Southern New Hampshire University

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AN ANALYSIS OF BUSINESS MODELS AND FINANCIAL FEASIBILITY OF FRINGE BANKING INSTITUTIONS

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I. Context and Background

It is expensive to be poor. The costs and availability of financial services for low income people clearly demonstrate one element of this unfortunate statement.

Low income people do not have access to the full range of financial services that most middle and upper income households have access to in the United States. The costs of the services that are available to them are higher than the costs paid by most other people. As a result of this inadequate access and the high costs of the available services, these households tend to pay a very high percentage of their available income for interest and fees to obtain these services, compared to what they might pay if they were able to use the financial services that are available to most other people in the country. These higher payments significantly affect their ability to move out of poverty and attain higher living standards.

There are various estimates of the number of people not served by conventional institutions, or the "nonbanked" or "unbanked" population, as they are called. The estimates range from 10% to as high as 15% of the U.S. population. And, if this is the percent for the country as a whole, then the percent in low income neighborhoods, where most of the nonbanked are clustered, must be significantly higher in most situations.

For the most part, the range of financial services and investment institutions that serves the larger community does not reach low income neighborhoods. For example, although there are occasional branches, banks and savings institutions tended to move out of low income neighborhoods many years ago and, except for a few small exceptions, have not relocated there since. Other financial services, such as insurance, which may occasionally locate in low income neighborhoods, may also be difficult to find on the scale needed.

A “dual financial economy” now exists. Many people are aware of the check cashers, pay day lenders and pawn brokers in low income neighborhoods. They are aware that low income people clearly use them. But the extent of the use of these institutions, the number of institutions and the impact on low income neighborhoods is often unclear.

There is an entire set of financial institutions and practices in low income neighborhoods that replaces the institutions that the rest of the society uses. It is not just check cashing companies or pay day lenders that create the problems. Low income households use the entire range of services, not just an occasional or isolated service. It is an entire range of institutions that constitutes a dual financial economy.

The lack of financial services and the existence of harmful financial institutions and programs in low income neighborhoods work against the other efforts being made in this arena. Wealth building programs, for example, are less effective when pay day lenders charge high fees or predatory mortgage lenders take large amounts of equity out of homes that the owners have worked a lifetime to build. The savings provided by affordable housing developments can be reduced when the interest and fees on financial services are so high that they can cancel out the housing savings.

Therefore, it is worth considering new ways, approaches and paradigms for community development financing efforts to be implemented alongside the primary existing methods described above. Community Development Finance (CDF) was created to be involved in these new directions.

The purposes of this report are to describe the findings of extensive analysis in the area over the past few years (Part A) and to offer a business plan to suggest new approaches to this problem (Part B). The business plan part of this report will review the market, its psychology and economic structure and create alternatives to the present institutions. One major effort would involve finding alternatives to check cashing outlets/pawn brokers/rent-to-own stores/personal finance companies. It may be possible, for example, to create a single type of financial institution to address some or all of these needs, since they are all related in some way. This institutional approach would operate in combination with other legislative and community efforts to make significant changes to this industry.

CDF began exploring this area in 1998-99. The original goals were 1) reaching an understanding of the financial services industry serving low income households and 2) creating a business plan to support various alternatives.

All of the work completed to date has been framed from the perspective of developing and understanding a range of business models, their financial feasibility and possible new, financially feasible models or alternatives. There is an increasing amount of activity and research in this field now. Most of this work, which is of very high quality, focuses on programmatic and policy options. However, there is also a need for work that is aimed at understanding the business models and financial feasibility underlying the industry. These additional steps are absolutely necessary to understand the present situation and develop new approaches to improve conditions. Therefore, the primary focus of most of CDF's Financial Services program activities has been aimed at understanding the business models and their financial feasibility as a base for developing different alternatives.

Obtaining information on the businesses in this field is extremely difficult. The information sources used in this report include focus groups organized by CDF; nine case studies conducted around the country; professionals in the business who agreed to help with understanding the financial feasibility of check cashing stores, including pay day lending activities, as well as some of the operating business practices of these businesses;
financial statements and other materials of check cashing businesses that were placed on the market for sale; assisting a community based organization in Baltimore considering various options to deal with the financial services needs of the low income people in its neighborhood; aggregate numbers on the internet for a few public companies listed on the stock exchanges; and aggregate numbers for all the check cashers in New York State, where they are regulated.

Other sources also offered insights, from individual credit unions, courses, a conference held by the check cashing organizations' trade association, etc. In addition, I talked to a lot of people, visited many of the stores directly, read articles and occasional books extensively, and used various other sites on the internet. Also as part of these efforts, I worked as a consultant with the Southern New

Hampshire University in staffing a Financial Innovations Roundtable, which focused on financial services. People from around the country have participated and that has allowed me to find out a great deal of additional information.

This report is split in two basic segments. Part A contains the description of the industry and its separate businesses, its financial feasibility and its impact.

- Section I. Context/Background.
- Section II. The Industry. The market; types of financial services, institutions; case studies; impacts on the consumers.
- Section III. Review of the economics of financial services delivery in low income neighborhoods by banks, fringe banking institutions, credit unions, community development credit unions, nonprofit organizations and other institutions. The impacts and implications of different business models and approaches are also described.
- Section IV. Financial feasibility model for check cashing/pay day loan businesses. The experience in New York State. The involvement of corporations and Wall Street in the industry.

Part B contains the Business Plan, including general strategies/approaches for the field and an implementation approach for CDF or another organization to begin addressing these issues.

II. The Fringe Banking Industry

The range of institutions, that provides such a broad offering of financial services to low income households, includes check cashing outlets, pay day lenders, pawn brokers, rent-to-own stores, consumer lending companies, mortgage lending companies and automobile title lenders. The overall industry is described – numbers of unbanked, reasons for their use of these services, characteristics of the industry and the types of businesses, numbers and sizes of the types of businesses that provide financial services, growth of the industry, reasons for the present conditions, etc.

Then, each of these services is discussed briefly to offer an overview of the types of institutions that are available to low income households. Four – rent-to-own stores, consumer finance companies, money wiring and income tax refund anticipation loans – are discussed in greater detail. Two – check cashing outlets and payday lenders – are described in much greater detail later in this section. The various products offered by this range of institutions also will be described.

