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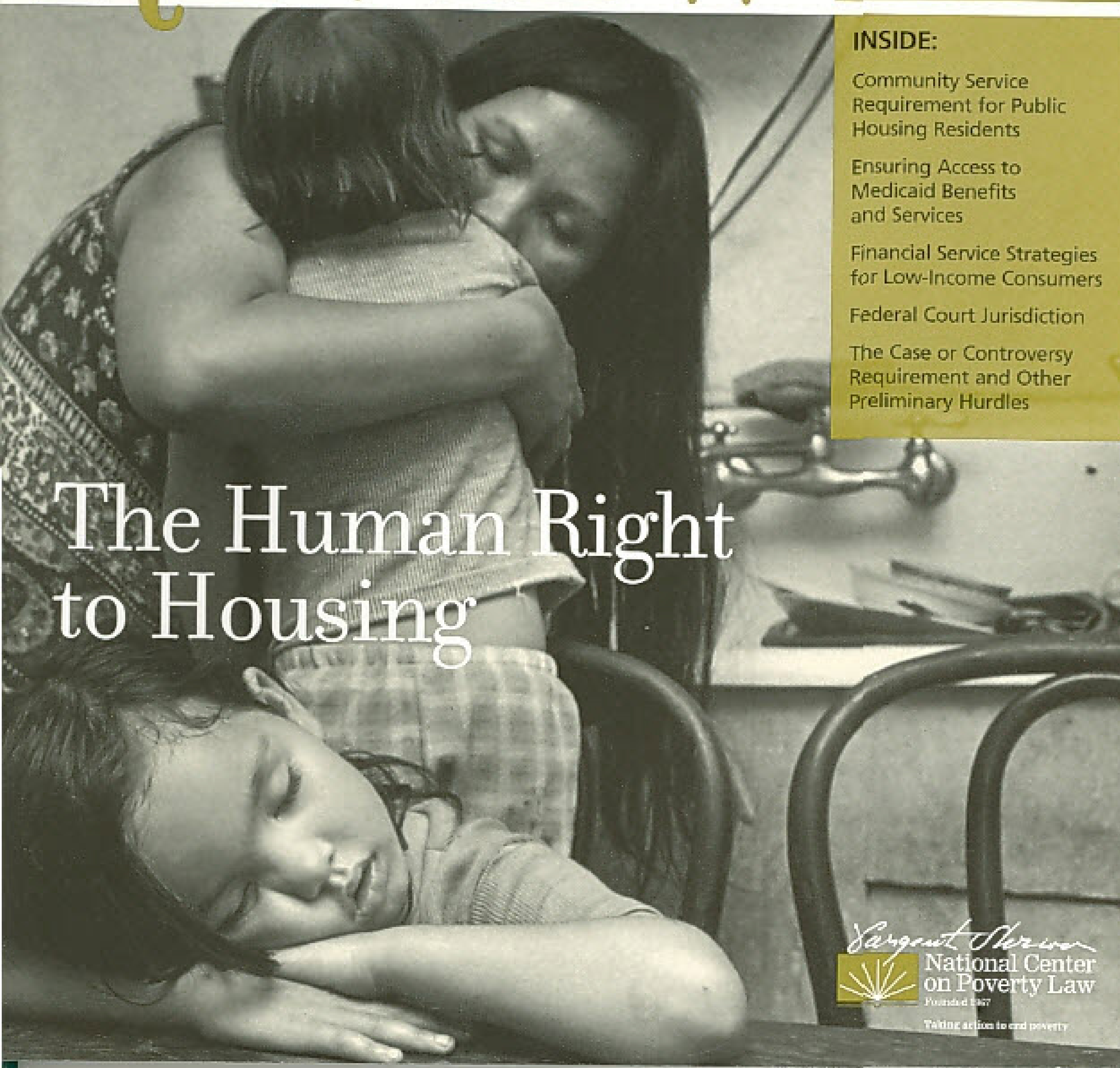

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Navigating the Shoals: Financial Service Strategies for Low-Income Consumers

By Deborah B. Goldberg

The old adage "It's expensive to be poor" is nowhere more true than in the area of financial services. People with modest incomes often cannot avail themselves of the low-cost financial service products or savings and investment vehicles that offer healthy returns and are available to people with higher incomes. Any lawyer serving low-income clients has likely had to contend with this phenomenon.

Advocates, attorneys, and policymakers may respond to this situation by emphasizing financial literacy, which aims to educate consumers about the intricacies of the financial service marketplace and teach them how to make "smart" decisions about their financial service providers. The hope is that, armed with better information about the true costs of their current choices and the true benefits of the options available to middle- and upper-income consumers, low-income people will follow in their footsteps and reap the financial rewards.

Being well informed is always a good idea for consumers, and certainly the world of financial services is complex enough that most consumers could benefit from some education. However, financial literacy training may not be enough to help low-income consumers gain access to more affordable financial services. In fact, many of their choices are highly rational in the current world of financial services. And many of the choices available to their higher-income counterparts are effectively barred to low-income consumers.

Over the last three decades, powerful forces at work in the financial service industry have created a two-tiered system. In the top tier is one set of service providers, offering a range of products aimed at affluent customers. These companies are what we often think of as the "mainstream" of the financial service industry. They include banks, thrifts, credit unions, mutual funds, brokerage houses, and certain segments of the insurance industry. Lower-income consumers often find themselves trapped in the lower tier, or the "fringe banking" market, generally with a different set of players offering a different range of products. These products often carry a higher risk for the consumer and almost always come at a higher price.

Attorneys and advocates concerned about the impact of financial choices on the lives of low-income clients and constituents need to understand the trends under way in the financial service world if they want to craft or support successful alternatives to the options currently available.

I examine here some of those trends and their impact on low-income people. I describe the types of financial service providers that proliferate in low-income communities and the costs that they impose. I examine the forces that have propelled the withdrawal of "mainstream" financial institutions from lower-income neighbor-

Deborah B. Goldberg
Consultant

122 Fleetwood Terrace
Silver Spring, MD 20910
debbygoldberg@juno.com

and formerly *Codirector*
Neighborhood Revitalization Project
Center for Community Change

hoods. Finally I look at some of the alternatives that community groups are exploring in an effort to make higher-quality, lower-cost financial services available to their constituents.[1]

The Fringe Banking Sector

Access to financial services is a fundamental need in our society. People must have a secure way to receive income, be it from an employer, public assistance, or other sources. People at all income levels must pay for housing, utilities and other bills. People need credit to finance sizable purchases, such as major appliances, automobiles, or homes. Homebuyers must get insurance, and, in most states, automobile owners also must carry insurance. People whose incomes exceed their expenses also need a way to save and to increase their savings through earned interest or other types of investments.

