

**Reframing the Debate About Financial Inclusion:
Evidence from an Up Close View of Alternative Financial Services**

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I. Introduction

The Federal Deposit and Insurance Corporation's (FDIC) most recent "National Survey of Unbanked and Underbanked Households," found that nearly 8 percent of Americans were "unbanked" in 2013 — they have no bank account at all. Another 20 percent are "underbanked": they have bank accounts but also rely on alternative financial services providers (AFS) such as check cashers and payday lenders. Policy makers are concerned about the growing number of people in the US who manage their finances outside the banking system, and have been working on strategies to move more people to the "banked" category.

The framing of this issue around one's relationship to banking assumes that banks are superior to the alternatives without fully questioning the reasons why the 'alternative' system persists and has grown significantly since the early 2000s. This framing also fails to explain the rationale behind the decisions made by the *under-* and *unbanked* to manage their finances in different ways.

The purpose of this paper is to provide a better understanding of the reasons why such a large number of people use informal and alternative financial services instead of, or in addition to, mainstream financial institutions. This understanding is critical in order to guide policy regarding how best to help all people get their financial needs met. We find that people use AFS for three primary reasons: cost, transparency, and service. Our research shows that AFS users' choices are often driven by logic and experience.

Whether and how people use consumer financial services is also connected to their potential for economic mobility. But the equation is more complex than the assumption that being banked leads to financial stability and thus to economic mobility. Although a correlation

between bank account ownership and financial stability can quite easily be argued, the circumstances surrounding households' decisions on how to manage their finances are not so straightforward. We find that changes in the banking industry and larger economic forces also constrain consumers' choices around financial services. We argue that policy makers need to address both the consumer financial services industry and these larger forces in order to enable all consumers to use financial services as a tool for economic mobility.

The Consumer Financial Services System

The consumer financial services system forms a fundamental part of our daily lives. However, the extent to which people are engaged in the traditional banking system varies widely across households, individuals, and geography, and depends on a complex equation that includes one's particular circumstances, personal histories, and preferences and needs. Larger economic forces also play a role.

The consumer financial services industry consists of three components: mainstream (banks and credit unions), alternative (check cashers, payday lenders, pawnbrokers and the like), and informal (loan sharks, rotating savings and credit associations (ROSCAs), and borrowing from friends or family) (Figure 1). Mainstream financial services include all transaction, saving, and credit services offered by banks and other insured depository institutions, such as credit unions and thrift banks.²

² As defined by the Federal Deposit Insurance Corporation (FDIC),

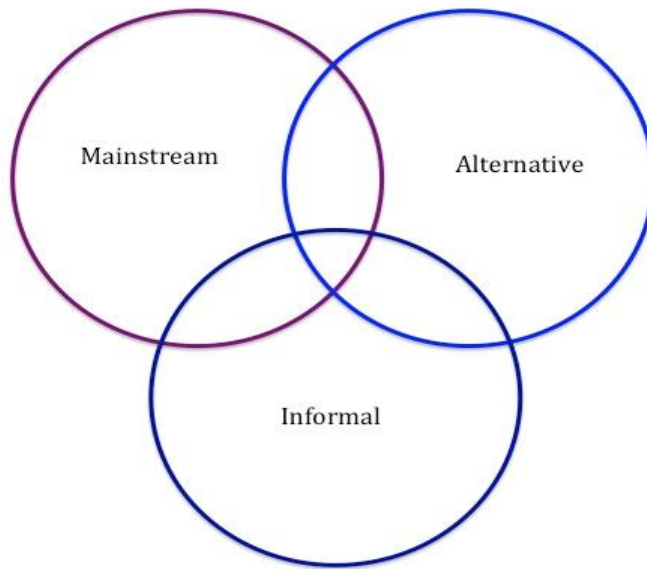


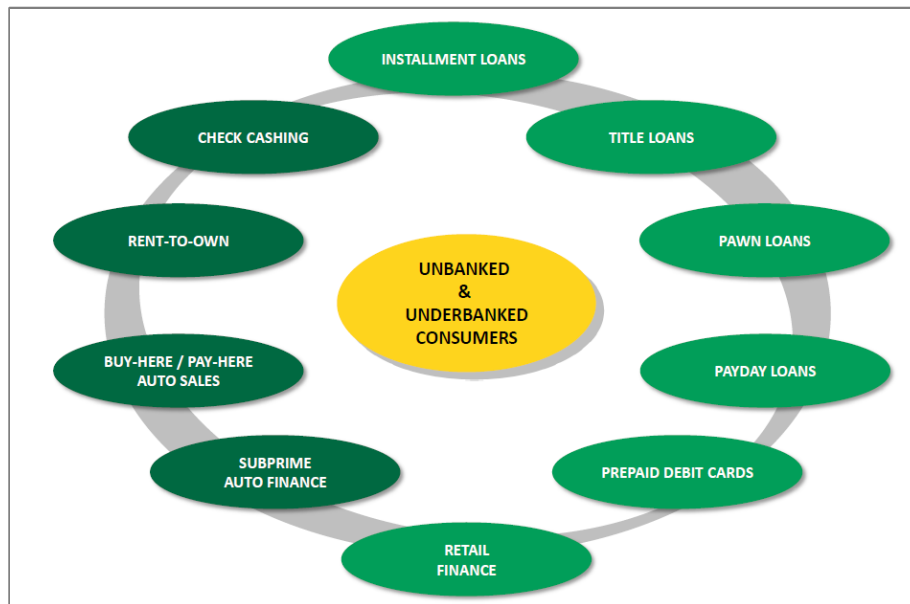
Figure 1: Components of the Consumer Financial Services System

Figure 2 illustrates the range of alternative financial services products. The US Treasury Department defines the businesses that sell these products as ‘Money Service Businesses’ (MSBs) (FINCEN, 2015); much of the regulation of these businesses occurs at the state level. Individual states determine how much these businesses can charge to cash a check, and how much interest they can charge on a loan, for instance.³ With approximately 39.3 percent of all US households having used one or more services offered by providers not classified as banks during 2013 (FDIC, 2014: 41), the label of these services as ‘alternative’ requires questioning. Estimates of the amount consumers spend annually on alternative financial products and services tally it up

³ Check cashing charges range from a fee of two dollars per check in North Carolina to 2.01 percent of face value in New York, and payday loan interest rates range from 10 percent in Florida to 75 percent in Missouri; payday lending is illegal in 14 states and the District of Columbia.

at 1.3 trillion dollars (CFSI, 2014: 1) in 2013, which illustrates the central role that these services play in the financial lives of so many people.

