The Brookings Institution

Metropolitan Policy Program
Matt Fellowes, Senior Research Associate

Grounds for Competition: The Basic Financial Service Infrastructure in Low-Income Neighborhoods

The High Cost of a Low Income: Financial Services in Underserved Markets
Louis L. Redding Public Policy Forum, University of Delaware

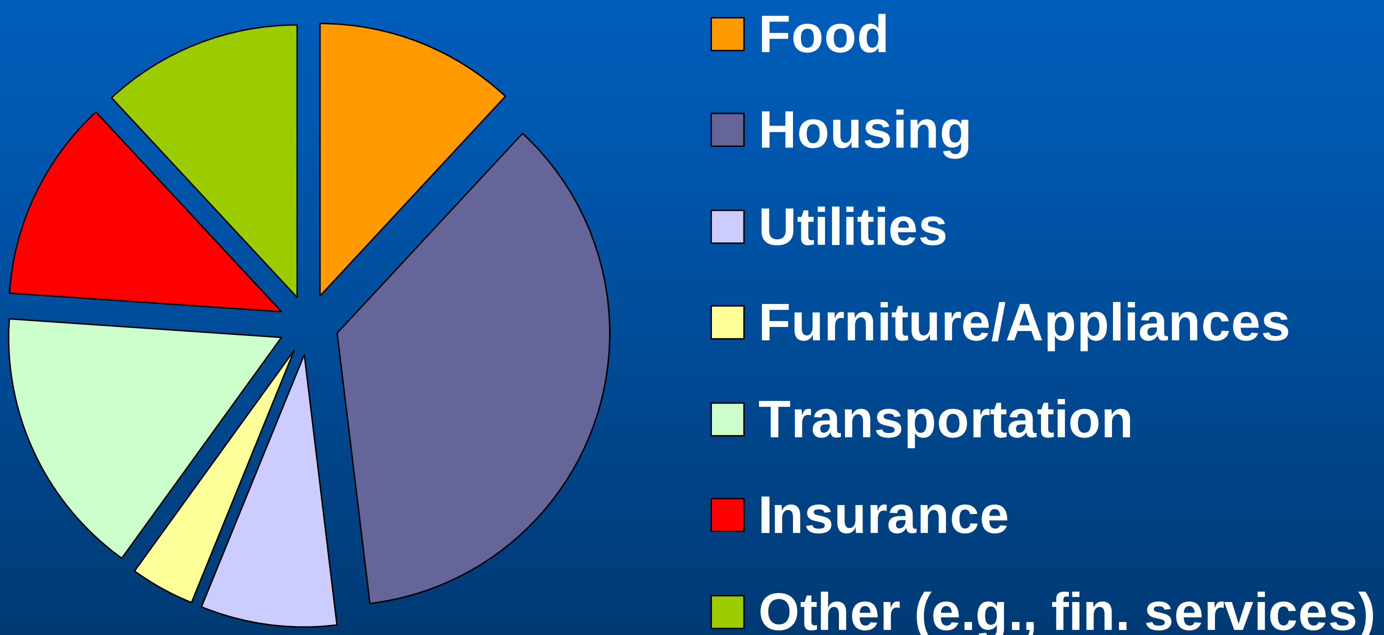
Grounds for Competition:
The Basic Financial Service Infrastructure in Low-Income Neighborhoods

I Why are we asking these questions?

II What are the major findings?

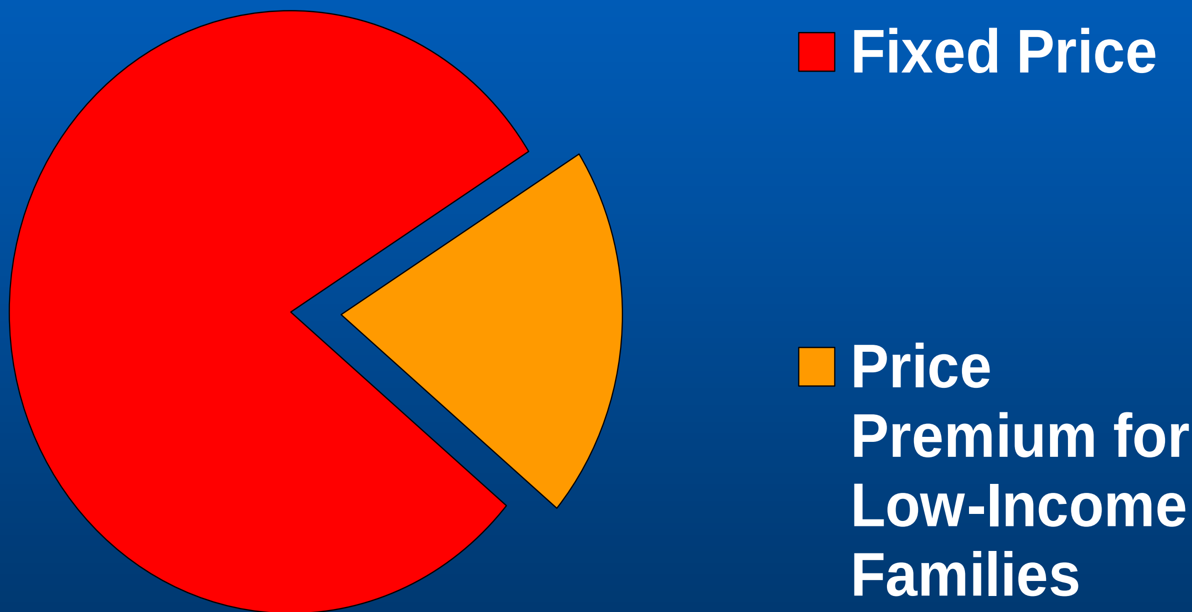
III How is the market and public policy responding?

