

Financial Services for Low- and Moderate- Income Households: Evidence from the Detroit Area Survey



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Based on Joint Work with Dokko & Keys

Introduction

- LMI households need a range of transactional services to receive their income, store its value & pay bills
- LMI HH need opportunities for saving
 - Short-term (emergencies, asset purchase)
 - Longer-term (housing, education)
- LMI HH are underinsured for key events
- LMI HH often pay high costs to borrow
- The financial services system is not well organized to serve LMI HH

The Financial Services Mismatch

- ❑ The financial services lives of low- and moderate-income households—living on the financial edge.
- ❑ The financial system is not designed to serve low- and moderate income households
 - Supply: High bank account fees, high minimum balances, overdraft & NSF fees, check-writing delays & fees, Chexsystem for past account problems
 - Demand: Low income, low savings, immediate needs
- ❑ Alternative financial services sector serves poor
 - Check cashers, payday lenders, refund anticipation lenders, pawnshops, title loans, etc.
 - Often costly, inefficient & dead-end

Should we care?

- High costs to convert income to usable form
 - Reduces take home pay
 - Diminishes efficiency of government payments

- Lack of a regular mechanism for saving
 - Vulnerable to emergencies
 - Hardships
 - Reliance on government programs
 - Bankruptcy

 - Unable to save for longer-term goals
 - Education, home ownership

- Broader social inclusion

Detroit Area Household Financial Services Survey

- Survey of 1,003 households in Detroit metro area conducted with Survey Research Center
- Random, stratified sample. HH area median = 49,000 (census definitions)
 - 0-60% of area median (up to \$29,000)
 - 61-80% of area median (\$29,000-\$39,000)
 - 81-120% of area median (\$39,000-59,000)
- Oversample low-income census tracts
- Ask randomly selected individual from household about own & household's financial service use
- In-person, computer assisted. Average interview length 76 minutes. Production hrs/interview: 8.8
- 65% response rate

Description of Sample

- More socio-economically disadvantaged than average US household
 - Mostly black, 2/3 female, mostly unmarried
 - \$20,000 median household income
 - 33% live below federal poverty line
 - 30% have less than a HS Diploma or GED
 - 56% currently employed

