Financial Services in Distressed Communities:

Framing the Issue, Finding Solutions

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As many as 12 million households in the United States either have no relationship with traditional financial institutions or depend on alternative or "fringe" lenders for financial services. These households are disproportionately poor and minority. Among lower-income families surveyed in a 1995 Federal Reserve Survey of Consumer Finances, 25 percent were "unbanked," as were one-third of African-American households and 29 percent of Hispanic households.

Without banks, these households operate largely in a cash economy or resort to alternative banking services that routinely charge much higher fees than mainstream banks. Reliance on fringe services can be extremely expensive for low-income consumers, as the following examples demonstrate:

- ***Check cashing***. Although the average fee at a check cashing outlet for a government or payroll check ranges from 1.5 percent to 3 percent of its face value, fees can run as high as 20 percent for personal checks.

- ***Payday loans***. Payday lenders—institutions that offer small consumer loans of $100 to $300—routinely charge 15 percent per two-week period. In addition to offering annualized interest rates of more than 400 percent, these loans encourage households to spend the next paycheck before it arrives, thus encouraging a dangerous cycle that can trap a household into permanent debt.

- ***Pawnshops***. Pawnshops offer small, short-term loans using personal items as collateral. State-imposed interest rates are capped as high as 25 percent monthly, which, annualized, can exceed 300 percent. Loopholes in some states allow "lease back" or "rollover" agreements under which a borrower can extend the term of a loan for an additional fee, sometimes doubling the already high interest rate.

- ***Rent-to-own***. The rent-to-own industry offers purchasing credit to consumers for a variety of merchandise, such as furniture and home electronics, for weekly or monthly payments that can be applied toward ownership. Leased items are typically priced two to three times more than the standard retail amount. No equity builds up in the leased items until the final payment. According to a

Federal Trade Commission survey, 60 percent to 70 percent of customers who initiate leases eventually purchase the leased item. The Association of Progressive Rental Organizations, however, estimates that the percentage of customers who complete a purchase is less than 25 percent.

- ***Title loans***. Auto title lending is a variation on traditional pawnbrokering. A person with clear title to a vehicle can borrow money from a lender by giving him or her power of attorney to transfer the title should the borrower default. Title loans are typically made for about 25 percent of the car's value. Interest rates and other service charges vary from 2.5 percent to 25 percent per month, depending on a state's pawnshop laws. Title loans are particularly dangerous for working families because defaults can result in the loss of the car and, consequently, the job, if there is no other way to get to work.

- ***Secured credit***. Robert Manning, in his book *Credit Card Nation*, also describes direct marketing campaigns for high-interest "secured" credit cards that are marketed to customers who likely would not qualify for a standard-rate bank-issued credit card. In one example, he cites an offer for a $400 line of credit for which, in return for applying for the credit card, an unsuspecting consumer agrees to pay a variety of fees totaling $369.

Alternative financial services providers argue that the poor credit risk posed by their typical customer justifies the high fees they charge. However, most fringe lenders have devised creative ways–in addition to their fees—to reduce or protect themselves against borrower default. Payday lenders, for example, not only require proof of employment, income, and a personal checking account, but also the deposit of a postdated personal check from the borrower. In the rent-to-own industry, customers build no equity in the leased item until the final payment. This means that a customer who meets all weekly payments but defaults near or at the end of the loan term will lose both the leased item plus all previous cash payments. The retailer can then re-lease the item at the same weekly or monthly rate. Pawnshops provide cash loans in return for collateral left in the possession of the pawnbroker. And "cash leasing," a cross between payday loans and pawn loans, involves small, short-term cash advances that carry monthly interest charges of up to 30 percent, backed by an active checking account and "pledged" household items, such as a stereo, computer, or television.

Another example of how fringe institutions can overstate the risks involved in their business to justify their fees is in the check-cashing industry. According to Progressive Policy Institute analyst Anne Kim, the two largest check-cashing companies in the United States cashed roughly $6.5 billion in checks last year, the majority of which were payroll checks or government benefit payments. As a result, the value of bad checks–that is, the checks for which those companies could not collect upon–totaled less than one-fourth of 1 percent of the total amount of checks cashed. Meanwhile, the fees charged to cash these checks averaged between 2.2 percent and 3.5 percent of the face amount of the checks cleared—resulting in a healthy profit.

