

# New England Community Developments

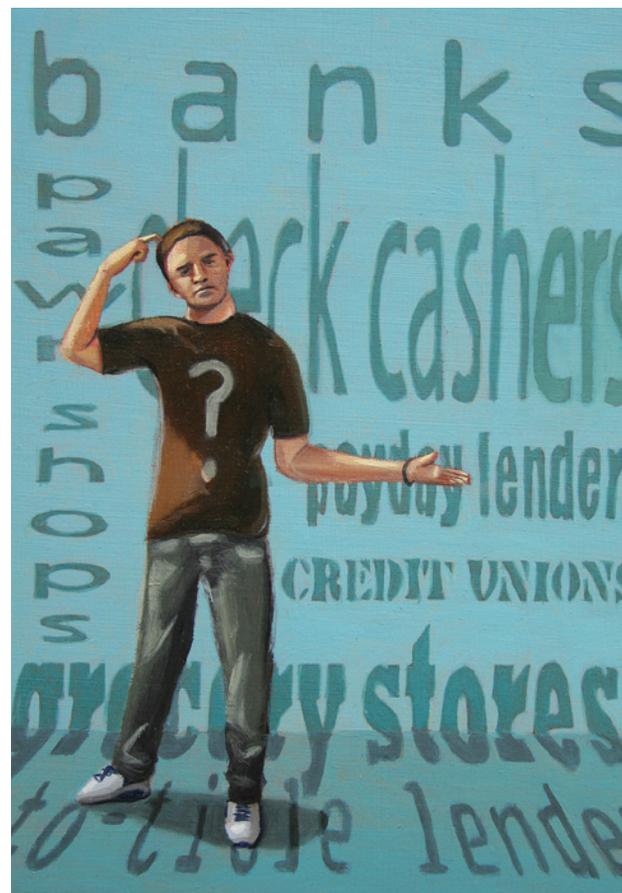
Emerging Issues in Community Development and Consumer Affairs

## Promoting Banking Services among Low-Income Customers

by Rebecca M. Blank

A considerable number of low-income individuals make use of nonbank financial services conducted at check-cashing outlets, payday lenders, pawn shops, auto-title lenders, and grocery, convenience, department, and other stores. Although the number of unbanked households has fallen during the past 20 years, currently about 10 million households do not have a checking account or savings account and rely on alternative financial service (AFS) providers to conduct their financial transactions. Many more are considered underbanked: they make use of banks and credit unions as well as AFS providers. Indeed, the use of such services as payday loans and refund anticipation loans (RALs) has grown over the last two decades.

A 2008 report by the Brookings Institution showed that low- and moderate-income households paid \$8.5 billion in fees to nonbank check-cashing providers and short-term loan providers in a recent year. The Center for Financial Services Innovation (CFSI) estimates that unbanked and underbanked households spend at least \$13 billion each year on nonbank financial transactions. Most check cashers charge between 2 percent and 4 percent of each check's value. And the interest rate on a two-week



or four-week payday loan is about 30 times the annualized interest rate of typical credit card.<sup>1</sup> The Brookings study suggested that a full-time worker could potentially save

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as much as \$40,000 over his lifetime by making use of a lower-cost checking account instead of check-cashing services.

In light of the high cost charged by many AFS providers, consumer advocates continue to explore alternative avenues for promoting financial inclusion and wealth creation among low-income households. New research on consumer behavior, financial education, and the use of financial services by low-income families is bolstering these efforts. This article provides an update on current thinking around how

## **A study of the demand for payday loans showed that about half of payday loan recipients claim to have considered a bank loan, but many of these borrowers indicated that it was easier to obtain a payday loan.**

to strengthen the welfare of low-income families by promoting the use of banking services by these families.<sup>2</sup> I begin with an overview of why low-income households utilize AFS institutions and then focus on policy options that might move more people into traditional banking services. Where possible, I emphasize new research and new thinking about these issues.

### **Why Do Customers Use Alternative Financial Services?**

Research conducted in recent years has provided insight into why low-income households choose informal financial services over banks. Below I group these findings into five primary reasons.