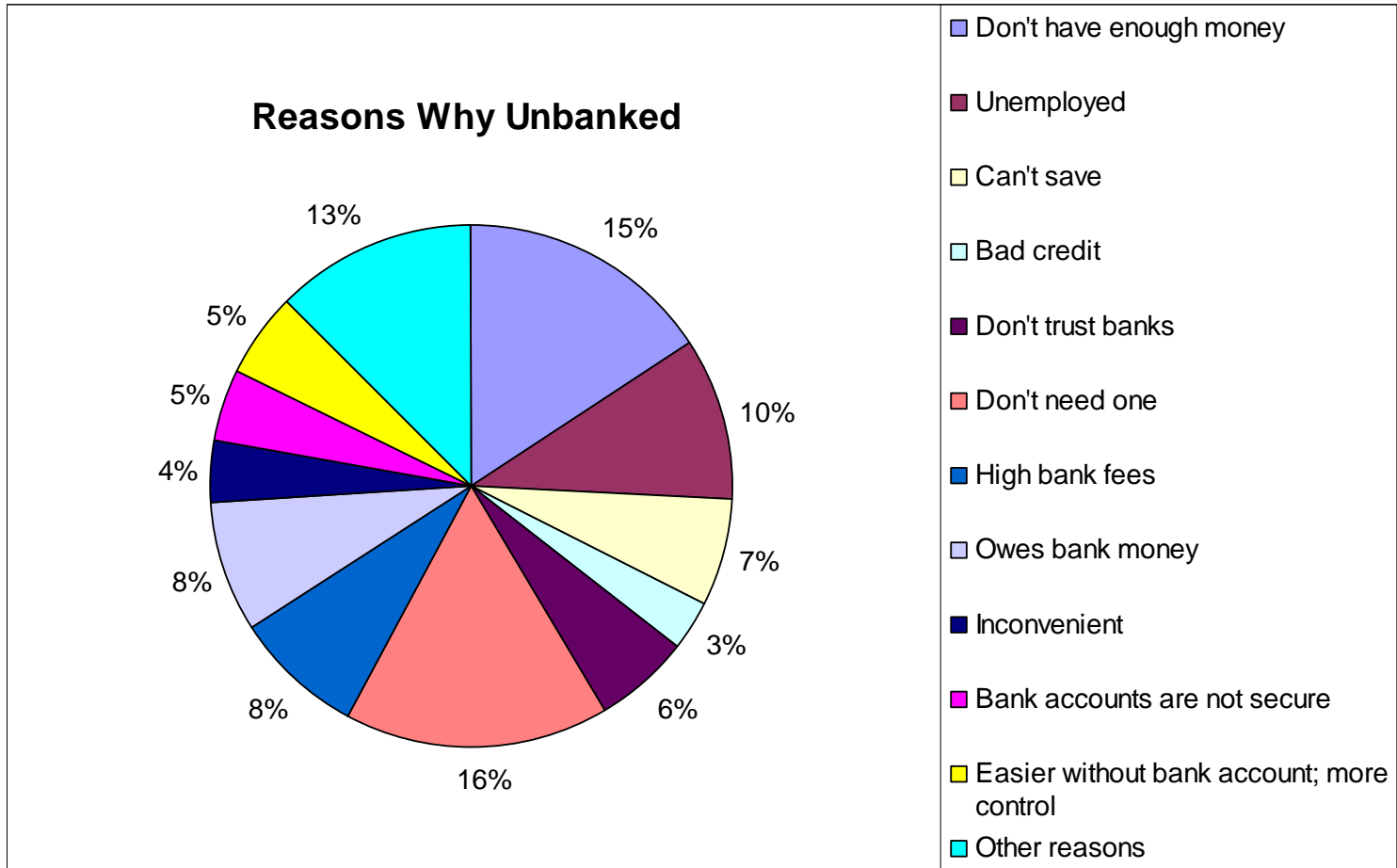
Bank & AFS

- 29% of LMI individuals (23% of households) do not have a bank account.
- The unbanked are younger, less educated, less likely to be employed, and poorer than banked individuals.
- But being “unbanked” is not a permanent state of the world.
 - Among the unbanked, 70% previously had a bank account.
 - 12% of the “banked” respondents previously were “unbanked” because their bank closed one or more of their accounts

