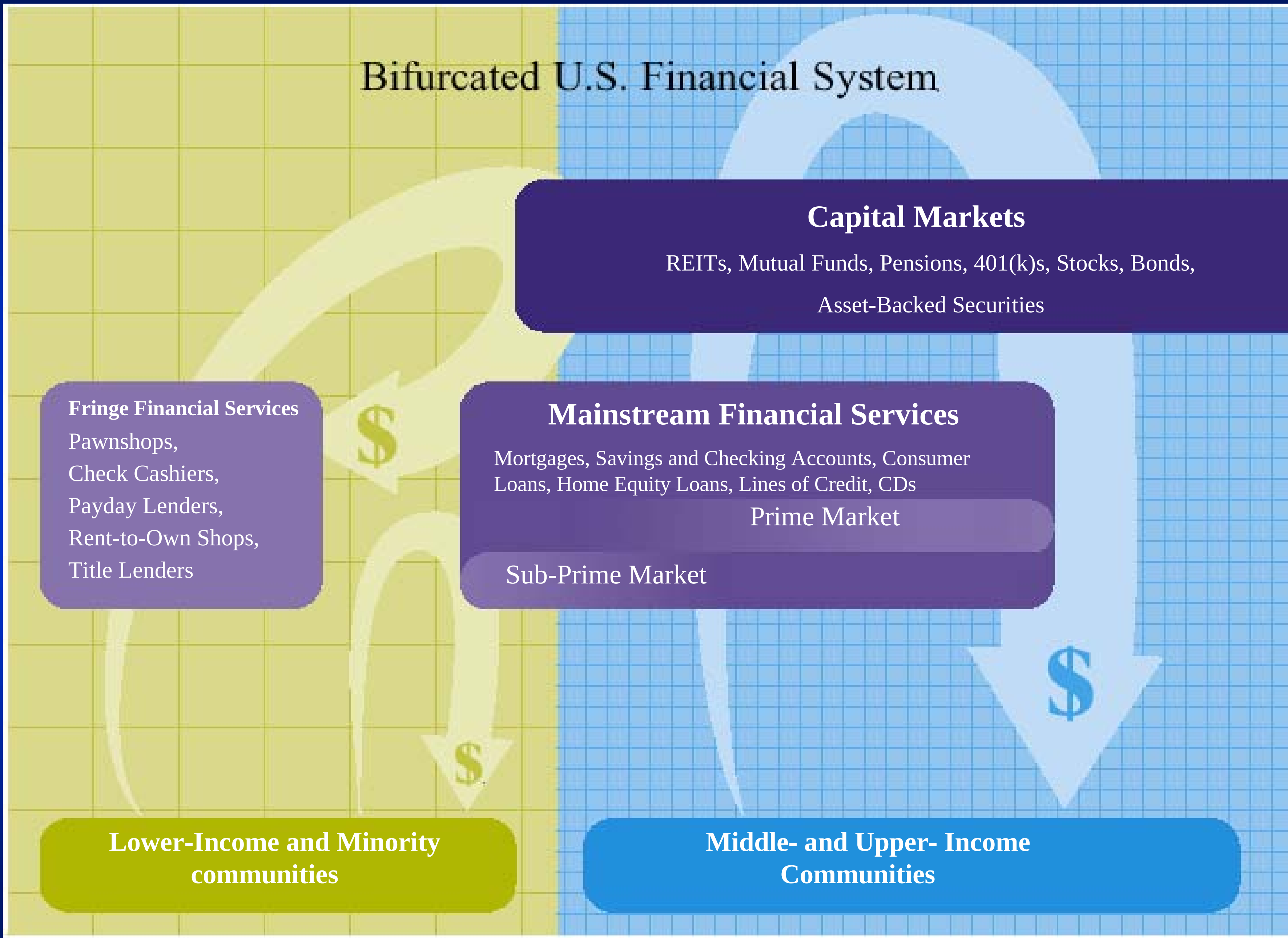
Financial Services for Low- and Moderate-Income Households

James H. Carr
Senior Vice President
Innovation, Research and Technology
Fannie Mae Foundation


Bifurcated U.S. Financial System
Capital Markets
REITs, Mutual Funds, Pensions, 401(k)s, Stocks, Bonds, Asset-Backed Securities
Fringe Financial Services
Pawnshops, Check Cashiers, Payday Lenders, Rent-to-Own Shops, Title Lenders
Mainstream Financial Services
Mortgages, Savings and Checking Accounts, Consumer Loans, Home Equity Loans, Lines of Credit, CDs
Prime Market
Sub-Prime Market
$
$
$
Lower-Income and Minority communities
Middle- and Upper- Income Communities

Growth of Fringe Banking:

