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The Consolidation of the Secondary Financial Services Market

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Stagnant income and persistent debt have induced low- and middle-income households to rely on alternative financial services (AFS): buy-here-pay-here auto loans, check-cashers, payday loans, auto title loans, rent-to-own furniture and appliances, and pawnshops. A secondary financial services market has evolved to serve the secondary labor market, replete with trade associations as well as state and federal regulators. Mainstream financial institutions have marketed innovations, such as reloadable debit cards, to appeal to low- and middle-income consumers. High fees and interest rates of AFS products have fueled a volatile debate about the future of the secondary financial services market, with options including prohibition, regulation, and inclusion.

Key words: *debt, alternative financial services, AFS, secondary financial services, secondary labor market*

A tidal wave of debt has swept over the lower economic elevations of America, not only obliterating the prosperity of poor households that had struggled with declining incomes for decades, but more recently destabilizing a large swath of middle-income families that relied on credit to bolster family finances (Edsall, 2012). The Great Recession, a dramatic reversal of the fortunes of low- and middle-income families, caused working class families to resort to Alternative Financial Services (AFS) to maximize their increasingly tenuous resources; however, as the tsunami reached higher elevations, middle-income households turned to AFS, as well. When banks and credit unions failed to respond to the needs of increasingly desperate working families, struggling households resorted to a burgeoning network of buy-here-pay-here auto sales, payday and auto title lenders, check-cashers, rent-to-own vendors, and pawnshops.

Theory

That such vendors would evolve during a prolonged economic crisis is consistent with Robert Merton's (1957) observation that those of lower status create institutional arrangements when mainstream opportunity structures are not available. Practically speaking, AFS evolved to serve financially bereft households. In theoretical terms, a secondary financial services market, providing quick cash at relatively high fees and interest, had evolved parallel to a secondary labor market, consisting of low-wage, intermittent jobs without benefits or career trajectories.

The theoretical basis of AFS is largely derived from neoclassical economics, which presumes that people use information at hand in order to make rational choices about their well-being. Various factors interfere with this formulation, explaining the advent of AFS: people lack adequate information about products and make suboptimal decisions; vendors are not equally distributed geographically and they customize products to meet consumer preferences; and, consumers are creatures of habit, frequenting vendors when better choices are readily available (Thaler & Sunstein, 2008). Within a larger social context, these imperfections contribute to economic inequality, which is exacerbated by institutional dynamics: public schools fail to educate, employers discriminate against job applicants, and social programs provide inadequate benefits and services (Stiglitz, 2012). The interaction of these dynamics leaves certain rural and urban areas in chronic poverty (Jargowsky, 1997), and residents frequently resort to AFS.

Initially justified in order to reverse the ravages of the Great Depression, government has been actively involved in public policy, in the process affecting economic inequality (Noah, 2012). Since the 1980s, policies preferred by conservative Republicans have subverted the prosperity of low- and middle-income Americans, battening those with high incomes (Johnson & Kwak, 2012). Thus, dualism, a persistent feature of democratic-capitalist political economies, has become more pronounced. While the primary labor market has benefited from job security and financial products, the secondary labor market has experienced significant erosion in its economic

circumstances. This is evident not only with respect to income, but assets as well (Lerman & McKernan, 2008). Without adequate income to sustain an already precarious level of consumption, many working class families sought credit wherever it was available, finding AFS vendors receptive to their needs. The cost of AFS products was high, but the plight of many low-income people was urgent, and they had few options.

As the secondary financial services market expanded and diversified, it became embedded in lower-income urban and rural communities. Eventually, AFS vendors became a fixture in the lives of the working poor. At the same time, the high fees and interest rates of some products (such as payday loans, which carry an APR of 391 percent for $15 charged per $100 over two weeks) have provoked a volatile debate about reform of AFS. Innovation in the secondary financial services market evolved as technological developments, such as payroll direct deposit and reloadable debit cards, are marketed to consumers who find them more attractive than traditional financial products of mainstream financial institutions.

A burgeoning secondary financial services market would mature with the establishment of trade associations representing the interests of vendors. At the same time, fierce opposition would arise from nonprofit organizations that vehemently objected to the high APR of AFS products. The Consumer Financial Protection Bureau (CFPB), established in 2010, was designed to rein-in financial abuses from Wall Street to Main Street; however, its rocky start reflected the turbulence of the financial services markets. Ultimately, the future of the secondary financial services market will be determined by three quite disparate strategies of reform: prohibition, regulation, or inclusion.

