ALTERNATIVE FINANCIAL SERVICES USE ACROSS INCOME, RACE, AND ETHNIC GROUPS

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Executive Summary

Alternative financial services, such as pawnshops, payday lenders, and check cashers, offer essential services to individuals and households who may not have access to traditional bank accounts or credit. These alternative services may charge high fees and interest rates and can trap their users in cycles of debt, reducing their ability to build savings and establish credit. In order to develop policies that can help reduce reliance on higher-cost alternative financial services, it is important to understand who uses these services and why.

This brief examines the findings of two recent articles and our calculations from a Census Supplemental data set on the use of payday lending, check cashing, and other alternative financial services (AFS) by various demographic groups:

> Jane Cover, Amy Fuhrman Spring, and Rachel Garshick Kleit. (2011) "Minorities on the Margins? The Spatial Organization of Fringe Banking Services." *Journal of Urban Affairs* 33(3): 317-44
>
> Federal Deposit Insurance Corporation. (2009) "FDIC National Survey of Unbanked and Underbanked Households."

Findings

- Overall, 24% of households used at least one alternative financial service in the past year, but rates were much higher for lower income households.
- Households without a bank account (about 8% of households) use alternative financial services at a significantly higher rate than do households with a bank account (64% versus 18%).
- Minority households use AFS at rates that are approximately 25 percentage points higher than those for whites, and are roughly 15 percentage points more likely to not have a bank account.
  - 49% of African-American households used AFS and 21% had no bank account.
  - 39% of Hispanic households used AFS and 19% had no bank account.
  - 18% of White households used AFS and 3% had no bank account.
- Alternative financial service providers in some cities concentrate in Hispanic neighborhoods, although the evidence is not conclusive, and Hispanic households likely experience greater barriers to traditional banking services.
- Most households that use alternative credit services, particularly payday loans and pawnshops, do so for daily living expenses or to make up for lost income (54%).
- Reducing the use of high-cost financial services for minority and low-income households will involve a dual approach: regulating AFS providers to prevent usury rates and accumulation of debt, and providing lower-cost alternatives that can facilitate savings and build credit.

Understanding why households use AFS will allow services and advocacy efforts to be tailored toward providing less harmful alternatives to AFS and improving regulation of the most predatory AFS.

Alternative Financial Services & Traditional Banking

Alternative financial services, such as pawnshops, payday lenders, and check cashers, offer essential services to individuals and households without access to traditional bank accounts or credit, but are also used by some households who do have bank services. These alternative services may charge high fees and interest rates, and can trap their users in cycles of debt, further reducing ability to build savings and establish credit.

Alternative Financial Services

Transaction services
Money orders
Check cashing

Credit services
Payday loans
Pawnshops
Rent-to-own services
Tax refund loan

Many households that do not have bank accounts—which often require minimum deposits or balances, are complicated in structure, and are commonly perceived to be inconvenient—use alternative financial services. To better understand the use of alternatives financial services, in 2009 the FDIC sponsored a supplement to the U.S. Census Bureau's Current Population Survey to collect data on U.S. households with a focus on those that are unbanked and those that do have bank accounts, but used at least one AFS in the past year (referred to by the FDIC as "underbanked"). The report finds that an estimated 7.7% of U.S households are "unbanked," or do not use any form of bank account, equivalent to approximately 17 million adults. Further, being of minority status or poor raises an individual's likelihood of being unbanked.

At least 64% of households without bank accounts use some form of Alternative Financial Service

Source: FDIC Report

Minorities are significantly less likely to have a bank account, including 21.7% of black households, 19.3% of Hispanic households, and 15.6% of American Indian/Alaskan households. Nearly 20% of households making less than $30,000 per year did not have a bank account. Unbanked households have fewer mechanisms to facilitate savings, are more vulnerable to theft and loss, and often struggle to build credit and financial security.

Advocates and policy-makers concerned about the use of alternative financial services by low-income and minority households have asked whether providers are targeting minority neighborhoods and whether we can better understand why families use these services.

Minorities on the Margin: The Spatial Organization of Fringe Banking Services

Do AFS Providers Target Certain Ethnic Groups?

