Making Markets an Asset for Lower Income, Working Families

Matt Fellowes
Fellow, The Brookings Institution

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Chairman Lieu, Vice Chairman Gaines, and other members of the committee, thank you for inviting me to talk with you today about this important opportunity to build wealth among California's lower income, working families by expanding access to banking services. Building a relationship with a bank is one of the first crucial steps that families must take to have any meaningful chance to get ahead in today's economy, and I applaud the committee for striving to expand access to that opportunity. If you are successful, I am confident that you will be rewarded with more upwardly mobile working families, a growing California economy, and a more vibrant, robust banking industry.

In this testimony, I want to discuss relevant findings from a research project that I have been directing at the Brookings Institution over the past several years. I will make three major points:

- Large shares of California's lower income families lack access to normally priced financial services, particularly among the nearly one million families that live below the poverty line in the state.

- The lack of access to normally priced financial services erodes the ability of lower income, working families in the state to save for and invest in their future economic mobility, and may also erode the potential for economic development in lower income markets.

- California policymakers can expand access to normally priced financial services by addressing the numerous market problems that curb access, including misplaced demand for financial services among working families and the lack of normal priced financial services in lower income markets.

Large shares of California's lower income families lack access to normally priced financial services, particularly among the nearly one million families that live below the poverty line in the state.

California's lower income families (50 percent of the state median income) roughly earned about $37 billion in 2004. That large sum of money speaks to the robust buying power that this group of families collectively has in the state.

Yet, the higher prices that these families tend to pay for financial services curb the buying power of that substantial amount of income.

In a recent report by the Brookings Institution, I found that low-wage families often pay higher prices than higher income households to buy car loans and insurance. They often pay higher prices to buy mortgages and insure homes. They often pay higher prices to buy furniture and appliances. And they often pay high prices for basic financial services, like cashing a check and taking out a short-term loan.

Higher business costs, bad apples in some industries, and profound information shortcomings all help explain these higher prices.

Together, they can add up to thousands of dollars in extra costs for individual lower income families that other households don't have to pay for the same basket of goods and services. That's a roadblock for these families; it's also a drain on the California economy.

Let me give you two examples of how this market dynamic plays out in California's basic financial service marketplace—the subject of today's hearing.

The first example I'd like to mention regards the most basic financial service of all: cashing a check. Most Californians have some type of account at one of the 8,013 bank and credit union branch locations in the state, and use that account to cash their paychecks.

But an estimated one out of every four families in California do not have a checking or savings account, instead relying in large numbers on some form of non-bank alternative, like one of the 8,775 check cashing establishments in the state. My research, along with others, shows that the bulk of these unbanked families are lower income, have a low level of educational attainment, and are minorities.

To be sure, non-bank establishments like check cashing businesses are currently providing an essential service for some of these unbanked lower income families, particularly those who lack the paperwork that most banks require of prospective customers, or have had trouble maintaining bank accounts in the past.

But the check cashers' business model is built around and sustained by very high prices. Where banks pay for their capital costs—like their employees, utilities, and brick and mortar retail branches—by selling a suite of financial services, most check cashing businesses only sell a handful of financial service products. With fewer products to sell, and similar capital costs, check cashing establishments have to sell their smaller number of products at comparably much higher prices than what is normal. Exactly how much more depends on what state the business is in, since states have the authority to regulate these fees. In California, the maximum rates are 3.5 percent of payroll or government checks and 12 percent for personal checks. In contrast, most major banks reportedly do not charge a penny to their customers for this service.

Given that massive price difference between what check cashing businesses and banks charge for the same service, why in the world are there more check cashing locations in California than bank branches?

Unfortunately, there's not one answer to this problem, and thus no one silver bullet solution to lower these prices.

Some lower income families use non-bank check cashing services because they cannot access a bank or credit union. Over 75 percent of California's lower income neighborhoods have access to a check cashing establishment; only 40 percent have access to a bank or credit union branch. Just as important, nearly 70 percent of California's 8,775 check cashing establishments are doing business in neighborhoods where there is no bank or credit union branch. And, even those lower income neighborhoods that do have access to a branch may not have access to products that make financial sense for them to use.