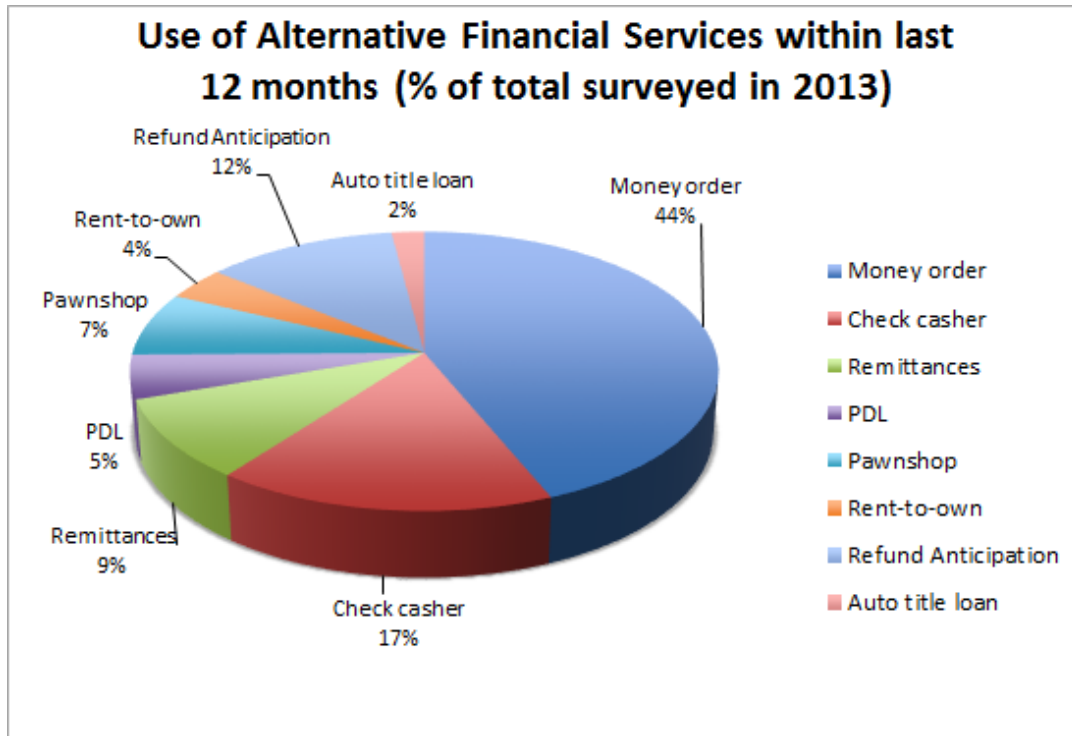
Figure 2. Alternative financial services



Source: Stephens, 2012.

Figure 3 illustrates how common the use of each alternative financial service was in 2013. Our paper focuses on check cashing and payday lending stores, which offer the most commonly used products and services show in Figure 3. The check casher we studied offered prepaid debit cards, money orders and remittances along with basic check cashing services. The payday lender offered the same services and also payday loans.

Figure 3. Use of Alternative Financial Services



Source: 2013 FDIC National Survey of Unbanked and Underbanked Households, Appendices. October 2014:72. Total number of households surveyed was 123,650.

The third component of the consumer financial services landscape consists of informal practices such as rotating savings and credit associations (ROSCAs), money guards, and loan sharks. Loans from friends and family also belong in this category. The informal nature of these transactions makes it difficult to estimate the size of this component, but some indicators of its prevalence are beginning to emerge. In its 2012 Financial Inclusion Report, the World Bank reported that six percent of the US population aged over 15 saved in an informal lending group, and 17 percent borrowed from family and friends in the last year. The US Financial Diaries project, an intensive one-year study of 244 low- and moderate-income households, found that 41

percent of participants had borrowed from family and friends during the study, and 39 percent had lent money to family or friends during the same period.⁴

The three components of the consumer financial services system are not separate silos. Individual consumers access products and services from these components according to their needs and particular circumstances. In addition, the institutions that comprise one component also often depend on institutions in another component. For example, check cashers use banks to deposit their funds. Payday lenders require borrowers to have checking accounts, and use the automated clearinghouse (ACH) process to deduct loan payments directly from borrowers' accounts. Flor, a Honduran woman who runs two ROSCAs in the South Bronx, allows members of the ROSCA to deposit their weekly payments directly into her Citibank account.

Changes in one sector also affect what happens in another. We focus specifically on the alternative financial services sector in this paper in order to unpack the assumption that banks are the best way for all consumers to meet their financial needs.

II. Literature Review

Existing research has found that the reasons why people turn to alternative financial services range from language and identity requirements –especially for immigrants–, to lack of knowledge, anticipated use of an account, terms and conditions, bank charges, fear of overdrafts, and perceptions of banks versus institutions and practices in the other components of the consumer financial services industry (Caskey, 1994, 1997, 2005; Barr, 2004). In a study aimed at

⁴ Morduch, Ogden, and Schneider. An Invisible Financial Sector: How Households Use Financial Tools of their Own Making. <http://www.usfinancialdiaries.org/issue3-informal>, Accessed 4 November 2014. The 244 USFD study households are not representative of the larger population. Instead, they “aimed to track households that were typical of various experiences, and formed the sample with an eye to incomes, demographic profiles, and locations.”

deepening understanding of the behavior of 84 low-income American individuals who signed up for an Individual Development Account (IDA), Margaret Sherraden found that customers choose their preferred financial services based on “price, convenience, necessity, and safety considerations” (Sherraden, 2010). Sherraden found that 23 respondents, or 27.4 percent, used alternative services, most of them to pay bills using money orders, which they found cheaper and safer than checks.⁵

In a survey of studies researching the use of alternative financial services among low-income households, Blank (2008) summarized the five reasons why customers use alternative financial services: 1) ill-fitted financial product and services (Elliehausen and Lawrence, 2001; Caskey, 2005; Berry, 2005; Barr, 2007); 2) mistrust or misunderstanding by lower-income households (Elliehausen and Lawrence, 2001; Berry, 2005); 3) past credit or payment problems which limit access to formal financial institutions (Berry, 2005); 4) short-term horizons (Shafir and Mullainathan, 2009); and 5) unstable incomes experienced by such households (Bania and Leete, 2007; Hoynes, 2001).

Elliehausen and Lawrence (2001) analyzed data from a 15-minute telephone survey they applied to a sample of 427 nationally representative customers of payday advance companies who belong to the Community Financial Services Association of America (CFSA), the trade association. Analyzing the data with a standard economic model of consumer credit, they concluded that the “[U]se of a payday advance is advantageous if the net present value of the

⁵ The study, part of an experimental test of IDAs, called American Dream Demonstration (ADD), looked at a randomly selected sample of 59 low, medium and high savers in the IDA program, as well as a group of 25 low-income participants who had signed up to get an IDA but were not selected. The researchers evaluated whether the IDA savers could successfully save and what difference that made in their lives in the long term. To do this, the research team followed all participants into adulthood, holding in-depth interviews with all 84, conducting quantitative surveys and monitoring their accounts.

transaction is positive” (Elliehausen and Lawrence, 2001: 54). In other words, they found that consumers placed a high value on the availability of accessing the money when they needed it. Based on data from the 2001 Survey of Consumer Finances as well as on a survey he commissioned in 1996 for 900 low-income households (Caskey, 1997b), John Caskey (in Sherraden, 2005: 21) observed that low-income unbanked consumers did not have enough money to keep in an account, and thought that the bank fees or minimum balance requirements were too high.