It depends, say Cover, Spring, and Kleit. In their analysis of four Northwest area cities, Yakima, WA; Boise, ID; Rapid City, SD; and Waterloo-Cedar Falls, IA, the researchers find mixed relationships between the concentration of AFS providers and minority population. Commercial activity proves to be the greatest indicator of location for AFS providers—check cashers, pawnshops, and payday lenders appear to locate where there is relatively high business activity. Cover et al. find that AFS providers tend to locate in the same neighborhoods as banks, rather than targeting neighborhoods with a low prevalence of banks. Therefore, it appears that those who use AFS do so for reasons other than the fact that banks are not present in their neighborhoods. Rather, barriers to banking and greater convenience of AFS providers, among other factors, may contribute to high rates of AFS use.

There is some evidence, however, that AFS providers target Hispanic populations specifically. Cover et al. find that in Boise and Yakima, cities with relatively large Hispanic populations, AFS providers were more prevalent in neighborhoods with concentrations of Hispanic households, regardless of the level of commercial activity in the neighborhood. This was particularly true for neighborhoods whose population was made up of at least 20% of Hispanic households.

Use of Alternative Financial Services by Hispanic Households

Because of these findings, it is helpful to look more closely at the rate at which Hispanic households use alternative financial services. The FDIC survey shows that Hispanic households use AFS at a high rate, particularly non-bank check cashing, money wiring (money orders), and pawnshops. This research indicates that approximately 39% of Hispanic households used some form of AFS. Nearly 20% of Hispanic households did not have a bank account. Twenty-four percent of Hispanic households did have a bank account, but still used some form of AFS. Most of the Hispanic households that used AFS while possessing a bank account used transaction services, like check cashing and money wiring (63%), the highest rate of any ethnic group.

Nearly 20% of Hispanic households are unbanked.

24% of Hispanic households have bank accounts, but still used an AFS in the past year.

Source: FDIC Report

The experience of barriers to traditional banking may have played a role in Hispanic households' use of AFS. While Hispanic households had the second highest percentage of households with no bank account of all minority groups (19.3%), this rose sharply for Spanish-only speaking households (35.7%), indicating that language barriers present a significant obstacle to establishing a bank account.

Additionally, among households without a bank account, Hispanics had the second highest percentage of "never banked" households (65%), behind Asians, indicating that many Hispanic households have never entered the traditional banking system. This is likely a byproduct of banks' identification requirements to open an account and the high rates of immigrant status among Hispanic households.

These findings, taken with evidence that AFS service may be offered more prevalently in in Hispanic neighborhoods, indicate that AFS providers may be capitalizing on the frequency with which Hispanic households send remittances to other countries, or the barriers to banking that Hispanic households may experience. As noted, these obstacles include language barriers, immigrant status, and identification requirements, along with other factors.

Many banks do not offer money wiring services, or do not provide services to some countries, and thus check cashers like Western Union may be the only option for Hispanic households to send remittances. However, if Hispanic households experience greater barriers to banking, they may rely on AFS providers for all services, including check cashing and access to credit, putting them in greater jeopardy of debt accumulation and preventing them from building credit histories. Because many AFS providers offer more than one service (i.e., cash cashing providers often provide payday loans as well), a reliance on one service because of a lack of a bank account may make other alternative financial services more convenient as well, leading to higher rates of these complementary services.

The nature of these findings (Hispanic households might use money wiring even if they had a bank account, but they also may experience greater barriers to banks) necessitates a dual approach. First, tailoring financial services to Hispanic households, such as providing cheaper alternatives to money wiring (or linking money wiring to a bank account) and offering alternatives to AFS may reduce reliance on more expensive money wiring services.

Secondly, deconstructing the barriers to traditional banking often faced by Hispanic households, by providing targeted financial education, multi-lingual bank support, reducing minimum deposits required for accounts, and minimizing identification requirements will help Hispanic households break a reliance on other services like bill payment or check cashing.

Lastly, because AFS providers may locate in neighborhoods with high concentrations of Hispanic households, locating these services within Hispanic neighborhoods and conducting targeted outreach to these households will be vital.

Because Cover et al.'s research was confined to case studies of only four cities, it is useful to more fully explore additional research on the varying AFS usage rates of ethnic and vulnerable populations.

Most popular AFS products (banked households)

- Money orders: 81%
- Check cashing: 30%
- Payday loans: 16%
- Pawnshops: 16%
- Rent-to-own: 13%
- Tax refund loan: 13%

Source: FDIC Report

Use of Alternative Financial Services by Banked and Unbanked Households

Alternative Financial Services and the Unbanked: About 66 percent of unbanked households use some form of alternative financial service, including non-bank money orders, non-bank check cashing, pawn shops, payday loans, rent-to-own agreements (RTOs), and refund anticipation loans (RALs). About one-quarter of unbanked households do not use any AFS, suggesting a strong reliance on cash transactions.