Banks and thrifts—insured depository institutions—are generally at the heart of the financial service strategy used by middle- and upper-income consumers. Bank branches and online services offer convenient access. These institutions offer a host of deposit service options, both for checking and savings, and banks and their affiliates also offer a range of investment options from certificates of deposit and money market accounts to mutual funds. A number of banks even offer access to insurance through relationships with major insurance carriers. Banks also offer an array of loan products, including credit cards, mortgage loans, car loans, student loans, and home equity lines of credit.

For low-income people, the picture is very different. In most low-income neighborhoods the financial service landscape largely comprises a completely different set of players:

- Check-cashing outlets cash checks for fees that, if regulated at all, range from 1.5 percent to 3 percent of the face value for government checks to 20 percent for personal checks.[2]
- Payday lenders make small, short-term loans (usually in amounts under $500 for periods up to two weeks) that are secured by a postdated personal check or electronic access to the customer's bank accounts. The average interest rate for payday loans is 15 percent to 17 percent for a two-week period; this translates to an annual percentage rate of 400 percent.[3]
- Money transfer services, also called remittance services, are used to transfer funds either domestically or internationally for fees that commonly range from 10 percent to 25 percent of the amount transferred.[4]
- Tax preparation services assist taxpayers in preparing and filing their federal income taxes and tend to be heavily concentrated in neighborhoods with significant numbers of families qualifying for the earned income tax credit. The average fee for this service is $120. Many tax preparation services also market to their customers refund anticipation loans or other ways to receive a tax refund quickly for a loan fee ranging from $30 to $105, administrative fees averaging $32, the option of an "instant" refund for an additional $15-$30, and a number of other associated charges (e.g., account opening fee, check-cashing fee).[5]
- Rent-to-own stores rent television sets, furniture, and other appliances

[1] This article is based in part on work I did for the Center for Community Change and the Annie E. Casey Foundation. See Deborah Goldberg, Allen Fishbein & Lisa Smith, Land Sharks Circling: The Changing Financial Services System and Its Implications for Low-Income Families and Communities (Aug. 2003).

[2] James H. Carr & Jenny Schuetz, Fannie Mae Foundation, Financial Services in Distressed Communities: Framing the Issue, Finding Solutions 8 (2001).

[3] *Id.*

[4] National Consumer Law Center, Money Wire Transfers—How to Help Immigrants Avoid Fraud and Save Money (n.d.), available at www.consumerlaw.org/initiatives/osi/miscellaneous/wire_transfer.shtml.

[5] Alan Berube et al., Brookings Institute et al., The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC (2002).

on a weekly or monthly basis to customers who lack the cash or credit to purchase these items outright. During or at the end of the lease period the customer may purchase the item at a price that is two to three times the conventional retail price. Since the customer does not build up any equity interest in the item, failure to make a scheduled payment results in repossession of the item.[6]

- Pawnbrokers take personal items as collateral for small, short-term loans. The interest rates that they charge are dictated by state law and may be as high as 25 percent per month; this translates to an annual percentage rate of 300 percent.[7]
- Auto title lenders provide short-term loans with interest rates and other charges ranging from 2.5 percent to 25 percent per month. The collateral is access to the borrower's car title, which must be free and clear. The loans usually do not exceed 25 percent of the car's value, and if the borrower defaults, he loses his car and often his only means of transportation.[8]
- Car dealers often provide financing for the cars that they sell. A series of class action lawsuits gives substantial evidence that African American and Hispanic car purchasers are subject to significant markups in the price for the car and the interest rate for the financing.[9]
- Subprime mortgage lenders specialize in loans to borrowers who do not meet the standards of the prime market. Subprime borrowers pay significantly higher interest rates than prime borrowers. The subprime market has proven to be fertile ground for predatory lenders, aggressively marketing loans designed to strip away homeowners' equity. These loans often charge extremely high fees, along with features such as single-premium credit insurance and prepayment penalties that can combine to trap the homeowner in an unaffordable loan.

The Cost of Fringe Banking

The aggregate annual cost of these services is staggering. Researchers calculate that low-income households spend in the range of $5.45 billion to $7.25 billion a year on check cashing, payday loans, pawnshops, rent-to-own transactions, and auto title loans.[10] These families spend another estimated $1.5 billion on fees and interest for income tax preparation and refund anticipation loans.[11] And the excess cost of subprime mortgages may reach as high as $9.1 billion a year in loan features that strip borrowers' equity and in excessively high interest rates.[12] Taken together, this suggests that the total price tag for fringe banking services nationwide may be somewhere between $16 billion and $17.85 billion a year.

Reliance on fringe banking institutions has other costs as well. Because these institutions do not take deposits, their customers have no opportunity to save in a secure place or to earn interest on savings. This means that consumers cannot get the maximum benefit from any funds put aside.

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[6] Carr & Schuetz, *supra* note 2, at 8.

[7] *Id.*

[8] *Id.*

[9] Brenda Y. Muniz, *Discrimination in Auto Financing Makes Dream of Owning a Car Elusive*, Agenda (Nat'l Council of La Raza), Fall 2002, at 1.

[10] Carr & Schuetz, *supra* note 2, at 10; see also Eric Stein, Center for Responsible Lending, Quantifying the Economic Cost of Predatory Payday Lending 8 (2003).

[11] Chi Chi Wu & Jean Ann Fox, National Consumer Law Center & Consumer Federation of America, All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans 1 (2004).

[12] Eric Stein, Coalition for Responsible Lending, Quantifying the Economic Cost of Predatory Lending 2 (2001).

Further, consumers in the fringe banking sector are not building relationships with insured depository institutions: banks, savings institutions, and credit unions. Such relationships are key to a range of asset-building strategies—including homeownership and small-business ownership, among others—to improve low-income consumers' long-term financial stability.