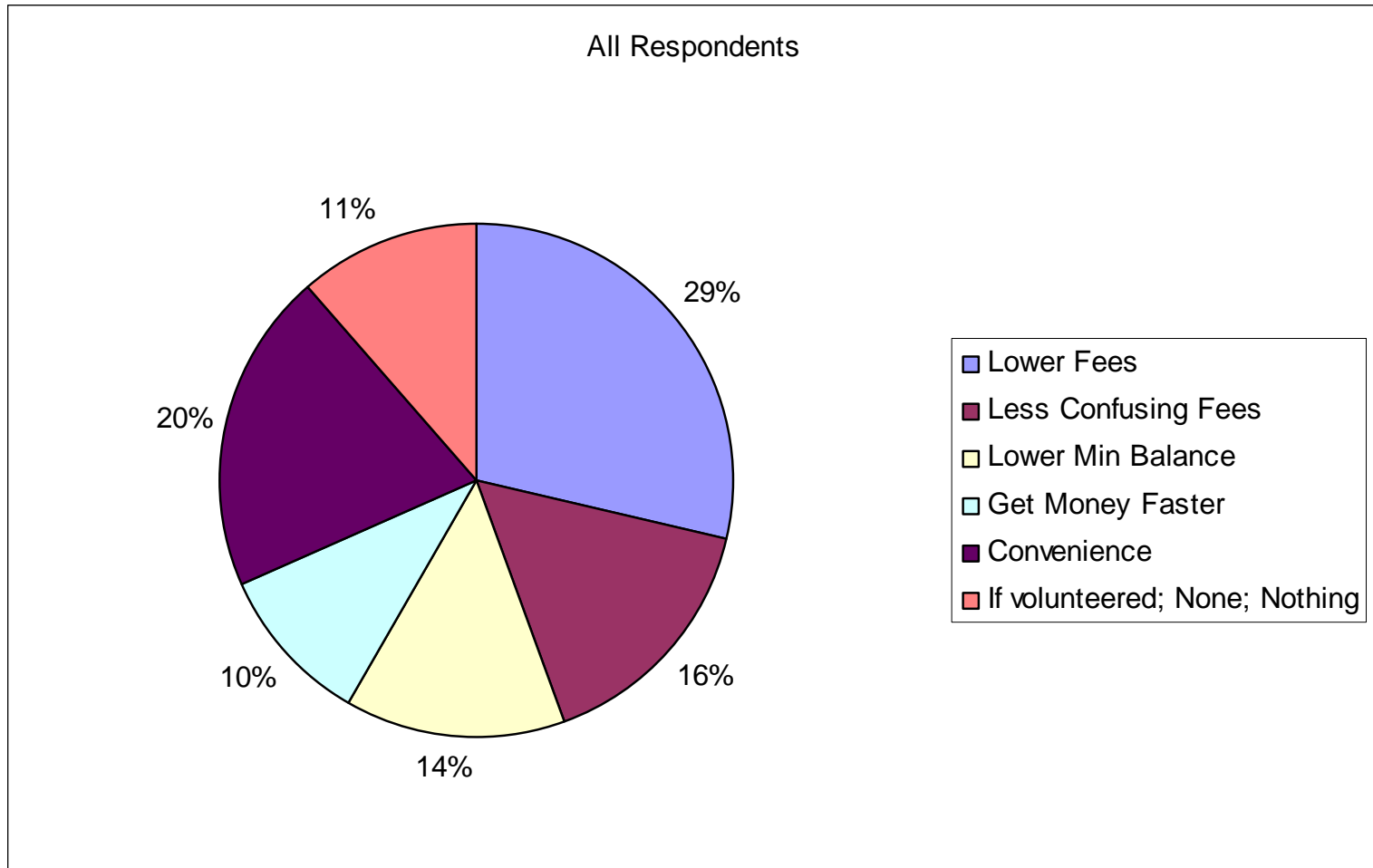
Unbanked

- 70% previously banked
 - 70% closed it b/c moved, high fees, NSF
 - 30% bank closed b/c overdrafts
- 75% want to open a bank account
- 33% have looked into opening an account
- 17% report that a bank has denied an application to open a bank account

Reasons Why Unbanked



What would make you open an account?