We're in the middle of a multi-year study that is evaluating how prices for basic goods and services vary by income

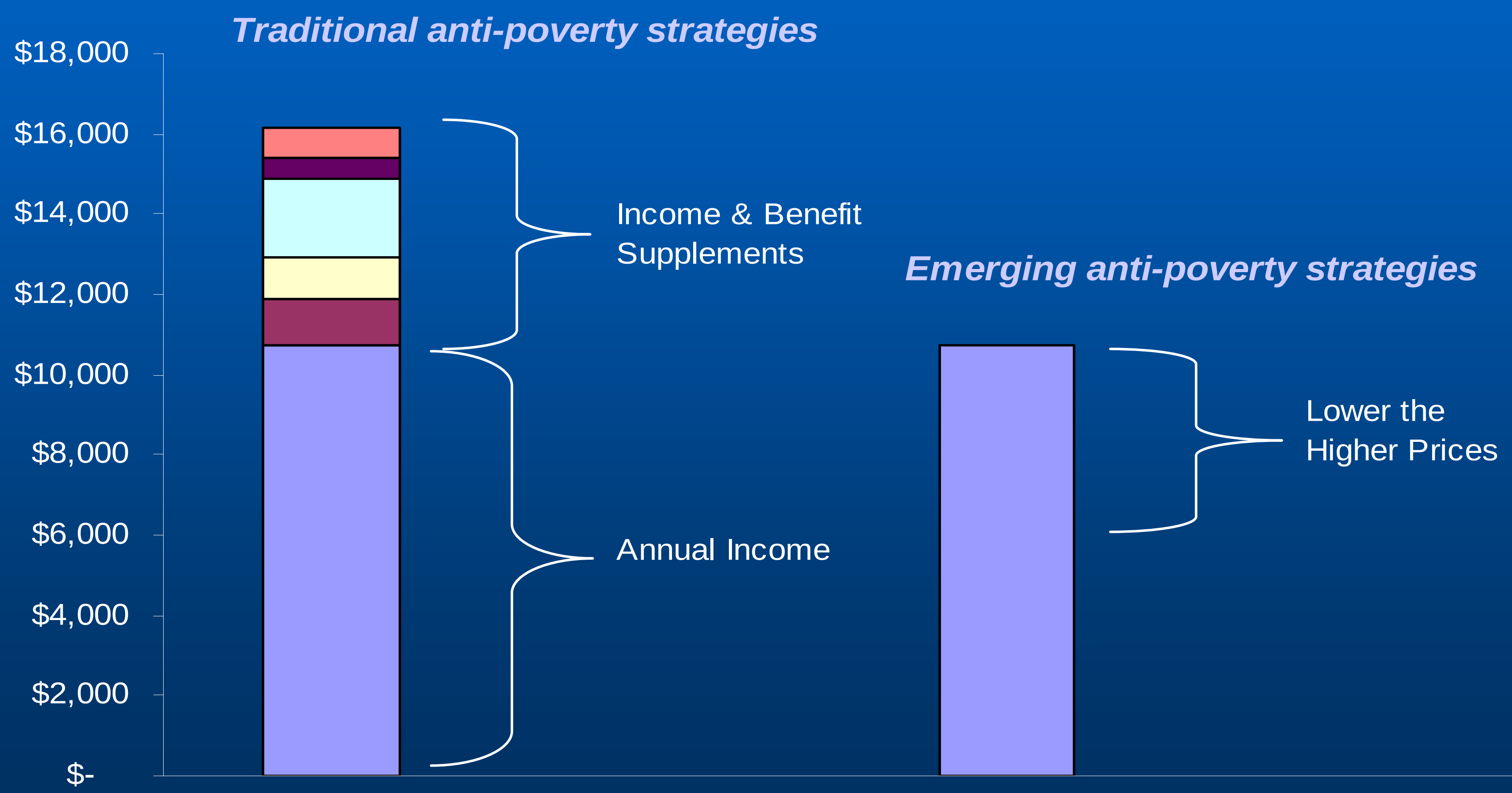


Why?

Low-wage families pay higher prices than higher income households for nearly every basic necessity



The implication is that lowering prices for low-income families is a powerful, and widely underutilized tool to fight poverty



In July ‘06 we will publish our second report in this project, an analysis of prices for necessities within 12 markets

This forthcoming report will provide extensive evidence of these higher prices, along with an agenda for policy and market-based reforms to lower these higher prices

Today, I want to give you a preview of our findings, by presenting some evidence related to the higher prices low-income consumers tend to pay for:

short term loans and cashing checks

Over the past decade, policy, social, and economic trends triggered massive growth in the demand among low-income families for these basic financial services

- Welfare reform spurred millions of low-income adults into the workforce
- Immigration is at a recent high, many of whom have lower incomes than the national average
- Wages have not kept pace with inflation through much of this period, particularly among low-income workers

DEMAND

Market entrepreneurs responded to this surging demand with new establishments, market products, and business models.

- Much of this entrepreneurship and innovation was spawned by new businesses rather than traditional, mainstream financial institutions.
- The result is that low-income neighborhoods have a very unique infrastructure of financial services

As has been well documented, the outcome of these changes is that low-income consumers tend to utilize higher-priced providers of short-term loans

Examples of Sources	*Monthly Advance*	*Fee*	*Monthly Interest Rate*	*APR*	*Total Monthly Charge*
NCSECU Credit Union (Payday Loan)	$200	0%	1%	12%	$1.20
Credit Card	$200	0%	1.5%	18%	$3
Credit Card Cash Advance	$200	2%	1.5%	91%	$7
Overdrawn Checking Account	$200	$20	0%	120%	$20
Auto-title Lender	$200	11.5%	0%	300%	$23
Payday Lender	$200	15%	0%	390%	$30

Note: All estimates based on published analyses, but APRs widely vary across both places and companies; the credit union pay day loan is based off of the North Carolina State Employees Credit Union program Also, all sources are assumed to be utilized once per-month.