Background

The working poor have long relied on financial services that have been separate from mainstream banking. As such, various financial products have evolved which have prompted state and federal regulation; regardless, low-income, minority families have found mainstream financial institutions chronically problematic with respect to their financial needs.

For example, the proliferation of salary lenders after the Civil War served as an impetus for state usury prohibitions, contributing to Progressive Era reforms and, ultimately, the regulatory regime of the New Deal (Longman & Boshara, 2009). Denied access to mainstream financial institutions, immigrants and freed slaves established their own savings institutions. Early in the 20th century, the credit abuse of poor immigrants prompted the Russell Sage Foundation to subsidize philanthropic pawnshops (known as remedial loan societies) in several large cities, of which only the Provident Loan Society still exists in New York City at five locations (Caskey, 1994).

In 1933 the Glass-Steagall Act authorized the newly established Federal Deposit Insurance Corporation (FDIC) to regulate savings institutions and limit interest rates for savings accounts as well. Decades later, the 1977 Community Reinvestment Act (CRA) prohibited "red-lining," the practice of denying mortgages and other loans to entire neighborhoods of consumers suspected of being high risk, and required banks to make credit available to poor families. Just as the CRA prompted banks to serve low-income, disproportionately minority families, stagflation of the mid-1970s pushed interest rates above traditional usury limits, prompting states to relax regulation of financial institutions. Soon, bi-partisan support grew for deregulating financial services altogether, liberal Democrats advocating for innovative financial products to bring the marginalized poor into the economic mainstream, and conservative Republicans seizing the opportunity to shed the burdensome regulations that had interfered with self-correcting financial markets. The resultant 1980 Depository Institutions Deregulatory and Monetary Control Act removed interest rate caps on loans, providing a fertile ground for expansion of vendors outside the financial mainstream (Bostic & Lee, 2009).

As nonmainstream financial providers expanded after the 1980s, introducing new product lines, their lexicon evolved accordingly. Initial reactions were negative, as the invocation of "predatory lender" by Bruce Marks when he challenged Boston's Fleet Bank for appending high fees and interest rates on loans to duped consumers in the early 1990s, attests (Rivlin, 2010). An early study described the activities of check-cashers and pawn lenders as "fringe banking," a British term coined

by economist Hyman Minsky (Caskey, 1994). Eventually, scholars proposed the term "alternative financial services" to differentiate pawnshops, payday lenders, check cashers, and rent-to-own stores from traditional financial institutions. A journalistic exposé freighted the fringe economy with terms such as "shadow banks," "financial shakedowns," and "shark bait" (Hudson, 1996), while an academic critique that included payday lenders, buy-here-pay-here auto sales, and subprime mortgages referred to lenders as the "fringe economy or predatory lending" (Karger, 2005). In 2009, the FDIC published its first assessments of Alternative Financial Services (AFS), and the term has since become widely accepted.

Declining Fortunes

What had been a relatively small fringe economy expanded exponentially during the final decades of the 20th century. A primary factor was the decline in discretionary income of working class families. "The average two-income family earns far more today than did the single breadwinner of a generation ago," observed then-Harvard professor Elizabeth Warren and her financial consultant daughter. "And yet, once they have paid the mortgage, the car payments, the taxes, the health insurance, and the day-care bills, today's dual-income families have *less* discretionary income—and less money to put away for a rainy day—than the single-income family of a generation ago" (Warren & Tyagi, 2003, p. 3).

The expansion of AFS paralleled the steady erosion of the income of the working poor. Between 1979 and 2011, the growth in household income of the bottom quintile of families was negative 0.4 percent and zero for the next lowest quintile. Falling family income followed the decline of good jobs—those paying the median wage of $18.50 in 1979 (in 2011 dollars) coupled with employer-provided health insurance and a company pension—from 37.4 percent in 1979 to 27.7 percent in 2011, a drop of 25.9 percent. Meanwhile, from 1979 to 2011 wages fell 4.3 percent for the lowest decile of workers and increased only 1.3 percent for the second decile. The proportion of workers earning poverty-level wages remained virtually unchanged despite the economic expansion of the 1990s, 29.9 percent in

1973 dropping to 28.0 percent in 2011. The underemployment rate, historically higher for African Americans and Hispanics, compared to Whites, doubled from 2008 to 2010, reaching 25 percent. By 2010, the number of unemployed, those working part-time but wanting full-time work, and workers marginally attached to the labor force exceeded 25 million (Economic Policy Institute, 2012). Not only did the lowest forty percent of families absorb significant income losses during the Great Recession, but they also continued to lose income after the recovery began.