The impacts on low income households, including an example of effects on a hypothetical family, are discussed to show the effects of these services. Finally, there is a description of the focus groups commissioned by CDF and a discussion of the targeting of certain types of customers in order to generated maximum profits.

The term “unbanked” or “nonbanked” usually refers to households and individuals who do not have checking or savings accounts at conventional financial institutions – commercial banks, savings and loans, credit unions, brokerages and the like. Mostly, they tend to be poorer households who do not have adequate income to attract conventional institutions. They tend to live in neighborhoods that do not have conventional institutions' branches located in their areas. Nevertheless, households in these neighborhoods still have substantial incomes even if many are low income. Moreover, all of these households are not poor; they may have other reasons for not having banking relationships.

There are various estimates of the number of people not served by conventional institutions, or the "nonbanked" or "unbanked" population as they are called. The estimates range from 10% to as high as 15% of the U.S. population.
There is a wide range of reasons stated by people who do not use conventional financial institutions. These reasons include:

- The households do not write enough checks to make it worthwhile.
- The households do not like dealing with banks and/or bank makes customers feel unwelcome.
- The households do not have enough money to put into banks.
- The banks' service charges are too high (including monthly account fees¸ check writing fees, bounced check fees and ATM fees).
- The banks' minimum balance requirements are too high.
- The households cannot manage or balance a checking account.
- The households don't need or want an account.
- The households had credit problems.
- The banks do not have convenient hours or locations.
- The households desire privacy of financial transactions and status.

The industry is growing very rapidly. For example, in the check cashing segment alone, according to one study of 1998 numbers, there were 180 million transactions, generating $60 billion in gross revenue and $1.5 billion in fees. These figures are undoubtedly higher now. The report also discusses the growth in stores, increasing from about 7,100 in June 1998 to 9,500 in 2000. (The growth has occurred fairly recently, as there were only a reported 2,000 stores in 1985 and 2,151 in 1987.) In addition, another 1,300 stores list check cashing as a secondary line of business and another 831 stores in Illinois should also be classified as check cashing companies because they were not included due to the use of different terminology – the stores are called currency exchanges there. Also crucial in the industry is the very large, but unknown number of grocery stores and liquor stores that cash checks with purchases. And there is also an increasing number of check cashing machines in a variety of locations that are not included in these numbers. The growth in other segments of the industry has often been similar; there are now about 8,000 rent-to-own stores, for example.

There are many reasons for the rapid growth of the industry, including the restructuring of the financial services industry (mergers and consolidations), improved marketing and expansion of appropriate services, the influx of immigrants unused to banking institutions, changes in the banks and the government attempts to stop money laundering, the lowered real incomes of working households over the last two decades, etc. The changing relationships between fringe banks and mainstream financial institutions – for example, Wall Street activities such as securitization, secondary market sales and supporting "Initial Public Offerings" or IPOs; fringe banking institutions' enhanced access to capital markets; and banks' financing and/or purchasing of subprime lenders – also played a significant role in the growth of these institutions.

There are many parts to the financial services industry serving low income people. This entire set of financial institutions and practices that exists in low income neighborhoods replaces the institutions that the rest of the society uses. It is a range of institutions that is different from the institutions in the other neighborhoods with higher income residents and that have much more expensive costs. And it is this entire range of institutions that constitutes a dual financial economy. Core elements of this range of institutions are described briefly below.

- Check cashing outlets. One of the cornerstones of the fringe banking industry, check cashers cash payroll, government and personal checks for a fee, usually some percentage of the face amount of the check. In addition, they usually provide a range of other services including money wiring, bill payment and money orders. Sometimes, they offer pay day loans as well. Finally, they may offer many additional ancillary services, such as faxing, copying, stamps, mailboxes, notary service, stamps, envelopes, bus passes, lottery tickets, phones and prepaid phone cards, etc.
- Pay day lenders. These companies offer small, short term loans of up to two weeks in length. The loans may go as high as $500, but are often less. The charge for the loans is usually in the form of some fee per $100 borrowed. Many borrowers cannot repay loans on time and have to roll them over, incurring large borrowing costs in the process.
- Rent-to-Own (RTO) stores. Major appliances – washers, clothes dryers, refrigerators, etc., furniture, computers, televisions and stereos, VCRs, etc, can be "rented" for a short period of time or until the weekly payments after a set amount of time (often 18 to 24 months) allow the "renter" to purchase the item. These transactions can appeal to households which cannot afford full cash purchase at another store, have bad credit or cannot or will not save the full amount of the cash purchase.
- Consumer finance lenders. Unsecured personal loans are available to households without adequate credit records to enable them to obtain bank loans. The lenders include companies such as Household Finance, Beneficial Finance, the Money Store, Aames, the Associates (now owned by Citigroup), Citifinancial (also owned by Citigroup) and others. The rates charged are high – often over 30% -- and the industry is regulated. They may include additional types of insurance – such as single premium credit insurance – and other charges that significantly add to the costs.
- Money wiring. Many immigrants living in the U.S. routinely send money earned here to their relatives in their home countries. Many types of businesses provide this service – check cashing stores, pay day lenders, sometimes pawn brokers, grocery stores, some 7-Eleven stores and even storefronts specializing in wiring funds. Large corporations such as Western Union or MoneyGram actually do the wiring. They charge high fees and pay a portion of that fee to the local store. Typically, someone goes into a store and provides the cash and is then charged the fee. In addition to these fees, other costs – exchange rate commission, check casing fees, other charges at the point of receipt, etc, can eat up to 20% or more of the money sent. Competition and new technology are beginning to have an impact in lowering costs in some areas in the last two or three years. The market is quite

large at present, has grown considerably recently and is expected to continue growing extensively in the future.