In fact, reliance on fringe banking providers may actually hinder consumers' subsequent efforts to obtain credit or other banking services from mainstream institutions. Overreliance on certain types of credit and under-utilization of other types of credit may place consumers in the bottom ranks of the credit-scoring systems that are so widely used in today's credit markets.[13] Credit card companies use credit scoring to determine the rates and terms of credit cards. Banks use credit scores to determine who can open checking accounts. Virtually all car insurance companies and the vast majority of homeowners' insurance companies use credit scoring to determine the type and cost of insurance that they make available to an applicant.[14] It is used in nearly all mortgage loans sold in the secondary market to determine the interest rate to be charged on a mortgage. It is even used in some situations to decide whether to offer an individual a job, an apartment, or utility service.[15]

Consumers in the fringe banking market may find themselves trapped and unable to escape. This is particularly true with respect to payday lending. The payday lending industry is structured to encourage customers to roll over their loans repeatedly rather than paying them off on the due date. In North Carolina, for example, researchers found that 96 percent of the payday loans made in that state were to repeat borrowers, who took out five or more loans a year. The average North Carolina payday loan borrower takes out fourteen loans a year, eight of them from a single payday lender. After six loans, the borrower will have paid more in fees than the borrower received in cash.[16]

Predatory mortgage lending can be another trap. Households with these loans are often convinced to refinance their loans repeatedly and pay more fees and higher interest each time. Ultimately the payments become more than they can afford, their home equity is completely stripped away, and they face foreclosure and financial disaster.

Clearly both the costs and risks of banking in the fringe market are significant. Yet many of the consumers who use fringe banks have limited incomes and minimal assets and can ill afford either the costs or the risks.

Fringe Banking Market Expansion

As the $16 billion to $18 billion annual price tag suggests, the fringe banking market is a sizable one. It has grown explosively over the last decade or so, as illustrated by the rise of subprime mortgage lending. In 1994 subprime lending accounted for 4.5 percent of all mortgage loans nationwide.[17] By 1999 it had grown to 12.5 percent of the market. In 2003 subprime origination totaled over $332 billion.[18]

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[13]Credit scores are numerical indicators derived from an analysis of an individual's personal information and credit history. The scores are used to predict the level of credit risk that the individual represents. People with high credit scores may qualify for the cheapest credit on the best terms. Too many negative records or too few positive records can add up to a low credit score.

[14]Birny Birnbaum, Insurer's Use of Credit Scoring for Homeowners Insurance in Ohio: A Report to the Ohio Civil Rights Commission (2003).

[15]Consumer Federation of America & National Credit Reporting Association, Credit Score Accuracy and Implications for Consumers 2 (Dec. 17, 2002).

[16]Coalition for Responsible Lending, Payday Lending in North Carolina: Borrowers Trapped in a Cycle of Debt 1 (2002).

[17]Joint HUD-Treasury Task Force on Predatory Lending, Curbing Predatory Home Mortgage Lending 29 (2002).

[18] Federal Reserve Gov. Edward M. Gramlich, Subprime Mortgage Lending: Benefits, Costs and Challenges, Speech at the Financial Services Roundtable Annual Housing Policy Meeting (May 21, 2004), available at www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm.

Other segments of the industry have also experienced tremendous growth. According to industry research cited by Dollar Financial Group in its filings with the Securities and Exchange Commission, the number of check-cashing outlets nationwide grew from 1,350 in 1986 to 13,000 in March 2002—an increase of more than 860 percent.[19] Payday lending has grown at an even more rapid rate. In 1994 there were approximately 300 payday lending stores nationwide. By 1999 that figure had grown 2,500 percent to over 8,000 payday lending locations.[20] The latest research by Stephens Inc., an investment banking company that specializes in the fringe banking market, estimates the total number of payday lending stores nationwide at 22,000 and predicts a loan volume of $40 billion in 2004, yielding revenues of $6 billion.[21]

Three principal factors explain this dramatic growth: deregulation, access to capital, and the withdrawal of mainstream financial institutions from lower-income communities.

Deregulation

The year 1980 marked the beginning of a wave of banking deregulation. As inflation drove interest rates into the double digits in the 1970s, savers turned away from banks—which were limited by law in the amount of interest that they could pay on passbook savings accounts—to mutual funds and other investments offering higher interest rates. In 1980 Congress phased out the ceilings on passbook savings accounts and preempted state usury ceilings on first mortgages.[22] Congress intended these moves to help banks regain a competitive position in the market by allowing them to pay higher interest on deposits and charge higher interest on mortgages. In 1982 Congress preempted state restrictions on certain kinds of risky mortgage loans such as those containing balloon payments, prepayment penalties, and negative amortization.[23] Encouraged by the federal actions, a number of states went even further and eliminated interest rate ceilings on other forms of home loans, including second mortgages. Policymakers hoped that these regulatory changes would spur competition in the mortgage market and provide cheaper mortgages for consumers. However, they also provided the opening for unscrupulous lenders to enter markets where mainstream lenders were not active and to offer loans with exploitative rates and terms.[24]

Similarly, for many years, states strictly regulated small consumer loans. To discourage loan sharking, usury ceilings limited the interest rates that lenders could charge for these loans. Lenders could be licensed to make loans of less than $300 at interest rates of up to 36 percent per year.[25] Small loan laws typically also limited fees and other charges. States also restricted other consumer credit transactions that tended to be abusive and predatory. Finance companies arose to fill this market niche. As credit cards emerged as an alternative source of small unsecured loans for many, finance companies found that they could no longer make their desired returns. New forms of alternative credit

[19]Dollar Financial Group, Annual Report Pursuant to Sec. 13 or 15(d) of the Securities Exchange Act of 1934 for Fiscal Year ended June 30, 2003 (10-K), at 15.

[20]Michael A. Stegman, Savings for the Poor: The Hidden Benefits of Electronic Banking 67 (1999).

[21]Dennis Telzrow & David Burtzlaff, *The 3U Consumer Finance Monthly: Undiscovered Companies Serving Underbanked and Unwanted Consumers*, Industry Notes (Stephens Inc. Investment Bankers, Little Rock, Ark.), Mar. 29, 2004, at 2.

[22]The Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 161 (codified in scattered sections of 12 U.S.C.).

[23] Alternative Mortgage Transaction Parity Act, 12 U.S.C. §§ 3801 *et seq*.

[24]For further discussion on the role of deregulation and preemption of state limits on consumer credit charges, see Kathleen Keest, National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges (1995).