Other lower income families chose not to use banks to cash their checks because banks are frankly more difficult to use than check cashing businesses. Banks are subject to a wide range of regulatory oversight and store vastly higher sums of money at their retail locations, which means they have to be more cautious than check cashers about doing business. They require comparably more paperwork up front; they operate during normal business hours; and they attach high fees to customers that cannot maintain their accounts. In contrast, check cashing businesses are loosely regulated, require little or no paperwork before cashing a check, and operate during off-business hours.

Still others are unbanked in California because of the lack of information about banks and credit unions. Unbanked families report in surveys that they do not have a bank account because they hadn't ever thought about it, they don't trust banks with their money, or they think that banks are just for wealthy people.

The second example I'd like to mention regards short-term loans. Where most Californians use credit cards for short-term loans, mostly lower and moderate income Californians also use, or use instead, one of the 2,439 payday loan branches in the state to buy payday loans. Where credit card companies lend short-term, unsecured loans, payday lenders lend short-term loans secured by an advance check.

Like other non-bank financial service establishments, the payday loan business model is built around very high comparable business costs. Where credit cards are sold either by banks, or by companies that have no retail location and costs, payday lenders must pay for their capital costs and make money by selling a very limited suite of services out of retail locations. Given those higher costs of doing business, it's no surprise that in California these businesses can charge 35 to 40 times the rate charged by credit cards. It's a much more expensive business model, which translates into much more expensive products.

Still, why would anyone want to buy such an outrageously expensive product? Like check cashing customers, there isn't just one type of payday loan customer.

Some of these payday loan customers are maxed out on credit cards, and are desperate to find additional sources of credit to either pay their bills or continue to finance a lifestyle that their income does not afford. Others use payday lenders because they are convenient way to quickly get cash: over one in three lower income neighborhoods in California has access to a payday loan business establishment, compared to about one out of every 100 higher income neighborhoods. Still others likely use payday lenders because there is nothing similar sold by banks. And there are likely others who are confused about the real costs of these loans, compared to credit cards. Paying $5 for a $100 two week loan, for instance, may not seem like a lot if you cannot do the math to calculate what the similar charge would be for a cash advance from a typical credit card.

Lack of access to normally priced financial services erodes the ability of lower income, working families in the state to save for and invest in their future economic mobility, and may also erode the potential for economic development in lower income markets.

Together, these higher prices can add up to a major roadblock for individual lower income families, curbing their ability to convert hard work into economic mobility. Take someone who works at one of California's largest employer's today, UCLA, and earns an after-tax income of $26,815, or about 50 percent of the median household income in the state. If they managed their money and banked with one of the state's largest banks—Bank of America, Washington Mutual, Wells Fargo—they would likely pay nothing to cash their biweekly checks. Alternatively, if they did not have a bank account, and used a check cashing business instead, this employee would pay about $804 a year to cash their checks.

That may not sound like a lot of money, until you think about the value of that money over time. If it were instead socked away in a money market account, that one overcharge would add up to almost half of that family's annual income in about ten years. That's money for a family to pay for their kids to go to college, invest in a car to get to a better job, buy a house, or lay the foundation for a retirement nest egg. That's not a future that an unbanked check cashing customer can reasonably dream of as long as they are not using a bank for this financial service.

Besides the costs this adds to individual families, it also adds up to missed opportunities to grow California's economy. Instead of this $804 potentially being spent on investments every year that grow wealth over time, it's going to a check cashing business. It's true that these businesses employee thousands of Californians, but those thousands of Californians would likely be better off in the long run if more Californians were able to save for and attend college and make other wealth-building investments.

Similarly, these higher prices for basic financial services help drive up the cost of government in California by eroding the effectiveness of California's substantial investments in lower income families. The purchasing power created by these policies is eroded by higher prices for basic financial services, curbing the ability of family's to invest in their futures and leave state support behind.

California thus has a choice. Maintain the status quo, where nonbanks are thriving, an estimated one in four families are unbanked, and millions cannot reasonably dream of saving for and investing in upward mobility. Or choose a future where banks are thriving, more Californians are banked, and millions more can reasonably dream of economic mobility.

Finally, California policymakers can expand access to normally priced financial services by addressing the numerous market problems, including misplaced demand for financial services among working families and the lack of normal priced financial services in lower income markets.