• In the past five years, the number of check cashing centers has doubled, and payday lending grew from 300 to 10,000 stores between 1993 and 2000.[1]

• An April 2000 report shows that 11,000 check cashing outlets generate $60 billion in business annually.[2]

• The estimated 13,000 pawn shops in the United States outnumber credit unions and banks. [1]

• In 1996, an estimated 8,000 rent-to-own stores served 3 million people, grossing $4.7 billion.[3]

Sources:
[1]D'Amours, Norman, "The Battle to Increase Access and Ensure Fair Pricing," *The Neighborworks Journal*, Winter 2000;
Robinson, Jerry, "The Deferred Deposit Industry Payday Advance Product Overview," PowerPoint presentation at the annual meeting of the Financial Services Centers of America, October 6-8, 2001.
[2]Dove Consulting, "Survey of Non-Bank Financial Institutions," Final Report for the U.S. Dept. of Treasury, April 4,2000.
[3]Lacko, James, Signe-Mary McKernan, and Manoj Hastak, "Survey of Rent-to-Own Customers," Federal Trade Commission, Bureau of Economics; April 4, 2000

Payday Lending Industry Continues to Grow

- Industry will grow to 20,000-25,000 outlets in next 6-8 years[1]

- Today in CA, there are more than 2,000 payday lenders --- more than all the McDonalds and Burger Kings combined![2]

Sources:
[1]Community Financial Services Association of America
[2] Source: *San Diego Union-Tribune*, Jan. 14, 2001 and AARP, 2002

Fringe Lending is Real Money

Service	Fee/Rate per Transaction	Number of Transactions	Volume of Transactions	Total Fee Revenue
Check Cashing	2-3% payroll and government checks (can exceed 15% for personal)	180 million	$60 billion	$1.5 billion
Payday Loans	15-17% per 2 weeks 400% APR	65 million	$8 -14 billion	$2.4 billion
Pawnshops	1.5%-25% monthly 30-300% APR	42 million	$3.3 billion	N/A
Rent-to-Own	1.5-12 times retail	3 million	$4.7 billion	$5.3 billion
Auto Title Lenders	1.5%-25% monthly 30-300% APR	N/A	N/A	N/A
Total	N/A	290 million	$82 billion	$9.2 billion

Filling the Financial Services Gap? Yes -- But...

- Cost to access services routinely excessive
- No savings products undermines incentive and ability to build assets
- Some services worse than none at all -- can create cycle of debt

Justification of Fees Contradicted by Profitability of Industry

Example of Payday Lending:

- Growth Rate: From 300 to more than 10,000 Stores in less than 9 years

- Industry losses are 1.1% - 1.3% of receivables

- Return on investment in 1999 was 24%

Sources: Robinson, Jerry, and Gerald L. Lewis. "The Developing 'Payday Advance' Business. The Next Innings: From Emergence to Development Report," Stephens Inc., September 28, 1999.

High Cost of Rent to Own (continued)

APR at rent-to-own shops is often 10-16 times greater than credit cards. Example:

• A $196 Magnavox TV from a rent-to-own shop costs $9.99 a week for 78 weeks. Total cost: $779 -- that's an APR of 238.4[1]

• Same television purchased with a 22.8 APR credit card from a national discount electronics store: $231

• Difference in finance charge: $548

Source:
[1]Manning, Robert D. *Where ACE is Not a Hardware Store: Fringe Banking and the Expansion of Second-Tier Financial Services.* Chapter 7, Credit Card Nation: The Social Consequences of America's Addiction to Credit. (Unpublished Manuscript.)

Small Savings Over 10 Years

	At 4 percent annually:	*At 5 percent annually:*
$200/year:	$2,497	$2,641
$500/year:	$6,243	$6,603
$800/year:	$9,989	$10,566

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

Growth of Subprime Lending:

- Between 1993 and 2001, subprime loans grew eight-fold in dollar volume, from $20 billion to $173.25 billion.
- Between 1993 and 2000, the number of subprime loans grew 10-fold, from 73,881 loans to 723,097 loans. Subprime refinance loans grew from 57,563 loans in 1993 to 475,583 loans in 1998.
- The growth in subprime compares to a less-than 60% increase in prime lending for home purchases and a 67% decrease in refinance loans.

Source: HUD/Policy Development and Research. 2001/Inside B&C Lending. February 2002.

Subprime Lenders Concentrate:

- HUD reports that subprime loans are 3 times more likely in low-income neighborhoods than in high-income areas, and 5 times more likely in black neighborhoods than in white neighborhoods.

- In predominantly black neighborhoods, high-cost subprime loans accounted for 51% of home loans in 1998, compared to 9% in white areas.