Under optimal circumstances, households can rely on assets to buffer income shocks; however, few low-income families have sufficient reserves to sustain themselves for three months at the federal poverty level. Before the Great Recession, such "asset poverty" was extensive: between 1996 and 2001, the average family in the lowest quartile of households claimed assets valued at $0 and for the bottom half only $31. Fully 84.5 percent of families in the bottom third of the income distribution claimed such small reserves as to be asset poor (McKernan, Ratcliffe & Vinopal, 2009). During the 2000s, many low-income families went into debt, some spectacularly so. In 2001, the mean net worth of households at or below the 25th percentile was $100, but by 2010, it was *negative* $12,800. During this period, the mean net worth of households between the 25th and 49.9th percentile dropped from $54,400 to $35,600 (Federal Reserve, 2012). Predictably, the financial prospects of lower income families worsened during the Great Recession. In 2009, the average wealth of the lowest quintile of families was negative $27,000, while that of the second lowest quintile was only $5,000. Between 1983 and 2010 the net worth of the lowest 40 percent of households declined 1.95 percent, leaving them with few resources to address routine bills, let alone expense shocks (Economic Policy Institute, 2012).

The Great Recession effectively erased the asset gains of minority households. Between 2005 and 2009, median wealth of White households fell 16 percent, but 53 percent for African-American families and 66 percent for Hispanics. Minority families not only lost financial ground, but many found themselves in debt: almost one-third of Black households (35 percent) and Hispanic households (31 percent) had zero or negative net

worth in 2009, compared with 15 percent of White households, a significant increase since 2005, when 29 percent of Blacks, 23 percent of Hispanics, and 11 percent of White households reported zero or negative wealth. Put another way, in 2009 24 percent of African-American households and 24 percent of Hispanic households had no assets other than a vehicle (Taylor, Kochar, Fry, Valasco, & Motel, 2011, pp. 1, 23).

Table 1. Share of Debtors with Any Payment 60 Days or More Past Due, Percentile

Family Income	2001	2010
Less than 20	13.4	21.2
20 to 39.9	11.7	15.2
40 to 59.9	7.9	10.2
60 to 79.9	4.0	8.8
80 to 89.9	2.6	5.4
90 to 100	1.3	2.1
Family Net Worth		
Less than 25	17.8	22.2
25 to 49.9	7.1	13.3
50 to 74.9	3.6	6.8
75 to 89.9	.7	2.0
90 to 100	.3	1.2

Source: Federal Reserve Board, Survey of Consumer Finances, 2012.

From 2001 to 2010, faltering income and eroding assets in relation to household expenses left consumers in debt, struggling to pay bills on time. While more than one in ten low-income and low-wealth households had missed a debt payment beyond two months in 2001, the percent had increased significantly by 2010. More and more families were falling further behind in debt (Federal Reserve, 2012).

The Great Recession also retarded upward mobility among minority families, which had lagged previously. A pre-recession report on mobility sponsored by prominent policy institutes across the ideological spectrum concluded,

> It is fairly hard for children born in the bottom fifth to escape from the bottom: 42 percent remain there and another 42 percent end up in either the low-middle or middle fifth. Only 17 percent of those born to parents in the bottom quintile climb to one of the top two income groups. (Isaacs, 2006a, p. 5)

Many minority children actually experienced downward mobility. Of Black children with middle class parents, 45 percent fell to the bottom of the income distribution, compared to 16 percent of White children. Poor Black children fared the worst: 54 percent of children in families in the bottom quintile remained there, compared to 31 percent of White children (Isaacs, 2006b). The recession further slowed the upward mobility of minorities. A post-recession analysis of economic mobility concluded that one-fourth of middle class children had fallen out of the middle class as adults, a prospect that affected 38 percent of African-American men (Acs, 2011).