It is also widely known that low-income consumers are now more likely than other consumers to utilize check cashing services

Unlike most banks and credit unions, check cashing services charge a fee (usually 2-5% of the face value) to cash checks

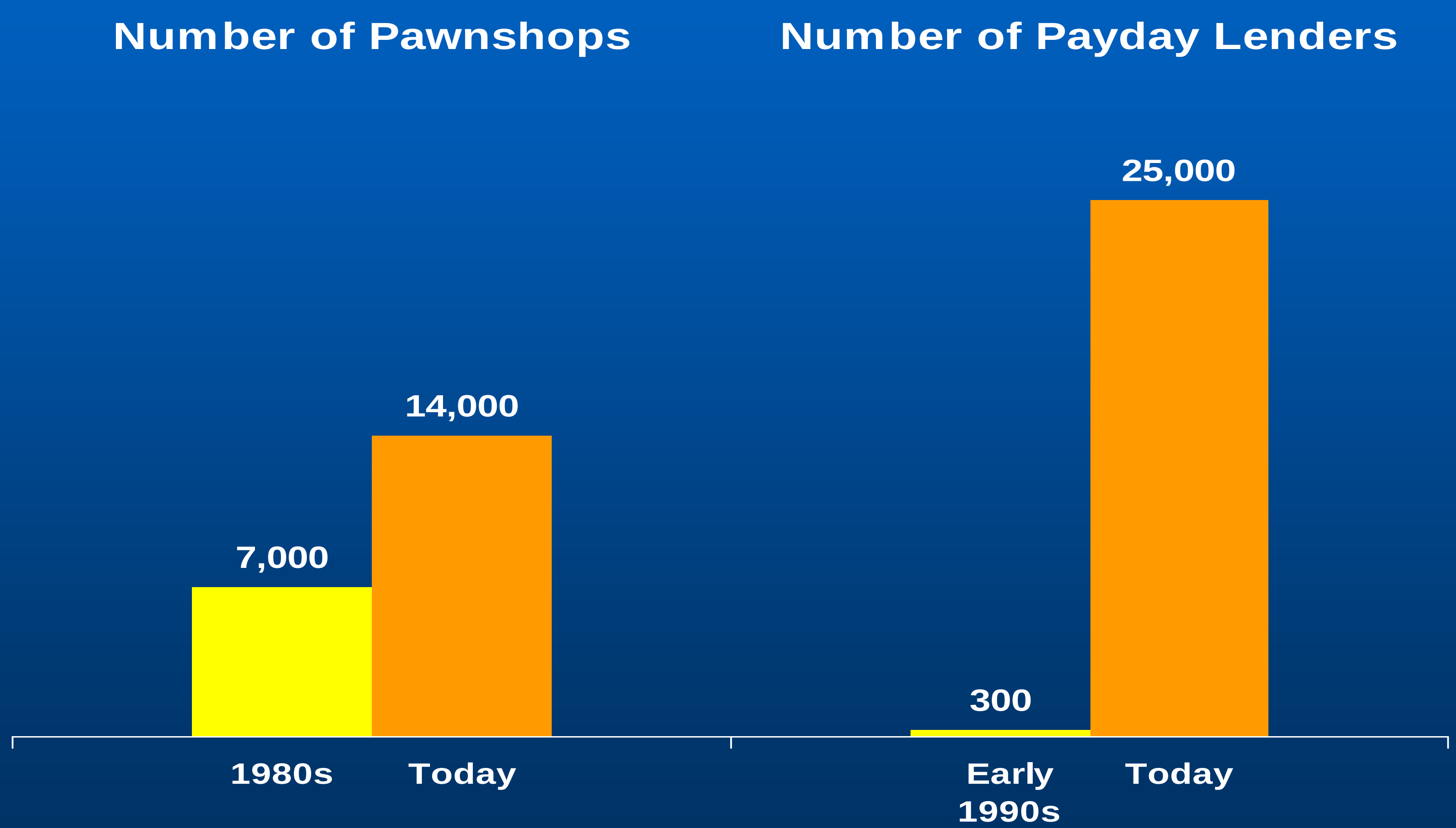
Using this service makes sense for households who would frequently overdraw a checking account, but most researchers assume this is a small part of the population

Among the numerous causes, many have pointed to problems associated with access to mainstream products

- Alternative providers (e.g., check cashers, pawnshops, payday lenders, & auto-title lenders) target low-income consumers

- Mainstream providers (e.g., banks, credit unions, credit cards) dissuade low-income consumers

But, much of the data that speaks to these issues is out-of-date because this market is rapidly growing. For instance:



Note: Estimates are from John Caskey (*Fringe Lending*) and Sheila Blair (Low-Cost Payday Loans: Opportunities and Obstacles)

This leaves important questions unanswered..

- Where is all of this growth happening?
- What implications do these trends raise for public policy and the market?

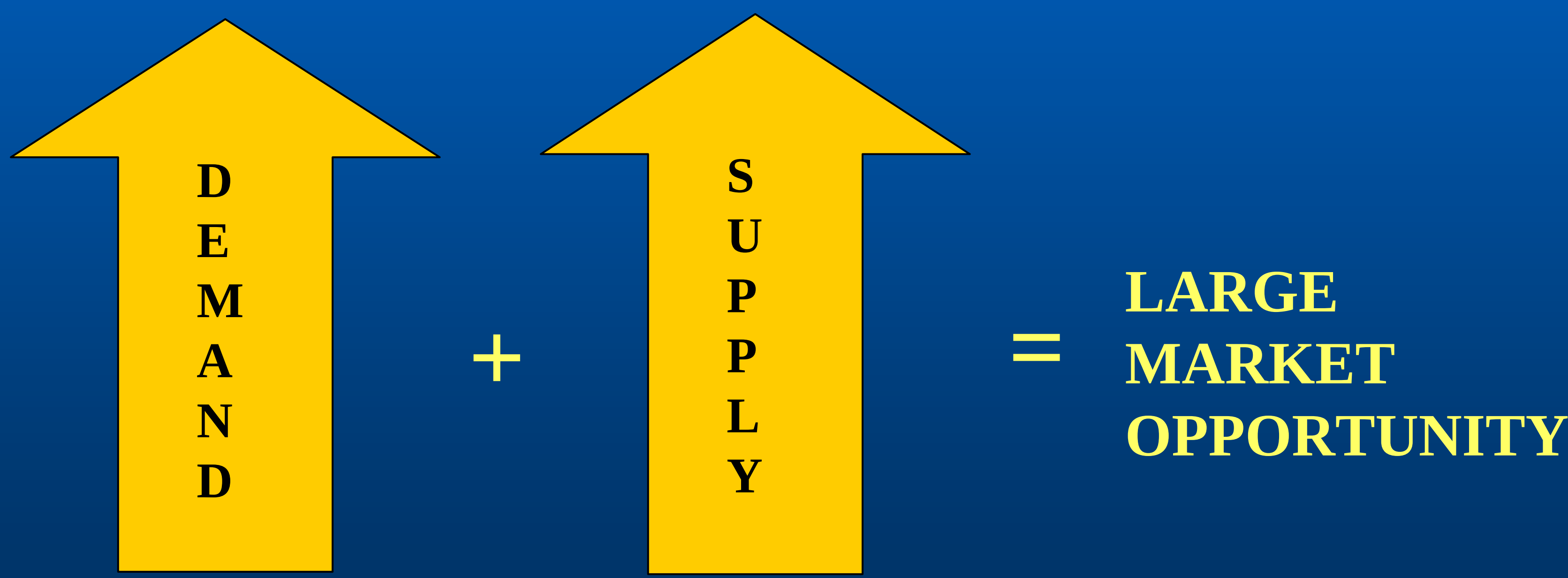
Grounds for Competition:
The Basic Financial Service Infrastructure in Low-Income Neighborhoods