[25] Elizabeth Renuart & George Gaberlavage, American Association of Retired Persons, Payday Loans: A Model Statute, n.8 (Oct. 2000).

providers emerged, such as payday lenders, to serve those without access to credit cards. Many of these companies specialize in ways to circumvent the restrictions on lending imposed by the small loan laws and the usury caps by, for example, "renting" bank charters or selling loans disguised as Internet access, phone cards, or catalog coupons.[26]

Meanwhile, deregulation of the mortgage market sparked a movement to eliminate interest rate caps on small loans. Some states abolished usury caps and other consumer protection measures. Others repealed their usury laws but maintained consumer protection measures. For example, thirty-three states and the District of Columbia have laws specifically authorizing payday lending. Two others permit payday lenders to charge unlimited interest and fees, although they must comply with other small loan provisions.[27] The end result in the consumer credit marketplace is a patchwork of regulation, enabling predatory practices to propagate.

Access to Capital

A second key factor in the growth of the fringe banking sector is increased access to financial resources, both from mainstream banks and Wall Street investors. The biggest check-cashing and payday lending operations, such as Ace Cash Express and Dollar Financial Group, have been able to use Wall Street as a source of capital and have stock that is publicly traded. In fact, the résumés of many of Dollar's executives and directors read like a "who's who" of Wall Street. Their past (and in some cases current) affiliations include such firms as Bear Stearns, Goldman Sachs, Drexel Burham Lambert, and Donaldson, Lufkin and Jenrette.[28] Wall Street is also a source of capital for the bigger subprime mortgage lenders; such lenders pool their loans and use them to back securities, which they sell to pump capital back into their lending operations.[29] Fannie Mae and Freddie Mac, the government-sponsored enterprises that serve as a secondary market for mortgage lenders, are also venturing into the subprime mortgage market. They have significantly increased their purchases and securitization of subprime loans in recent years and put capital back into the coffers of the originating lenders.[30] A number of major banks provide capital in the form of lines of credit, along with other vital financial services, to check cashers and payday lenders. These banks include Chase, Wells Fargo, European American Bank, and LaSalle, to name a few. Thus, while once investors might have viewed the fringe banking market as one to avoid, now many are eager to reap a share of the profits.

Withdrawal of Mainstream Banks

Another factor in the growth of fringe banking is the vacuum left as mainstream institutions have withdrawn from lower-income communities. Over the last twenty years, the number of bank branches in lower-income neighborhoods dropped by 21 percent while the total number of branches increased by 29 percent. Most of this increase occurred in middle-income neighborhoods.[31] In many metropolitan areas low-income neighborhoods have no bank branches left. This shift is a tangible sign of many banks' growing disinterest in doing business with lower-income consumers.

[26] Jean Ann Fox, Consumer Federation of America, Unsafe and Unsound: Payday Lenders Hide behind FDIC Bank Charters to Peddle Usury (2004).

[27] *Id.* at 4.

[28] Dollar Financial Group, *supra* note 19, at 62.

[29] William Apgar et al., Harvard University Joint Center for Housing Studies, Capital, Credit and Communities: The Implications of the Changing Mortgage Banking Industry for Community-Based Organizations 11 (March 9, 2004).

[30] Gramlich, *supra* note18.

[31] Robert Avery et al., *Changes in the Distribution of Banking Offices*, Federal Reserve Bulletin 707 (1997).

A number of forces have contributed to this trend, most of them the outgrowth of deregulation. One such force is competition. In the last few decades banks have felt increased competition from other segments of the financial service industry, such as mutual funds, brokerage houses, and investment banks. The competition has narrowed their profit margins and forced increased attention to the bottom line. Traditional lending services represent a decreasing share of banks' income, and fee income has grown as a source of profit. As banks have raised their fees for deposit and other banking services, they have priced out many lower-income customers.

Consolidation has been another important force at work. To increase their competitive position, many banks have purchased others and thus gained access to new customers. Between 1984 and 2001 the total number of banks declined from 14,392 to 8,016, mostly as the result of mergers and acquisitions.[32] Now the eighty largest banks, which represent 1 percent of all institutions, control over 70 percent of all banking assets and over two-thirds of all deposits in the United States.[33] These huge institutions, many of which have branch networks covering substantial geographic areas, can afford to be picky about where they place their branches. In the wake of any merger the surviving institution evaluates the resulting branch network and eliminates branches with overlapping service areas, those that the new owners deem insufficiently profitable, or those whose customer base is incompatible with the institution's business strategy.

Cross-industry aggregation has played a significant part also. Many institutions have adopted the strategy of cultivating more affluent customers, whom they believe have the potential to purchase many different products and services. In aid of this strategy these banks have gathered many types of financial service companies under one corporate roof, either through direct ownership by the bank's parent corporation or through other types of corporate relationships. Regardless of the corporate structure, the goal is to cross-sell a wider range of products to a narrower band of customers.

Technology has driven many of these trends. Technological advances have enabled institutions to gather and analyze information about their customers. With such information in hand, institutions can undertake sophisticated sorting, evaluating customer behavior at a fine level of detail. They can segment their customer base by level of profitability and focus resources on those market segments that they believe will yield the greatest profit. In the process banks have eliminated the old system of cross-subsidy, in which more profitable customers subsidized less profitable ones. This cross-subsidy allowed essentially universal access to deposit services, if not loans. Now banks expect each customer segment to be profitable all by itself and discourage customers viewed as less profitable.

All of this has influenced the way that banks structure and price their products. Many set high opening and minimum balance requirements for accounts, charge high fees for accounts with small balances—especially if the accounts have a high transaction volume—and charge high fees for bounced checks. This last is a particular problem for consumers who live from paycheck to paycheck. A single miscalculation about when a deposit will be credited or when a check will clear can set off an avalanche of bounced-check fees. The cost of these may be quite considerable for someone living on the margin. Banks have found many other opportunities to charge fees. All of these costs can be barriers for lower-income customers and may make it financially infeasible for them to use mainstream

[32]Allen N. Berger, *The Economic Effects of Technological Progress: Evidence from the Banking Industry*, 35 JOURNAL OF MONEY, CREDIT, AND BANKING 141 (2003).

[33]Federal Deposit Insurance Corporation (FDIC) data, as compiled by the Insurance Information Institute (2002). See www.financialservicesfacts.org/financial2/banking/commercial.

banking institutions to conduct their routine business transactions.