Reducing the higher prices that lower income Californians are often paying for basic financial services is an important, and too often overlooked way to promote economic mobility. To seize this opportunity, leaders need to connect more banks and credit unions to lower income customers. In general, there are three ways California policymakers can do this.

First, leaders can encourage banks and credit unions into lower income markets by providing incentives. These incentives can take any number of forms. For instance, New York state and cities across that state have successfully used state deposits to encourage mostly small banks into lower income markets. In particular, this program—passed and implemented with bipartisan support—authorizes both the state and city banking departments to transfer more than $100 million in revenue to branches that open in lower income neighborhoods and offer those branches a discounted interest rate on up to $10 million of the deposit for up to two years. This deposit makes up for the relatively low depository and borrowing power among lower income consumers, allowing branches to open up in lower income markets. At the same time, this program gives state and local leaders the opportunity to oversee the development of branches in lower income markets, helping to ensure that participating banks offer and market reasonable, lower cost products.

According to an analysis of fifteen of these branches, more than 20,000 new checking or savings accounts were opened between May 2005 and April 2006, along with about $84 million in new loan originations. Though a small part of New York's banking market, the program has had an unmeasured further effect by encouraging additional banks to open and lend in these markets. This program can easily be expanded because the costs of the program—administrative and lost interest income—are minimal.

Formally partnering with banks to meet this demand for bank accounts in lower income markets is another incentive open to California's policymakers. San Francisco's Mayor Newsom and Treasury Secretary Cisneros, for instance, have set a goal to open checking accounts for at least 20 percent of the city's unbanked households within the next two years through a partnership they formed with participating banks and credit unions. In exchange for free marketing supplied by the city, the banks and credit unions are working together to design appropriate banking products and marketing strategies that will lure lower income consumers away from high-priced alternatives and into the lower-priced mainstream financial service industry. In this way, banks and credit unions are sharing the start-up costs associated with entering new markets, and the city is able to lower the cost of financial services for the poor by working to ensure that banks offer responsible, lower-priced products. State policymakers could easily replicate this model.

Second, leaders can lower the prices that nonbanks charge for their services. Check cashing businesses, for instance, are thriving in at least ten other states that have lower maximum fees, including in New York, where these businesses are allowed to charge a maximum of 1.64 percent of the face value of a check. California allows these same businesses to charge more than two times that rate for payroll and government checks, and seven times that rate for personal checks. That's money that lower income New Yorkers have in their pockets or bank accounts today that Californians do not.

Finally, leaders have to address the yawning gap between what lower income families know about personal finance and what they need to do know, including that having a bank account is essential for most people.

To be sure, nearly every state over the past five years has considered legislation to expand financial education investments. Likewise, the federal government now has dozens of initiatives designed to boost financial education, and countless financial service companies now have similar services available. At the same time, financial advisor personalities are now constant fixtures on cable channels, in newspapers, and the internet; and countless webpages, like those at beehive.org, fill the Internet up with sage financial advice. Why would we possibly need more financial education?

Put simply, the current financial education investments—by both the private and public sector—are not as effective as they need to be. The evidence is unmistakable: most Americans do not understand financial matters, and what knowledge does exist among borrowers systematically varies with household income. Among the signs of this, the savings rate is negative and has been since the second quarter of 2005, all while the future of private and public pensions looks increasingly bleak. More specifically, Providian Financial and the Consumer Federation of America recently found that 73 percent of Americans do not understand that credit scores measure risk; the General Accountability Office found in a recent analysis of credit card customers that "many failed to understand key aspects of their cards, including when they would be charged for late payments or what actions could cause issuers to raise rates"; and the Jumpstart Coalition for Financial Education found that a majority of Americans do not understand basic financial management skills. The list of data from a wide range of sources goes on and on.

California policymakers, along with policymakers around the country, need to get serious about this problem, particularly with regard to lower income families, who have small margins of error in their budget and limited chances to get ahead. That should include a statewide commission that is charged at looking into how financial planning can be meaningfully institutionalized in lower income markets; how financial education can be meaningfully integrated into school curriculum; and the role that the private sector can play in each of these efforts.

California can bank the unbanked, and put the market to work for lower income, working families in the state. The poor do not need to pay more.