INSUFFICIENT FUNDS: SAVINGS, ASSETS, CREDIT
AND BANKING AMONG LOW INCOME HOUSEHOLDS

Segment #3: How Individuals Engage with Formal and Informal Financial Institutions, Jane Dokko

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How Individuals Engage with Formal and Informal Financial Institutions

MS. DOKKO: Good morning. I just wanted to thank Becky for inviting me. And I just need to state the usual disclaimer, that I’m only speaking for myself and not the Federal Reserve Board or the Federal Reserve System. So today I’m going to be speaking about what Michael Barr and I learned from fielding a large scale survey about the financial services behavior of low and moderate income households.

And so, as Ron mentioned, Michael Barr has taken a position in the Obama Administration and was unable to be here, and so I touched base with him last week about what aspects of his chapter he wanted me to highlight, and he sent me a four word email, and those words were, thanks, permeability, formal, and informal.

And so I’m going to just try to - I mean I guess I’m done, right, so I can stop. So I’m just going to try to channel -

MS. BLANK: Say those four words again.

MS. DOKKO: Thanks, permeability, formal, and informal.

MS. BLANK: Okay.

MS. DOKKO: So I’m going to try to channel that inspiration for the project, and obviously I’m not speaking for
him or the institutions with which he is affiliated. So one of the many motivations Michael had for this project back in 2004, when he was raising the funds and when we were designing the survey was the “problem” that 25 percent of households in the bottom quintile of the income distribution do not have checking accounts.

And to economists, this presents somewhat of a puzzle, because, seemingly, households are choosing more expensive alternatives to bank accounts in order to make payments and convert their income to cash.

Things raises a lot of questions about the financial products offered by banks versus those in the alternative financial services sector or the AFS sector, such as check cashers, money transmitters, liquor stores providing bill payment services and money orders, pay day lenders, and many more fringe banking providers.

And so what Michael and I did was, we designed a survey which we call the Detroit Area Household Financial Services Study, and we fielded this with the help of a survey research center at the University of Michigan. We interviewed over 1,000 randomly selected low income households living in the Detroit metropolitan area in 2005. And low income households in Detroit are largely African American, headed by a single female, and a third have less than a high school education.
The median household income is $20,000, and a little under half were employed at the time of the survey interview. And in this sample, one-third do not have a bank account or are unbanked.

Unlike New York or Las Angeles, Detroit has a small low income immigrant population, so you have to be a little more careful when you’re generalizing to other low income communities, and as Becky mentioned, there’s another chapter in the book that discusses some issues that immigrants – some unique issues that immigrants face.

And so here’s a very short list of what we found. Consistent with work that Peter has done, it seems that having a bank account is not a fixed state for low income households, and so I think this is what he meant by permeability.

Among the unbank, 70 percent have previously had a bank account, and among the bank, 12 percent have had a bank close an account because of bounced checks, maintaining too low of a balance, or fraud. Eleven percent of the banked have closed a previously held account because the fees were too high to justify their need for a bank account. And so we interpret these results as suggesting that maintaining a bank account can be challenging for low income households.

Part of the reason seems to be the fee structure. Forty-five percent of the unbanked would consider opening an
account if the fees were lower or if the fees were less confusing. But other factors are at play, including the convenience of banks and bank products and the reported economic activity among households.

Unbanked households are much less economically active than banked households. They are less likely to be employed at the time of the survey interview, they have lower household income, and as a result in the survey, we estimate that their annual outlays on financial services, so this is both transactional financial services and short term credit, are much lower than for banked households.

On a final note, incomes are volatile for some households and material hardships are common. And 23 percent of households experienced a job loss during the year prior to the survey interview. And so it’s hard to identify whether it’s the structure of bank accounts or household economic circumstances or some combination of both that makes it difficult for low income households to maintain a bank account. But regardless of the actual reason, it’s just hard to do.

So the second point is that many low income households use alternative financial services, including households with bank accounts. So, for example, 21 percent of households use a check casher to cash checks, 33 percent use a grocery or liquor store to cash checks, 68 percent use money orders, 28 percent
took out a refund anticipation loan, and 11 percent have taken a pawn shop loan.

These figures are higher among the unbanked, but not by a whole ton or not by a lot. And we found this to be interesting and a little bit surprising. So this is one of the survey findings that, you know, we think is new to sort of the literature.