In addition to branch location and account pricing, other elements of the banking business model in vogue also discourage low-income consumers from using mainstream institutions. Among the factors leading lower-income customers to fringe financial services are convenience (hours of operation, availability of an array of appropriate products and services such as bill payment, low-cost money orders, stamps and envelopes, phone cards,); obtaining funds quickly rather than waiting several days for checks to clear; shielding financial information from government agencies; distrust of banks; and the perceived lack of courtesy and customer service. On all of these fronts, banks fail to compete effectively for the business of low-income customers. Banks refuse to allow consumers who have had bank accounts in the past and had problems with bounced checks, or those with low credit scores, to open accounts. Even those with accounts may find that local landlords and merchants refuse to accept personal checks and force them to use cash or money orders to pay bills.

There is a key difference in the type of relationship that mainstream institutions and fringe banking institutions have with their customers. Mainstream institutions use structure and pricing to encourage customers to buy an array of banking products. The best pricing—whether low fees or high interest rates—is available to those who have the most funds on deposit or purchase the largest number of products. Those with few funds, or those with no account, are either unable to access many services or charged considerably higher fees for them.

By contrast, the relationship between fringe institutions and their customers is based on individual transactions—more of a "pay as you go" system. Fringe institutions are not in a position to offer deposit accounts, but they recognize that their customers want and need a variety of convenient transaction (and, in some cases, loan) services, and this is what they offer. One need not have a high income to get in the door, customers are treated with courtesy, and nearly everyone qualifies for the services.

The strategies that banks have adopted to discourage low balance accounts have had an impact. In 1977 there were 6.5 million households (9 percent of all households) without a transaction account. By 1989 that number had grown to 11.5 million (14.9 percent of households), and by 1995 that figure had stabilized at 13 percent of households.[34] According to some estimates, more than 22 million American households currently do not have a bank account.[35] Among families without a checking account in 1995, 85 percent had incomes of less than $25,000, and 54 percent were nonwhite or Hispanic.[36] For many low-income consumers, the disadvantages of banking in the mainstream outweigh the advantages.

Blurring Lines

As the financial service market has evolved, the lines between the mainstream and the fringe banking institutions have begun to blur. From the perspective of consumers, there has never been an absolute division between the two. People use the providers that make the most sense, based on cost, convenience, and level of comfort. For example, payday loan customers must have bank accounts since the collateral for the loan is the postdated check that the customer gives to the lender.

At the same time more mainstream institutions are venturing into the fringe

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[34] ROBERT MANNING, CREDIT CARD NATION 199 (2000).

[35] GENERAL ACCOUNTING OFFICE, GAO-02-913, ELECTRONIC TRANSFERS: USE BY FEDERAL PAYMENT RECIPIENTS HAS INCREASED BUT OBSTACLES TO GREATER PARTICIPATION REMAIN 55 (2002).

[36] Arthur B. Kennickel et al., *Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances,* FEDERAL RESERVE BULLETIN 7 (1997).

banking market. One way that banks are doing this is through their corporate affiliates, such as mortgage companies or finance companies that specialize in subprime mortgage lending. In 2003 six of the top ten subprime mortgage originators were affiliated with insured depository institutions: Countrywide Financial, First Franklin Financial, Household Financial, Washington Mutual, Wells Fargo Home Mortgage, and CitiFinancial. Together they originated nearly $125 billion in subprime loans.[37] Further, a number of the bigger bank holding companies have securities affiliates that securitize subprime mortgages, both for their lending affiliates and for others. Among these are Bank of America, Washington Mutual, and Chase Mortgage Finance.

Some banks have direct relationships with check cashers and payday lenders. These banks offer the check cashers and payday lenders lines of credit to carry them over until the checks they take in clear or the loans they make are repaid or rolled over.[38] Banks also help these businesses meet their cash needs and process the checks they take in. In fact, check-cashing outlets and payday lenders cannot conduct their businesses without access to the payment system, the system by which coin and currency are moved from the federal government to the private sector, checks are cleared, and funds are transferred electronically among banks. Because access to this system is limited to insured depositories, many "fringe" banks cannot function without a relationship with a mainstream institution.

In recent years community reinvestment advocates have drawn attention to another type of relationship between mainstream and fringe banks, the so-called rent-a-charter phenomenon. Because state restrictions or prohibitions on payday lending do not apply to banks and thrifts, some payday lenders have partnered with these institutions to evade state laws. Through these partnerships, loans are nominally made in the name of the bank, with the payday lender merely serving as an agent.[39]

The banks involved have generally been small and apparently have not been concerned about the risk of this activity to their reputation. They have encountered some bumps in the road, however. The Office of the Comptroller of the Currency and the Office of Thrift Supervision, which regulate nationally chartered banks and thrifts, respectively, discourage the institutions that they supervise from entering into such relationships.[40] While neither agency has adopted formal regulations to prohibit this activity, both have taken enforcement actions that have had much the same impact. The Federal Reserve Board has not adopted any formal guidance, but it has taken supervisory action to discourage its member institutions from entering the business.[41] The Federal Deposit Insurance Corporation (FDIC), which regulates state-chartered banks that are not Federal Reserve members, has adopted guidance cautioning banks about the dangers of payday lending but has not been effective in enforcing the guidelines to discourage its banks from entering into partnerships with payday lenders.[42] FDIC-insured banks are the

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[37] National Mortgage News, Top Subprime Originators in Q1-Q4 03, at www.nationalmortgagenews.com/mortgagestats/freedata/bcorig.htm (last visited July 11, 2004).

[38] Dove Consulting, Survey of Non-Bank Financial Institutions for Department of the Treasury, Final Report 68 (April 4, 2000); Gerald Goldman & James R. Wells Jr., Financial Service Centers of America, Check Cashers Are Good Bank Customers (2002).

[39] Fox, *supra* note 26.

[40] Advisory Letter on Payday Lending from the Office of the Comptroller of the Currency, AL 2000-10 (Nov. 27, 2000); Memorandum for Chief Executive Officers from Richard M. Riccobono, Deputy Director, Office of Thrift Supervision, on Payday Lending (Nov. 27, 2000).

[41] Fox, *supra* note 26, at 19.

[42] Federal Deposit Insurance Corporation, Guidelines for Payday Lending (July 2, 2003); Fox, *supra* note 26.

current partners of choice for a growing number of payday lenders.