- Refund Anticipation Loans (RAL). When households have their taxes prepared, they are eligible for an immediate loan based on the amount of the tax return. About 40% of the people who obtain these loans are receiving refunds through the Earned Income Tax Credit program, a federal tax refund program for low income households. The borrowers are charged a fee for the tax preparation and a fee for the loan; the loan results in a check, which is then cashed, also for a fee. In total, 7% to 20% of the total refund checks can be eaten up with these fees. The loans bring in the refunds within two to three days compared to 8 to 17 days if the borrower waits for the refund from the IRS, since the refunds are usually filed electronically. The effective rate for this loan can be from 100% APR to 700% or even higher.
- Pawn shops. Pawn shops make small, short fixed term (often around 3 months with a grace period) consumer loans to borrowers (often with bad credit and/or high debt) who secure the loans with some form of collateral – jewelry, musical instruments, computers, watches, etc. The loan is equal to some percentage of the appraised value of the collateral – sometimes 25% to 30% or slightly higher. About 30% of borrowers default on their loans; in this case, the pawn shop keeps the collateral and the debt is extinguished. The others pay interest on the loans and sometimes fees; they can redeem their collateral once the principal and interest is repaid. The rates vary depending on the state from about 1.5% to 25% per month. Pawn shops have grown extensively. There were 4,850 in 1985 and 8,878 in 1992. By the end of the century, there were almost 14,000.
- Car title lenders. Car title loans are similar to pay day loans in some ways. A borrower needs a small loan for a short period of time. Car title lenders make larger loans than pay day lenders and pawn brokers – typically up to perhaps $1,200 for a period of about one month. The rate can be from 2.5% up to 25% per month, depending on the state and its regulations. (Some states specifically allow car title lending while others allow it under pawn brokerage laws.) The lender does not lend more than a portion of the automobile's worth and the borrower uses the car's title as security for the loan – similar to pawn brokers, but the lender usually requires that the title is free of liens. Very often, additional insurance and other fees are added to the loan principal. The loans are made quickly without much underwriting or credit checks. The loans can be rolled over several times, like pay day loans and the rate of return on capital is very high compared to banks. If the borrower defaults, the lender can sell the car and charge late fees and repossession charges. The repossession rate is quite high compared to prime car lenders; some repossession tactics have come under criticism. The industry is growing rapidly with strong industry lobbying pressures and political contributions to legislators in some cases. While most banks and investment bankers would not make these loans directly, they are willing to offer lines of credit, help them become publicly listed on stock exchanges and package their loans for resale.
- Credit cards. Many low income households have no credit or poor credit. As a result, they may be unable to obtain a conventional credit card. Nevertheless, there is a very large "subprime" credit card volume for many credit card companies – between 1997 and 2001, the number of subprime credit cards grew to 26.8 million, an increase of 215%. Some of

the companies enter the subprime market as only a part of their business (e.g. Capital One Financial) and others enter it as the main focus of their business (e.g. Providian Financial).

- Electronic Funds Transfer (EFT). The federal government prefers to deposit transfer payments (e.g. Social Security, SSI, Veterans Administration payments, welfare, etc.) electronically by direct deposit into recipients' accounts. Some check cashing agencies offer this service. In one service, the government sends the funds to an account that is accessed with an ATM card. In another type of service, the check casher prints the check and then cashes the check; the recipient is charged for both activities. Initially, the EFT was mandatory, but the service was not used with great frequency. The program then became voluntary. Citibank has been a major provider of EBT services for welfare recipients.
- Mortgage lenders. Some mortgage lenders in low income neighborhoods target highly vulnerable homeowners for high interest mortgages with additional fees. These lenders often foreclose on unwary homeowners, often elderly, who are forced out of their homes (and primary asset) with no equity left. One recent estimate of these costs placed the total at $9.1 billion annually to lending practices associated with predatory mortgage lending. (Stein.) This topic has been covered extensively (e.g. Carr and Schuetz; Gramlich; Bradford; M. Saunders; Immergluck; Peattie; Goldstein; California Reinvestment Committee) and has been the subject of many efforts to change the practices. Therefore, it will not be included in any detail in this report. However, it will be tied in to other efforts in Part B, the business plan.

More detailed information is provided on rent-to-own, consumer finance lenders, money wiring and refund anticipation loans. Case studies are provided for check cashing and pay day lenders.

Many of these services that the fringe banking institutions provide are essential for low income households. Without them, they might have to pay even more or find other even less efficient methods to address their needs for financial services. There have been some attempts to actually determine the impacts the existing financial services on low income households. In addition, there is a case study presented of a hypothetical family and the impact of these services on that family. These estimates show the extensive financial impact on these households.

Some of the businesses appear to depend on households which cannot appropriately deal with the costs of the financial services and either some of their waste precious funds or are driven into deeper financial problems; some significant level of profit of some of these businesses are built on use of the services by these households. This segment of the population which is targeted faces an explosive and extremely difficult problem.

III. Economic and Social Elements of Financial Services Delivery in Low Income Neighborhoods: Business Models

Many different types of financial institutions operate in low income neighborhoods. Commercial banks and savings and loans have been moving out of these neighborhoods for some time. However, some have remained and occasionally, some start new branches or new institutions. There are also credit unions, often but not always Community Development Credit Unions, with branches there. Also, insurance companies, mortgage companies and other mainstream financial companies often operate in low income neighborhoods, although with not with the frequency that they exist in middle and upper income neighborhoods. Then, of course, there is the whole range of specialized institutions/fringe banking institutions that have been discussed in this report in Section II: check cashing outlets, rent-to-own stores, car title lenders, consumer finance companies, pay day lenders, pawn brokers and the like.

Each type of institution, as well as each individual institution within each generic type, generally has a different way of looking at how to operate in low income neighborhoods.

- They have different views of risk and they handle risk differently.
- They have different views of costs and the structure of the costs they incur.
- They have different approaches to their staffing.
- They have different ideas about what level and types of fees and rates to charge.
- They have different mixes of financial products that they offer.
- They have different needs for volume of transactions.
- They have different capacities to access to capitalization, capital markets and startup capitalization needs.
- They have different ideas about profitability and how to achieve profitability.

These factors vary depending on the generic type of institution. They also vary within types of institutions. A large bank will view these issues in a different way than small ones will. Likewise, a national chain of check cashing stores listed on the New York Stock Exchange will view many of these issues in a different way than a local owner of three stores that does not offer pay day lending. The locations will also create differences; rural areas will create different approaches than urban areas. Likewise, the types of clients – income levels, immigrants, age, employment levels and types of employment, etc – will dictate differences such as variations in financial services products that are offered.

Nevertheless, certain generalities about the different approaches – or business models – can be detected. This section views some of these generalities, while attempting to account for some of the variations of the following institutions at the same time:

- Commercial institutions (banks and savings institutions).
- Credit unions.
- Community Development Credit Unions.
- Fringe banking institutions.
- Nonprofit efforts (shorter discussion).
- Newer entrants into the field such as large, national chains of retailers, in addition to long time participants such as convenience stores and grocers.