Banking Defections

While the economic travails of the working poor became more acute, mainstream financial institutions were less accessible to them. Between 1975 and 1995 the number of banks and savings institutions serving communities with upper incomes increased from 9,251 to 15,646, while those serving neighborhoods with lower incomes decreased from 2,164 to 1,719 (Avery, Bostic, Calem, & Canner, 1997). Karger (2005) observed:

> The consolidation in the banking industry over the past 20 years has reduced the number of banks in low-income neighborhoods, increased the focus of banks on corporate and high-income customers, and limited banks' interest in serving consumers with small accounts or less-than-perfect credit. (p. 12).

Bank deregulation, in other words, left large numbers of poor Americans without convenient banking institutions for essential financial services, a vacuum that AFS would quickly fill. "Check-cashing stores and pawnshops and payday lending stores, those are the poor man's institutions," proclaimed former pro-football player and ad man for Advance America,

Willie Green:

> You go to any poor Black person, and I guarantee you, they've borrowed money from a payday person, a title loan person, or a pawnshop. That's what you do if you don't have the luxury of going into a bank and borrowing money. (quoted in Rivlin, 2010, p. 256)

As banks and savings associations retreated from low-income areas, a significant number of consumers became "unbanked" because they did not have an account with a bank or credit union or "underbanked" because they had such an account, but used AFS as well. In part, not having a formal relationship with mainstream financial institutions was due to bad experiences. During a five-year period, 73 percent of payday consumers had loan applications refused or limited by mainstream financial organizations. Subsequently, 67.7 percent did not apply for loans from banks or credit unions because they expected the application to be rejected (Elliehausen, 2006). By the late 2000s, the number of unbanked consumers lacking a savings or checking account totaled 7.7 million households or 9 million Americans; underbanked consumers who had a savings or checking account but relied on AFS represented 17.9 percent of households, or 21 million Americans. Access to financial services fell disproportionately on racial and minority groups. While 21.7 percent of African Americans and 19.3 percent of Latinos were unbanked, those underbanked were 31.6 percent and 24.0 percent respectively, rates significantly higher than the general population. The Federal Deposit Insurance Corporation (FDIC) concluded, "overall, almost 54 percent of black households, 44.5 percent of American Indian/Alaskan households, and 43.3 percent of Hispanic households are either unbanked or underbanked" (2009, pp. 3-4). Even if they held accounts with mainstream financial institutions, many lower income families relied on AFS as well, especially minority households.

The defection of consumers from mainstream financial institutions is evident in data collected by the Survey of Consumer Finances. In 1989, 18.7 percent of respondents had a checking account. By 2010, the percentage had dropped to 9.6 percent. Over a decade, consumers voiced different reasons for

not having checking accounts, as seen in the following tables. Conspicuous changes include the percent of consumers who do not write enough checks to make a checking account worthwhile and the increase in those who do not like banks, over one-fourth of respondents (Federal Reserve, 2012).

Table 2. Reasons for Not Having a Checking Account, Percent

Reason	2001	2010
Do not write enough checks to make it worthwhile	28.5	20.3
Minimum balance too high	6.5	7.4
Do not like dealing with banks	22.6	27.8
Service charges too high	10.2	10.6
Cannot manage or balance a checking account	6.6	4.7
Do not have enough money	14.0	10.3
Credit problems	3.6	4.2
Do not need/want an account	5.1	7.3
Other	2.8	7.4

Source: Federal Reserve Board, Survey of Consumer Finances, 2012.

Table 3. Select Populations by Banking Status

Population	% Unbanked	% Underbanked	% Fully Banked
All Households	8.2	20.1	68.8
Blacks	21.4	33.9	41.6
Hispanics	20.1	28.6	48.7
Foreign-born noncitizens	22.2	28.9	45.8
Unemployed	22.5	28.0	47.5
Income below $15,000	28.2	21.6	47.6
Unmarried	19.1	29.5	48.8
Under age 24	17.4	31.0	49.7

Source: Federal Deposit Insurance Corporation, 2012.

By 2012, many consumers had begun to use AFS. While a majority of the population had a financial relationship with

a bank or credit union, many demographic groups either engaged with AFS or lacked *any* relationship with mainstream financial institutions.