A Growing Problem

As Table 1 illustrates, fringe banking is big business. Fringe institutions engage in at least 280 million transactions each year with a gross dollar value of more than $78 billion. The fees extracted from these transactions each year total at least $5.5 billion. According to Norman D'Amours, former chairman of the National Credit Union Administration, the number of unregulated and unlicensed financial service providers is growing nationwide, but the increase is exponential in low- and moderate-income and minority communities.

He notes that while the number of credit unions, banks, and thrifts has been steadily decreasing over the past five years in the United States, the number of check-cashing outlets has doubled. An April 2000 report by Dove Consulting for the U.S. Department of the Treasury reveals that about 11,000 check-cashing outlets in the United States cash more than 180 million checks annually, worth roughly $60 billion. D'Amours also estimates that there are between 12,000 and 14,000 pawnshops across the country, outnumbering credit unions and banks. Further, in 1996, there were 8,000 rent-to-own stores that served three million customers, according to a recent Federal Trade Commission survey. And in *Savings for the Poor*, Michael Stegman of the University of North Carolina, Chapel Hill, reported that payday lending grew nationally from 300 stores seven years ago to more than 8,000 in 1999.

Table 1. **Fringe Lending Is Real Money**

Service	**Fee/Rate per Transaction**	**Number of Transactions per Year**	**Annual Gross Revenues**	**Annual Total Fees**
Check Cashing	2-3 % for payroll and government checks (Can exceed 15% for personal checks)	180 million	$60 billion	$1.5 billion
Payday Loans	15-17% per 2 weeks 400% APR	55–69 million	$10–13.8 billion	$1.6–2.2 billion
Pawnshops	1.5-25% monthly 30-300% APR	42 million	$3.3 billion	N / A
Rent-to-Own	2-3 times retail	3 million	$4.7 billion	$2.35 billion
Auto Title Lenders	1.5-25% monthly 30-300% APR	N / A	N / A	N / A
Total	N / A	280 million	$78 billion	$5.45 billion

Lack of physical access to mainstream banks is perhaps the most frequently cited reason why low-income and minority households are less likely than wealthier households to use mainstream financial services and more likely to use fringe services. A 1999 *Harvard Business Review* article, for example, cites extreme disparity in the financial services options available to residents of two neighborhoods in Los Angeles—one in low-income South Central and the other in wealthy Pacific Palisades. South Central has one bank for every 36,000 people, while Pacific Palisades has one for every 1,250 people.

While physical proximity is important, it is not the only—and often not the most significant—barrier to the use of mainstream banking services by lower-income and minority households. A variety of complex reasons explain why many lower-income and minority households do not use traditional financial services, even if access is not an issue. For example, some consumers are unfamiliar with traditional banking and savings services, and others believe that they do not write enough checks to justify an account. Many consumers cite a lack of trust in mainstream banks. In addition, mainstream financial services can be very expensive for some consumers, especially those who cannot fulfill minimum balance requirements and must pay maintenance fees. Poor management of an account can also result in unaffordable bounced check fees.

In fact, high-cost lenders justify the rapid growth of their industry on the basis of what they argue are large unmet needs for consumer financial services among lower-income households. According to the Financial Service Centers of America, formerly the National Check Cashiers Association, fringe lenders fill an important financial services gap for "individuals with limited financial means or who may lack the tangible assets to pledge in connection with traditional types of collateralized transactions." They further argue that alternative financial services providers are in higher demand than banks or credit unions in many markets because check cashers, pawn shops, payday lenders, and related institutions provide a wider range of services and more flexible hours of operation tailored to meet the unique needs of their clients.

Undeniably, fringe lenders provide critical services to customers whose extremely low or unreliable incomes, limited tangible assets, or inability to manage credit make them unlikely candidates for mainstream financial services. But the explosive growth of these alternative financial services outlets over the past decade raises many critical policy issues. First, since fringe lenders do not typically provide savings accounts, households that rely exclusively on them lack both the incentive and the option to save. Second, the heavy concentration of high-cost lenders in minority communities means that these households are disproportionately burdened with second-class financial services options. Finally, reliance on alternative financial services firms, even to the extent they provide needed financial services, routinely comes at a very high cost

Fringe Banking Undermines Households and Communities

Even at the most modest levels, fringe banking fees can greatly undermine the asset-building capacity of lower-income households. According to research cited by the Federal Reserve, check-cashing and bill-paying services would cost an average $20,000-income household between $86 and $500 per year, while the same services at a bank would cost only $30 to $60 (assuming that low-cost banking services are available and the prospective customer is not disqualified for an account by lack of credit). To illustrate the magnitude of these expenses over time, assume that a household currently spending $500 a year on high-cost services was instead able to set this money aside in a savings account. If this household were able to save $500 a year for 10 years at a modest interest rate of only 4 percent, the total savings at the end of this period would equal more than $6,000. This amount is sufficient for a down payment on a modestly priced home.