I Why are we asking these questions?

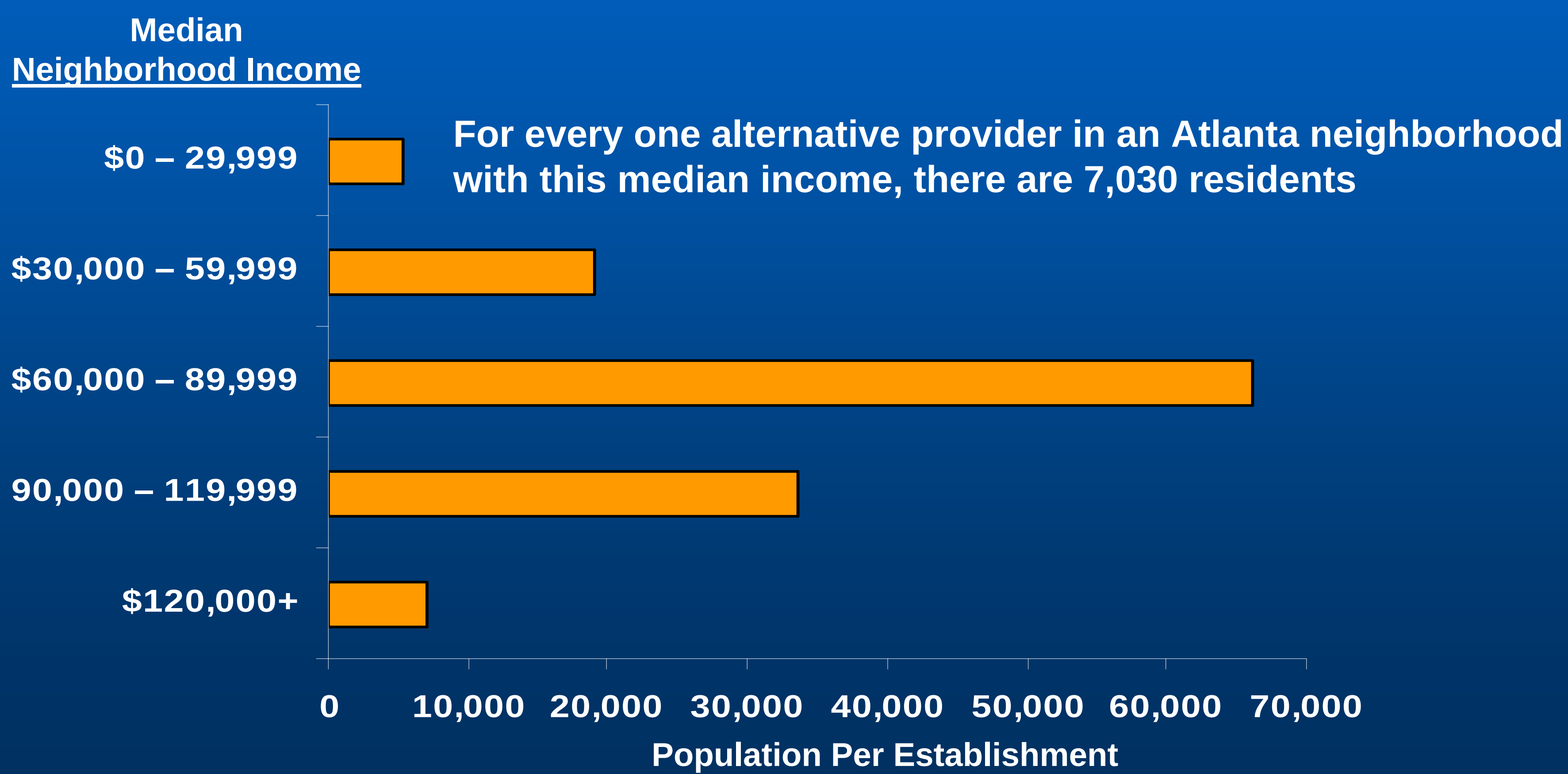
II What are the major findings?

III How is the market and public policy responding?