The generic business model issues were reviewed and the key elements were highlighted. Some of the key issues that emerged in the form of business models for different types of institutions included:

- Operating costs. Conventional institutions tend to have the highest cost structure due to their reliance on more costly branches, greater use of technology, higher paid staff and central administration. Although probably not as high, credit unions also had relatively high operating costs. Community Development Credit Unions usually had lower costs than traditional, employer-based credit unions. The check cashing/pay day lenders had the lowest operating costs, although the chains probably had higher costs than the smaller operations.
- Fringe banking institutions depended more on volume, partly based on much longer hours of operation, and receiving smaller individual payments from many transactions. Banks and credit unions depended more on loans and deposits for generating revenues. They had less interest in a high volume of relatively low margin transactions.
- As a result, each tends to prefer prioritizing certain financial products.
- They tend to use different fee structures as well.
- The result is a different profile of profitability; different institutions stress different products and different fee structures in order to achieve profitability.
- They are different institutions that, basically, have different businesses.
- Fringe bankers probably tend to take more risk with some of the financial services that they offer – check cashing and pay day loans in particular – than the more conventional institutions.
- Achieving scale on a regional or national basis requires access to the capital markets in some fashion. The larger banks, credit unions and larger fringe banking institutions (usually chains that are listed on a national stock exchange) often had excellent access to these markets.
- The more traditional financial institutions that are beginning to look at low income and immigrant populations are beginning to modify their business models, which they must do if they want to successfully reach them.
- Changes are needed to offer improved financial services to low income households at lower costs.
- Some sense of what are realistic, financially viable prices for the various services needs to be developed, if possible, that will satisfy the customers, potential business partners and advocates and yield some minimum, acceptable level of profit or cash flow that will bring appropriate, affordable financial services to the neighborhoods and keep them there.

Low income neighborhoods and households would benefit greatly from the provision of financial services at lower costs. There are many obvious issues for creating a successful program to meet the needs of low income people for financial services while building an economically viable institution that offers better terms than fringe banking institutions. These requirements will vary depending on the type of institution, the particular history of the institution, the target population, geographic location, existence of fringe bankers and the types and costs of the services they offer, etc.

Nevertheless, certain guidelines for these needs are clear.

- Clear definition of the actual model and how financial feasibility can be achieved.

- Clear understanding of the specific target market. It is crucial to have a solid understanding of the local market for financial services. There are many different markets in many neighborhoods – different immigrant groups of many kinds with different interests and goals, individuals, families, seniors, working poor, people with government assistance or social security, etc. Each of these markets tends to relate to financial service needs differently. To successfully address these needs, an institution needs to understand these differences. This is not easily accomplished. Generally, it requires some funding support to obtain this market data – through focus groups, surveys, interviews, market studies, etc. – in order to support the appropriate product design.
- Careful design of new products that both meet the needs of the target populations and fit within the institution's capacities.
- Emphasis on particular, key financial product needs. For example, viable options to pay day loans must be developed. There is a major effort throughout the country at present to eliminate or restrict these loans. This effort is very appropriate. However, if pay day loans were to end or be rendered ineffective, many borrowers could be forced to find other lenders who could be even worse. Therefore, it is very important to develop viable alternatives.
- Alternative loan products for larger, longer term loans often used for buying automobiles, furniture, computers and other high cost items.
- Reducing the charges for most of the financial services of most fringe banking institutions.
- Achieving scale for new options. Pay day lenders, for example, and other fringe banking institutions and products have spread with remarkable rapidity across the country. Therefore, it is equally important to not only develop pay day loan alternatives but also to find ways to achieve scale in these efforts. Moreover, it is also important to find ways to make them more accessible to a wider range of people. Credit unions, for example, only lend to their members (and cash checks, usually, only for their members). The check cashing outlets accommodate everyone. Similarly, the check cashing stores have many more locations convenient to their customers and they are open for much longer hours and on the weekends as well. To compete on a larger scale and meet these financial needs, the alternative lending institutions will have to find ways to expand their coverage, locations and hours.
- Access to capital markets. Affordable access is one of the keys to being able to achieve scale.
- Competition in key markets. Competition, which has proven to effectively reduce the prices of some financial services in some markets, should be one method used to bring changes to the industry. Strategic locations and programs with appropriate pricing may achieve changes in the practices of nearby fringe banking institutions through an appropriate level of competition.
- Adequate banking services for the homeless and near homeless.
- Use of new technology. The rapid advancement of technology has opened up the possibilities of reaching many more low income people in a cost effective manner. However, the use of new technologies faces obstacles in acceptance and methods need to be developed to overcome this resistance.

- Use of advance planning, business plans, financial feasibility projections. Appropriate initial planning is essential to the success of any effort. Evaluation of each effort is also important once they are operating.
- Allowing adequate time to determine the effectiveness of new programs before making changes or abandoning the efforts. These new strategies can require a long time period to become effective. There is a need to develop a clientele that is committed to the institution that is of sufficient scale to support the program. The growth cannot always be accomplished too quickly.
- Support, leadership and vision from the top levels of the organization.
- Creativity, flexibility and openness to develop special approaches.
- Practical implementation skills.
- Dedicated, fully committed people at all levels of the organization and board.
- Strong day-to-day management skills for operating a business.
- Support from the overall community.
- Use of partnerships. There are many different types of partnerships available to communities for bringing improved financial services to low income communities. Partnerships are an essential element of this effort and are necessary to their success.
- New approaches to marketing.
- “Branch accounting” and other means of tracking income and expenses.
- Reporting mechanisms for impact of the programs, such as effectiveness in “mainstreaming”.
- Literacy training. This element is very important, but improved mechanisms need to be developed in order to become more effective.
- Replication of successful approaches.

The field of financial services for low income households is very complicated and involved. There are many facets that must be carefully addressed: planning, site buildout, technology, partnerships, financial feasibility, operations, pricing, selection of financial services, social and community goals, etc. This discussion of business models highlights many of the associated complexities.

The different financial approaches have their own individual requirements and complexities. But there are some key, general issues.

- Generally, it is difficult to provide financial services effectively in low income neighborhoods.
- Banks and fringe banking institutions are often seen as competitors, but they are really different institutions operating different businesses. It is possible to combine all, or many, of the needed financial services into one institution, but that is difficult and may create an unusual institution.
- Another approach is the combination or partnership of different institutions in some fashion, a very important but sometimes difficult approach.