The cost of alternative financial services can be even higher if households using check-cashing and bill-paying services also resort to payday loans, pawnshops, rent-to-own retail, or auto title loans. An example Manning offers in *Credit Card Nation* is of a $196 Magnavox TV that costs $9.99 a week for 78 weeks from a rent-to-own shop, for a total cost of $779. In comparison, a consumer who buys the same TV from a national discount electronic store with a credit card at 22.8 percent annual interest would spend only $231, including finance charges, over the same 78-week period. The difference in finance charges would be $548—an amount that can have devastating financial consequences over the long term. For example, assume that the hypothetical household described in the preceding paragraph spent an additional $300 per year on rent-to-own financing fees, which means $800 a year in total spending for fringe financial services. Again assuming a modest 4 percent rate of return, this household could have saved nearly $10,000 over 10 years.

Even if these households actually were able to save some of their earnings, their failure to access mainstream financial services institutions undermines their long-term asset accumulation. To illustrate, Table 2 calculates the effect of a 10-year investment in different investment vehicles. If, in 1989, a family had $3,000 in savings, but saved the money in a shoebox, that $3,000 would still be worth $3,000 in nominal dollars 10 years later but only $2,233 when adjusted for inflation. However, the same sum invested in a 10-year Treasury note would have grown to more than $5,000 by 1999. Investment in an S&P index fund would have yielded $9,180 over that 10-year period. And if the family had, by prophetic insight, invested their savings in Microsoft Corp. in 1990, their wealth could have grown to a staggering $211,360 by 1999.

Table 2. **The Value of Saving $3,000***

Year	**Shoebox**	**Treasury Note**	**S&P 500 Index Fund**	**Microsoft Stock**
1989	$3,000	$3,000	$3,000	$3,000
1999	$3,000	$5,072	$9,180	$211,360

*Table in nominal dollars

Subprime Home Mortgage Lending

As with fringe lending, subprime mortgage lending has also experienced tremendous growth in recent years. A recent U.S. Department of Housing and Urban Development (HUD) study indicates that between 1993 and 1998, the dollar volume of subprime loans grew sevenfold, from $20 billion to $150 billion, and the number of subprime refinance loans grew tenfold, from 80,000 loans to 790,000 loans. This growth in subprime lending compares to a less than 40 percent increase in prime lending for home purchases and a 2.5 percent increase in prime refinance loans.

HUD reports that subprime loans are heavily concentrated in lower-income and minority communities—the same communities that are the target for fringe financial outlets. HUD's analysis indicates that subprime loans are three times more prevalent in lower-income neighborhoods than in high-income areas, and five times more likely in black communities than in white neighborhoods. In fact, in black neighborhoods, high-cost subprime loans accounted for 51 percent of home loans in 1998, compared with 9 percent in white areas. Moreover, homeowners in high-income black communities are six times as likely to have a subprime loan than homeowners in high-income white neighborhoods. Estimates by Fannie Mae, Freddie Mac, and others conclude that many households in the subprime market could reasonably qualify for a prime market loan (see Part II).

The Financial Impact of Unjustified Subprime Lending

Subprime loans do not have to be predatory to seriously undermine the financial viability of households. Targeting or referring households to the subprime market in instances in which those loan applicants could reasonably have qualified for prime market loans greatly undermines the long-term asset-building potential of those households. Each additional interest point on a home mortgage totals tens of thousands of dollars on the total cost of a mortgage over the life of a loan. Subprime mortgages are routinely three to four percentage points or more higher than a comparable prime market loan. Yet a mere one percentage point of additional interest can make a substantial financial impact over the life of a loan (see Table 3).