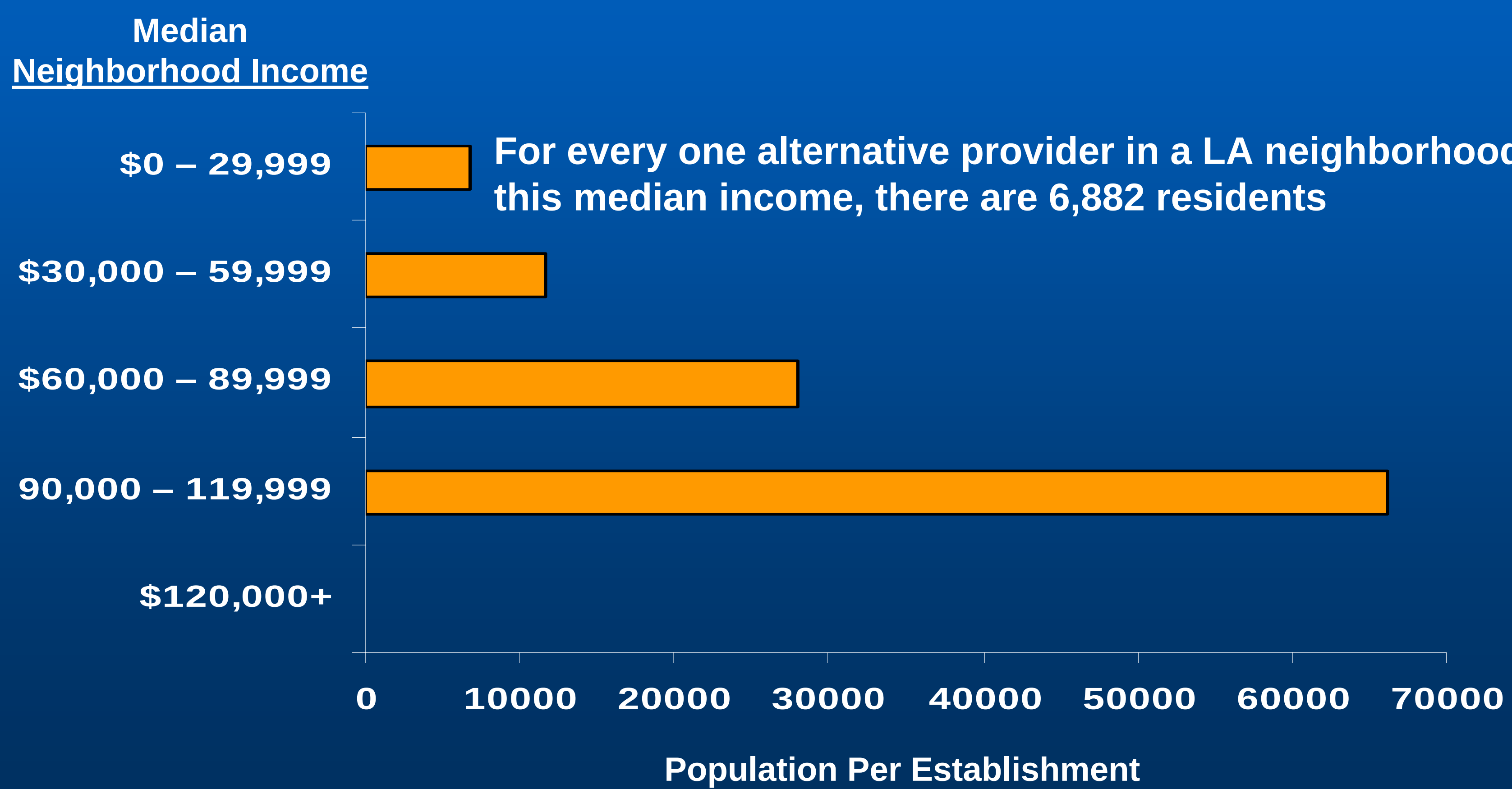
Across the 12 metropolitan areas in our sample, there are approximately 5,243 alternative providers of check cashing and short term loan services, collectively earning about $3.2 billion in annual revenue.



The highest per-capita number of alternative check cashing and short term loan providers tends to be in the lowest income neighborhoods of metropolitan areas. For instance:

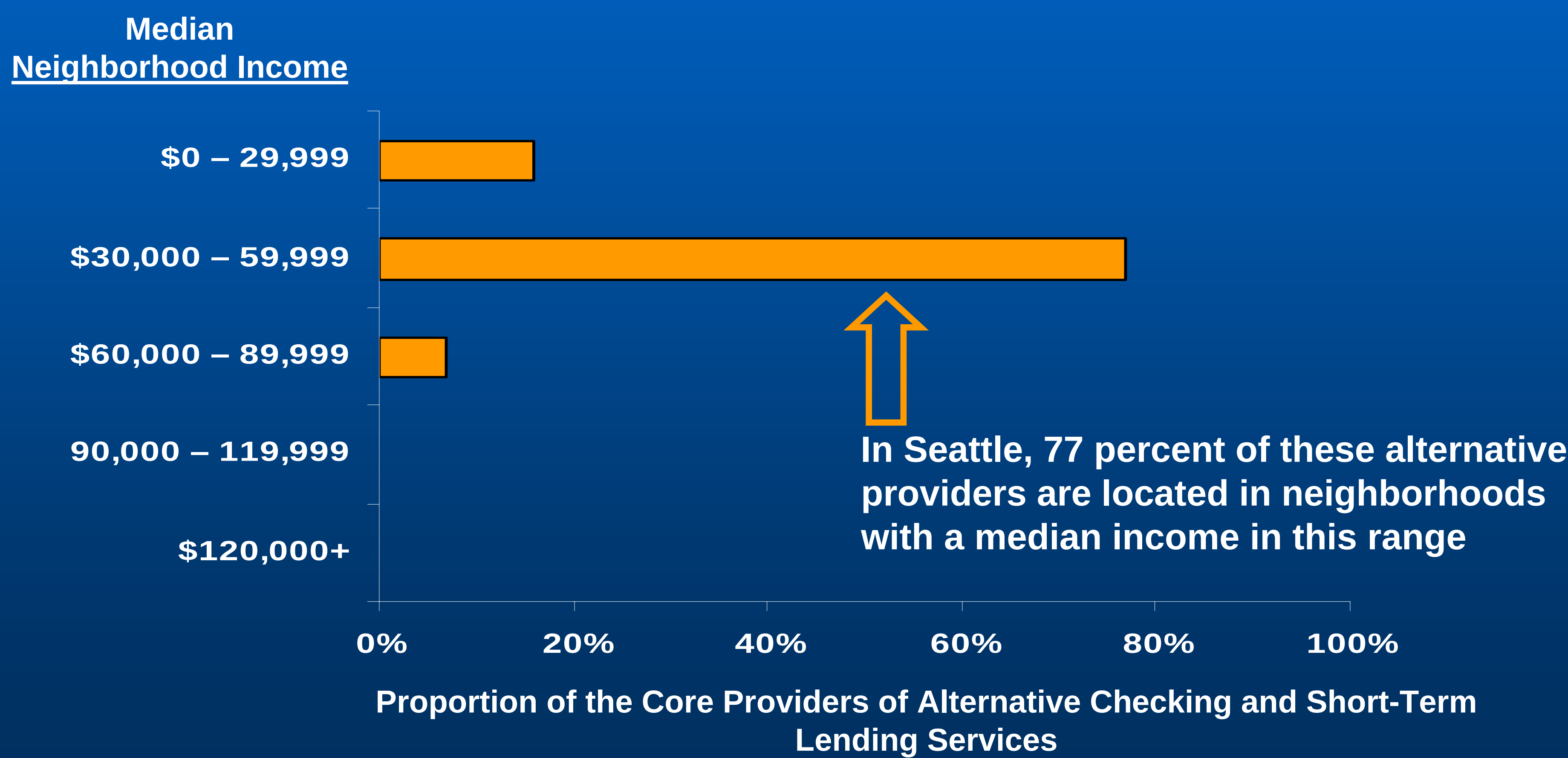


The same trend is found if we look at only the central cities of these metropolitan areas. For instance:

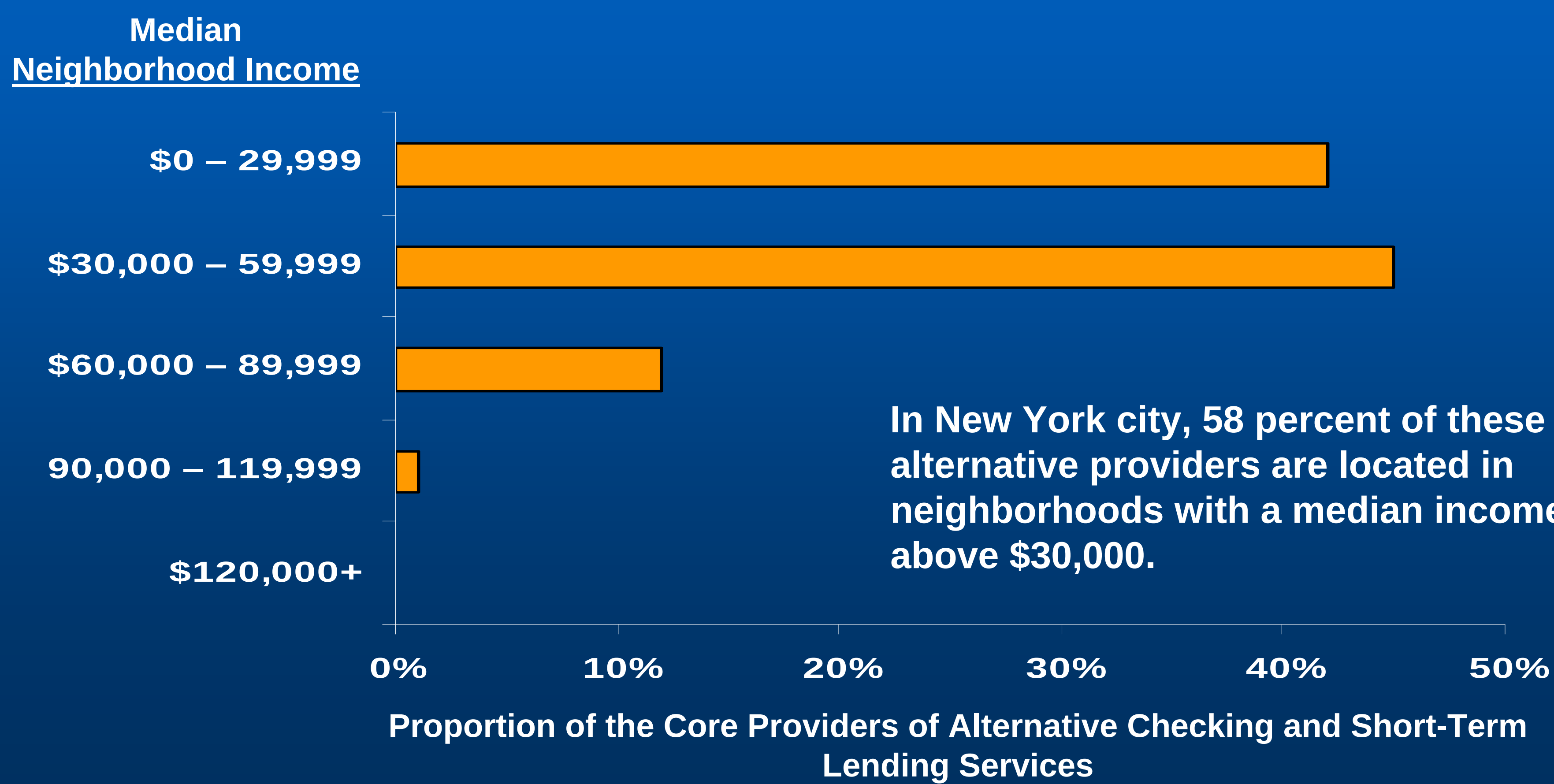


This evidence suggests that alternative check cashing and short-term loan providers tend to be more densely concentrated in low-income neighborhoods

But, the majority of these alternative financial service providers in metropolitan areas tend to be located in more moderate income neighborhoods. For instance:



The same trend is reflected in 9 of the central cities within these 12 metro areas. For instance:



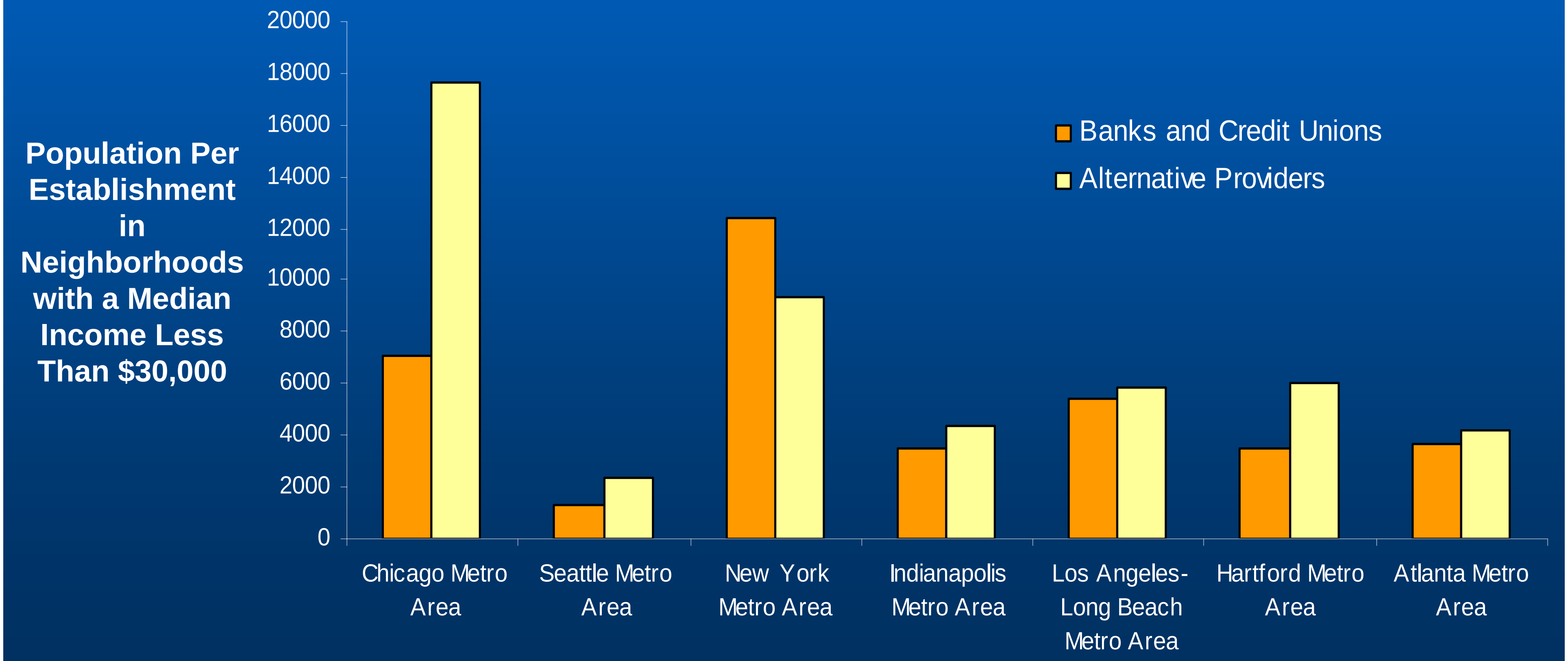
In New York city, 58 percent of these alternative providers are located in neighborhoods with a median income above $30,000.

This evidence suggests that most alternative check cashing and short-term loan providers tend to be located in moderate income neighborhoods.

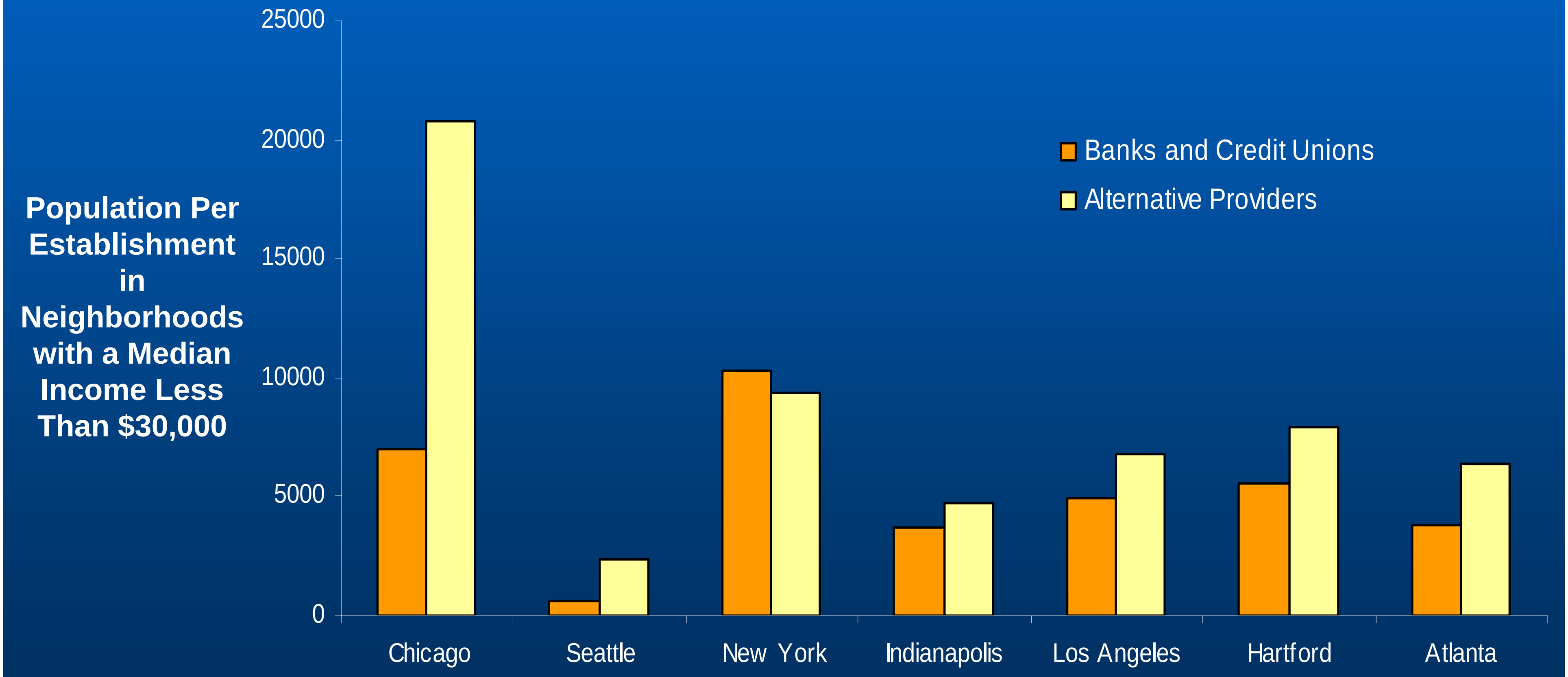
The natural market competitor to these alternative financial service providers are mainstream financial institutions. Do they have the infrastructure to compete?