- Many of these institutions and businesses may prefer that each product stands on its own financially or at least break even. That goal may be very difficult to achieve with a model that tries to lower costs in low income neighborhoods.
- Stronger legal guidelines can be placed on fringe bankers and some improvements in financial services could result.
- Different products can be combined in some ways to improve other financial needs. For example, savings programs can help increase savings rates; lower costs can be used to reduce the financial pressures on low income people; programs can be created to help mainstream interested households into the conventional banking system; etc.
- Although it is not really their business or expertise, conventional institutions can be encouraged to offer fringe banking financial services. However, these services will need to be combined with programs that create profitability.
  - The goal of mainstreaming as many customers as possible to generate earnings to break even or make a profit is crucial.
  - Institutions that enter into this arena preferably will be efficiently operated, use a lower cost model, generate appropriate profits and have adequate reserves.
  - Conventional institutions will need to modify their business models to successfully address the needs of low income households through changing the product mix, modifying fee structures and finding methods to improve the ratio of mainstreamed customers.
- With some of these changes, banks can provide many of the needed financial services. They have been involved in a few cases, probably due mostly to Community Reinvestment Act pressures to date. A few are involved because of the potential for new markets but they have not tried to achieve adequate scale that would solve the financial services issues in many neighborhoods. It is important to move beyond demonstrations and “exception” activities.
- Technological changes may offer greater opportunities to reach a higher level of scale, but it is not clear that immigrant and low income communities are ready to accept these technological solutions without additional motivation and efforts from the institutions.
- Subsidy is necessary for some efforts targeted at very low income and homeless people and, in some cases, for financial services for low income households as well. This subsidy can be constructed in different ways.
  - Internal or external: a bank may offer a range of financial services by subsidizing the losing products with income from the profitable services.
  - The bank may subsidize unprofitable services with revenue from other parts of the bank product line and other locations.
  - Public sector/foundation subsidy can be provided.
  - Friendly depositors can make below market rate deposits even though there are draw backs – lack of scale, withdrawals, etc.
  - Friendly investors may provide patient equity capital, again with the drawbacks that exist.
  - Employment of a different business model that uses lower costs.
- Create new financial vehicles, institutions and mechanisms. This topic will be discussed in the business plan

- These approaches need extensive support, in addition to possible operating subsidies, to work.

Many different efforts to bring change to financial services for low income households have been evolving throughout the country and it is likely that many more individual, ad hoc projects will be initiated. However, a much more systemic approach is needed. For that type of response, a more coordinated effort will need to take place and a high level of resources will need to be allocated. The level of assistance needed is extensive, due to the large numbers of people across the country who may need and choose assistance and the difficulty of creating a business model that has financial feasibility. Therefore, future efforts could use much more support in a coordinated, systematic method of assisting new programs. These methods include

- Availability of technical assistance in helping organizations create new efforts;
- Availability of development capacity to create these efforts de novo in areas without any existing capacity to create a new effort; and
- Availability of a financing vehicle to help new financial services programs begin, including startup funds, ongoing subsidies, and investment and lending support.

If community development efforts in the U.S. have a goal of seriously approaching these issues, they will need to find ways to address these replication issues.

IV. Financial Feasibility for Check Cashing and Pay Day Lending Businesses

Obtaining accurate information on the financial feasibility of check cashing and pay day lending businesses was extremely difficult. There were several sources used for the information in this chapter, including:

- Focus groups held in Oakland (3) and Los Angeles (2) with different ethnic groups.
- An analysis of the impact of typical financial services on a hypothetical low income family.
- Nine case studies conducted with a range of different financial institutions involved in providing financial services to low income households in different parts of the country. The case studies were conducted from the viewpoint of developing and understanding a range of existing business models and possible new models, including financial feasibility.
- Professionals in the business who agreed to help me with understanding the financial feasibility of check cashing stores, including pay day lending activities, as well as some of the operating business practices of these businesses. The main sources included a software company for check cashers – B.E.S.T. – and the company's accountant in Chicago.

The fringe banking industry is quite large by any measure. One recent report estimated the sizes of some of the different components in the following way:

	Volume of Transactions	Gross Revenues	Fee Total
Check cashing:	180 million	$60 billion	$1.5 billion
Pay day lending	55 to 69 million	$10 to $13.8 billion	$1.6 to 2.2 billion
Pawnbrokers	42 million	$3.3 billion	NA
Rent-to-own	3 million	$4.7 billion	$2.35 billion
Totals	280 million	$78 billion	$5.45 billion

In New York, a state which does not allow pay day loans (although they are apparently being made anyway through out of state banks, as described in Section II) and limits check cashing fees to a maximum of 1.4% of the face amount of certain kinds of checks, the results still demonstrate a very substantial business. In New York, the State Banking Department regulates check cashing companies and requires an annual report from them. The Department then compiles the information and issues a report with aggregate numbers for the state as a whole. In 1999, according to the report, the industry cashed $14.5 billion in checks. The average check totaled $378.56 and the average check cashing fee was $4.18. Check cashing fees collected totaled $160,183,816 compared to $128,378,056 in 1998. Total fees collected in 1999 were $218,999,857 including electronic benefits transfers and other income from money orders, wiring, lottery fees and miscellaneous transactions.

Fringe banking, in contrast to its name, is a major industry in the United States, although its activities and inner workings remain hidden for the most part.

There are many characteristics that influence the operating costs, revenues and profits of a fringe banking institution. Some of the key variables include the following:

- The demographic profile of the surrounding neighborhood will be important.
- The income levels and sources of income of the nearby households will also have an effect.
- The community should be growing, or at least stable in population and the crime rate should be relatively low.
- The competition in the immediate vicinity will also be critical. Almost all of the business typically comes from residents with a 1 to 1.5 mile radius of the store. Some states regulate the proximity of these stores with minimum distance requirements, creating small geographic monopolies, in effect. (New York requires 3/10 of a mile between stores and New Jersey requires 2,500 feet.) In other situations, competitors locate next to each other, creating the possibility for greater price and product competition, at least until one or more may be forced from the location.
- The type of location can also vary. The density of the surrounding neighborhood can play a role. With higher densities in large cities, customers should be able to easily reach the

stores by foot or public transportation. A good mix of small and medium businesses in the neighborhood with a higher level of hiring needs is also important. Urban and rural stores may vary.
- The hours that the store is open are also important.