Table 3. **Comparing Mortgage Payments for Different Interest Rates**

30-Year Fixed-Rate Loan	
House Value	**$85,000**
Down Payment	**$4,250 (5%)**
Loan Amount	**$80,750**

Annual Interest Rate	Monthly Payment	Annual Payment	Annual Difference from 8%	Lifetime Difference from 8%
8%	$592.51	$7,110.18	N / A	N / A
9%	$649.73	$7,796.79	$686.61	$20,598.43
10%	$708.64	$8,503.67	$1,393.49	$41,804.69
11%	$769.00	$9,228.01	$2,117.83	$63,535.05
12%	$830.60	$9,967.26	$2,857.08	$85,712.32

Take the example of a home modestly priced at $85,000. Assuming a 5 percent down payment, the amount of a mortgage on this home would be slightly under $81,000. Assume further that the current average interest rate for a 30-year, prime market loan is 8 percent. If the buyer of this home obtains a loan one percentage point higher than this rate, the buyer would pay an additional $687 in interest a year. Over the lifetime of this loan, the difference in interest would total $21,000. At two percentage points—a 10 percent interest rate—the difference from a prime loan of 8 percent would be $42,000, half the original loan amount.

Now, take that same $687 a household could save each year by shaving off a percentage point on their mortgage and invest it at 6 percent. At the end of 30 years, that household would have $57,572 instead of having to pay $21,000 in additional interest. The two-percentage-points savings of $1,393 per year, invested at 6 percent, would total $116,736 at the end of 30 years for the household. And if the subprime loan carried a 12 percent interest rate, the extra interest payment over the base 8 percent loan would be $85,712 over the life of the loan. Invested at 6 percent for 30 years, that $85,712 of additional payments would grow to $239,421 in savings over a 30-year period.

Predatory Lending

"Predatory" lending is an extreme example of the abusive practices that can arise in communities without a robust financial services market. Generally speaking, three features—alone or in combination—define predatory lending practices. Those features include: (1) targeted marketing to consumers of a particular race, ethnicity, age, gender or other personal characteristic unrelated to creditworthiness or to households that are otherwise financially vulnerable, (2) unreasonable and unjustifiable loan terms, and (3) outright fraudulent behavior that maximizes the destructive financial impact on consumers of predatory marketing strategies and loan provisions. Although a loan involving any one of these tactics might be considered predatory, most predatory lenders use some combination of all three to extract the greatest profit and, as a consequence, cause the greatest financial harm to the borrower.

Aside from excessively high interest rates or fees, predatory lenders deploy an arsenal of wealth-stripping tactics against borrowers. Some common examples of potentially predatory practices:

- ***Negative amortization loans***. Unlike standard loans, these loans are structured with attractively low monthly payments that are insufficient to pay off the accrued interest. The difference between the monthly payment and the accrued interest is added to the principal balance of the loan, which consequently increases each month and thereby makes it impossible for the borrower to build up equity. At the end of the loan term, the borrower may owe more than the originally borrowed amount and in an amount that exceeds the value of his or her home.

- ***Excessive prepayment penalties***. While prepayment fees are rarely charged in the prime market—some two percent of mortgages carry them—they are included in 80 percent of subprime mortgages, according to the Detroit Alliance for Fair Banking. And, unlike in the prime market, where prepayment fees are a tradeoff for lower interest rates, subprime mortgage holders rarely, if ever, get anything for the added fees, which can cost as much as a six percent penalty for early payoff. Consumers are locked into the subprime market even if they demonstrate improving creditworthiness, and doubly hurt because they are not free to take advantage of lower interest rates as can prime market customers.

- ***Balloon payments***. Balloon mortgages are characterized by low monthly payments that are insufficient to amortize the principal of the loan over its term. Consequently, the borrower must repay the outstanding principal at the end of the loan in a large "balloon" payment. Borrowers who are unable to afford this balloon payment are often effectively forced to refinance their loans at even higher rates later.

- ***Single-premium credit life insurance.*** Theoretically, the purpose of credit life insurance is to protect a borrower or his or her family in the event that he or she dies (or becomes disabled or unemployed) and is consequently unable to pay off his or her loan. In those circumstances, the insurer either agrees to pay off the loan or to make payments on the loan for a specified period of time. Borrowers can pay the premium for a credit insurance policy in either monthly installments or in a one-time, up-front lump-sum payment (a "single-premium"). Sales of single-premium credit life insurance policies can be predatory if the borrower does not need or is overcharged for the policy, or if the policy does not adequately provide the protection that is represented. Requiring a borrower to pay the insurance premium up front in a single payment that is then added to the loan's principal balance and financed over the life of the loan is also one of the most common predatory lending practices. In this circumstance, the borrower ends up paying additional interest—on top of the cost of over-priced and often unnecessary insurance. (See "Predatory Lending: An Overview" by Carr and Kolluri, Fannie Mae Foundation, 2001, for further descriptions of common practices by predatory lenders.)