- Homeowners in high-income black neighborhoods are 6 times as likely to have subprime loans than homeowners in high-income white neighborhoods.

Concentration of Subprime Loans Among Minority Households

- Reliance on subprime loans increases with income among both black and Latino households.
- Lower-income black households are 2.4 times more likely than a lower-income non-Hispanic white household to obtain a subprime refinance loan
- Yet, higher-income black households are 3 times more likely that higher income white households to rely on subprime refinance to rely on subprime loans loans

Source: [1]Bradford, Calvin, Risk or Race? Racial Disparities in the Subprime Refinance Market, Center for Community Change, May 2002.

Concentration of Subprime Loans Among Minority Households (Continued)

- Lower-income Latino households are 1.4 times more likely than a lower-income non-Hispanic white household to obtain a subprime refinance loan
- Yet, higher-income black households are 2.2 times more likely that higher income white households to rely on subprime refinance to rely on subprime loans loans

Source: [1]Bradford, Calvin, Risk or Race? Racial Disparities in the Subprime Refinance Market, Center for Community Change, May 2002.

Comparing Mortgage Payments for Different Interest Rates

30-Year Fixed Rate Loan

House Value	$85,000
Down Payment %	5%
Down Payment	$4,250
Loan Amount	$80,750

Comparing Mortgage Payments for Different Interest Rates (continued)

Annual Interest Rate	Monthly Payment	Annual Payment	Annual Difference From 8%	Lifetime Difference From 8%
8%	592.51	7,110.18	NA	NA
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

Growth of Investments at 6% Annual Percentage Rate

Annual Investment	Value at End of Year 10	Value at End of Year 30
$687	$9,599	$57,572
$1,393	$19,462	$116,736
$2,118	$29,592	$177,492
$2,857	$39,917	$239,421

The Earned Income Tax Credit

- Refundable tax credit for low-income employed individuals and families -- offsets Social Security payroll taxes on low-wage workers, creates strong work incentive for those at or near poverty
- Estimated to have moved 4.8 million people out of poverty, including 2.6 million children
- Worth up to $3,888 for families with 2 or more children

Source: [1]Gish, Melinda T., The Earned Income Tax Credit: A Fact Sheet, Congressional Research Service (CRS) Report for Congress, May 6, 1999

Unclaimed EITC Benefits

• In 1999, 17.2 million taxpayers were eligible for the EITC -- only 12.9 million claimed the credit

• Fully 4.3 million workers or 25% of eligible taxpayers did not claim the EITC

• According to GAO, those unclaimed benefits amounted to $2.7 billion for 1999

Sources:
White, James R. Letter to The Honorable William J. Coyne, House of Representatives. Dec. 14, 2001. U.S. General Accounting Office (GAO-02-290R Earned Income Tax Credit Participation), Washington, DC;
Scholz, John Carl. "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," *National Tax Journal*, Vol 47(1), 1994.

High Use of Tax Preparation Services By EITC Recipients

- IRS publications on EITC too complex for poor, immigrants with language barriers without assistance
- 60% of families filing for EITC used tax preparation service
- 90% of taxpayers who file electronically apply for tax-anticipated refund loan

Source: Consumer Federation of America and National Consumer Law Center, 2002

Average EITC RAL Borrower With $1,600 Tax Return

Type of Fee	Cost to Taxpayer	Drain on EITC Program
Tax Preparation Fee	$85	$367.2 million
Electronic Filing Fee	$40	$172.8 million
RAL Loan Fee	$75	$324 million
Check Cashing Fee	$67	$130 million
TOTAL	**$267**	**$994 million**

Source: Consumer Federation of America and National Consumer Law Center, 2002

IRS Tax Refund Turnaround Time

- Regular Filing: Up to 45 days for tax refund
- Electronic Filing: Up to 21 days for tax refund
- With Direct Deposit, can average as little as 8 days
- Tax anticipation refund loans average waiting time is 48 hours or two days

Sources: Joel Dresang, “Electronic Filing Saves Over Tax Refund Loan,” Milwaukee Journal Sentinel, Business Section, January 30, 1999, p. 3; A.J. O’Connell, “H&R Block Offer Draws Rapid Warning,” The Boston Herald, March 1, 2001, p. 33.

