash per week to a laundromat where the fee is \$1.50 per load instead of purchasing and keeping Walden's least expensive machine at \$375. As with RTO, the laundromat provides immediate service with no credit review but requires an outlay of \$12 per week for eight years or 416 weeks—the expected life of the machine. Disregarding the significant value of convenience and treating the periodic payment for laundromat services in the same manner that RTO payments have been treated, as equivalent to an installment purchase, the weekly coin deposit yields an extraordinary APR. Based only on the purchase price and the cash flows per week, the consumer's implied APR for the laundromat is 171.9 percent while Walden's comparable APR for the rent-to-own agreement is 143.8 percent. Though of the same magnitude, these APRs neither convey sufficient information to enable a consumer to rationally choose the most efficient alternative nor can they be cited as evidence of exploitation of either RTO or laundromat customers.

The layaway plan is another market alternative that competes with rent-to-own in that no credit check is required and cancellation of the agreement imposes no significant financial burden. An APR can also be calculated for layaway, but again it is not the key feature of the financing mechanism or of the consumer's choice. In the Kmart layaway plan, for example, the consumer is required to deposit 10 percent of the purchase price as a down payment and then pay 20 percent of the remaining balance every two weeks for ten weeks. At the time of the initial payment, Kmart sets aside the selected merchandise in its warehouse. There is a \$4 initiation fee for the layaway item and a \$6 cancellation fee. After the final payment is made at the end of ten weeks, Kmart delivers the layaway merchandise. A consumer choosing to acquire the above \$375 washing machine through Kmart's layaway plan is exposed to an APR of 23.7 percent due to the \$4 fee at inception. The APR for a layaway on a portable television with a retail price of \$152 is 57.1 percent. Compared

to RTO, layaway has a lower APR but requires higher payments over a shorter time period and does not include delivery or maintenance beyond the warranty period. Most importantly, the consumer starts paying immediately and at regular intervals but must wait more than two months for delivery of the layaway merchandise.

ALTERNATIVE VIEW OF RTO

While the principal advantage of an installment agreement is the deferred payment schedule, an RTO contract leading to eventual ownership has important additional features of considerable value to certain consumers. These features include (1) provision of all customary retail services, such as delivery, set up, maintenance, and repair; (2) immediate product availability without a formal credit check; (3) immediate product availability without a security deposit or 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; and (6) termination of the agreement by the consumer at any time without further financial liability or damage to his or her credit history.

Not all consumers benefit equally from each of the above additional features, nor are these features equally valuable across all rental items. However, one or more features may make an RTO agreement the optimal choice over an installment purchase. Regardless of their credit standing, the option to terminate is key for those with short-term needs for an item due to the transient or unsettled nature of their employment or living situation. The acceptance by RTO dealers of weekly payments reinforces the flexibility of the consumer's option to cancel the agreement at her or his discretion. Nearly 40 percent of all RTO users ultimately take advantage of the termination feature (FTC 2000). The alternative of using cash payments with RTO is vital to the 23 percent of its users who are *unbanked* with no access to a credit card, checking account, or savings account (FTC 2000). RTO is also a rational choice for consumers with good credit but whose credit card balances are near their limit or for those without sufficient funds for a down payment. The availability of insurance to cover damage or theft on the RTO item is a high priority for consumers who have experienced repeated property losses in the past and for whom comprehensive homeowner's or renter's insurance is unavailable or unaffordable in their neighborhoods.

Research investigating the primary motivation for the choice of RTO is inconclusive. Swagler and Wheeler's (1988) survey and the in-depth

interview process of Hill, Ramp, and Silver (1998) determined it is the consumer's need for immediate product availability without a credit check. Zikmund-Fisher and Parker's (1999) study emphasizes the consumer's preference for risk management as provided by RTO's escapability or cancellation feature. The FTC (2000) survey also found high levels of consumer satisfaction with the offer of immediate availability regardless of credit history, the flexibility provided by cancelability, and, in addition, the agreement's inclusion of all service and repair costs.

One approach is to look at an RTO contract as a series of payments that purchase a bundle of services and financial instruments that includes (1) the service of the product for the time period, (2) a put option with a zero strike price that expires at the end of the period, and (3) an option to acquire a call with a zero strike price when the final rent-to-own payment is made. A decision not to make the next payment means the consumer no longer has the services of the product, exercises the put option by selling the merchandise back to the dealer-owner at a zero price, and foregoes the option to acquire a call on the product. Through time, as the final payment approaches, the value of the put option should decline while the value of the call option increases.