Some banks are beginning to venture into direct competition with payday lenders by offering "bounce protection" plans, whereby banks (purportedly at their own discretion) offer customers the "courtesy" of honoring their checks even when their accounts lack sufficient funds to cover them. Customers normally pay the bank's standard bounced-check fee (generally $20–$35) for each check covered through the bounce protection plan and, in some cases, a daily fee for each day the account is overdrawn. The fee and the amount of the overdraft are then deducted from the customer's next deposit. At a fee of $20 for two weeks, this works out to an annual percentage rate of 541 percent, compared to the 400 percent (annualized) interest rate that is commonly charged by payday lenders.[43]

Consumers at Risk from Market Failure

Once bankers were viewed as the gatekeepers of credit. One aspect of this gatekeeping role was the notion that there was a convergence between the best interests of both the borrower and the bank. Borrowers assumed that if they did not qualify for a loan their banker would turn them down. If they were seeking a loan too big for them to repay, their banker would give them a smaller loan or no loan at all. These days, however, greater market segmentation is creating a divergence of these interests. Lenders can compensate for what they perceive as the higher credit risk posed by some market segments by charging higher rates. Now both mainstream and fringe lenders are willing to lend to almost anyone, and the only question is how much they will charge. Some lenders are quite aggressive in pushing credit onto borrowers. There is so much profit to be made that the risk is viewed as a cost of doing business and simply built into the profit margin.

Such profits, combined with weak regulation, distort the smooth functioning of the market, as the trends in payday lending illustrate. It has become a pot of gold that many lenders are chasing. As other forms of fringe banking (check cashers, pawnbrokers) become less profitable, some companies in those sectors are turning to payday lending as a way to boost their bottom lines. The tremendous profitability of payday lending has even attracted some mainstream institutions, which are getting into the business through various bounce protection plans, described above. One might expect the competition to lead to better products and lower prices for consumers, but this has not happened. Instead the payday lending market exhibits the reverse competition found in the credit insurance and subprime mortgage markets, where many lenders compete to get into the business, but the prices remain high. In this sense the market is failing. And, in this kind of marketplace, individual consumers can do little to battle the tide of profit seeking with which they are faced.

The shift from lender as the gatekeeper of credit to lender as credit peddler comes at considerable risk to the consumer. Most fringe banking institutions are regulated at the state level, if at all. Generally companies must get a business license, and they may be required to meet certain guidelines or standards (e.g., usury ceilings, fee limits, or limitations on rollovers for payday loans). There is no system of supervision comparable to that which is applied to federally regulated, insured depository institutions, in which examiners routinely look at records and assess the institution's degree of compliance. Instead compliance is assumed unless a complaint (or more likely many complaints) is made. This places the burden of enforcement on the consumer to know the law, recognize the occurrence of a violation, determine how and where to file a complaint, and affirmatively seek a

[43] Consumer Federation of America & National Consumer Law Center, Bounce Protection: How Banks Turn Rubber into Gold by Enticing Customers to Write Bad Checks (2003).

remedy in order to have the consumer's rights upheld and be compensated for any injury. Such a system clearly has limitations, especially for protecting the rights of people whose resources are already stretched thin. At best this type of regulatory framework provides redress in the most egregious cases. It does little to insure that consumers in general get a fair deal.

Moreover, existing community accountability tools, such as the Community Reinvestment Act, cover a shrinking share of the loan market.[44] Lenders covered by the Act constituted 80 percent of the mortgage market when the law was enacted in 1977. Today this figure has dwindled to an estimated 30 percent. The lending activities of these noncovered institutions do not have to pass muster with federal examiners, as banks must.

Community Responses: New Products and Institutions

Community groups and consumer advocates have begun to develop a variety of responses to the problems of the two-tiered financial service system and the high cost of many fringe banking products. These responses draw on the experiences of three decades of advocacy on mainstream banking issues, as well as more recent efforts to combat predatory mortgage lending practices. One type of community response has been to develop alternatives to the fringe banking institutions that have become so prevalent in low-income communities. These include new, hybrid institutions that combine the respective strengths of fringe and mainstream banks, with additional features that are designed and implemented by community residents. They also include mission-driven versions of existing institutions such as credit unions, dedicated to serving the needs of a particular constituency with products and prices that are competitive with those offered by fringe institutions. Two of these are described below.

Our Money Place. A Baltimore, Maryland, hybrid institution designed to provide convenient, affordable financial services to neighborhood residents, Our Money Place was developed by Operation ReachOut Southwest, a project affiliated with the Bon Secours Foundation. When the last bank branch in southwest Baltimore closed in 1997, the community was spurred into action. Residents attempted unsuccessfully to prevent the closing. In its wake they were forced to travel a significant distance and expend considerable time to reach the closest bank branches. For those without cars, the trip could involve several bus transfers in each direction, a burdensome journey.

The residents launched a community planning process that identified two top priorities: jobs and access to affordable financial services. Their next step was to dig deeper into the financial service needs in the neighborhood with FDIC assistance. FDIC staff analyzed available data about the neighborhood economy and existing financial institutions, while community residents surveyed their neighbors about their banking relationships and needs.

The FDIC and residents discovered that neighborhood residents generated more than $200 million a year in wage, pension, and government income. However, the neighborhood had become a target for subprime mortgage lenders, which accounted for over 95 percent of the home loans made in the area. In terms of their relationship with banks, neighborhood residents split along age lines. Nearly all of those who had accounts were over 55; almost none of the residents under 40 had a bank account. Yet 68 percent of the survey respondents said they would open an account if the location were accessible. At the same time the survey revealed that community residents used check cashers because they were convenient and friendly and afforded immediate access to cash.

[44] Community Reinvestment Act, 12 U.S.C. §§ 2901–2908 (2003).

The need for immediate access to cash emerged as a critical finding of the survey. The survey also revealed that neighborhood residents had mixed feelings toward banks. On the one hand, they wanted accounts. On the other hand, they felt unwelcome in bank branches, were concerned about hidden fees and government access to their account information, and found it difficult to manage their money. The refusal of most area landlords and merchants to accept personal checks had forced even people with bank accounts to use money orders to pay their bills.

Armed with the information about the cash flowing through the neighborhood and residents' interest in bank accounts, Operation ReachOut Southwest leaders met with a number of local institutions to find one that would open a new branch in their area. They were largely unsuccessful. However, one institution, the Social Security Administration Baltimore Federal Credit Union, which was already contemplating expansion, did express an interest.

At the same time the group began to explore the feasibility of opening its own check-cashing operation. However, they determined that the volume of transactions that they could expect would not be high enough to enable them to charge fees below those set by state regulation. They explored the possibility of a partnership with an existing check casher instead. State banking regulators put them in touch with A&B Check Cashing, a large Maryland check casher with a good reputation for fairness and compliance.