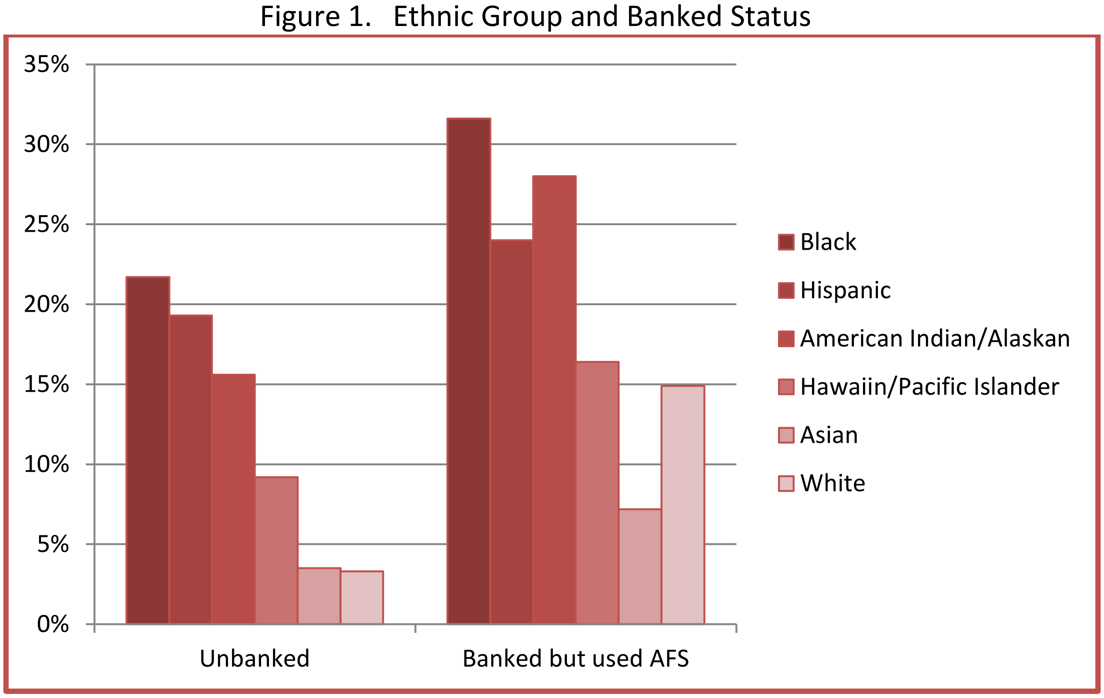
Convenience of Transaction Services: Transaction services make up the majority of AFS used. The survey data indicate that the majority of households with bank accounts that used money orders and check cashing do so primarily for convenience. Speed and cost were also commonly cited by banked households as reasons that they use these non-bank transaction services.

Credit Services: Many banked households that use payday loans or pawn shops rather than banks for credit services do so primarily because it is easier to qualify for a loan from the AFS provider or because it is more convenient. More than half of the households that used these credit services did so for basic living expenses or to make up for lost income. Thus, although these households had bank accounts, they still appeared to encounter barriers to traditional credit options or savings solutions.

Alternative Financial Services use by Ethnic Group and Income Level

Our calculations indicate that minority households use alternative financial services at a rate approximately 25 percentage points higher (44%) than do white households (18%). Additionally, minority households were 15 percentage points more likely to not have a bank account (18%) than white households (3%). Figure 1 indicates the percentage of households from each ethnic group that were unbanked, as well as those that were banked but still used alternative financial services.

Figure 1. Ethnic Group and Banked Status



African-American Households: Remarkably, our calculations indicate that 49% of African-American households, banked or unbanked, reported using at least one alternative financial service in the year prior to the survey. African-American households also had the highest percentage of unbanked households of all minority groups, at 21.7%. Nearly one-third of all African-American households had a bank account, but still used an AFS in the previous year. Of those households, the majority used transaction services only (55%), but over one-third used both transaction and credit services, the highest rate among all racial minorities.

American Indian/Alaskan Households: Nearly 85% of American Indian/Alaskans had bank accounts. However, 28% of all American Indian/Alaskan households had bank accounts, but still used an AFS (compared to 15% of white households). Thus, many American Indian/Alaskan households are not receiving all of the financial services that they require from banks, and exploring the reasons that this ethnic group uses AFS may prove valuable.