Other financial services products may not generate the same kind of revenue but they can be important for other reasons.

- Some products can generate almost all profit from their revenues, once fixed costs are covered. This condition can occur because these operations have a set of fixed costs – rent, insurance, salaries and benefits, marketing, utilities, etc. Therefore, if a store is open a certain number of set hours and it can add certain products with relatively small costs, most of the revenue from the new services will create mostly profit.
- Although some of the products may generate additional amounts of revenue and profit in relatively small increments once the fixed costs are covered, they have additional uses as well. They bring cash into the store that can be used to either lower costs or generate additional income. For example, money wiring and bill payments bring in cash into the store for short periods of time that can be used to cash checks, thereby lowering the cost of obtaining money from a bank.

The volume becomes a critical matter and it depends on many of the issues discussed above – location, demographics, product mix, competition, etc. After the fixed costs are covered, new revenues that are generated add to the store's profitability. The stores that have the greater volumes can generate more profit. Of course, as the volume grows, some other costs will grow – perhaps an added staff position, more accounting, higher interest on borrowed bank funds, etc. – but these costs are relatively small compared to the added revenues.

The report discusses the financial feasibility of a sample store. There is a breakdown and discussion of stabilized annual revenues by source, a stabilized operating budget and a startup budget for capital costs and working capital needs. Most of the line items have annotations describing the issues for each of them. There are also ranges shown for some of the operating costs that depend on the store size and volume of transactions.

The budgets are intended to show not only the potential for different costs in different locations but also the possible range for a smaller store and a larger store. There is a discussion of cash flows and profits at the end of the section.

The numbers presented are representative of a larger check cashing operation, presumably in a larger city with higher densities. The numbers are also very conservative. An experienced owner-operator likely could operate a business with lower costs than those presented here. Moreover, the pay day loan numbers for operating costs are understated and the resulting pre-tax income figures are overstated.

The summary of these projected, stabilized revenues, costs and pre-tax income figures – including and excluding pay day lending – are as follows, although the pay day costs are understated and the resulting pre-tax income is overstated:

Without Pay Day Loans

	Small Store	Larger Store – no PD Loans Lower Fee Schedule	Larger Store – no PD Loans Higher Fee Schedule
Revenues	$190,000	$326,675	$667,950
Operations	135,000	$187,700 – $249,700	$187,700 – $249,700
Pre-tax Income	$55,000	$ 76,975 – $138,975	$418,250 – $480,250

With Pay Day Loans

	Small Store	Larger Store – PD Loans Lower Fee Schedule	Larger Store – PD Loans Higher Fee Schedule
Revenues	$190,000	$556,625	$974,550
Operations	135,000	$187,700 – $249,700	$187,700 – $249,700
Pre-tax Income	$55,000	$306,925 – $368,925	$724,850 – $786,850

The larger store may have higher possible pre-tax income if the costs can be controlled and the lower end of the operating cost range ($187,700) can be achieved.

The start up budget also needs to be considered, as the figures above represent a stabilized operating budget for a business that has completed its start up phase and has entered a different phase. The early time period may include the startup capital expenses (equipment, remodeling, computers, staff training, marketing, signage, legal assistance, etc) plus the operating losses that would need to be covered. In addition, an estimate of initial working capital for check cashing was also included. The analysis concluded the following:

Startup capital expenses:	$ 108,000 – 182,000
Operating losses	30,000 – 60,000
Working capital	50,000 – 150,000
Total	$ 188,000 – 392,000

Again, it is important to emphasize that these projections were conservative, especially those for operations and start up capital. They were made with the possibility of start up for nonprofits or otherwise relatively inexperienced operators.

In addition, other measures were analyzed. As described above, the Banking Department of the State of New York regulates the check cashing industry and publishes aggregate data for the industry. The profits are most likely lower in New York, but nonetheless, fringe banking in the state is still profitable and draws businesses into the industry. In part, the requirement that check cashing stores must maintain a minimum distance helps to offset the other regulatory limitations by creating small market areas where a single store has a distinct advantage.

Dove Consulting completed a report for the U.S. Treasury in 2000 (Dove) that surveyed "non-bank financial institutions", mostly check cashing companies with additional services (money wiring, money orders, etc. and in some cases, smaller amounts of pay day lending). Dove surveyed these businesses in four cities – Boston, Atlanta, San Antonio and San Diego in December 1999 and January 2000. While the results are not indicative of the industry as a whole throughout the country and no conclusions can be drawn from this information, the surveys and the analysis do offer useful information that can be used to compare with other sources and offer insights into the issues that exist.

The pre-tax returns on sales (revenues less operating expenses) averaged almost 34% across the four cities. Roughly one third of all revenues became pre-tax profits. The report noted that these profit margins were roughly equal to the 32% average documented in the aggregate report for Massachusetts, compiled by state regulators. Another industry participant also pegged revenues at a similar range; 20% was considered a reasonable return, but the percent could be over 40%.

The value of a fringe banking institution is mostly in its cash flow. There are few tangible assets that are of significant value. The location is crucial in generating the cash flow. An excellent, long term lease is essential. Without a good lease, the location is not very valuable; renewals or re-establishing the business in a new location to obtain a less expensive lease negates the value of the good will of the existing location. A check cashing business is valued on its cash flow. However, it is not always clear how much the cash flow actually is, as is the case with many businesses based on cash.

In addition to the profit potential, which exists for the smaller companies, there are also several large companies that now exist in the industry. Mostly, they are listed on various stock exchanges. Cash America, for example, provides financial services to individuals in the U.S., United Kingdom and Sweden. It is listed on the New York Stock Exchange (PWN). The company makes secured, nonrecourse loans to individuals through 473 locations, known as pawn shops. At the end of 2001, the company had over $76.7 million in outstanding domestic loans. It also has 135 locations (both franchised and company-owned known as "Mr. Payroll") that offer check cashing services. The company also had rent-to-own operations (Rent-A-Tire), which it sold for $3 million in 2002.

Cash America's total revenues for 2001 were $356 million, increasing from $346.4 million the year before. Pre-tax income from operations in 2001 was $12.725 million (52 cents per share), increasing from $701,000 (3 cents per share) the previous year, which included some large, unusual chargeoffs.