Ultimately Operation ReachOut Southwest leaders settled on a plan for a hybrid institution that the community group would own and control but that would be operated in partnership with the credit union and A&B Checking. It would offer the check-cashing and other transaction services that residents relied on, the account-based services of the credit union, and credit repair, financial planning, and money management services provided by the community group.

These three elements are combined in Our Money Place, which opened in March 2003. Our Money Place has four teller windows, three of which are operated by A&B, one by the credit union. Customers can cash checks, get free money orders, pay most of their bills, buy stamps and envelopes, photocopy, and access a notary. An Operation ReachOut Southwest staff person is in the lobby to reach out to customers and encourage them to use the full range of services offered. She puts a human face on the business and routinely helps older customers use the automatic teller machine. People talk to her about many different problems that they are having, and she refers them to a variety of programs to help solve them. Credit union accounts can be opened for as little as $6—a $1 membership fee and $5 initial deposit. The credit union set up a special savings account available to people whose past credit records disqualify them for a deposit account.

The goal of Our Money Place is to serve people's immediate needs while offering them the opportunity and the means to move into an account relationship with an insured depository institution, set and reach financial goals, and build wealth. To achieve this goal, the community decided to exclude some services, such as the sale of lottery tickets, which members viewed as inappropriate.

The group developed an emergency loan program, which offers loans of up to $300 for twelve months at 13 percent interest to help people in a crisis, such as eviction, foreclosure, or the like. The credit union administers the loans, and Our Money Place guarantees those that do not meet the credit union's underwriting standards. The loan volume has been small, but the group is pleased with the program's performance.

In its first year 600 people opened accounts through Our Money Place; this exceeded the goal set. Several thousand people come through the doors monthly, many drawn by the free money orders offered by A& B, and the credit union has some 1,100 transactions per month. This volume also exceeds expectations, and the partners are all very pleased with the arrangement.

As it gains experience, Our Money Place is refining its product offerings and beginning to think about ways to help local residents take a more proactive approach to financial planning and building and preserving wealth.

Latino Community Credit Union. Opened in 2000, the Latino Community Credit Union serves North Carolina's sizable Latino population. Between 80,000 and 100,000 Latinos live in the Triangle area of Raleigh-Durham-Chapel Hill, with more than 20,000 in Durham alone. While less than half of Latino households nationwide have bank accounts, an estimated 75 percent of Durham's Latino residents lack such accounts. These families face barriers to the financial service mainstream: language and cultural barriers, bad experience with unstable financial institutions in their countries of origin, and lack of documentation of their residency status, among others. This forces them into a cash economy. One unexpected consequence of is that many Latino residents are victims of violent attacks from people trying to steal their money. Not having a bank account also forces many to pay high fees for such basic services as cashing checks, paying bills, and wiring money abroad.

El Centro Hispano, a local community-based organization, endeavored to stem the tide of violence by addressing the underlying problem of lack of access to mainstream financial services. In 1998 the group began discussions with local banks and credit unions about ways to increase Latino families' access to mainstream financial services. The best option they arrived at was to establish a community-based financial institution. Such an institution could bridge barriers created by language and culture, overcome the distrust of banks that many immigrants developed in their home countries, and offer financial education. El Centro Hispano partnered with the NC State Employees Credit Union, Self-Help Credit Union, and the North Carolina Minority Support Center to charter the Latino Community Credit Union. The business model is one based on a vision of social and economic justice, in which respect, justice, dignity, and a sense of community are just as important as building assets and creating wealth.

The Latino Community Credit Union offers savings accounts ($10 opening balance), interest-bearing checking accounts ($25 opening balance), money market accounts, and certificates of deposit (the last two requiring a $500 opening balance). The credit union offers consumer loans and expects to begin offering mortgage loans. Members also get free access to automatic teller machines, low-cost money orders ($0.25 each), free check cashing, direct deposit, and low-cost remittance services.

The last has become a high-volume business for the credit union, which charges significantly less than other remittance services. For example, a credit union member can send up to $1,500 to El Salvador, Honduras, or Guatemala for a charge of $10. For the same fee, members can send up to $1,000 to Mexico. Compared to commercial wire transfer services' charge of as much as 20 percent of the amount wired, the credit union fees are a real bargain. The credit union now sends $32 million a year in remittances to Latin America and is the largest user of the credit union international remittance network.

The credit union also offers services to help its members better manage their money and build toward financial goals. Among these are financial planning, credit repair, and financial education classes.

Clearly the Latino Community Credit Union model appeals to its target members and meets their needs. In its first three years it enrolled 16,000 members, built a fully bilingual staff of twenty-six, opened three branches, and accumulated $13 million in assets. Although it was designed to serve members of the Latino community, many other immigrant groups have also taken advantage of its services.

Policy Responses: Changing the System

Community groups have also acted to change the regulatory or policy framework within which fringe banking institutions operate. Rather than developing new options for families, their goal is to improve the options available from institutions that are active in lower-income neighborhoods.

Kansas City Church Community Organization. The payday lending industry has been the target of a number of community group campaigns aimed at cleaning up abusive practices. One of these occurred over the last few years in Missouri, where the Kansas City Church Community Organization spearheaded a campaign to rewrite the state's payday lending law. The organization is a federation of twenty-two congregations from across Kansas City. A number of its members had run into severe financial difficulties as the result of taking out and rolling over payday loans when they needed short-term cash and had no access to other sources of credit. This led the organization to identify payday lending as a priority issue.

The payday lending industry in Missouri dates back only to 1992. In 1998 the cap on interest rates for most small loans was eliminated, and the number of payday and car title lenders in the state has tripled since. More than 650 payday lenders operate in Missouri, with 208 in Kansas City alone.[45] The Kansas City Church Community Organization found that payday lenders tended to target working families, students, senior citizens, and military personnel, with loans carrying annual percentage rates between 391 percent and 782 percent. While the initial loan term is fourteen days, most are rolled over several times, making them extremely costly for the consumer.

The organization also uncovered another abusive practice of many payday lenders in Kansas City. On the date the loan is due, the lender may submit the check that secured the loan for payment many times, even after the lender knows that the account lacks sufficient funds to cover the check. For each time the check is returned, the payday lender charges the borrower a returned check fee. This improves the payday lender's profitability but considerably raises the cost to the borrower, who most likely is also charged a series of bounced-check fees by the bank.