The vast majority of state and federal policymakers concerned about the problem of predatory lending have proposed a variety of legislative solutions aimed at stamping out specific practices deemed to be predatory. The most effective strategy, however, may be to correct the market failures that enable predatory lenders to thrive. Predatory lending does not occur in a vacuum. Rather, it breeds in an environment characterized by little competition for traditional financial services. A community flush with fringe providers, therefore, is an ideal breeding ground for predatory lenders to flourish.

Reasons for Rapid Growth

The confluence of three trends in recent years appears to have contributed to the growth of the alternative financial services industry: 1) the increasing consolidation of fringe institutions into large, publicly held firms with standardized business outlets across the nation; 2) the increasing involvement by mainstream financial institutions in the fringe lending industry; and 3) the aggressive marketing of financial products and services designed to meet the unique needs of lower-income and low-wealth households.

Industry Restructuring

Restructuring within both the mainstream and fringe financial services industries is contributing to the growing significance of fringe financial storefronts in disenfranchised communities. Michael Stegman cites consolidation in the banking industry as one reason for the decline in the presence of traditional banks in neighborhoods of all income levels. In *Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor*, John Caskey suggests that banking deregulation and pressure for increased profits have led banks to charge for previously free services and to close unprofitable branches (often in low-income and minority areas) as well as eliminate money-losing services, such as small-balance deposit accounts.

Over the same period, several fringe financial outlets, such as pawnshops, check cashers, and payday lenders, have engaged in major consolidations. In the check-cashing industry, for example, six firms owned at least 50 outlets each in 1991. By 1999, one of the largest of these establishments had grown to more than 1,000 company-owned stores with franchises in 30 states. Further, this company has expanded its traditional in-store check-cashing business to include bill payment services as well as automated check cashing using advanced function ATMs with user-friendly touch screen menus.

Pawnshops, too, have grown into national chains. Data from *Fringe Banking* report the existence of at least five large, publicly traded nationwide pawnbrokering firms. The largest of these chains went public in 1987 and by 1999 had acquired 414 stores in the United States. The rent-to-own industry has shown similar trends of consolidation. The largest firm was founded in 1986 and by 1999 owned 2,300 stores across the nation, or roughly one-fourth of all rent-to-own stores.

Convergence of Fringe and Mainstream Lenders

Wall Street has also fueled the growth in fringe and subprime activity. A recent *Business Week* article notes, for example, that through securitization—that is, the practice of issuing securities based on a pool of mortgages that can be sold to investors—leading Wall Street firms resold $60 billion of subprime mortgage loans in 1999, up from $3 billion in 1995. Between 1995 and 1998, subprime loan note sales rose from $10 billion to $87 billion. Banks now control five of the nation's top 10 subprime lenders and 10 of the top 25 subprime lenders.

Effective Marketing and Customized Services

While many low-income households exhibit reluctance to use traditional banks, fringe institutions have well-developed marketing strategies to draw in and retain customers by focusing on the relationship between customers and staff. Pawnshops and rent-to-own stores emphasize treating customers with personal attention and encourage small weekly payments made in person, allowing the retailer to market additional products to existing customers. These types of businesses rely heavily on repeat customers, which they cite as a means of increasing transactions while reducing risk, as Caskey reports in *Lower Income Americans, Higher Cost Financial Services.*

Role of Financial Markets in Community Reinvestment

Creating efficient markets in distressed communities is essential to successful revitalization of those areas. Building community wealth requires the building of individual wealth. Mainstream financial institutions are engines of wealth creation and upward financial mobility in America. Improving access to and use of the mainstream engines of wealth creation would by itself promote significant community investment.

Each dollar that is spent on overpriced financial services by a lower-income household represents potentially important savings that could lead to wealth building. For example, the more than $5.45 billion in fringe financial services fees that are collected from financially vulnerable consumers each year is slightly less than the entire asset base of the more than 460 community development financial institutions (CDFIs) operating in the United States. It is also moderately less than the fiscal 2000 HUD budget for Community Development Block Grants plus all HOPE VI and Empowerment Zone/Enterprise Community funding.