ACE CASH Express, the country's largest check cashing chain, was founded in 1968. It is listed on the Nasdaq Stock Exchange (AACE). It now has a total network of 1,178 stores (999 company owned stores and 179 franchises stores) in 35 states and the District of Columbia. A recent press release further describes the company's activities in the following way:

> ACE also maintains automatic self service machines, which provide certain retail financial services without the need for a service associate, at 71 company owned
> Store locations and 100 automatic self service machines at H&R Block office locations. ACE offers a broad range of financial and check cashing services and is one of the largest providers of Money Gram wire transfer transactions. In addition, ACE offers money orders, bill payment services and prepaid local and long distance telecommunication services. Under ACE's agreement with Goleta National Bank (GNB), GNB currently makes small short term consumer loans available to customers at various ACE company-owned stores.

The press release announced that ACE had "achieved record revenue during its second fiscal quarter ended December 31, 2001". Revenues for the second quarter increased to $54.7 million compared to $45.1 million for the previous year's second quarter. The revenues for the fiscal year ending June 30, 2001 were as follows:

Check cashing fees:	$105,479,000
Loan fees and interest:	$ 54,771,000
Bill payment services:	$ 10,376,000
Money transfer services:	$ 10,270,000
Money order fees:	$ 7,245,000
Other fees:	$ 6,377,000

For the fiscal year ending on June 30, 2001, ACE had the following transactions:

- Face amount of checks cashed: $4,498,000,000.
- Face amount of average check cashed: $358
- Average fee per check: $8.38
- Fee as a percent of the average check: 2.34%
- Number of checks cashed: 12,580,000
- Face amount of returned checks: $26,536,000
- Collections: $17,717
- Net writeoffs: $8,819,000
- Collections as a percent of returned checks: 66.8%
- Net writeoffs as a percent of revenue: 4.5%
- Face amount of money orders sold: $1,709,000,000
- Number of money orders sold: 12,787,000
- New small consumer loans and refinances: $396,783,000

- Average advance: $269
- Average finance charge: $42.30
- Number of transactions – new loans and refinances: 1,477,000
- Gross loans receivable (6/30/01): $27,768,000
- Allowance for loan loss as a percent of gross loans receivable: 48.2%

Rent-A-Center is the largest rent-to-own (RTO) operator in the country. Listed on the Nasdaq stock exchange (RCII), the company now owns and operates over 2,360 stores in 50 states, Washington, D.C. and Puerto Rico (out of a total of about 8,000 in the country). It began in 1986 with 8 stores. Mergers fuelled a major part of its growth, as well as the growth of other companies in the field. In 1998, Renters' Choice Inc. purchased Rent-A-Center from Thorn Americas, Inc. for $900 million.

Rent-A-Center has experienced extensive growth. Revenues in 1995 were $133,289,000 and increased to $1,808,528,000 by the end of 2001. Similarly, net earnings after taxes increased from $10,712,00 to $97,497,000 during the same period.

The presence of large corporations in the industry also changes the equation concerning access to capital. Large corporations have access to the capital markets to finance their activities that many other businesses do not have. For example, Rent-A-Center announced a conversion of the company's Series A preferred stock into over 7.2 million shares of common stock, allowing the company to reduce its dividends. Rent-A-Center also announced a public offering of 3,120,000 of its common stock. The shares are being offered by affiliates of Apollo Advisors IV, LP and Bear, Stearns & Co. Morgan Stanley is acting as the book-running manager; Lehman Brothers will be a co-lead manager with Bear, Stearns while Wachovia Securities and SunTrust Robinson Humphries will act as co-managing underwriters.

Cash America announced on August 14, 2002, that it had completed two financings totaling over $130 million that will provide long term liquidity resources for working capital for acquisitions and new store openings and support other corporate purposes such as its lending to low income customers. Cash America is able to access the capital markets at very favorable terms – 7.2% for part of the funds and probably a similar rate for the remainder – and then use these low cost funds to make much higher rate loans to individuals that generate high returns.

Other large corporations may not focus on financial services for low income households entirely, but are nevertheless heavily involved in other ways. For example, First Data Corporation, a large financial services company, owns Western Union, the money wiring service. The company serves nearly 2.5 million merchant locations, 1,400 card issuers and millions of consumers. Wells Fargo Bank and Capital One Financial Corporation combined with Diebold, Inc. and Cash America to provide $253 million in private financing for InnoVentry, a developer of automated machines that provided check cashing and was preparing machines that would include money wiring, money orders, short term loans and credit cards. The machines, exclusively manufactured by Diebold, Inc., were placed in kiosks in Albertson's, Circle K, Texaco and Wal-Mart. The company closed in 2001. Citigroup, involved in a different manner, has won government contracts to distribute welfare benefits through its ATM cards in several states.

These corporations represent a sampling of the large corporations involved in fringe banking activities. When reviewing the wide range of activities from a very wide range of corporations – large grocery and convenience store chains, major banks and other financial services companies, companies manufacturing expensive and sophisticated machines and equipment supporting the industry, investment banks and secondary markets, stock exchanges, credit card companies, consumer lending corporations, etc., in addition to the large corporations that have emerged directly from the industry itself – it is clear that financial services for low income people is an extensive and profitable business, with excellent profit growth in the future for both small and large scale efforts.

V. Conclusion

Most low income people in the United States do not have access to the full range of financial services that most middle and upper income households do. As a result of this inadequate access, these households tend to pay a very high percentage of their available income for interest and fees to obtain these services, compared to what they might pay if they had access to the financial services that are available to most other people in the country. These higher payments significantly affect their ability to move out of poverty and attain higher living standards.

There is a range of institutions that provides a broad offering of financial services to low income households. It includes check cashing outlets, pay day lenders, pawn brokers, rent-to-own stores, consumer lending companies, mortgage lending companies and automobile lenders. Together, they constitute a financial system that can create great barriers for low income households in their attempts to improve their living standards.

Many people are aware of the check cashers and pawn brokers in low income neighborhoods. They are aware that low income people clearly use them. But the extent of the use of these institutions, the number of institutions and the impact on low income neighborhoods is often unknown or underestimated. There is an entire set of financial institutions and practices in low income neighborhoods that replaces the institutions that the rest of the society uses. It is this entire range of institutions that constitutes a dual financial economy and it is the problem created by this range of institutions, which must be addressed.