Low-Income Households: While low-income households undoubtedly face significant barriers to saving and building assets, the findings of the FDIC Survey are mixed. The lowest income households (with income less than $15,000) were most likely to be unbanked (27%). The proportion of unbanked households decreased with income. The use of alternative financial services also decreased with income from over 40% of the lowest income households using AFS to 10% of those with income over $75,000. However, among banked households, the rate of AFS use did not decrease much with income: households with banks accounts making up to $50,000 a year appeared to use AFS at the same rate as households making less than $15,000 a year (Figure 2).

Thus, while the financial security of low-income households would likely be strengthened through savings or checking accounts, AFS regulation or more financially beneficial alternatives to AFS might be most effective across the income spectrum.

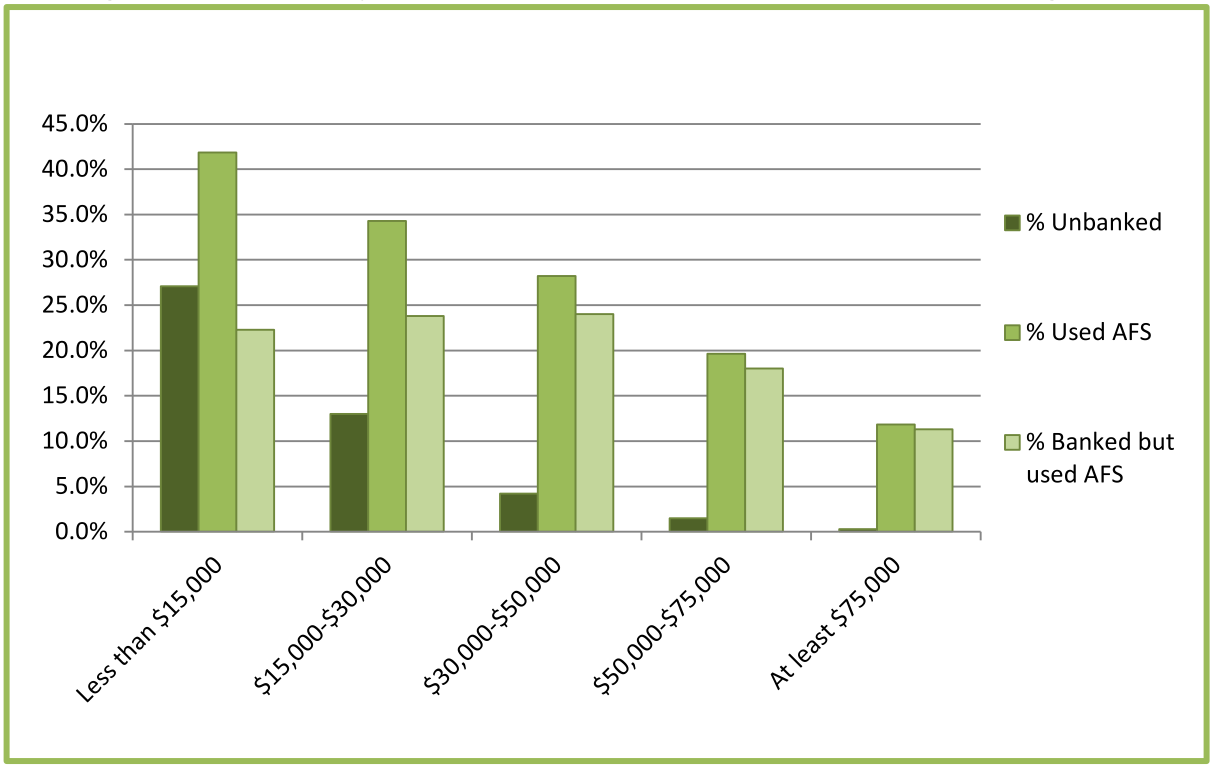
As noted above, lacking a bank account may prevent households from developing long-term savings and present a barrier for building credit. Additionally, while having a bank account appears to help households avoid alternative transaction services, the ability to develop savings likely plays an important role in preventing alternative credit services. One study estimated that low-income families with no emergency savings were 8 times more likely to use payday loans than families with just $500 in savings, even though both groups had bank accounts.[1]

Additional research shows that low-income households experience the greatest economic instability, due to reduced protection against economic shocks, job or income loss, medical expenses, and other unexpected incidents.[2] These households also tend to hold the fewest liquid assets—a longitudinal study by the Urban Institute in 2010 finds that possessing even modest liquid assets in a bank account ($0-$2,000) significantly reduces a household's experience of material hardship due to financial volatility. Cash reserves provide households with a buffer against unexpected hardships and variations in

[1] Testimony of Jean Ann Fox, Director of Consumer Protection, Consumer Federation of America, before the Subcommittee on Domestic Policy of the House Committee on Oversight and Domestic Reform (March 21, 2007).
[2] Mills, Gregory and Amick, Joe. "Can Savings Help Overcome Income Instability?" *The Urban Institute* Brief 18. December 2010.

income, though there may be other family differences that explain differences in both savings and hardship.