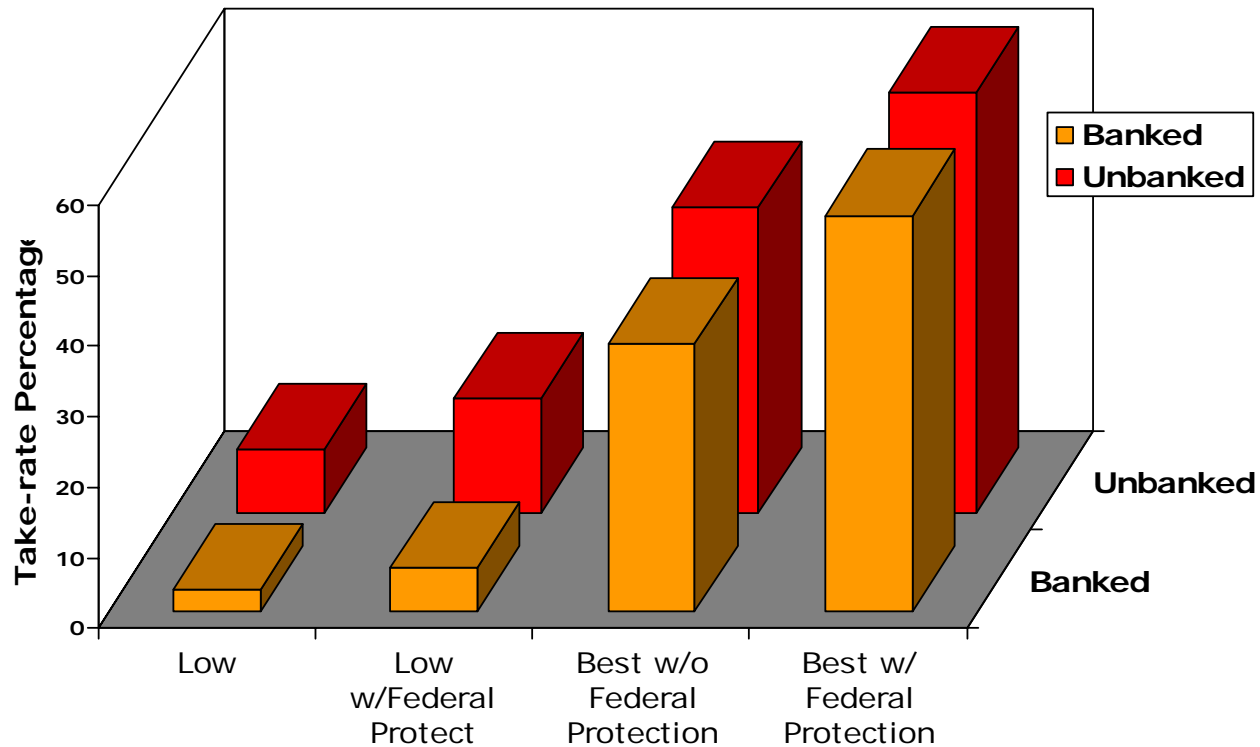


Banking and Payment Cards

- ❑ Traditional checking accounts don't work for LMI households
- ❑ Payment cards (debit & prepaid) are a potentially attractive financial product for LMI households and for financial institutions: a win-win.
- ❑ Conjoint analysis to test what types of bank/payment card features do different LMI households find attractive
 - Many unbanked HH would like a bank account & payment cards
 - LMI HH's value low monthly cost & federal protection
- ❑ Policy Implications

Preference by Banked Status

- Unbanked prefer even the lowest value cards, which Federal Protection makes twice as attractive.



Key Product Features

- PIN debit card bank account
 - No overdraft
 - No check-writing
 - No chexsystem screen
- Optional Savings Feature
 - Can include automatic savings plans through which households can pre-commit to saving fixed amount each month automatically set aside into savings “pocket”
- Optional Credit Feature
 - Can include option of self-amortizing, 6 month, consumer loan (up to \$500) with direct debit, after seasoning period
- Key Linkages
 - IRS direct deposit of tax refund
 - Direct deposit payroll income
 - Direct deposit government benefits (including Social Security)
 - Direct deposit state benefit payments (EBT programs)
 - Direct deposit through automatic savings plans at work
 - Potential for link to simple retirement savings accounts

Quick Highlights: Tax Prep & RALs

- 66% of low- and moderate-income tax filers used a paid preparer to file.
- About 38% of all LMI taxpayers using a paid preparer took out a RAL.
- 51% of unbanked use RAL vs. 31% others
- 50% of EITC filers use RAL vs. 14% others
- RAL users paid \$177 for tax preparation & RALs, which represents 7% of the average refund of such households (\$2,505).