**1.** Bank services may be ill-fitted to the needs of low-income households. A study of the demand for payday loans showed that about half of payday loan recipients claim to have considered a bank loan, but many of these borrowers indicated that it was easier to obtain a payday loan.<sup>3</sup> Many local banks do not make short-term loans available to low-income customers. High minimum balance checking accounts with multiple fees may be too expensive for low-income customers, who are more likely to incur penalties for lower balances and for overdrafts. And these customers appear to conduct financial transactions where they transact other business. For example, check-cashing outlets are often one-stop shops for customers, providing more comprehensive products and services than banks, such as bus passes, mobile-

phone minutes, and prepaid debit cards. One study showed that 77 percent of individuals using check-cashing services reported that these services are more convenient than using banks.<sup>4</sup>

New research suggests that a significant number of low-income households use both banks and informal financial providers for their transactions.<sup>5</sup> The fact that many people choose among banks and nonbanks for different financial services supports the conclusion that low-income families often turn to informal providers to meet needs that banks ignore.

**2.** Low-income households may mistrust banks or have difficulty comparing costs across financial institutions. A subset of low-income persons actively mistrusts banks or perceives using them as an unpleasant experience. These customers may feel intimidated by bank employees or feel that they have been treated rudely by bank staff in the past. Some customers worry about incurring penalties or limitations on bank accounts that they do not understand. Some may not understand the true costs of using payday loans, such as the compounded costs of rolling over loans multiple times. The previously mentioned survey of payday loan users found that almost all of them were aware of the dollar charges on their most recent payday loan, but few knew how these translated into an annual percentage rate that would let them compare rates across providers.

**3.** Past credit problems can hinder low-income persons from qualifying for bank accounts or for bank loans. In one study, 18 percent of low-income respondents indicated that their poor credit histories prevent them from qualifying for an account.<sup>6</sup> Others have not yet built up their credit histories, hindering their ability to qualify for a loan. Immigrants, documented and undocumented, may not be able to provide the financial documentation required by banks for a loan. In all these cases, the simpler requirements of payday lenders make them the only viable source of credit.

**4.** Low-income consumers are more likely to discount future costs at high rates, making them more willing to pay high up-front costs for short-term loans or check-cashing services. Low-income consumers may have a high immediate need for funds or may place a high value on immediate gratification. This will lead them to discount future costs at a high rate and make high-cost alternative financial services look more attractive. A growing body of work in behavioral economics indicates that many people (both low- and high-income) demon-



strate time inconsistencies when making decisions. When asked, people will say that they want to save, but then will proceed to spend their money as they receive it. Unfortunately, these behavioral tendencies are more costly for low-income individuals, who have less margin for error in their financial decision-making (i.e. any “mistakes” may have much greater consequences).<sup>7</sup>

5. Greater income volatility for low-income households increases their need for short-term credit. Lower-income or less-educated households experience greater fluctuation in their incomes. Work hours on low-wage jobs often vary substantially from week to week, especially in the service sector. Employment is more cyclical among less educated workers. Household composition is also more unstable in lower-income families: marriage is less common and cohabitants come and go with greater frequency. Residential instability is higher and is often linked with job changes. Thus household instability feeds into earnings and income volatility.

Families can deal with short-term income instability in three ways. First, they can reduce expenditures as income falls. However, this can be difficult for low-income families as a higher share of expenditures goes toward necessities such as food or rent. Second, households can utilize savings to help smooth expenditures. For many reasons, low-

income households are far less likely to have savings than higher-income households (e.g., because their incomes are low relative to needs), so this mechanism may be unavailable to them. This leaves a third option, borrowing to smooth spending in the face of income fluctuations. Although expensive, taking out a short-term, high-interest payday loan may be a better choice than having one’s phone or electricity turned off.

### **A growing body of work in behavioral economics indicates that many people demonstrate time inconsistencies when making decisions.**

Interest in the question of how to increase the welfare of low-income families through financial services has increased in recent years, leading to some interesting new research and policy proposals. In the following sections, I discuss different policy approaches that address the issues raised above.

### **Encouraging Greater Use of Banks**

The most direct way to encourage the utilization of banks and credit unions is for these institutions to expand and market competitive products and services



that meet the unique needs of low-income households. These products and services could include no-minimum-balance debit accounts that exclude the fees associated with overdraft protection; short-term loans that provide liquidity much like payday loans but cost less; or low-cost check-cashing facilities inside banks for noncustomers. A key question is whether these activities will be profitable enough to encourage banks to engage in them, or whether the public sector will need to provide incentives or partner with these institutions to help recruit low-income customers.

A number of financial institutions have taken leadership in providing banking services to low-income households. ShoreBank in Chicago is perhaps the best-known example, but other institutions around the country are experimenting with ways

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to serve these customers profitably. Some banks offer “starter” accounts aimed at serving customers’ needs. The Massachusetts Community and Banking Council provides guidelines to banks on what constitutes “basic banking” checking and savings accounts. Some banks and credit unions offer short-term loans explicitly designed to compete with payday lenders for much lower fees.