Berry (2005) analyzed a survey conducted by MetroEdge of households in low-income neighborhoods in Washington, Los Angeles and Chicago. The survey, modeled on the Survey of Financial Activities and Attitudes conducted by the Office of the Comptroller of the Currency in 1998-1999, used a multistage, stratified, random sampling design, and stratifying the 62 census tracts by city (21 tracts in each city), income, and race and ethnicity. After doing a total of 1,532 interviews: two-thirds by phone and one-third in person, Berry observed that most respondents who did not have a bank account, did not have one because of their “inadequate income” (Berry, 2005: 55) He also found that five percent of them did not like dealing with banks and another five percent did not trust banks (Berry, 2005: 56). Seven percent of Berry’s respondents had past credit problems that kept them from entering the opening a checking account, and three percent said they had not been allowed to open a savings account for the same reason.

Research on the fourth reason, short-term time horizons, relies on laboratory experiments and field studies showing that the challenging financial conditions low-income people face can diminish their cognitive capacity and, thus, the quality of their decisions (Mani et al, 2013: 980; Shafir and Mullainathan, 2013). Mani et al found that “being poor means coping not just with a shortfall of money, but also with a concurrent shortfall of cognitive resources” (Mani et al, 2013:

980). Income volatility is another important reason why consumers are found not to have bank accounts. Bania and Leete (2007) used data from the 1991, 1992 and 2001 panels of the Survey of Income and Program Participation (SIPP) and measured volatility as the deviation in monthly income from the average over the previous 12 months. They found that that income volatility is highest for lower income households, and that volatility has increased substantially between 1992 and 2003, for all income levels (Bania and Leete, 2007: 16). They arrived at these conclusions by doing statistical tests to see whether income volatility correlates with food insufficiency. We take up the issue of income volatility again later in the paper.

In a study based on the 2005-2006 Detroit Area Household Services (DAHFS) data, which includes over 1,003 low- and moderate-income families in the Detroit area, Michael Barr (2012) found that traditional financial services have high transaction costs for lower-income households, thus increasing their costs of credit and holding them from saving in such institutions. The study consisted of computer-assisted, in-person interviews conducted by the Survey Research Center of the University of Michigan, each of which was designed to last 76 minutes on average, and was targeted at households with median incomes of 0 to 60 percent (low), 61 to 80 percent (moderate), and 81 to 120 (middle), of Detroit's \$49,057 median income. Barr also observed banked households faced higher average annual outlays for transactional and credit services than the unbanked, with \$206 versus \$123. This finding contradicts the common argument that having a bank account reduces total financial outlays." On the other hand, though, the study also found that such users faced relatively higher "nonpecuniary costs of using alternative financial services, such as waiting in line to pay bills in person, lacking ready mechanisms to save, and burdening friends and family with borrowing needs" (Barr, 2012:9). Barr found that, "policies designed to expand access to traditional bank accounts are unlikely to

improve financial outcomes unless accompanied by improvements in the functionality of banking products for low-income households” (Barr, 2012: 9).

Whether because of structural, contextual or even psychological conditions, most researchers agree that consumers make their “financial decisions in a social context that shapes priorities and behaviors” (Sherraden, 2010:103). The US Financial Diaries project, cited earlier, (Morduch et al, 2013) sheds light on the multiple challenges low-income families face, like income uncertainty. The US Financial Diaries provides a more fine-grained perspective on the strategies low-income families devise at the household level to overcome financial obstacles, such as using credit cards if they have one, borrowing from relatives or taking out a small-dollar loan from an alternative services provider. Because the USFD focuses on the entire process of how households are managed, does not allow for a deeper analysis of their interaction with the different financial services outside their homes. Our work dives deeper into that component of the issue. The other studies cited here use methods that provide critical broad insights but do not allow for a deeper, more holistic understanding of how and why consumers manage their finances the way they do.

III. Growth and Size of the AFS Component

A survey commissioned by the US Department of Treasury estimated the value of transactions performed by all MSBs in 2010 at \$80 billion, of which \$58.3 billion were check cashing operations (FINCEN, 2011). Transactions in the check cashing industry have grown significantly in the last twenty years, both in quantity and value. From a total of 128 million checks worth \$38 billion dollars in 1990, they increased to 180 million checks worth \$55 billion in 2007 (Barr, 2007), and up to 350 million checks totaling \$58.3 billion in 2011 (FiSCA, 2011).

For payday lenders, the growth has shown similar increasing trends, although with slight decrease in the last two years, likely a result of restrictive regulation introduced in some states. The number of storefront payday loan businesses grew from roughly 200 locations in the early 1990's nationally (Caskey, 1994), to 10,000 in 2000 (Stephens, 2004) and 22,000 in 2004 (Stephens, 2004). After reaching a peak 23,586 in 2007 (Stephens, 2008), regulations began to be put in place and the number started to decline, reaching an estimate of 22,000 in 2012 (Center for Responsible Lending, 2012; Stephens, 2012). The amount of dollars loaned by these payday lending stores is estimated to have gone from \$10 billion before 2000 (Stephens, 2003), to \$25 billion in 2003 (Stephens, 2012). The amount then reached a peak of \$44 billion in 2007 (Stephens, 2012), and decreased to \$30 in 2012 (Stephens, 2013). In recent years, online lenders also began to make payday loans; these lenders are estimated to be the fastest growing component of the industry. According to the Online Lenders Association (OLA), an estimated 36% of payday loans in 2011 were made by online lenders, and analysts predict that online lenders will have captured over two-thirds of the short-term loan industry by 2016 (JMP Securities, in OLA 2012). At the 2013 Small-Dollar Credit Symposium, the President and CEO of OLA informed that these lenders loaned \$18 billion in 2012. According to a recent study made by Pew Charitable Trusts (Pew, 2012), 5.5 percent of American adults have used a payday advance in the last five years. This estimate translates into approximately 12 million adult Americans who said they used either a storefront or online payday loan to meet their financial needs. This number is lower than the CFPB's 2014 estimate of 19 million users, but also illustrates the huge jump it experienced from 7.6 million customers in 2003.

Presumably, growth of the AFS industry is the result both of the profitability of the businesses and the public demand for the services the industry offers. According to Stephens

(2012:13), a consulting firm specializing in consumer financial services, the AFS industry has grown for the three following reasons: 1) the underserved demographic is expanding due to economic conditions; 2) consumer credit remains very tight; and 3) banks are alienating customers. On the credit side, Stephens reports “Healthy transaction volumes and year-over-year growth; generally favorable bad debt trends; online sector continues to take market share; and modest store growth by strong operators” (Stephens 2012: PAGE). In this context, there is a growing trend for companies to consolidate into fewer and larger companies, with the top 50 companies owning approximately 90 percent of market revenue.