The organization's first victory in its payday lending campaign occurred when the group convinced the county prosecutor to stop prosecuting payday borrowers for writing bad checks. A key element in this and subsequent victories was putting a face on the problem and demonstrating the pain that payday lending abuses were causing to people who were struggling to survive. In mounting the legislative campaign, the organization recruited allies to complement its own strength: local legislators, the AFL-CIO, Missouri Catholic Conference, Missouri Impact, and AARP. Collectively the allies could showcase payday lending victims, mobilize a grassroots base both in Kansas City and across the state, reach out to the media, dissect the politics of the issues, lobby effectively in the state capital, and provide knowledge of the industry.

The payday lending legislation passed by the Missouri legislature in 2002 did not contain every provision that the organization and its allies were seeking, but it did incorporate a number of critical provisions. These include a prohibition on multistate payday lenders importing interest rates from other states; a decrease in the number of loan renewals permitted from thirteen to six; a prohibition on criminal prosecution of payday borrowers who default on their loans; a dollar limit on the amount that payday lenders may lend to any one borrower; and allowing for partial payments on payday loans.[46] This last provision is

[45] Warren Adams-Leavitt, Executive Director, Kansas City Church Community Organization, Presentation at Annie E. Casey Foundation Meeting on Predatory Financial Services (June 6, 2003).

[46] Mo. Senate Bill 884 (2002).

very important since one of the common reasons for the frequent rollover of payday loans is borrowers' inability to come up with the entire principal and lenders' unwillingness to accept partial payment. This "all or nothing" system had prevented many borrowers from reducing their principal over time through a series of more affordable payments.

Building on these victories and utilizing the strength of its coalition, the organization went back to the Missouri legislature this year to seek additional improvements on the laws governing payday lending in that state. A new bill would lower the interest rate cap from 75 percent to 15 percent for a thirty-day loan, with the rate dropping further if the loan is not repaid within thirty days; prohibit renewals of payday loans; and give the attorney general enforcement authority to issue cease-and-desist orders, impose civil penalties of $1,000 per day, sue for injunctions, let consumers out of illegal loans, and order restitution. Missouri Gov. Bob Holden supports the legislation.[47]

Community Reinvestment Association of North Carolina. Advocates in North Carolina have also taken on the payday lending industry. After the North Carolina legislature passed landmark legislation on predatory mortgage lending in 1999, community groups in that state began to look at other types of predatory financial services and to address the problems that they presented.[48] One such group is the Community Reinvestment Association of North Carolina, formed in 1986 to advocate on a range of financial service issues on behalf of community-based organizations in that state. After the 1999 victory, the group turned its attention to the problem of payday lending.

The association researched the payday lending industry in its state, conducted outreach and education on the issues among its members and their constituents, and joined forces with other local and national groups to tackle the broader policy issues surrounding payday lending. In 2001 the association and its allies waged a successful campaign to convince the North Carolina state legislature to allow the law authorizing payday lending to sunset. They expected that this would be the virtual end of the industry in their state and were surprised and dismayed to find the industry exploiting the cracks in the federal and state regulatory frameworks to continue operating, now with even fewer restrictions.

Those lenders partnered with out-of-state banks and took advantage of the banks' ability under various federal laws to export their home state interest rates to other states. The loans are nominally made by the bank, but they are marketed, originated, serviced, and collected by the payday lender, and sometimes even sold to that lender upon closing.[49] This "loophole" in consumer protection laws is currently the single most contentious regulatory issue in the payday lending field, and the subject of ongoing litigation.[50]

The association and its allies have attempted to address this problem by pressuring federal banking regulators to use their authority over the banks involved to end this practice and by acting directly on the institutions involved. The association has developed a network of allies—national and local consumer, civil rights, and community reinvestment organizations—and has worked with them on a number of fronts. It has helped educate others about the problem, the policy issues, and the key play-

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[47]Press Release, Office of the Missouri Governor, Holden Supports Legislation to Protect Missourians from Payday Lenders (March 8, 2004), available at www.gomissouri.gov/press/press030804.htm.

[48]See N.C. Gen. Stat. §§ 24-1.1E, 24-10.2.

[49]Community Reinvestment Association of North Carolina, Small Loans, Big Bucks: An Analysis of the Payday Lending Industry in North Carolina 2 (2002).

[50]*BankWest v. Baker*, No. 104CV0988-MHS (N.D. Ga. filed April 9, 2004).

ers—both in industry and among policymakers—through publications, videos, media, conferences, and direct outreach. It has an ongoing series of protest actions in North Carolina and elsewhere against banks that are enabling payday lenders to evade the North Carolina laws. It has helped convince federal banking regulators to take action against specific banks and to adopt policies that limit or prohibit banks from entering into payday lending arrangements.[51] The association's efforts have yielded some notable results, as described earlier.

Although the community groups described here have pursued different courses of action, all share some characteristics critical to their success. In its local community each has a solid base, which has enabled it to bring in allies, challenge market forces, and influence powerful institutions. Their work has been community-driven, responding to problems and needs identified by community residents and thus garnering the support of those residents. And they share a sense of mission and a commitment to social and economic justice sustaining them through inevitable setbacks and protracted campaigns. They reflect the best successes of the community reinvestment movement of the last three decades.

Conclusion

Fringe banking poses considerable cost and risk to low-income consumers. Yet, in our two-tiered banking system, the advantages of the fringe sector can be compelling, and the barriers to the mainstream can be extremely difficult for low-income consumers to overcome. In this sense low-income consumers may find themselves between the proverbial rock and a hard place. Individual consumers are not well situated to counter the forces of the marketplace, in which the drive for profits combined with ineffective restraints leads mainstream and fringe institutions alike to exploit vulnerable consumers.

Despite this daunting array of forces, community groups are demonstrating that a well-organized constituency rooted in the community can have a positive impact. Some groups are tackling the regulatory environment and winning stronger protection measures and better enforcement for consumers. Others are pioneering financial institutions that are community-controlled and strive to offer an attractive array of products on reasonable terms.

Both approaches are necessary to create a marketplace in which lower-income consumers can gain access to the financial services that they need on terms that are fair to consumers and providers alike. With an understanding of the overall context of today's financial service industry and the powerful forces at play in it, attorneys can help guide their clients—be they low-income individuals or community organizations—toward strategies that hold the promise of success.

[51] See *supra* note 40; Federal Deposit Insurance Corporation, *supra* note 42.