Figure 2. Relationship Between Income Level, Bank Account, and AFS Usage



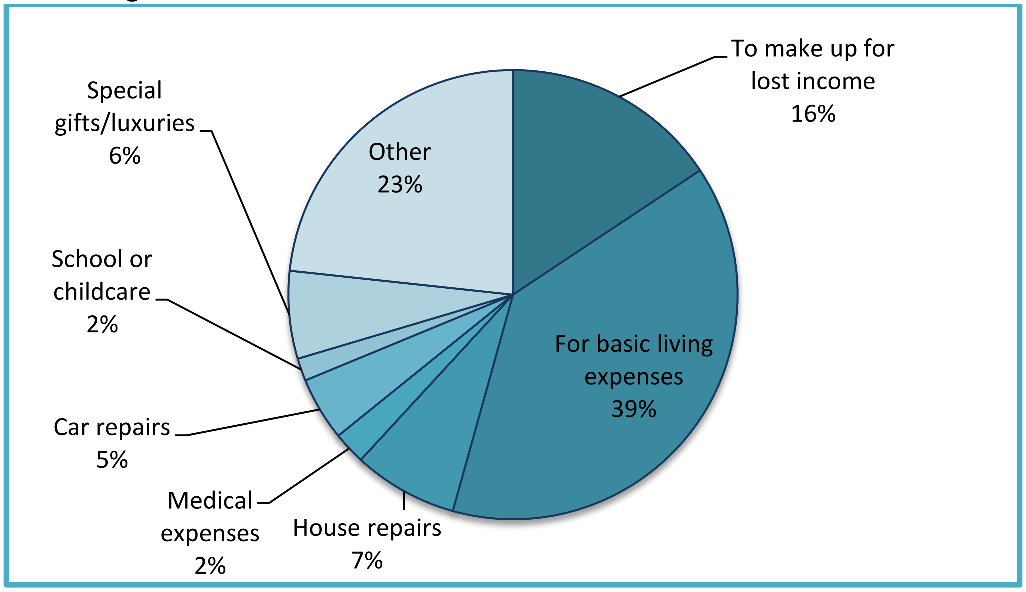
While policies regulating AFS providers might reduce fees, interest rates, and debt accumulation for households using these services, without a strategy to decrease the rates of unbanked minority and low-income households, the likely cause of the problem—barriers to traditional savings and credit—will go unaddressed. Additionally, as Cover et al. show, the location of traditional banks does not appear to be a barrier, as banks and AFS providers tend to both locate in high commercial areas. Rather, it is likely other barriers, such as high fees or account balances, the inability to qualify for a loan, lack of money to make an account attractive, or the convenience of AFS providers that contribute to the high percentage of unbanked households. Potential strategies to increase the use of banks by these households include providing short-term credit solutions, forgoing high fees and account balances, incentivizing savings accounts, and offering bank accounts tailored specifically to minority and low-income populations, many of which have difficulty building savings and establishing credit.

Use of AFS Credit Services for Daily Living Expenses

The FDIC Report finds that the majority of households using AFS credit services, such as payday loans, pawnshops, and tax refund anticipation loans, use them for day-to-day living expenses (Figure 3). This indicates not simply a lack of access to credit, but a structural lack of income and an inability to accumulate emergency savings. Enhancing the ability of these households to access more traditional credit services, while cheaper, may simply transfer their debt to a more traditional provider.

Providing households with easy to access or incentivized savings accounts, and access to "safe" or securitized credit may help to bridge the gap between paychecks without high fees or accumulating debt.

Figure 3. Reason for Household's Use of AFS Credit Services



Initiatives to reduce AFS usage rates and improve poor and minority households' financial security offer the opportunity for low-income and minority individuals to find viable alternatives to AFS, lowering the costs they pay for financial services, reducing vulnerability to theft and indebtedness, and promoting savings and asset accumulation. Understanding the reasons that various demographics groups use AFS will increase the effectiveness of policies and services designed to target these groups with the financial services that they need to access credit, build savings, and enhance their financial security.