The “economic conditions” the Stephens report list deserve to be highlighted here, as they in particular have hindered consumers’ economic mobility. Three trends have affected the context in which people make financial decisions, leading to a greater reliance on AFS: declining wages/increasing expenses; greater reliance on credit/disappearance of small dollar credit; and increased income volatility.

First, despite decades of increased productivity and increasing value for the overall U.S. economy, the typical American family has experienced a steady decline in inflation-adjusted income since 2001.⁶ The federal minimum wage—the agreed-upon standard for what a worker should be paid—has stagnated and began to decline in 1968.⁷ Had the minimum wage grown at the same rate as average wages or total U.S. productivity over this period, it would be about \$10.65 today.⁸

⁶ Garcia, Jose (2007) “Borrowing to Make Ends Meet: The Rapid Growth of Credit Card Debt in America” Demos, Washington, DC.

⁷ Cooper, David (2013) “Raising the Federal Minimum Wage to \$10.10 Would Lift Wages for Millions and Provide a Modest Economic Boost” Economic Policy Institute, Washington, DC. December 13, 2013.

⁸ Cooper, 2013.

Those hardest hit by the decline in wages are in the lowest 20 percentile of income,⁹ but workers with high levels of education have also experienced weak earnings trends. Between 2002 and 2012, full-time workers age 25 and over with a college degree saw their wages decline nearly 7 percent for women and almost 9 percent for men (DaNavas-Walt et al, 2012). Meanwhile, the cost of living has increased 90 percent due to the rising cost of healthcare, housing and transportation¹⁰. The average cost of higher education, a key indicator of future financial mobility, increased 165 percent (in 2005 adjusted dollars) between 1970 and 2005¹¹. Childcare is now a significant expense for families, whereas it was virtually non-existent as an expense as recently as a generation ago¹².

Second, during the same period that Americans' earnings declined, income became more volatile. The combination of these two trends have acted as a double whammy, making it difficult for people to budget, plan and save. Income volatility contributes to economic instability among American families.¹³ Income volatility is caused by several factors including: sudden loss of income, unpredictable expenses, lack of savings, inadequate financial management, and reliance on complicated or poorly designed financial products¹⁴. In addition, increased reliance on low-wage, hourly work means that household incomes can fluctuate from month to month, in both the amount and timing of funds, in ways that are beyond the household's control¹⁵.

⁹ Garcia, 2007.

¹⁰ Garcia, 2007.

¹¹ Garcia, 2007.

¹² Garcia, 2007.

¹³ Hacker and Jacobs, 2008.

¹⁴ Morduch and Schneider, 2013.

¹⁵ Morduch and Schneider, 2013.

A 2008 briefing paper by the Economic Policy Institute found that household income volatility increased by 99% between 1973 and 2004¹⁶. This trend is the result of a complex set of factors affecting households across the income levels. For example, welfare reform policies in the 1990s requiring low income mothers to pursue low-wage work instead of receiving stable government benefits contributed to income instability among single-parent households¹⁷.

The EPI paper identifies two eras of increasing volatility: the early 1970s to the mid-1980s, and the mid-1980s and beyond. In the first phase (early 1970s to mid-1980s), income volatility was greatest among single earner families, those with lower educational attainment and lower income groups in general. This coincides with the period of time when women began to enter the workforce in large numbers. Having a second income could mask income volatility among some households as a decline in one partners' earnings could be offset by the other partners wages. Elizabeth Warren writes that, when families were not wholly dependent on women to work, they could enter and exit the workforce as needed to cover emergencies and shortfalls. Once women working became the norm, that buffer disappeared, and many Americans had to turn to credit.

Once families had begun to operate as two-income households, volatility continued to increase¹⁸. In this second phase, volatility began to affect workers with more education and higher earnings primarily because people are much more likely to fall down the income ladder in recent years than they were in the 1970s¹⁹. This second phase of income volatility has spurred the emergence of a new group of payday loan borrowers—those who have higher incomes and

¹⁶ Hacker and Jacobs, 2008.

¹⁷ Hacker and Jacobs, 2008.

¹⁸ Hacker and Jacobs, 2008.

¹⁹ Hacker and Jacobs, 2008.

more education. Tim Ranney, President and Chief Executive Officer of Clarity Data Services, a credit bureau for nonprime consumers, calls this group “the new nonprime.” Ranney says they are the fastest growing group in his database of over 35 million consumers.²⁰

The third larger force that has likely motivated more consumers to use AFS is a greater reliance on credit overall and the reduction of small dollar credit from mainstream sources. As American’s financial situations have grown increasingly insecure, reliance on credit has increased. Political and economic forces are responsible for some of the problem: unemployment has remained high since the 2008 financial crisis. Forty percent of Americans report that income shortfalls cause them to spend more than they earn; and 29 percent of low- and middle-income Americans say their credit card debt results from medical expenses.²¹ Record levels of student debt are keeping recent graduates from moving forward in their lives, and damaging the wider economy.

The consumer financial services industry has also played a role in the current situation. Low interest rates and easy access to credit made credit cards a simple option for people experiencing financial stress, and credit card companies did everything they could to entice new categories of consumers.²²

The mix of cardholders also changed between 1989 and 1995: in 1995 cardholders were more likely to be single, more likely to rent instead of owning their homes, and had less seniority at work. Certain factors made these new borrowers riskier than traditional credit card holders²³.

²⁰ Author A personal interview with Tim Ranney, January 2014.

²¹ The Survey of Consumer Finances (2012). The Federal Reserve

²² Ross, Andrew. (2013) *Creditocracy and the cause for debt refusal*. OR Books, New York, NY

²³ Black, Sandra E. and Morgan, Donald P. (1999) “Meet the New Borrowers” *Current Issues in Economics and Finance* Federal Reserve Bank of New York. Volume 5, Number 3. February 1999.

New cardholders had a substantially higher debt-to-income ratio, so even small drops in income led to financial distress—new borrowers were also more likely to work in unskilled jobs with wages dependent on the business cycle²⁴. The median available credit per card increased about \$900, or about one-third and the median outstanding balance rose from \$1,100 in 1989 to about \$1,700 in 1995²⁵.

The cost of using credit cards has also risen, and policy has abetted rising costs. Consumer debt has grown along with deregulation of the credit card industry beginning with the 1978 Supreme Court ruling of *Marquette vs. First Omaha Savings Corp* which virtually eliminated interest rates on credit cards. In 1996, the *Smiley vs. Citibank* decision did the same for credit card fees, allowing them to be determined by the lender's home state²⁶. Prior to this decision, credit card late fees averaged sixteen dollars²⁷. Before the passage of the CARD Act in early 2010, the average late fee had climbed to thirty-nine dollars. The Act capped the first late fee at twenty-five dollars, and a second at thirty-five dollars.