Quick Highlights: Home Mortgages

- Broker Usage
 - 58% used a mortgage broker
 - Of those using a broker, only 33% were offered loans from more than one lender
- 29% paid points or fees up front
 - Blacks pay 2.5-3 times the points & fees whites pay
- “High Cost” mortgages held by 55% of HH
 - Include high APR, balloon payment, prepayment penalty
 - 63% for blacks, 46% for whites
- When “high cost” mortgages also include ARM, 62% of LMI HH hold such mortgages
 - 70% for blacks, 51% for whites

Quick Highlights: Home Mortgages (2)

- ❑ Roughly 13% of LMI HH have “D” class subprime loans (APR = 10% or greater).
- ❑ 29% have ARMs
 - 32% of blacks and 22% of whites
- ❑ 23% face prepayment penalty
 - 29% blacks face prepayment penalty but only 13% of whites
 - Median APR on loans with prepayment penalty higher than loans without penalty (7% vs. 6.5%).
- ❑ 11% have balloon payment
 - 15% blacks, 5% whites

Quick Highlights: payday loans

- 3.4% of LMI HH used payday loan in last year.
- Why? 60% to pay for everyday expenses, 11% to pay down credit card or bank debt, 8% for transportation expenses.
- Why payday lender? Convenient hours/locations (24%), expected to be approved for loan (22%), needed a small amount to pay a bill (19%).
- Common risks associated with payday loans are to delay/rollover payment, which 40% did.
- On average, borrowers rolled over 4 times.
- 14% took a loan from one payday lender to pay back a loan to another payday lender.
- Payday borrowers have lower asset levels (especially homes) than non-borrowers

AFS Likely Complements Not Substitutes

Among those using other AFS/not using other AFS,
what % use payday?

AFS	What % of users use payday?	What % of non-users use payday?
Pawnshop*	16%	3%
Cash Advance*	14%	4%
RAL*	9%	3%
Rent-to-Own*	16%	4%
Cash out Pension*	12%	4%
Overdraft*	13%	2%

*Significant difference at 10% level after controlling for age, race, gender, and income

Credit Policy Implications?

- Savings cushions
 - Direct deposit programs
 - Automatic savings plans
 - Tax refund savings programs
- Short-term loan alternatives
 - Direct debit, longer-term, self-amortizing consumer loans provided by banks.
- Develop new “opt-out” regulations for model credit card or mortgage plans

Saving in the DAHFS

- Diversity in how regularly LMI HH's save
 - Frequency of contributing to financial savings:
 - At least every month – 32%
 - Once or twice – 11%
 - Never – 42%
 - Contributions last year to financial savings (among those w/+ contribution):
 - Mean = \$2628; Median = \$1000
- 74% saving to make purchase this year or next year

Assets in the DAHFS

- 90% of LMI HH's accumulate formal & informal, financial & physical assets
 - 75% have formal or informal financial asset
 - Savings accounts (48%)
 - Retirement savings (36%)
 - Life insurance (29%)
 - Money market funds/bonds/CDs (17%)
 - Cash/jewelry/gold/appliances/electronics (15%)
 - 73% own car
 - 45% own house
 - Median value of assets:
 - Excluding house & auto: \$2,500
 - Including house & auto: \$68,000

Reasons for Saving

- Precautionary/Buffer Stock reasons
 - To feel financially secure: 78%
 - Emergency/Medical costs: 70%
 - Lose job: 51%
- Future consumption
 - Special event (wedding, funeral, vacation): 53%
 - House or home improvements: 49%
 - Retirement: 48%
 - Furniture or HH appliance: 33%
- Investment
 - Education or training: 40%
 - Self-employment: 16%
- Debt: 47% save to make payments on existing debt
- Can we better frame the saving decision for LMI HH's?