Unlike conventional put and call options whose value to the investor increase 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 RTO options have significant value to individuals in housing arrangements that may or may not be permanent, in jobs that may prove to be temporary at best, in family relationships that may or may not be stable, in financial predicaments that may or may not be resolved speedily, or in other volatile situations where the assumption of noncancelable installment credit is unavailable or unsuitable.

An alternative formulation of the rent-to-own contract sees it as a combination of a multiperiod rental agreement and an installment purchase. This approach is supported by the FTC study that found that over 90 percent of those customers who canceled the agreement did so within the first six months. In this initial phase, the RTO agreement, as before, corresponds to a multi-period rental with the purchase of delivery, service, and a put option with a zero strike price. In the next phase, cancellation is rare, and the consumer regularly makes payments toward acquisition in a manner that closely resembles an installment purchase.

Consumer behavior suggests that, in addition to service and a put option, the initial payments provide an embedded option to convert the

rental agreement to an installment contract at the end of an initial period at a competitive interest rate. Of course, unlike a traditional installment agreement, the RTO contract in the installment phase still offers the consumer an imbedded put option and available insurance coverage. This construction also fits into the hypothesis that RTO is particularly suited to individuals in volatile financial or personal situations. The first months of cancelable multi-period rental provides a time interval within which the customer's financial or personal affairs can be resolved, and, once resolved, the contract can then be converted to a regular installment loan.

The washing machine RTO agreement cited earlier will illustrate the proposition that RTO combines a multi-period rental with an installment purchase. The agreement is for fifteen months and requires a payment of \$55 per month on an appliance that could be purchased for cash at a price of \$489, including delivery and a two-year service contract. An installment contract on the appliance, assuming a 24 percent interest rate, would require approximately ten monthly payments. The fifteen RTO payments can now be separated into a rental phase of five months where the customer obtains service, an option to cancel by exercising a put with a zero strike price, and an embedded option to acquire an installment agreement on the washer at the end of five months at a competitive interest rate. The following installment phase is for ten months with a payment of \$55 per month with an APR of 24 percent.

The key to this interpretation of rent-to-own depends primarily on the consumer value derived from the initial rental phase. During this phase the consumer acquires (1) immediate access to a needed appliance, furniture, computer, or electronic equipment; (2) a valuable put option that can be exercised to cancel the agreement without negative financial repercussions; and (3) an option to secure an installment agreement at a competitive rate after the rental phase is completed.

The rental phase of RTO is well suited to consumers who find themselves in personal, financial, or employment situations that are seen as temporary or unpredictable. For this consumer group of *renters*, the embedded put option is highly valued while the option to secure an installment agreement at a later date increases in value through time. A second group of consumers may have as an objective the purchase of an essential ingredient for household formation but are uncertain whether they can assume the stringent financial obligations of an installment agreement in which legal action, including the garnishment of wages, is a reality for noncompliance. For this group of financially *tentative buyers*, the rental phase of RTO serves as a time interval where the abil-

ity to meet a series of regularly scheduled payments is tested. Should the rental phase payments be completed satisfactorily, the tentative buyer then exercises the option to enter into an installment agreement. If the consumer discovers the payments are unmanageable, the RTO contract can be canceled without any further legal threat to her or his welfare.

The rental phase of RTO also serves a purpose for a third consumer group that can be classified as buyers but, for various reasons, have been denied bank credit and store installment credit. The rental phase of RTO not only provides a *denied buyer* with immediate, and otherwise unattainable, access to the services of needed household goods but provides the opportunity for the consumer to *bootstrap* herself or himself into an installment agreement by successfully completing the initial series of payments. Within this rental phase, this consumer is effectively given the opportunity to establish or restore a record of financial responsibility. Should the denied buyer be incapable of adhering to the payment schedule, the option to terminate is effectively exercised. The consumer is left to search for a less convenient source of asset acquisition than RTO and a more cumbersome way of gaining entrance into mainstream consumer credit markets.

CONCLUSION

The rent-to-own industry continues to prosper in the marketplace in spite of continued assertions from consumer groups and academicians that RTO agreements are disguised installment contracts at usurious interest rates. When viewed simply as installment contracts, the implied APRs are indeed extremely high even when the value of additional services provided by the RTO firms are included in the calculations.