Moreover, the fees represent an annual funding stream. If only a portion, perhaps 20 percent, of those dollars lost each year to fringe financial services could be captured and redirected to housing, that would represent more than $1 billion for home-buyer assistance or housing rehabilitation in many of the most distressed communities in the nation. That funding stream would also not require any additional taxpayer contributions. Add to that sum the hundreds of millions of dollars unnecessarily paid each year, by households unfairly and unnecessarily steered into high-cost subprime loans, and it is immediately clear how better organizing the financial markets in distressed communities and connecting households to mainstream tools for wealth creation can provide a major boost to the community revitalization process.

Flowing to a broader range of consumer goods and services, that money could encourage the opening of new business based on market demand for locally desired products or services. Helping to create wealth could reduce the need for complex tax-related government subsidies that encourage businesses to relocate to distressed communities that have no economic rationale for being there other than to benefit from untargeted and questionable tax subsidies. If channeled into savings, money lost to check cashers and similar high-cost services could offer financial institutions and community residents enormous wealth-generating potential.

Fixing the Problem

Improving the availability and quality of financial services in distressed communities will require action in three areas:

- Improving the availability of information on fringe financial services transactions and aggressively enforcing fair lending, equal credit opportunity, and consumer protection laws and regulations.

- Encouraging the development and availability of low-cost products and services designed to meet the unique needs of lower-income and lower-wealth customers.

- Funding government and community-based initiatives to offer consumer financial education and outreach programs.

Collecting Additional Data and Enforcing Laws

The first step toward improving financial services in low-income communities is to collect better data on the financial services currently available. It is simply not possible to resolve a problem that cannot be identified and examined. Consequently, it is critical to gather the information necessary to understand the scope and nature of the alternative financial services and subprime lending industries.

One way to accomplish this is to establish a national database to which alternative service providers must disclose their lending activities. Required information might include such data as fee structure, revenues and earnings, collateral requirements, and the number and key demographic attributes of the customers served. For subprime loans, additional information to be collected might include loan terms such as credit life insurance, balloon payments, prepayment penalties, interest rates, points, processing fees, and closing costs. This information can serve both to illuminate appropriate policy prescriptions and to bring to light both the best and worst practices. For example, more comprehensive information could help pinpoint potential discriminatory behavior that requires further investigation and the possible enforcement of fair housing, equal credit opportunity, and a variety of consumer protection laws. On the other hand, this data could highlight business opportunities for prime lenders who may have overlooked the market potential in many communities.

The power of information should not be underestimated. When the federal government, for example, first sought to include borrower race/ethnicity information in the database established by the Home Mortgage Disclosure Act, many argued that this information would be useless because it would answer only *who* was accepted or rejected for mortgage credit but not *why*. Nevertheless, that data exposed widespread and potentially discriminatory lending practices in underserved communities. Shining a spotlight on these problems led to widespread reform, and the net result has been explosive growth in affordable lending to low-income and minority households over the past decade.

Similarly, an explicit focus on how equal credit opportunity and consumer protection laws are violated in distressed communities by fringe lenders would provide financially vulnerable households with the kind of support offered to middle-income and wealthy households in vibrant communities. Each year, millions of dollars are spent on financial system regulation through agencies such as the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Department of the Treasury, and Federal Reserve System, to name a few. But federal institutions can do relatively little to protect the financial interests of households operating in a cash economy or relying on fringe financial services providers whose activities are not covered by those key federal financial regulators. Unlike nationally chartered banks, alternative financial services providers are currently free of federal oversight and are instead subject to a patchwork of regulatory efforts at the state level. Subjecting high-cost lenders to a single national reporting requirement could greatly enhance the ability of regulators, community groups, and research institutions to examine the practices of these firms.

The goal of greater regulation of fringe lenders should not be to eliminate those sources of credit, especially since these lenders do provide important access to credit for a variety of consumers. Rather, regulation should ensure that to the extent those services are provided, they are offered at costs that more reasonably reflect the real risks presented by consumers. For example, interest rates that when annualized exceed 300 percent are hard to justify under any circumstance. Further, the targeting of high-cost financial services on the basis of a consumer's race, ethnicity ,or other characteristics, rather than on the basis of income or creditworthiness, should be closely monitored and effectively addressed.