Challenges to Saving: Low Income

- 71% find it very or somewhat difficult to live on current HH income
 - 24% have utility/phone shut off
 - 17% are food insufficient; 6% evicted
 - 18% see themselves in deep financial trouble
- For 29% of LMI HH's, monthly expenses exceed income during most of year
 - To make up difference:
 - 50% rely on family/friends
 - 23% spend assets; 13% borrow from bank/use credit card
 - 45% always able to cover expenses
- Should LMI HH's save? If so, which ones?
 - Lifecycle view: if current income is low relative to expected future income, HH's should not save

Challenges to Saving: Many Needs

- 86% find it hard to save because most of their money goes toward necessities
- 37% expect to face a big expense in next 5-10 years for which unable to save
- During year prior to interview:
 - 23% lose job
 - 27% face major illness or have major medical expense
- 28% have health condition inhibiting work
- 86% of those with a credit card owe money (40% of all LMI)

Challenges to Asset Accumulation

- Income is volatile—in year prior to survey:
 - 17% - income went down
 - 29% - income went up & down
 - → Lifecycle view: 46% should draw down their assets
- Debt-service burden (excluding house & auto)
 - Median debt outstanding = \$500
 - Mean debt outstanding = \$5,667
- Informal financial obligations
 - 45% save in order to help family/friend in need

Challenges to Saving & Asset Accumulation: Credit & Insurance Market Imperfections

- High cost of credit & insurance:
 - Reduces ability to use credit & insurance to smooth consumption
 - Higher debt-service burden crowds out current consumption & saving
 - Cannot pool risk to mitigate income volatility
- How can credit & insurance markets & government policy serve HH's that experience downward shocks to income?

Tax Refunds: Saving Opportunity?

- 15% state that they have employer withhold extra from paycheck to save
- 80% tax filers receive federal refund
 - Mean refund = \$1700
- 69% tax filers *want* to over-withhold income
 - Related to dynamic inconsistency & wanting to use withholding system as pre-commitment device against over-consumption (Barr & Dokko, 2007)
- With tax refund:
 - 24% spend all of refund
 - 76% save some or all of refund
 - 62% pay bills or debt (positive net saving)
 - 79% of those who spend all pay bills or debt

Tax Refunds: What Type of Opportunity?

- Only 27% of LMI HHs purchase durable goods.
 - Contrasts with middle & high income HH's (Souleles, 1999)
- Given self-control problems related to dynamic inconsistency:
 - Illiquid saving enables pre-commitment
 - Pre-commitment finances future consumption
- Given that 76% of LMI tax filers save some or part of refund:
 - Marketing & framing during tax season
 - Simplify fee structure & minimum balance requirement
 - Opt-out savings products for LMI tax-filers

Tax Policy Implications

- Tax filing may be an important opportunity for savings (see Barr, Rhine, Duflo, Tufano, etc.)
 - Short-term savings more likely than long-term
 - Paying down debt as form of savings, together with preference for lump sum, suggests tax over-withholding as precommitment device (Barr & Dokko 2007).
 - Split refunds can be used for savings policy
- Tax preparation & RALs consume non-trivial portion of refund, so optimal income redistribution policy would suggest
 - Reduce tax complexity (see McCubbin & Holtzblatt)
 - Alter unbanked status (see Barr, Banking the Poor)
 - IRS direct deposit into “opt out” bank accounts for unbanked
- Inclusive national savings policy

Financial Services Policy

- Encourage low-cost, electronically-based bank accounts with a new tax credit
 - Pay for performance, fixed cost per account
 - Administered by IRS & FMS using adjustments to quarterly withholding payments
 - Can include incentive for matched savings plans provided by financial institutions, funded by Treasury
 - Can include option of self-amortizing, 6 month credit product with direct debit after seasoning period
 - No overdraft, no check-writing, no chexsystem screen
- IRS should deposit tax refund to default, privately offered bank accounts for the unbanked
- States should use EBT to move beneficiaries into banking system

Conclusion

- The Financial Services Mismatch
 - The financial services system is not designed to serve low- and moderate-income households.
- The Costs of Financial Exclusion
 - Inefficient for national economy
 - Costly for low-income households
 - Promotes dis-saving
- The Need for Inclusive Financial Policy
 - Low-cost banking & payment systems reforms
 - Inclusive national savings policy

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□ For further information

- see <http://www-personal.umich.edu/~msbarr/> and click on "Detroit Area Study"