The Rise of Alternative Financial Services

Declining fortunes with respect to income and assets eroded the already fragile finances of working poor families. A survey of the unemployed showed that many resorted to borrowing to meet routine expenses but all too often found that inadequate; as a result debt accumulated. Researchers from Rutgers University found that 56 percent of the unemployed borrowed money from family and friends to cover expenses in 2010; 45 percent increased credit card debt, but 25 percent missed credit card payments. While 24 percent missed a mortgage or rent payment, 8 percent declared bankruptcy (Borie-Holtz, Van Horn, & Zukin, 2010, p. 12).

Mounting stress on family finances increased the demand for credit in low- and moderate-income households. As their economic prospects dwindled and households struggled to pay routine bills and faced unexpected expense shocks, a growing number of families needed quick access to short-term credit to keep their foundering economic boats afloat. In 2010, the FINRA Investor Education Foundation published the first of three studies of financial capability which included several AFS products: auto title loans, payday loans, an advance on a tax refund, pawn, and rent-to-own. "Non-bank methods of borrowing" were higher among the minority poor who were younger and less-educated. While Blacks and Latinos were equally likely to take out an auto title loan, African Americans were more likely to frequent a pawnshop while Latinos were more likely to resort to payday lending. Almost one-fourth of respondents, 23 percent, had used one of these AFS products within the past five years, and utilization was higher for the unbanked, 44 percent, than those who had bank accounts, 20 percent (FINRA Foundation, 2010, pp. 6-7).

Similarly, a survey of Latino households in Los Angeles conducted by the Pew Health Group revealed that many households resorted to AFS: 37 percent of those with a bank account and 74 percent of the unbanked. Families found AFS

providers accessible geographically and during evening and weekend hours. Many found AFS a convenient way to pay monthly bills. Researchers concluded that Hispanic households represented a sizeable financial market that was served by AFS providers (Tellalian, Tseng, & Eleni, 2010).

In 2010, the Center for Financial Services Innovation (CSFI) surveyed 170 providers of financial products (32 percent nonprofits, 17 percent banks, 12 percent credit unions, 11 percent vendors, 8 percent prepaid card vendors, and 7 percent check cashers/payday lenders) and reported that 87 percent of those serving the *under*banked expected services to expand, including 94 percent of commercial providers. The portrait that emerged from the CFSI survey was one in which varied organizations—for-profit and nonprofit, mainstream and AFS—met a growing need for immediate, short-term loans. "Although the danger of using credit products to excess is undeniable, consumers need access to appropriate forms and amounts of credit in order to smooth income and pay for emergencies," observed CFSI analysts. "In fact, well-structured credit is essential to support a household's ability to save and build a robust credit history, and to facilitate crucial investments that can provide a foundation for other wealth-building activities" (Center for Financial Services Innovation, 2011).

A subsequent CFSI analysis of small-dollar credit borrowers suggested four primary reasons for resorting to AFS: (1) confrontation with expense shocks, leaving 47 percent of borrowers to take out one or two loans per year; (2) erratic cash flow, accounting for borrowing smaller amounts, with 42 percent taking out six or more loans annually, while 16 percent take out more than 12 loans annually; (3) insufficient income, prompting borrowers to take out loans to meet routine expenses, accounting for smaller loans, with 77 percent of loans less than $500; and (4) planned purchases for a car or appliance, accounting for one or two loans per year, but at amounts that exceeded $1,000 (Bianchi & Levy, 2013). CFSI research of borrowers' perceptions are supported by researchers from the Pew Charitable Trusts, who reported that 56 percent of consumers found payday loans a source of relief, as opposed to 31 percent who said payday loans were a source of anxiety. Yet, urgency plays a role in borrowing: 37 percent of respondents stated

they would have sought a payday loan under any conditions offered (Pew Charitable Trusts, 2013, pp. 21, 41). As consumer demand for credit expanded, working families resorted to various strategies to address static income and deteriorating assets, sometimes under acute financial distress.

By the end of the 2000s, AFS represented a significant market in financial services, generating over $319 billion annually by providing financial services to those who are excluded from, or elected to avoid, mainstream financial services.