In addition, to the greatest extent possible, these proposed reporting requirements should cover as wide a range of financial institutions as possible. Dissimilar reporting requirements across institutions that perform similar services create opportunities for abuse by institutions that are not covered, while at the same time stifling the potential for innovation by reporting firms. Further, because data collection can be very costly, care should be taken to ensure that any new reporting requirements do not overwhelm financial institutions with requests for insignificant and extraneous information.

Tailoring Products to Serve Lower-Income Households

Public policy should encourage efforts to create a wider range of financial products and services designed to provide low-income and minority consumers with low-cost banking services specifically tailored to their needs. For example, Congress can boost private sector investments in these efforts by providing funding for innovative pilot programs that mainstream financial institutions might otherwise consider too expensive or too risky. These demonstration projects may result in the creation of effective and profitable model products that mainstream financial institutions can then emulate on a large scale. Ongoing federal initiatives to build better access to mainstream financial services also deserve continued funding and support.

The extraordinary sums of money involved in excessive fringe and subprime lending clearly demonstrate the fact that there is substantial potential for low- and moderate-income households to build their financial assets. Further, recent research by Hogarth and O'Donnell in the *Journal of Consumer Policy* shows that when low- to moderate-income households are brought into institutions with a transaction account, there is a high probability of moving them "in and up" into other product lines. If, for example, only 20 percent of the $5.45 billion in fees collected by alternative financial services providers each year could be redirected to housing and community development, that would represent more than $1 billion of additional funding in the hands of some of the most financially vulnerable households in the country.

Improving the quality of products and services available to low-income households could include the following initiatives:

- ***Accelerate initiatives to deliver federal benefits electronically***. The Debt Collection and Improvement Act of 1996 required that all federal benefit payments be delivered electronically by 1999. The passage of this law promised many benefits: lower processing costs, reduced fraud, and the creation of opportunities to link low-income families and people living in underserved areas to banks and other savings institutions. Michael Stegman, in his forthcoming article, "Banking the Unbanked," says the electronic delivery of government benefits "promotes financial inclusion" and recognizes that "economic opportunity cannot thrive where access is denied." The deadline set in the law was not met, but the mandate created by the legislation prompted the launch of several promising initiatives that should continue to receive federal funding and support. The U.S. Treasury Department, for example, is beginning a pilot program to put ATMs in post offices for the distribution of Social Security payments, federal retirement payments, and other government benefits. Consumers use a debit card or credit card to access their benefits with no extra fees. The ATMs could provide safe and convenient access to banking services in traditionally underserved areas and limit consumers' reliance on check cashers and fringe institutions. The project, which is the result of a partnership among Treasury, the U.S. Postal Service, and Key Bank of Cleveland, will test the ATMs at three urban locations in Baltimore and three rural locations outside Tallahassee, Fla. Congress should encourage the development of similar innovative programs and provide adequate funding for their implementation.

- ***Encourage private-sector development of innovative products and services***. Mainstream financial service providers can learn from the considerable finesse demonstrated by alternative financial services providers in marketing, packaging, and bundling services. One example is bundling services such as check cashing, money orders, money wiring, utility and cable bill payment, and related services, as proposed by John Caskey.

Mainstream financial institutions can also take a lesson from and form partnerships with fringe service providers, creating efficient operating structures that lower costs and then pass along savings to clients. Some new partnerships between fringe lenders and mainstream financial services providers are proving highly beneficial to residents of distressed communities by offering more reasonable prices as well as savings vehicles to leverage household income. In *Banking the Unbanked,* Stegman cites the Chicago CRA Coalition and Bank One as an example. The organizations teamed up to increase lending, service, and investments in lower-income communities in the Chicago region. They are also piloting a program to promote deposit services to unbanked customers. This pilot, the "Alternative Banking Program," offers a safe, convenient, and inexpensive alternative to check-cashing services and conducts financial literacy workshops to demonstrate cost savings over check cashers.

Innovative programs that have recently been introduced or are being test-marketed by institutions such as community development credit unions (CDCUs) and CDFIs should also be encouraged and expanded. Woodstock Institute's *Reinvestment Alert No. 16* provides two examples of CDCUs that are offering alternative payday loan products to counter the often-excessive fees charged by fringe payday lenders. The Faith Community United Credit Union in Cleveland and the Louisiana-based ASI Federal Credit Union offer affordable alternatives to their members, and their experiences can show how other mainstream credit unions and financial service providers can establish similar consumer loan products. Both offer interest rates of 17 percent to 18 percent, with $15 to $30 processing fees and timely repayment requirements. Credit counseling is offered with the service, and a savings plan can be integrated into the loan.