More recently, policy changes such as the CARD Act triggered many credit card companies to decrease customers' credit limits. Under the CARD Act, credit card companies are required to calculate credit card limits based on individual income rather than household income. While this legislation was well-intended in that it aimed to prevent people from racking up credit card debt they could not afford to pay off, the problem is that credit agencies take the percent of available credit an individual is using into account as they calculate scores. Overnight, hundreds

²⁴ Black and Morgan, 1999.

²⁵ Black and Morgan, 1999.

²⁶ Garcia, 2007.

²⁷ Garcia, 2007.

of thousands of people saw their credit scores drop even though their own behavior remained unchanged.

Up until about the early 2000s, many mainstream banks offered small, unsecured loans to customers. Credit unions and community banks were another important source of this type of credit. Among credit unions, their small size increased the likelihood that the lender and borrower were acquainted, which made these loans an acceptable risk.²⁸

New banking policies, which made it possible for banks to offer a wider range of products and services, led to home equity lines of credit and bank-issued credit cards. In 1983, only 43 percent of US households had a MasterCard, Visa or some other general purpose credit card. By 1995, that number had risen to 66 percent²⁹. As credit cards became more widely available, banks began to encourage consumers to use credit cards or cash advances for small purchases and they became an easy and relatively inexpensive way to make small, unsecured loans³⁰.

IV. Methodology

In order to better grasp the logic of consumers and providers of AFS products and services, we needed to get as close to the moment of decision-making, and as close to the businesses, as possible. The majority of work on the issue of financial inclusion relies on survey data (for example World Bank, 2014) or one-time interviews (Barr, 2012). Our hypothesis going as we conceived of this project was that we could get a different kind of information and understanding of the problems by conducting ethnographic, participant observation over an

²⁸ Walter, 2006.

²⁹ Black and Morgan, 1999.

³⁰Walter, 2006.

extended period of time, and that this methodological approach would result in a more holistic understanding of the problem.

In order to do this, Author A worked part-time as a teller at a branch of Rite Check, a check casher in the South Bronx neighborhood of Mott Haven, and later at Check Center, a check casher/payday lender in Oakland, California. Author A worked weekly, eight-hour shifts at RiteCheck from November 2012 through March 2013. She worked full time for three weeks at Check Center, two weeks as a teller and one week as a loan collector in October 2013. Before being accepted to take these positions, she received appropriate training and a uniform, and underwent the procedures that employees usually go through during the recruitment process, such as credit history checking and drug and alcohol use testing. Author A was embedded, not undercover. The decision to reveal her identity to the managers of the businesses and the tellers she worked with enabled them to become informants, as the findings will show.

This embedded ethnographic approach enabled Author A to get to know the business and the regular customers. It also enabled her to experience what people do during different times of day, different days of the week, and different times of the month. People generally got paid on Thursdays and Fridays, for example, and the kinds of transactions conducted on those days were different from what people did on Mondays and Tuesdays. In addition, becoming a teller transformed the expert researcher/subject relationship. Wearing a uniform and working with other tellers to help customers, “get the line down,” made Author A part of a team. As the most junior teller, she was also, in some ways, subordinate to the other tellers—they were the experts, and Author A learned from them. The relationships between Author A and the other tellers also changed over time, as we became more comfortable working together and developed more trust.

We talked about our children, shared food, took on more work when one of us wasn't feeling well.

Following the embedded ethnographic research, we conducted a total of 50 semi-structured interviews in the South Bronx and 41 in the SF Bay Area focusing on the individuals' use of financial services. Interviewees were approached randomly at the store locations, were asked if they wanted to participate in the study and provided with an explanation of the research. Each interviewee received \$20 in recognition of the time they took to respond, and was asked to sign an informed consent. Most of the interviews took place at Rite Check or Check Center premises, or at a nearby coffee shop or restaurant. To expand the scope of our sample, we also visited the nearby Saint Jerome Church HANDS community center on East 138th Street and asked participants to introduce us to other people who they thought would be willing to participate. In the South Bronx we interviewed 35 people who were RiteCheck customers, one who was a Chase Bank customer, eight who we met at the community center, and six who were introduced to us by one of these primary contacts. The interview protocol used for the Check Center interviews included additional questions geared toward payday borrowers. In California, we interviewed 19 customers from Check Center store located in Hayward, and 22 customers at the Oakland branch.

V. Findings

Given that the majority of existing research classifies individuals by the degree to which they used banks, it is useful to report on how the population we interviewed (n = 88) looks from this perspective. RiteCheck customers (n = 47) were nearly split: 27 interviewees had a bank account and 21 either did not have a bank account or had had an account in the past but no longer

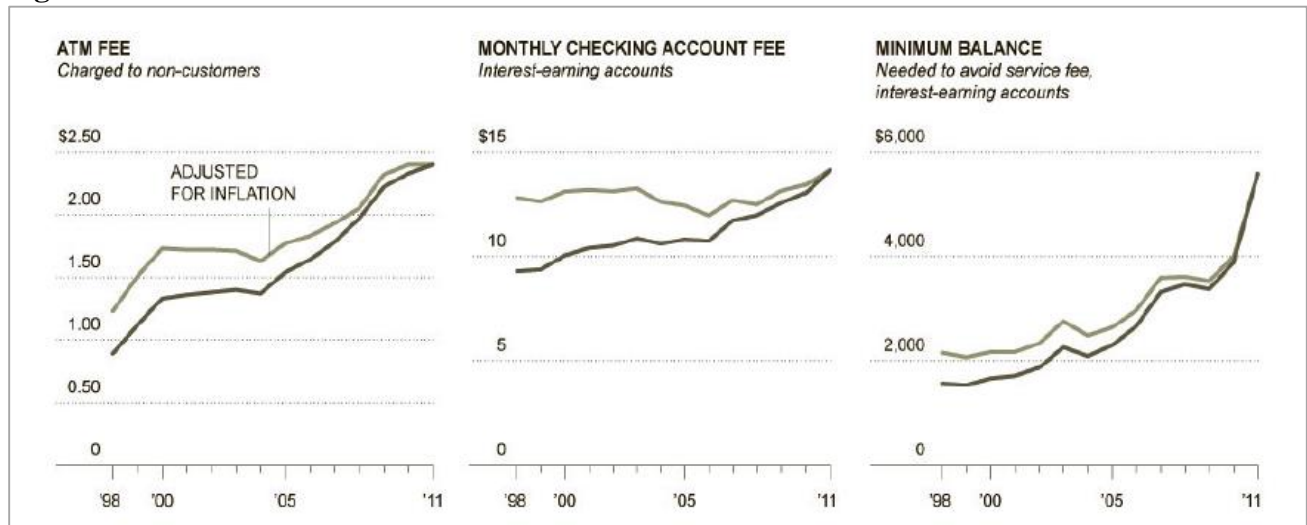
had one. All of the Check Center customers had a bank account given that a checking account is a requirement for obtaining a payday loan.