There are a variety of public sector initiatives aimed at encouraging the utilization of banking services by low-income customers. In San Francisco, the mayor’s office initiated the Bank on San Francisco program.

The city persuaded banks and credit unions to relax standards or waive fees for new account holders in exchange for a free marketing push from the government. The program recently expanded to the rest of California. A number of other cities, including Seattle and Savannah, are drawing up their own versions of the program. An earlier proposal by former treasury official Michael Barr includes the creation of tax credits that would be made available to banks based on the number of accounts they open up for low-income persons.<sup>8</sup> This concept, dubbed First Accounts, was tested in a small demonstration program.

Other public sector proposals include increasing the number of public assistance benefits that are distributed through bank debit accounts. This policy would give families a relationship with a local bank, and families would be allowed to retain the accounts when they move away from public assistance into work. In a similar way, the IRS could expand the ability of unbanked taxpayers to receive tax refunds in electronic debit accounts. A demonstration project sponsored by ShoreBank indicated that over half of the unbanked participants whose refunds were placed in accounts went on to use the accounts for other purposes.<sup>9</sup>

A growing body of evidence suggests that low-income families can save despite their small earnings. Policies aimed at increasing their savings rates could help smooth expenditures without the need for short-term credit and could create connections with formal financial institutions. There are a number of bills before Congress and at the state level that would provide incentives to help low-income households save more. Proposals include employer-based savings plans, government matched-savings plans, and national development or savings accounts.<sup>10</sup> President-elect Barack Obama has proposed a matched savings plan.

Finally, there are a variety of ways in which city and state governments have sought to regulate and limit AFS providers. Some states have made it impossible for payday lenders to operate or have limited the size of payday loans or the number of times a loan can be rolled over. Evidence on results is mixed. Some studies show that payday lenders provide helpful liquidity to certain households that do not have access to other borrowing sources. One study found that households in states with higher payday loan limits do not have higher delinquency rates, although they do have marginally higher debt levels.<sup>11</sup> After North Carolina and Georgia eliminated payday lending, households bounced more checks and filed for bankruptcy at a higher rate.<sup>12</sup> Another study found that areas

## Insufficient Funds: Savings, Assets, Credit and Banking Among Low-Income Households

Rebecca M. Blank and Michael S. Barr, editors  
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with payday lenders recover more quickly following a natural disaster, with fewer foreclosures.<sup>13</sup> Other research indicates that average payday loan recipients use multiple loans and run up quite large debt, which suggests these individuals are not using payday loans merely for occasional unexpected expenditures.<sup>14</sup>

### One important way of reducing families' use of high-cost credit is to reduce demand for this credit.

Greater competition appears to bring down the cost of AFS services.<sup>15</sup> So strict regulations on AFS providers may not reduce the demand for short-term credit and may even raise the costs unless such a policy is closely linked with efforts to provide affordable credit and banking services through banks and credit unions.

### Reducing Demand for High-Cost Credit

One important way of reducing families' use of high-cost credit is to reduce demand for this credit. Many researchers and practitioners believe in the need for financial education to promote wise use of credit and effective money management and financial planning. Unfortunately, there is at best limited information showing that financial literacy courses help increase savings or improve credit records.<sup>16</sup> There is therefore a need for well-evaluated demonstration programs that would advance our knowledge of best practices. Currently, a number of researchers have embarked on longitudinal studies of financial education programs and several organizations have produced materials to help practitioners evaluate their financial education programs, including the National Endowment for Financial Education (NEFE) and *The Journal of Extension*.

In addition, families with inadequate or no health insurance are at a greater risk of incurring medical debt and being forced to resort to high-cost credit to make ends meet. Low-income families often have low levels of private health insurance and limited Medicaid eligibility (Medicaid typically covers children but not parents in low-income working families). As a result, these families often pay cash for dental visits, eye care, or care that requires multiple doctor visits. In a 2007 report by Demos and the Access Project, 29 percent of indebted low- and moderate-income households reported that medical expenses

contributed to their current level of credit card debt. Better health insurance coverage for low-wage families would help.

## Stabilizing Incomes

One cannot consider how to strengthen the financial standing of low-income families without considering policies to stabilize their incomes. Stable incomes help reduce low-income families' need for short-term credit and help make them more attractive customers to financial institutions.

Stable incomes require a macroeconomic policy of maintaining low unemployment. Maintaining a high-employment economy is more important for this group because of the greater cyclical in employment and jobs among lower-wage workers. Elsewhere I have noted that a strong macroeconomy is probably the most effective long-term antipoverty strategy.<sup>17</sup> As welfare reform has moved more single-mother families off public assistance and into low-wage employment, even more families rely on low-wage jobs for their primary income support.