Value of the Earned Income Tax Credit

- In a recent survey, one-half (49%) of all respondents stated that they would save some or all of their EITC check. Evidence also shows that lump-sum recipients of EITC benefits have been used to finance major capital expenditures (e.g., household repairs and purchase of a car)1

- Because lower-income minority households tend to be geographically concentrated particularly in larger older urban areas, many communities may have high concentrations of households eligible for, but not claiming, EITC benefits

Sources: [1]Issue Brief, National Council of LaRaza, April 2000; [2]Smeeding, Timothy M., Katherin E. Ross, and Michael O'Conner, the Economic Impact of the EITC, Syracuse University, Syracuse, 1999

Mainstreaming Lower-Income Consumers with Traditional Financial Services Requires Understanding Consumer and Institutional Barriers and Methodically Addressing Each Impediment

Consumer Reasons for Being Unbanked- The Push Away from Banks

- Lack of financial sophistication of lower- and moderate-income households that render them unable to fully appreciate the most appropriate financial services products for themselves and their families
- Distrust or discomfort dealing with banks
- No surplus cash
- Bank fees are too high
- Bank minimum requirements are too high
- Do not write enough checks
- Requirement for credit check
- Desire to keep financial records private

Source: Fannie Mae Foundation

Consumer Reasons for Being Unbanked- The Pull Towards the Fringe

- Customized products and services to meet the unique needs of lower-income consumers
- Convenient locations and hours of operation
- Perceived flexible and confidential identification of consumers
- Loyalty to range of high-cost providers
- Predatory nature of many products that trap consumers in cycle of debt

Source: Fannie Mae Foundation

Financial Institution Reasons for Not Serving the Unbanked

- Misperceptions about the willingness or ability of lower-income households to save and invest
- Lack of appropriate products and services
- Uncertainty about the size or characteristics of the market
- Uncertainty about profitability of the market
- Lack of appropriate locations and operating hours
- Bank minimum account standards too high [minimum credit score, minimum deposit, minimum balance, clean ChexSystem Record
- Uneven regulatory playing field relative to alternative financial services providers

Source: Fannie Mae Foundation

Fixing the Problem

- Improve data on financial services transactions and enforce fair lending, equal credit opportunity, and consumer protection laws and regulations;
- Enhance products and services for lower-income and lower-wealth customers; and
- Offer consumer financial education and outreach programs.

Emerging Financial Services Mainstreaming Practices
Innovative Case Studies (Summary Matrix)

Product Mixes	Type of Organization/ Services	Delivery Systems (Infrastructure, Technology and Distribution Channels)	Pricing / Costs	Innovations/Unique Features
Transactions and Basic Banking	Partnerships among community development banks, credit unions, and mainstream commercial banks with check cashing outlets and community-based organizations.	• Delivery outlets at convenient, high traffic locations like other CCOs is important. • Utilize technology to provide services, to minimize loss from bad checks, and combat fraud. • ATM networks facilitate banking needs. • E-banking and tele-banking.	• Cost of transactional and banking services typically lower than banks and CCOs.	• Transactional services to move consumers from CCOs to low-cost depository accounts. • Leveraging of technology to provide services and manage portfolio. • Cross-selling and leveraged packaging of services. • Financial education and planning. • New and creative service delivery (e.g. DMV "satellite" location).
Payday Lending and Basic Banking	Credit Unions offering qualifying members affordable payday loans, including and education and planning.	• Utilizes existing banking infrastructure. • Direct deposit.	• Cost of transactional services typically lower than banks and CCOs. • Free banking services. • Minimum account balance and savings commitment to be eligible for payday loan.	• Existing infrastructure to deliver new services. • Limited roll-overs. • Automatic pay back through direct deposit. • Goal to graduate consumers away from payday loans.
Savings Plus	Partnerships between payroll solutions company, banking institutions, employers, and community-based organizations provide low-cost depository relationship.	• Card-based electronic banking uses electronic payroll, direct deposit, and infrastructure of partnering FDIC-insured bank. • EITC programs couples existing bank infrastructure with customized tax planning assistance. • IDA programs use existing banking infrastructure.	• Cost to provider of card-based account well below the national average of $10-11. • EITC and IDA program startup requires initial subsidy / investment to provider. • No fees to participants associated with these programs.	• Viable alternative to unbanked population. • Long-term strategy for self-sufficiency. • Financial education and planning. • Free tax consulting services for EITC savings program. • Linked subordinate accounts for card-based program.

Continuum of Financial Services for Low & Moderate Income Households

Income → Transactions → Credit → Savings → Insurance

Income
- Salary
- Government Benefits
- Miscellaneous Income

Transactions
- Direct Deposit
- Check Cashing
- Bill Payment
- Checks or Money Orders
- Remittances
- Debit Card Purchases

Credit
- Small Consumer Loans
- Credit Cards
- Microloans
- Home/Home Equity Loans

Savings
- Basic Savings Account
- IDAs
- EITC
- IRAs, Pension Funds,401(k); 403(b), Stocks
- Home Equity

Insurance
- Health
- Automobile
- Life
- Home

Financial Education, Planning, & Management