Our findings support and add nuance and texture to some findings of the earlier research that has been conducted about financial inclusion. Our work challenges other findings, and adds additional explanations for why so many people choose to use alternative financial services instead of, or in combination with, mainstream financial services. We found that cost, transparency and service all played large roles in consumers' decision-making processes.

Cost

When policy makers and consumer advocates denounce check cashers and payday lenders, they cite overly high fees as the primary critique of these businesses (See for example Montemezolo, 2013; Fox, 2000). In our research, one of the primary reasons people gave for not using a bank account is that they found banks to be too expensive. During the same period in which the AFS industry has grown, banks instituted a range of new fees and raised existing charges on ATM withdrawals --which more than doubled between 1998 and 2012--, wire payments, debit card replacements and paper statements. The availability of free checking accounts also dropped dramatically. Only 38 percent of non-interest-bearing checking accounts were free in 2013, down from 76 percent in 2009, and the average monthly service fee on checking accounts increased 25 percent in one year alone, from 2010 to 2011 (Bankrate, 2014). The rapidly increasing cost of bounced check fees and late payment penalties has driven many people away from banks.

Figure 4. Increase in Bank Fees



Source: FISCA, 2012.³¹

A single overdraft can result in cascading bad checks and hundreds of dollars in charges. Here is an example of how this works. In its study of checking accounts in the US, Pew found that the median amount a bank could charge a customer for overdrafts was \$140 per day, and that Americans spent \$38 billion on overdraft fees in 2011 (Pew, 2011).

Some of these new and increased charges represent an attempt by banks to make up the revenue they lost as a result of the CARD Act, which restricted the amount they could charge for overdraft fees and debit card swipe fees, the fees banks charge retail stores for each debit card transaction. Banks expect to take in average \$7.26 to \$20.09 per month from each account (CFPB, 2014), and this can be particularly difficult to do when serving low- and moderate-income people.

³¹ CHECK citation—is this from the Stephens report?

Zeke, a Rite Check regular, told us he used to have a bank account, but closed it soon after he lost his job as an assistant chef at John F. Kennedy airport. Zeke now works as a janitor and hopes he can one day go to college; he uses a loan shark when he is short on cash. “I’d like to go back [to the bank], but I can’t afford the monthly charges,” he told us. Maria left her bank for the same reason. “It was like I just kept paying more and more,” she said.

In November 2011, Bank of America was ordered to pay \$410 million to customers for wrongfully charging excessive overdraft fees resulting from “debit re-sequencing,” a practice in which banks process the debits and credits to an account in a way that causes account balances to fall faster, thereby boosting potential overdraft fees. This process works as follows: You have sent three checks out to pay your bills, one to your local electric company for \$75, one to your credit card for \$150, and one to your landlord for \$500. Your checking account has a balance of \$100. All three of these checks hit your account on the same day. The bank could easily clear the \$75 check first, resulting in two overdraft fees. But the bank instead uses re-sequencing software that reorders the bills from the highest amount, \$500, to the lowest. As a result, the bank can charge you for three overdraft fees instead of two. Banks were engaging in this practice as early as 1995, when the Baltimore Sun reported that Haberfeld Associates, a consulting firm that currently works with over 100 financial institutions, advised banks to debit large checks first in order to generate more overdraft fees.³²

Consumers who have no buffer in their accounts and who cannot predict exactly when checks will hit and clear are making rational decisions when they choose alternative services

³² Quinn, Jane Bryant. “In bounced-check fees, the innocent also pay.” The Baltimore Sun. February 27, 1995. Accessed February 12, 2015. http://articles.baltimoresun.com/1995-02-27/business/1995058127_1_bounced-checks-bounced-check-checking-account

over banks. It became clear to us from observing customers at the window and from interviewing them that cost was a relative concept. What seemed expensive to those who can afford to keep a minimum balance in a bank account is reasonable for those who make just enough to cover their monthly basic expenses, and thus need every dollar they can get as soon as they can get it. Alberto, a 20-year-old Puerto Rican man who lives in Mott Haven, told us he had to close his bank account after he incurred overdraft fees and “also lost my job so, you know, I had to keep paying a monthly payment.” Customers like Alberto and Zeke, both of whom lost their jobs, are more common today. Many more Americans have unstable work or have shifted to hourly work with less predictable hours. The severe income volatility discussed earlier makes it more difficult for them to use bank accounts that have minimum balances and monthly charges.

Related to cost, liquidity is also critical to users of alternative financial services. Working as a teller and as a counselor, Author A learned that her customers often paid a high price for their money because they need their money as soon as it is available to them. Joe Coleman, president of RiteCheck, explained this dynamic as follows: “Let’s say a customer gets paid on Friday. If he brings his check to us, he gets his money immediately. He can pay his bills right away, go food shopping over the weekend. If he goes to the bank, his check won’t clear until sometime the next week. He’ll be late on his bills. And if he writes a check and it hits his account before the check he deposited clears, he’ll be hit with an overdraft fee for more than \$30--much more than the fee he would have paid us.”³³

Michelle, a RiteCheck regular, came to Author A’s window one morning to withdraw money from her Electronic Benefits Transfer (EBT) card. The New York State Office of

³³ Personal interview, July, 2012.

Temporary and Disability Assistance delivers cash and Supplemental Nutritional Assistance Program (SNAP) benefits on these cards. The state deposits benefits into an account that recipients can access by swiping a card at an ATM or a terminal like the one that sat on my counter at the check cashing store. RiteCheck charges a flat, two dollar fee for each transaction even though there are ATMs in the neighborhood at which people can make two free withdrawals per month. Michelle asked Author A to take ten dollars out of her account; she would get eight dollars cash and pay what amounted to a twenty percent fee. At first she did not understand why anyone would pay so much for a small amount of money. She asked Cristina, the teller who trained her, to explain. Cristina explained that ATM machines rarely give out ten dollar bills, and that they never dispensed the odd amounts our EBT customers requested—27 dollars, 41 dollars. Cristina's explanation helped her understand that check casher customers often need every dollar they can access. They have no choice but to pay they two dollar fee, because they cannot wait until their account grows to twenty dollars.

If someone needs money immediately, this is clearly logical, albeit expensive, behavior. But it is expensive to be poor. These EBT transactions and the choice many people make to cash their checks at check cashers result from the same dynamic that, conversely, allows better off people to buy 30 rolls of toilet paper at a time at a bulk warehouse store instead of buying higher-priced smaller packaged at corner stores. A well-paid, steady job, a car, and space to store bulk goods means that spending \$200 at one time can save money over the long term. Michelle needed her eight dollars so urgently that she was willing to pay 20 percent to get it.