In addition, it is important to maintain access to coverage within the Unemployment Insurance (UI) system for low-income families. The UI system is designed to smooth income following job loss, but only a little more than one-third of unemployed workers receive UI; lower-wage workers have higher unemployment rates but are less likely to receive UI than higher-income workers. In part, this is because lower-wage workers are less likely to be eligible for UI benefits when a job ends. UI eligibility requires working at least two of the last four quarters in one job; in many states, part-time work, quitting, and being fired "for cause" are not covered. The UI system could be reformed to cover a higher share of low-wage workers and to encourage use among those eligible, making it a more effective income-smoothing mechanism for lower-wage workers.

Maintaining eligibility for and take-up in safety-net programs can also help stabilize income. While relatively few working low-income persons are eligible for cash assistance, various in-kind programs help supplement earnings and smooth incomes, including food stamps (now called SNAP, the Supplemental Nutrition Assistance Program), housing assistance, and Medicaid. While take-up in food stamps and Medicaid has risen as a result of efforts following welfare reform to increase program use among working low-income families, large numbers of eligible persons do not receive benefits. The low-take-up appears to be

caused by a combination of misinformation, distaste for the difficulties and indignities of participating in the programs, and efforts to discourage participation by program employees.

Finally, expanding the Earned Income Tax Credit (EITC) program for low-wage workers without children would greatly increase its power as an income supplement. The EITC provides substantial income support to low-income families with children, but low-wage workers without dependents receive only small EITC supplements. A variety of proposals to expand EITC to this group would particularly help low-wage male workers, many of whom help support their nonresident children.<sup>18</sup>

## Conclusion

There are many ways to encourage low-income households to increase their use of formal financial institutions. On the one hand, banks and credit unions can expand the services they provide; there may also be policies that would make informal financial services less attractive. On the other hand, focusing solely on banking services ignores some of the primary reasons why families seek short-term credit in the first place. Helping families save and smooth their expenditure and income streams is also important. This requires policies that address a range of goals, from promoting economic stability to incentivizing savings and strengthening the impact of EITC and proven financial education programs.

Policies aimed at promoting banking among low-income households need to address the multiple reasons why families utilize AFS providers. At present, we have only limited evidence on the comparative costs and benefits of the policies discussed above. Given the number of experiments with providing financial services to low-income customers that are under way, this is a particularly fruitful time to evaluate these efforts, their outcomes, and the challenges to implementation. It would be highly useful to define additional best practices to help guide federal, state, city, and institutional efforts aimed at improving the financial well-being of lower-income households by encouraging their greater use of banks and credit unions.

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## Endnotes

<sup>1</sup>McGray, 2008.

<sup>2</sup>A longer version of this article was written for the Federal Reserve Board of Governors Academic Consultants Meeting on Non-traditional Financial Services, April 16, 2008, Washington, DC.

<sup>3</sup>McGray, 2008.

<sup>4</sup>Elliehausen and Lawrence, 2001.

<sup>5</sup>See Berry, 2005, or John Caskey, "Reaching Out to the Unbanked" in Sherraden, ed., 2005.

<sup>6</sup>Michael Barr, "Financial Services for Low- and Moderate-Income Households," in Blank and Barr, eds., forthcoming, 2009.

<sup>7</sup>Berry, 2005.

<sup>8</sup>See Benton, Meier, and Sprenger, 2007 or Eldar Shafir and Sendhil Mullainathan, "Savings Policy and Decision-making in Low-Income Households," in Blank and Barr, eds., forthcoming, 2009.

<sup>9</sup>Barr, 2004.

<sup>10</sup>Sondra G. Beverly et al., "Linking Tax Refunds and Low-Cost Bank Accounts to Bank the Unbanked" in Sherraden, ed., 2005.

<sup>11</sup>Peter Tufano and Daniel Schneider, "Using Financial Innovation to Support Savers: From Coercion to Excitement," in Blank and Barr, eds., forthcoming, 2009.

<sup>12</sup>Morgan, 2007.

<sup>13</sup>Morgan and Strain, 2007.

<sup>14</sup>Morse, 2007.

<sup>15</sup>Skiba and Tobacman, 2008.

<sup>16</sup>Flannery and Samolyk, 2005 or Morgan, 2007.

<sup>17</sup>Caskey, 2006, or Hathaway and Khatiwada, 2008.

<sup>18</sup>Blank, 2000.

<sup>19</sup>Berlin, 2007 or Scholz, 2007.