In our sample of 12 metropolitan areas, there are about 14,423 banks and credit unions.

In all but two of the 12 metro areas, mainstream financial institutions are more densely concentrated in low-income neighborhoods than alternative providers of check cashing and short term loan services. For instance:



The same trend is found if we look at only the central cities of these metropolitan areas. For instance:



This evidence suggests there actually is more of a “product desert” than a “retail desert” in most low-income neighborhoods

All of this adds up to a few central conclusions:

1. **There is a very large market for alternative check cashing and short term loan services – over $3.2 billion in our sample.**
2. **This revenue is being generated in a diverse set of neighborhoods.**
3. **Mainstream financial service companies have a substantial infrastructure in place to compete with these alternative providers**

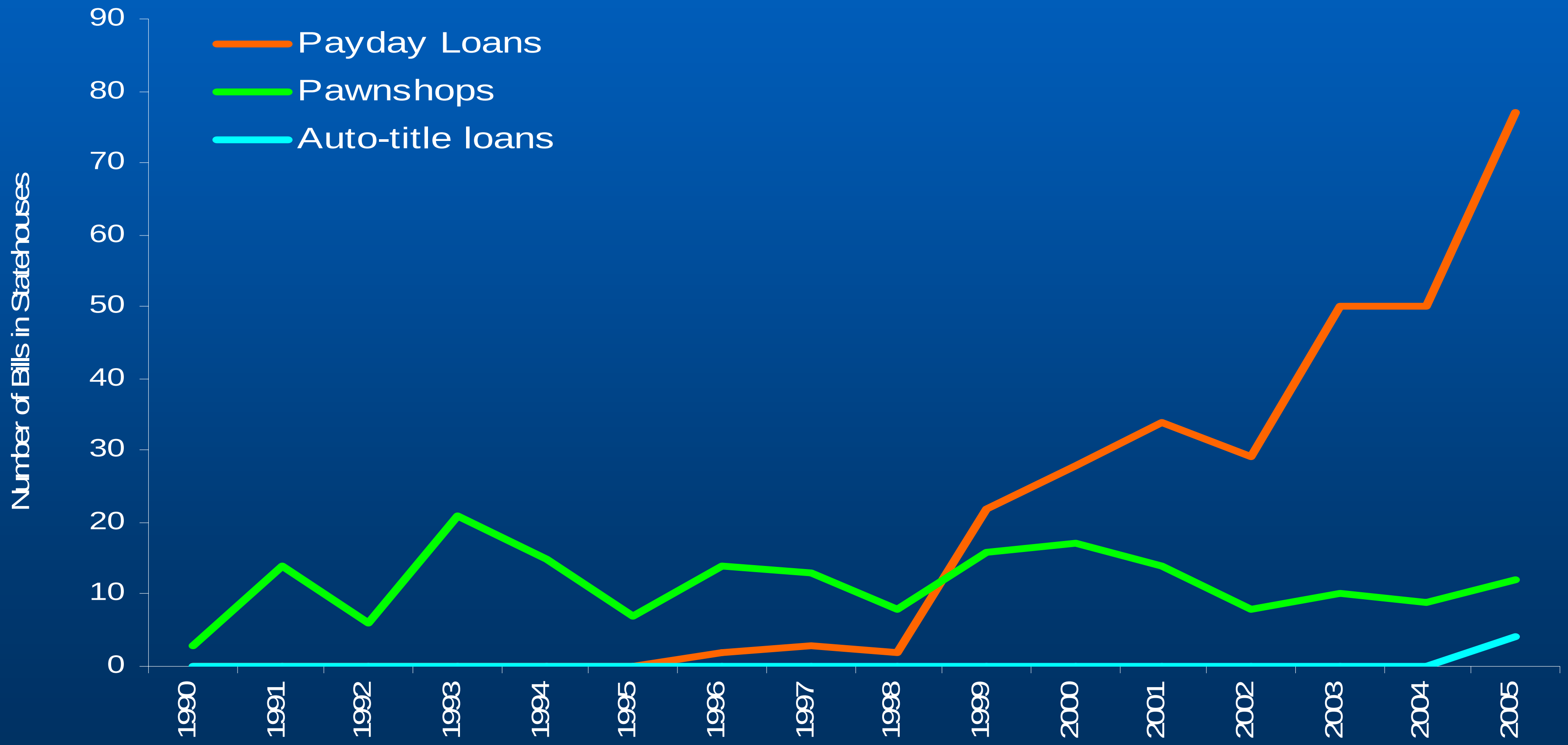
Grounds for Competition:
The Basic Financial Service Infrastructure in Low-Income Neighborhoods

I — Why are we asking these questions?

II — What are the major findings?

III — How is the market and public policy responding?

The massive expansion in the alternative check cashing and short-term loan market has caught the attention of state policymakers



Source: Matt Fellowes (Laboratories of Capitalism)

It has also caught the attention of mainstream providers of financial services

Credit unions are entering the payday loan market

Banks are exploring new, competitively-priced short-term loan products, and are increasingly competing for checking account customers

Going forward, this means that the alternative lending market may actually become a victim of its own success

Policymakers can encourage this by:

1. **Continuing to challenge the business model of alternative providers of these basic services**
2. **Curbing market demand for high-priced, short-term loans from mainstream providers**
3. **Fostering incentives for market innovation and competition in this market**

www.brookings.edu/metro