Working people increasingly need this kind of liquidity also. Carlos came to RiteCheck frequently to cash checks of several hundred to a few thousand dollars for his small contracting

business, paying the fee of 1.95³⁴ percent of the face value of the check every time. One Thursday Carlos brought in a check for \$5,000. After taking his photo and running his check through a scanner, I gave him \$4,902.50. He slid a ten-dollar bill back through the window, the tip. Carlos paid \$97.50 to cash that check. Witnessing the transaction, author A wondered why Carlos would pay that fee. Surely he had a bank account for his business. Once again she asked Cristina about the transaction. Cristina explained that, since it was Thursday, it was likely that Carlos would have to pay his workers the next day. If Carlos is like many small contractors operating in New York City, he relies at least in part on undocumented workers, who are unlikely to have bank accounts. If Carlos deposits his check into a bank account, it will not clear before he needs to pay his workers. Another possibility is that the check was a deposit for a job he had just been contracted to do, and that he needed to purchase supplies in order to get started.

Transparency

Another reason interviewees gave for choosing to use check cashers and payday lenders was that they did not feel the cost of services and the product mix at banks were transparent. Photos of the lobby of a bank branch and of the RiteCheck store where Author A worked clearly illustrate the difference in transparency (Figures 5 and 6).

³⁴ These fees are regulated by state law. The New York State fee was 1.95 percent of the face value of the check. It is indexed to inflation, so is now 2.01 percent.

Figure 5. Bank branch



Figure 6. Lobby of RiteCheck, South Bronx



The bank lobby, pictured in Figure 5, is nearly devoid of signage. Given that many of those who are classified as “unbanked” have never had a bank account and have no history of using banks, it is easy to see how walking into such a lobby could be intimidating. There is virtually no visible explanation of what products and services are offered and at what cost. The RiteCheck lobby is a complete contrast (Figure 6). Every product and service offered, along with its cost, is displayed on large signs that span the area above the tellers’ windows. The same holds true for payday lenders, where the fees for each loan size are displayed on large signs in the lobby (Figure 7).

Figure 7. Fees sign at Check Center, Oakland, CA

Amount provided	Fee	Amount of check	14 day APR	30 day APR
\$42.50	\$7.50	\$50.00	460.08%	214.71%
\$85.00	\$15.00	\$100.00	460.08%	214.71%
\$127.50	\$22.50	\$150.00	460.08%	214.71%
\$170.00	\$30.00	\$200.00	460.08%	214.71%
\$212.50	\$37.50	\$250.00	460.08%	214.71%
\$255.00	\$45.00	\$300.00	460.08%	214.71%

YOU CANNOT BE CRIMINALLY PROSECUTED OR THREATENED WITH CRIMINAL PROSECUTION FOR PURPOSES OF COLLECTING A DEFERRED DEPOSIT OBLIGATION.

California Financial Code Section 23035 (d) (2)
 Check Agencies of California, dba Check Center is licensed under the Department of Corporations under the California Deferred Transaction Law.
 The Department of Corporations toll free number for receiving calls concerning customer complaints and concerns is 1-866-ASK-CORPS (1-866-275-2677).

This transparency helps build the trust of customers. Many of the customers we interviewed signaled their lack of trust in banks, calling them “money-gouging devils,” or saying that they “feel robbed in them,” or simply “I don’t like banks.” Customers of RiteCheck and Check Center used very different terms to describe them, including “family” and “trustworthy.” Caroline, a RiteCheck customer we interviewed, opened a bank account in order to get her

disability check direct deposited. But she still goes to RiteCheck to pay her bills. “I like coming here because I know that it's going to get done fast, you know, and it's safe, reliable,” she told us. “And I know that my bills are paid, and I don't have to worry about anybody taking my money, so I gotta do it here.” Jack, a police officer at the local precinct in Mott Haven, opened a bank account in 2008 to save for his son’s college tuition. Before that, he had a checking account for six years but closed it after the bank withdrew money for an overdue credit card that Jack never had. He currently cashes his check at RiteCheck and deposits the cash he receives onto a prepaid card.

Many of the customers we interviewed told us that a lack of transparency at banks contributed to the costs they incurred; they found it difficult to predict when and what they would be charged. Banks’ checking account disclosure statements, for example, are unnecessarily opaque. A 2011 study by the Pew Charitable Trusts found that the median length of a checking account disclosure agreement is 111 pages. Pew created a new, one page disclosure document that makes it easier for consumers to compare terms on different accounts. Thus far, 18 banks have begun to use these shorter, simpler disclosure agreements, including seven of the 12 largest banks and two of the three largest credit unions, which together cover approximately 40 percent of domestic deposit volume

Service

A third factor that led to consumers’ choice to use AFS was the service they received. Several of our interviewees contrasted the service at RiteCheck or Check Center with the service they received at the bank. Maria, a middle-aged Puerto Rican mother of six and longtime resident of the South Bronx, told us she “had issues in the bank with two tellers, you know one of them was very nasty to me and I had to argue with her because I didn’t like the way she came

out to me because there was a better way for her to tell me that. She didn't have to come out the way she did, so I got upset." As a result of the poor treatment she received, she began to use a prepaid card she obtained at RiteCheck to pay for what she needed. She kept close track of the money she had on the card in order to avoid fees. When Maria contrasted her experiences at the bank with the service she receives at RiteCheck, she described the relationship as follows: My mother got sick a bunch of times and they called to ask. She passed out two times here, and they called the ambulance. So we can be family. . . . We know all of them."

One way RiteCheck customers showed their appreciation for the service they received was by tipping the tellers, as in the Carlos story above. Most customers who tipped left a dollar or two, but it was not uncommon for a veteran teller to make \$30 or \$40 during a shift. Regular customers would often bring us coffee in the morning. After Cristina, who was pregnant when Lisa began working at RiteCheck, gave birth, customers dropped baby gifts for her at the store.

People who patronize AFS providers tend to come to the stores frequently; some came every day and many more came weekly or every other week. Bank customers rarely transact business with tellers. This is partly because banks have encouraged the use of ATMs and electronic banking, which lowers the cost of doing business for banks. The majority of what AFS customers need—money orders, check cashing, an immediate loan—requires working with the teller. This difference stems from the difference in banks' and check cashers' business models. As Joe Coleman, president of RiteCheck told Author A during an interview, "Banks want one customer with a million dollars. We want a million customers with one dollar."

The small, frequent transactions that make up the majority of AFS providers' business, and the fact that there is not much differentiation in the products and services offered, nor the price of the services, means that they need to compete on service.

This level of affability wasn't accidental; it was baked into the culture of the businesses. Check cashers and payday lenders depend on customer loyalty. Their business models require a high volume of transactions in order to succeed; one of the best ways to ensure a high volume is to get customers to keep coming back. Rite Check and Check Center selected tellers using some of the same criteria Apple uses to staff its stores: friendliness, patience, and an orientation to service.

At Check Center, Author A attended a full day “conversational customer service training” during which she was taught to immediately greet a customer when she entered the lobby, use his or her name at least three times during a transaction, and give him or her her undivided attention for the entire time she was at the window. Author A was taught to use non-verbal cues such as leaning toward the customer and keeping her arms open and uncrossed, to dress professionally, and to keep chitchat to a minimum in “the cage”. One of the newer tellers Author A worked with at Check Center seemed to be falling short in this area, and the other tellers talked about how to address her attitude. Even though they were not managers, they took on the issue because they felt it reflected poorly on “their” store. The customer service training taught tellers to hold themselves personally responsible for the service offered at the stores where they worked.