And so although using alternative financial services is prevalent on the extensive margin, when we estimate use along the intensive margin and combine this information with the fees that low income households pay for financial services, median household annual outlays are around $180 or about one percent of income. And about half this amount is spent on services obtained in the alternative financial services sector. And so whether $180 is high or low, it sort of depends. I mean is one percent of income high or low for a low income household, you know, that's a value judgment that one has to make.

The counter factual that I like to think about is, you know, what middle and upper income households pay for transactional financial services through their checking account, and often times that number is zero. And so, you know, relative to that number, $180 is quite a bit of money.

This being Washington, I think there are at least three different ways to spin the numbers that I just gave you.
And the first is the usual consumer advocacy position. And the story here is the following; relatively speaking, the mainstream financial services sector is not meeting the needs of low income households, including those with bank accounts, in terms of the products offered, the fees charged, the level of convenience, and so forth. And a direct implication of this view is that public policy needs to address the incentives and mainstream banks and encourage them to provide the financial services that most low income households need. An alternative way to spend these numbers, and this is just the flip side of the consumer advocacy position, is to say that the much hated alternative financial services or fringe sector is doing something right. They design products that for, whatever reason, low income households find attractive enough to use in spite of their allegedly exploited fees.

Products offered in the AFS sector are relative attractive, especially in non-monetary terms, to low income households. Often times fees are expressed in dollar terms which are easier to understand than APR’s or percentages. The hours of operation are convenient, their locations are easier to access, and AFS providers may fill an unmet need for financial services among low income households.

If this is the case, then policies like usury ceilings which effectively ban AFS products or providers reduce the
choice set for low income households, and this makes them at least weekly worse off.

Both of these stories I told suggests that public policy needs to expand the range of financial services available to low income households in terms of increasing the types of products available and reducing their costs. But there’s a third view that you can take, and this recognizes that the research and behavior economics suggests that restricting choice can make households better off. In the behavioral economic paradigm, households have self-control problems, they procrastinate, they incur high fees because psychological forces dominate monetary incentives.

And under this view, restricting choice reduces the temptation of pay day loans or of over drafting on a bank account because of over consumption. And so in this paradigm, less choice can, but not always, make households better off.

The behavioral economics view suggests that public policy needs to restrict the choices available to households perhaps through stiffer regulation or mandating better default financial services for all households, not just low income households.

So the evidence in the Detroit area household financial services study is incredibly mixed about, you know, what the right way is to spin these numbers. On the one hand,
households seem to want better financial products from the mainstream sector. We fielded a conjoint study, which is a marketing technique, in order to estimate a hypothetical take-up rate for a payment card. And we found that 60 percent of households say they would use a well designed payment card with low fees and federal protection against losses. And that’s quite a high number, and that suggests that there is some kind of unmet demand. But then, on the other hand, households report they value services obtained in the alternative financial services sector. The words “convenient” and “easy to use” are often words used to describe AFS products.

And now if I had a third hand, I would say that taking options away could potentially leave households better off. Twenty percent of households over drafted on their bank accounts. Nearly 30 percent take out refund anticipation loans. And we can’t really comment on whether this borrowing represents a self-control problem, but to the extent that it does, taking away these options may make lower income households better off.

On sort of a final note, I want to just say that in our data, the extent of borrowing from either mainstream or alternative sources does not appear to be excessive or for the purposes of financing excessive consumption for a couple of different reasons.
First, many low income borrowers report that they took out a loan to pay bills and/or debt, and they may have had to do so because of some kind of excessive consumption, but at least they don’t think that this was the case. And second, low income households in Detroit are often too poor to qualify for pay day loans and generally have difficulty obtaining any type of credit. And so there are a ton of other results from the Detroit Area Household Financial Services Study that I’m just not going to have time to highlight. And so this is a really great reason to read Michael’s chapter in Insufficient Funds.

And also, I think that there’s a lot we don’t know about the financial services behavior of low income households. And, obviously, Michael and I were unable to ask everything we wanted to in the survey. And so there’s a lot of opportunity for research, and in particular, experimental research to extend what we know about the savings and borrowing decisions of low income households. So on that note, I’m just going to end, and thank you.