Table 4. Primary Sectors of the Secondary Financial Services Market

Sector	Volume ($Billions)	Percent
Buy-Here-Pay-Here Auto Loans	80	24.9
Check Cashing	58	18.1
Payday Loans	48	15.0
Overseas Wire Remittances	46	14.3
Open-Loop Prepaid Cards	39	12.1
Refund Anticipation Loans	26	8.1
Money Orders	17	5.3
Rent-to-Own Transactions	7	2.2

Source: (Bradley, Burhouse, Gratton & Miller, 2009, p. 39)

Such growth was evidence that AFS was responding to consumer demand by hiring courteous staff that arranged quick transactions through hours extended into the evenings and weekends (Servon, 2013). The proliferation of payday lending, by way of illustration, has been attributed to its appeal to consumers who have had negative experiences with banks. Scanning the interior of a payday loan store, a journalist observed, "It's like banking turned upside down. Poor customers are commodities, deposits are irrelevant, bad credit makes for a good loan candidate and recessions can be boom times" (McGray, 2008). In a presentation to the FDIC, the Financial Service Centers of America (FiSCA) described how its members responded to customers by including access to services at times and locations that are convenient to them, and that suit non-traditional work schedules that leave little free time.

> They need the services to be provided in languages they can understand—frequently more than just English and Spanish—by staff that makes them feel comfortable and that reflects the culture, customs and colors of the neighborhood. They need products and services tailored to their unique needs, preferences and economic circumstances, rather than being served "stripped-down" versions of what is designed for more affluent consumers. (FiSCA, 2007, p. 2)

In this regard, FiSCA reported in 2006 that 75 percent of consumers rated the value of its financial products as "excellent" or "very good," virtually the same level of customer satisfaction in 2000. Similarly, 78 percent of consumers rated service quality as "excellent" or "very good," a slight decrease from 81 percent in 2000 (Cirillo, 2006). Studies such as this are conducted on a sample of customers who use financial services at stores that subscribe to FiSCA's "codes of conduct" that prescribe best practices for member vendors (FiSCA, 2013), a condition of membership, so consumer perceptions may be different at non-FiSCA member stores.

The establishment of trade associations reflected the maturation of AFS. The Financial Service Centers of America (FiSCA) was established in 1987 and represents vendors of several products: check cashing, money transfers, bill paying, money orders, and payday loans. Initially representing check-cashers, FiSCA has expanded to other lines of financial services and now represents 7,000 providers serving 30 million consumers annually. Joseph Doyle, FiSCA's Chairman, noted the reason why the organization has grown:

> Our customers appreciate the convenient access and high quality services we offer. We fit into their busy lives, with most FiSCA member stores open six or seven days a week. Almost all of our members are open hours later than banks and credit unions; some even stay open 24 hours a day. Consumers are very willing to pay reasonable fees for this type of convenience and recognize that we offer good value. In many cases it is less expensive to use one of our outlets than to use a bank. In fact, 60 percent of FiSCA member customers

> have a traditional savings or checking account at a bank or credit union, yet choose to conduct their financial transactions at our member locations (Doyle, 2013, p. 1).

In 1999 the Community Financial Services Association of America (CFSA) was established as a membership organization of payday lenders. In April 2001, CFSA collaborated with the McDonough School of Business at Georgetown University in a survey of payday customers, which revealed that most were workers supporting young families and who possessed a checking account (Elliehausen & Lawrence, 2001). Subsequently, one of the researchers of this study moved to the Board of Governors of the Federal Reserve System and authored a January 2009 report on payday lending, which showed that most borrowers used loans for emergencies and were quite satisfied with the product (Elliehausen, 2009). CFSA promoted "best practices" among members, including the offer to customers of an "extended payment plan" through which borrowers are offered more time to pay off a loan (CFSA, 2009).

Conclusion

This installment, the first of a two-part series, chronicles the evolution of AFS in response to the deteriorating financial circumstances of working poor households. Already tenuous, as measured by income and assets, the prosperity of low-income families plummeted during the Great Recession, with the impact especially damaging for minority households. In order to sustain an increasingly precarious standard of living, families resorted to AFS. In response to rising consumer demand, AFS vendors formed trade associations to defend the industry, market their financial products, and develop model business practices. The second installment proposes AFS as reflective of a secondary financial services market that complements the secondary labor market, explores the controversy around "predatory lending" as well as regulatory strategies, and details the rapid innovation of financial products designed for the working poor. Community-based financial services are proposed as a strategy to provide constructive financial products to low-income families.

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