Recommendations for Policy and Practice

1. Reframe debates about financial inclusion. The dichotomous terms currently used to discuss issues related to consumer financial services--financial inclusion versus financial exclusion, banked versus unbanked--mask the complexity of factors that influence consumers' decision-making processes. Labeling people as “banked,” “underbanked,” or “unbanked”

presumes that relying exclusively on banks is the desired norm and that other choices are inferior. These debates also ignore the interconnections between the different types of financial services providers and how they rely on each other to make their profits.

Many people—and not just the poor—move in and out of the banking system and do not necessarily “graduate” from alternative to mainstream. During the course of our research, we also found that many of the people we interviewed also save and borrow informally and often in structured ways.

The size of and relationships between the three components of the consumer financial services system depicted in Figure 1 have changed as financial insecurity has spread. Fewer people rely solely banks. More people rely on check cashers and payday lenders. And informal strategies are very common, particularly in low-income and immigrant neighborhoods. Our research begins to illustrate how and why people move into and out of banking relationships, and why they continue to use alternative and informal mechanisms even when they have bank accounts. If we want the consumer financial services system to work better, we first need to better comprehend it in its entirety—formal and informal, mainstream and alternative.

2. Address the macro problems. In determining how to make the consumer financial services system work better for people, policy makers have focused primarily on regulating financial services providers. This approach makes sense given that the primary relationship in this area is between the consumer and the institution (or, in the case of the informal component, his or her network). While this regulatory approach is a necessary piece of addressing the problem, it is insufficient and reflects an incomplete definition of the problem. A significant portion of people are struggling not because of what financial institutions do or do not do, but because larger macro forces have created a situation of widespread financial insecurity. In order

to improve the situation, we need to not only ensure that the consumer financial services industry works in the best interest of consumers but also work on larger issues that include declining wages, increased income volatility, rising inequality, and the escalating costs of healthcare, childcare and education.

This recommendation is particularly critical from an economic mobility perspective. Many of the payday loan customers Author A served and who we interviewed told stories about losing their jobs, working reduced hours, or relocating for jobs. They often had to obtain payday loans to bridge gaps in their income. When they could not repay these loans because their work situations did not improve, they found themselves in worse situations because they continued to owe more on their loans. During the time Author A worked as a credit counselor she talked to Jeannine, who moved to Virginia from Pennsylvania after being downsized. Jeannine quickly found a job, but she didn't get paid for thirty days, and she needed money to get an apartment and cover her moving expenses. She turned to payday loans to get her through the transition. Clearly the problem here is not only the cost of the loans, but the financial security that initiated the cycle in the first place.

If every payday lender, check casher, pawnbroker and auto title lender were eliminated, the people who use these services would still lack good options. Policy recommendations need to focus on the nature of demand—on the conditions that lead people to seek these services in the first place.

3. Mandate greater transparency. It is virtually impossible to mandate that banks provide the kind of service RiteCheck and Check Center customers lauded during our conversations with them. Banks' practices send a message that customer service is not their top priority. Indeed, some banks are beginning to charge customers for using live teller services (Lake, 2015). Banks

can be made to make these practices more transparent, however. The Pew checking account disclosure statement, referenced above, is one example of a practice that creates more transparency that could all mainstream financial institutions could be required to adopt.

Historically, banks' attitudes have focused on figuring out how to make money without breaking the law, even when ideas for generating income—e.g., debit re-sequencing, multiple overdraft fees for the same charge—have been ethically questionable. In an article titled, “Nine dangerous words: Show me where it says we can't do that,” Jo Ann Barefoot, former deputy comptroller of the currency, writes that “using this traditional compliance process, most banks easily weathered controversies in recent years in areas like subprime lending, credit cards, and overdraft protection.” That situation is changing, Barefoot wrote in 2011, as regulators have increased their focus on UDAPP, Unfair, Deceptive and Abusive Acts and Practices. The law is over 70 years old but is being rethought as gaps between what is technically permissible and what is clearly wrong have been revealed. The problem is that applying words like abusive and deceptive is a subjective process, and the landscape of consumer financial services is very different today than when the law was enacted.

4. Stay tuned for industry innovations. The consumer financial services industry has entered a period of creative destruction. A confluence of forces have created a moment that is ripe for innovation and wholesale change, and a slew of innovators are poised to seize the opportunities this moment provides. Enormous advances in technology, significant changes in consumer behavior, a radically revised regulatory environment, and big shifts in capital markets are all coming together in ways that offer hope for more efficient, effective, and equitable provision of consumer financial services.

Policy makers and consumer financial services industry insiders need to keep tabs on innovations in this space. Although they are too numerous to cover thoroughly, a couple of examples will provide a sense of current developments. Atlanta-based L2C has created a credit score that uses completely different data from what the Big Three credit bureaus use. Advances in technology have enabled L2C to gather more kinds of data about more people. L2C's model enables more people to obtain credit who would have previously been denied, and it also enables many people to get cheaper credit. It appears that these new credit scores seem to make the biggest difference for lower-income people. The old [or more traditional] way of computing a credit score tended to simply disqualify a whole swath of would-be borrowers who were then shut out of the credit market entirely or pushed to more expensive forms of credit like payday loans. Improved accuracy of credit scores is particularly important now, as the use of credit scores has expanded to employers deciding who to hire and landlords deciding who to take on as tenants.

A critical part of the consumer financial services system is invisible to consumers. The infrastructure that undergirds the institutions is critical to the way money moves from person to person, place to place and institution to institution. One of the main reasons people choose to use check cashers instead of banks is because banks make them wait to get access to their money, whereas check cashers offer instant liquidity, albeit at a price. An increasing number of people cannot afford to wait. The cost of check cashing fees is better than the alternative—overdrafting, late fees, eviction. San Francisco-based Ripple is harnessing new technology to get people their money more quickly. If this technology is widely adopted, it would change the consumers' decision processes and allow them to transmit and receive money more cheaply and quickly.

Conclusions

Our work richly illustrates the context in which consumers make financial decisions, and highlights the complexity of the consumer financial services system. We show the ways in which consumers' decisions to manage their financial needs outside of the mainstream component of the consumer financial services industry are often logical, if expensive. There are clearly steps mainstream financial services providers could take to change their practices. However, our focus here is on policy. Perhaps most importantly, the way we talk about issues of "financial inclusion" needs to be changed to a language that better reflects what consumers are doing at ground level. Policy makers should also continue to do more to mandate that the details of financial transactions be made transparent. And a narrow focus on consumer financial services must be coupled with work at the level of macro forces in order to create the conditions that would enable all Americans to achieve financial health.

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