This paper has shown that the consumer needs being met by RTO, as well as pure rental agreements and layaway plans, cannot be fairly evaluated by their APR computations. An alternative view of RTO, in line with empirical evidence on consumer behavior, sees the agreement as a combination of a cancelable multi-period rental and an installment contract at a competitive interest rate. In the rental phase, the RTO payment secures the services of the item, a put option that permits sale back to the dealer-owner at a zero strike price, and an embedded option to purchase the item or enter into an installment contract at a future date. Option theory suggests that these options are most valuable to consumers in volatile financial and/or personal situations. Should this volatility prove to be temporary or manageable during the rental phase, the consumer can eventually exercise the option to secure an installment loan at a market

APR or to make an outright purchase. In the installment phase of RTO, the consumer still retains the option to cancel although the evidence indicates exercising this option is an infrequent occurrence. This option, however, continues to have considerable value to those who may still face a nontrivial probability of the reoccurrence of a precarious financial and/or personal situation. The characteristics of RTO as recast in this interpretation appear to serve the needs of a broad spectrum of consumer groups that include renters, tentative buyers, and denied buyers.

From a public policy standpoint, 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. Efforts by consumer groups to deter use of RTO by encouraging potential users to assume the obligations of installment contracts are, predictably, likely to damage all parties involved. When a very carefully screened, workshop-educated sample of 172 low-income consumers were given a *trial* department store credit card, only 61 percent of the accounts were current after eight months and fully 18 percent had to be charged off for nonpayment (Martin and Huckins 1997).

Legal and legislative moves to drastically curtail RTO (see Martin and Huckins 1997) have largely been neutralized by the industry's strategy to promote accommodating laws at the state level. Disclosure of the details of an RTO agreement is advocated in return for exemption from state laws regulating consumer credit and installment sales. Forty-six states have passed industry-supported legislation typically requiring stores to disclose the cash price, periodic rental payment, number of payments, and total cost if all payments are made (Waters 2001).

Consumer advocates have sought to discourage RTO by various means. There are efforts to sponsor federal legislation mandating a down payment set as a percentage of the cash price and to require RTO dealers to attach labels in bold print on floor models warning customers that the total cost will be cheaper elsewhere (Martin and Huckins 1997). Such efforts may be counterproductive in promoting consumer welfare because they would deny or limit immediate access to goods that are the basics of modern household formation. After all, the core of the RTO business is televisions, stoves, refrigerators, washers, sofas, beds, and, increasingly, computers rather than luxury items, such as home exercise equipment, oriental rugs, jewelry, hot tubs, and self-propelled lawn mowers. Requirements that rent-to-own agreements disclose implicit APRs merely cloud the issue for consumers because they are not simply disguised installment

contracts any more than are layaway plans or the long-term use of coin-operated washing machines and photocopiers.

There is clearly room for consumer laws mandating that the terms and conditions of RTO agreements be clearly presented and explained where necessary. The specifics are particularly important to the sizable group of individuals intending to purchase the merchandise prior to the end of the agreement or to gain ownership by making all rental payments. The FTC data reveals that 67 percent of RTO customers initially intend to acquire the item while 33 percent intend to return it prior to the end of the agreement. Ultimately, based on this and additional FTC information, approximately 61 percent of the merchandise is acquired and 39 percent returned. Public policy has to recognize the significant number of RTO customers who exercise the put option to return the rented item as well as those who exercise the option to purchase or to acquire the item by completing the rental payments.

Due to asymmetry in experience and depth of information, the salesperson is at an advantage to the ordinary consumer regarding not only the product but also, even more importantly, the legal and financial provisions of the contract. RTO agreements by their nature are more complex than an installment purchase and require greater attention to detail to ensure transparency. Highly publicized anecdotal evidence of the abuse of consumers by RTO representatives cannot be readily dismissed (Freedman 1993). For the significant number of consumers initially planning for a short-term rental, RTO is an appropriate, efficient vehicle to meet their needs and the informational requirements for this group is minimal as their primary focus is the put option allowing cancellation without penalty. For those consumers planning to acquire an item, the payments, purchase price, and the various options embedded in an RTO agreement have to be clearly presented by the dealer and understood by the consumer. The premise, however, that RTO requires greater scrutiny because of an intrinsic anticonsumer flaw in the agreement itself can lead to a host of unwarranted public statements, legislative activities, and legal actions whose consequences may be detrimental to consumer welfare.

REFERENCES

- Consumer Reports. 2000. *Buying Guide*. New York, NY: Consumers Union.
- Freedman, Alix M. 1993. Peddling Dreams: A Marketing Giant Uses Its Sales Prowess to Profit on Poverty. *Wall Street Journal*, September 22: A1, A10.
- Hill, Ronald Paul, David L. Ramp, and Linda Silver. 1998. The Rent-to-Own Industry and Pricing Disclosure Tactics. *Journal of Public Policy and Marketing*, 17, 1:3-10.