Technology can also help create products to reach the unbanked. A Ford Foundation white paper, "Financial Technology and the Lower-Income Consumer" by Steve Davidson et al., notes that new types of ATM and card-based technology have the potential for "turning the unbanked to the self-banked" while lowering costs and increasing access and convenience to financial services and products. The report provides several examples: Umbrella Bank in Illinois plans to put ATM-equipped kiosks in lower-income housing developments; FirstTel is gearing up for similar services in HUD housing in Florida; and Banco Popular offers an all-electronic account to customers without a traditional bank account.

Technology can also help modify existing products to make them more appealing to low-income consumers. Comptroller of the Currency John D. Hawke Jr. recently told the National Community Reinvestment Coalition that tailoring the structure of the direct deposit account to make it more appealing to the unbanked is critical to bring them into the mainstream banking system. For example, many immigrant families now rely on expensive wire transfer services to send funds to their native countries. Adding an inexpensive wire transfer function to a bank account can increase its appeal to these consumers and help create links between banks and lower-income residents.

Davidson also provides examples of how some mainstream financial services providers are expanding their reach to lower-income consumers by lowering the cost of those services to help "transition" these customers to mainstream markets. Union Bank of California has created a division called Cash & Save that offers check-cashing service at a lower-than-average 1.0 percent to 1.5 percent fee on payroll checks issued by area employers. Customers are permitted to open Union Bank savings accounts at Cash & Save outlets. Another company, Directo Inc., is serving lower-income customers—many of whom were denied bank accounts—with a payroll debit card, allowing employees to access their pay electronically through an ATM. Directo also has an innovative wire service/ATM feature that enables customers to wire money to foreign bank accounts that can then be accessed through an ATM. The fees are much lower than those for most wire services.

Improving Financial Education and Outreach

Educating consumers about the types of institutions, products, and services they should use, and ones they should avoid, is also critical. Many lower-income households have limited financial savvy and do not know the most basic aspects of household budgeting. Well-conceived, -designed, and -delivered consumer education programs can be instrumental in helping households more effectively manage their finances.

In addition, consumers need to know how to identify potentially fraudulent or otherwise questionable lenders. They need to know, for example, that when they see ads that read: "No credit, no job, no problem," they should respond with "No thanks!" Financially vulnerable households need help understanding that substantial wealth can be built from relatively small amounts of money. They need support to best understand how to properly and effectively evaluate the financial services options available to them and how to select the options that best meet their needs.

Financial education is critical, but it is also expensive. Lawmakers should earmark federal funding for grants to community-based organizations and nonprofit groups to provide this needed service. Policymakers should also encourage the inclusion of financial education in school curricula and in various training and education programs aimed at vulnerable populations, such as welfare recipients making the transition into work.

Conclusion

Improving the financial services market for lower-income and minority households is imperative to enabling them to benefit fully from the wealth-building opportunities available to most Americans. With regard to minority households in particular, it is useful to keep in mind that discrimination has played a significant role in creating many of the distressed markets heavily populated by fringe and predatory lenders—and that for many years government policies directly supported and even enforced many of the most discriminatory actions. As a result, government has an important role to play in helping eliminate the legacies of those actions.

Improving the markets can be accomplished by supporting financial institutions to reposition themselves to be more effective in meeting the financial services needs of residents of underserved communities.

Rather than acting solely as a policeman, enforcing laws and penalizing institutions that fail to perform, government should work with financial institutions to provide them with the flexibility to test programs or with the funding to pilot innovative financial services approaches that are too expensive for private financial institutions to pursue on their own.

The federal government is constantly engaged in the credit markets to ensure the efficient functioning of those markets as they pertain to middle- and upper-income households. In fact, even today, most households benefit from a substantial infrastructure of government agencies that work to perfect the operation of market mechanisms to ensure the most efficient delivery of financial services possible. But because most of the financial institutions supported or regulated by this infrastructure do not directly serve unbanked households, this elaborate system does little to promote the financial well-being of the residents of distressed communities.

Greater information and enforcement of relevant laws, combined with increased financial sophistication on the part of consumers, could go a long way toward eliminating, in the near term, some of the most egregious and abusive financial services practices in struggling lower-income and minority communities. By combining the private market's innovation with publicly supported initiatives to understand and address market failure, the full range of financial services that serve the majority of Americans can be made accessible in all communities.

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