This financial system needs to be altered. It needs to become more affordable for low income households, although without eliminating profit potential from the industry. It needs to become more efficient. And it needs to offer a more complete range of services so that low income households can more easily move out of poverty.

There are several ways to help create better options for low income households.

- Introduction of stronger statutory and regulatory efforts for fringe banking institutions.
- Creating political and operational pressures for existing fringe banking financial institutions to change some of their activities.

- Encouraging presently uninvolved, existing institutions – such as commercial banks and credit unions – to become more involved in providing affordable financial services to low income people.
- Encouraging expansion and new approaches by institutions, such as community development credit unions, that are already involved.
- Creating new alternative institutions, partnerships and financial products. (This is the topic of the business plan, Part B.)

Some of the guiding principles for successful efforts to create these changes include:

- Widest possible set of services meeting locally defined needs.
- Economic feasibility and self sufficiency if possible.
- Achieving scale in order to appropriately address the magnitude of the problem.
- Use of technologies that enhance the effort.
- Use of partnerships where appropriate – even where the partnerships may at first seem unlikely.

Although the fringe banking industry often has an unsavory reputation, these businesses provide important services to low income households that no other institutions are willing to provide in any systematic way. In some situations, the terms are fairly reasonable, in market terms. In New York, for example, check cashers are limited to charging 1.4% of the face amount and no pay day loans are allowed. There are loopholes that should be closed (pay day loans are being made through out-of-state banks) and the regulators created another mechanism that protects stores by preventing more than one store within a set radius. Nevertheless, the industry provides financial services at relatively reasonable prices, allowing profits that keep stores in business.

Moreover, other changes have occurred. Just a few years ago, most of this lending was problematic: check cashing mostly required payment of 3% or more; wiring money was much more costly; pay day lending was growing rapidly with little legislative or regulatory oversight or restraint; predatory mortgage lending was rampant with little awareness or action taken to prevent abuses; consumer finance companies used abusive practices; etc.

Now, there have been important inroads made in some of these areas. For example, check cashing costs has fallen to 2% or less in some areas where there is competition, and legal challenges have been mounted. Similarly, the costs of money wiring have fallen extensively in many areas due to competition and technological changes. Pay day lending is under attack and some restraints have been implemented through regulation and statute.

But make no mistake: while some progress has been made, there is still a very, very long way to go in many areas before a set of appropriate financial services is available throughout the country.

The fringe banking business is pretty well hidden from mainstream awareness. Most people are only vaguely aware of these businesses. Moreover, they are often seen as smaller businesses that face high risks and uncertainty due to the income levels of their customers.

While profit is potentially available, the businesses must be well managed or they will not succeed. Tight management – whether it is with marketing, employee selection, policies and underwriting of borrowers, collections, control over expenses, etc. – is critical in this business as in others.

However, it is clear that this business can be quite profitable. These businesses also do not represent the risk levels that appear from viewing the surface level of the businesses. There is risk, but it does not seem to justify the high level of prices for the services. There needs to be an appropriate level of profit available to attract and keep businesses in the industry, but the risk level does not seem to justify the prices that are being charged. At the same time, it is important to allow adequate profit incentives to maintain the industry and not regulate or legislate this potential out of existence.

While the present profit levels can be quite high, the future levels may be greater, as technological changes increase the profit potential further. Moreover, as the scale of these efforts continues to increase, the profit potential will probably increase and draw more entrants into the field. Also, it is increasingly clear that large corporations are finding methods to provide financial services to low income households – either directly or indirectly.

In addition, the increasing entrance by large corporations and the consolidation of the industry through large chains are probably creating barriers to entry for new institutions. There is still time to begin new efforts, but the window of opportunity may be lessening.

These trends can be positive – if methods can be developed to offer a wide array of financial services, including those not easily available to low income households at present, in a more efficient at reasonable costs. However, if some of the abusive practices are maintained and even intensified, then deteriorating conditions for low income households will continue.

The appropriate financial services needed by low income households include the following:

- Core Services
  - ✓ Check cashing
  - ✓ Wiring money
  - ✓ Money orders
  - ✓ Bill payments
  - ✓ ATM
  - ✓ Credit cards
- Financial Services – Loans
  - ✓ Small, short term loans (up to six or twelve months)
  - ✓ Personal loans (furniture, automobile, etc.) up to five years
  - ✓ Small business loans (relatively small loans – up to $5,000, with relatively short durations up to 3 years)
  - ✓ Non predatory home loans – repairs in particular, but also debt consolidation and refinancing
- Financial Services – Other

- ✓ Savings plans – savings accounts, IDAs, EITC, etc.
- ✓ Checking accounts
- ✓ Insurance – health, life, house, liability
- ✓ Investments – CDs, stocks, retirement
- ✓ Tax return preparation, tax anticipation loans and the EITC

- Training Services
  - ✓ Financial literacy training
  - ✓ Credit repair
  - ✓ Counseling
  - ✓ Savings and investments
  - ✓ Technology use
- Ancillary Services: bus passes, stamps, faxes, etc.
- Electronic Benefits Transfer

The key issues surrounding these businesses are finding ways of making it less costly for those who can afford it the least; finding better methods of delivering the services; and offering a more complete range of financial services. Moreover, the structure of the products that are based on the targeting of households with a lack of capacity to use these services needs to be addressed. The methods and technologies are developing that would allow this result and still generate adequate profits for participating businesses.

Presently, government officials and regulators have been encouraging banks and credit unions to find ways to offer more assistance to low income households. If community development efforts in the U.S. want to seriously approach these issues, they will need to find ways to provide extensive assistance in a wide range of areas – training and technical assistance, deeper study of workable models, different types of capital needed to begin and sustain new programs, provision of subsidy when needed, creating the capacity to adapt models to local conditions, etc.

Therefore, some method of providing systematic assistance – both financial and technical – on a greater level to support this type of effort is essential to creating a widespread web of financial services institutions capable of having an impact in low income neighborhoods and changing the financial practices that exist in them. This would allow some of the existing organizations as well as new community based efforts to obtain greater assistance in the early stages of developing their programs.

This type of assistance, in addition to the increased awareness of the financial services problems facing low income people, are helping to create an environment that may lead to the opportunity for a hybrid organization to help lower costs and provide improved services. That is the subject of Part B of this report, the Business Plan.