California Legislature,
Select Committee on California-Mexico Bi-National Affairs

Special Session on

"Transnational Financial Services: UCLA NAID Center Research Results"

Sacramento, California
March 21, 2008

Reforming Financial Services for the Under-banked: Moving from a High-Cost/Cash-Based Limited Services Model to Low-Cost/Electronic Payments Multi-Service Empowerment

Expert Testimony by:

Dr. Raúl Hinojosa-Ojeda
Executive Director
North American Integration and Development Center
César E. Chávez Department of Chicana and Chicano Studies
UCLA

An important source of inequality in the United States today is the huge divide that exists between the "banked" and the "un-banked and under-banked" members of society. The latter are trapped in a vicious cycle of cash-only transactions in low income communities, dependence on abusive and very high priced services, unable to build credit and payment histories, locked out of personal financial advancement, resulting in general under-investment and impoverishment of their already low income communities.

This vicious cycle, however, could be reformed and reversed into a virtuous cycle of dramatic economic empowerment with widespread benefits throughout society. For too long, policy makers have ignored this huge source of inequality in the nation, which with a solid strategy of reform, could actually produce a huge economic development boom for poor working families, their communities and the future of the overall economy.

In the state of California alone, it is estimated that low income families pay nearly $6 billion a year in fees to check cashers, payday lenders and remittance agents for financial transaction. These costs could be dramatically reduced and the quality of products and services dramatically increased if the industry adopted new technologies and business practices which would significantly empower poor working people as well as all California business and communities.

Current Vicious Cycle:

Poor working families are significantly more likely to be unbanked or under-banked, are thus forced to operate in a cash economy with extreme limitations to financial services, and thus must pay extravagantly more for all their financial transactions. We have created a financial system where "it is expensive to be poor", particularly for any basic transaction like check cashing, payment of bills (including government fees and services), buying products and services (like autos, insurance, travel and telecommunications), and the sending money to relative abroad or within the US. Millions of low-income families are paying the highest prices for all types of basic transactions, representing a disproportionately larger part of their incomes, which is multiple times what wealthier families pay. Operating in cash makes working families much more vulnerable to crime and abuse, the cost of which also burden the larger community. Perhaps most damaging to these families, local communities and businesses and governments in the state, is that billions of dollars in purchases and transactions go unrecorded and are thus not able to be used by families to build credit histories and ability to pay profiles, thus further limiting their access to asset building financial services.

- Un-banked and Under-banked populations are very large, and are highly concentrated in low-income communities.
    - The un-banked represent 12 million households or 13.3% of the U.S. population[i]
    - The un-banked comprise more than 13% of the 105 million households in the U.S[ii]
    - Under-banked households total 40 million[iii]
    - Over 50% of Latino households are unbanked
    - In highly concentrated Latino and working poor communities such as Santa Ana California, the unbanked rate goes up to 90%

- The traditional banking and financial services industries have long ignored and "redlined" these communities, arguing that providing services is not profitable enough, thus abandoning this market to technologically backward and high cost intermediaries.

- Poor people pay a significantly higher proportion of their incomes for financial services than do wealthier people. The Un/Under-Banked now pay the highest cost for all types of financial transactions and services, primarily via cash–based transactions, which rely on using higher cost antiquated technologies through decentralized agent networks.
    - Remittances, Check Cashing, Payday lending, Pawn shops, higher cost prepaid mobile telephony, higher commission cashed based travel agencies

- The cash-based transactions industry has achieved a dominate foothold on financial service access in most low income communities, controlling and "crowding out" the introduction of other alternative technologies and banking services. Because of their location-based control of access to financial services for cash dependent populations, the industry is rife with abusive and predatory pricing and lending practices.

- Dependency on the cash-based financial industry does not support the building of data histories of payments and credit, crucial for moving up the ladder of financial access to savings and loans for lower cost consumption, better autos, housing and small businesses.

- The cash-based financial industry also does a very poor job in tracking potential criminal and illicit financial flows and transactions.

- Dependency on the cash-based financial industry results in repressed economic development in communities through lower rates of personal disposable income, personal consumption, savings, insurance and mortgages, further depressing investments in businesses, housing and job creation, thus resulting in lower government revenues and public investments.

A New Virtuous Cycle is Possible Now:

- The good news is that the last decade has seen significant technological advancement, which has helped launch the "electronic payments revolution" allowing the under- and un-banked to posses debit card/accounts that can also be controlled via mobile phones, without ever having to open a traditional bank account. The massive proliferation of mobile phones among the under and un-banked, as well as access to ubiquitous low-cost ATM and POS devices, call center and internet purchases, can now "level the playing filed" for transactions between millions of newly empowered customers, businesses and governments.

- <u>For the typical un-banked consumer, moving from dependency on cash-only transactions and services to electronic based transactions is like receiving a wage increase of 10-20%, with savings on a wide range of transaction and opening a new horizon of financial services and wealth building avenues and tools!</u> Access to building data histories based on transactions and "ability to pay", available for new forms of credit ratings, opening up a wide range of financial services that increase rates for personal consumption, savings, insurance and mortgages.

- The potential proliferation of electronic payments mediums to the under banked links millions of new customers through unprecedented low cost mediums to the traditional financial industry who can now develop new products and services for lower income customers, traditionally developed only for the wealthy. Similarly, the electronic payments revolutions opens up the trillions of dollars at "base of the economic pyramid" to millions of other companies who also traditionally ignored the poor as customers due to previously prohibitive transaction costs, but now can reinvent and rescale products and services to this vast new market.

- The electronic payments revolution opens up "Branchless Banking" opportunities to millions of small business locations.

- Government transactions for both receiving transfers and making payments represent a huge opportunity for efficiency and growth in revenue collection, providing enhanced service and convenience to constituents, as well as protection and empowerment to the most needy and vulnerable members of the community.

- Providing access to financial services at the same lower cost that weather people pay, would represent dramatic improvement in their wages. The electronic payments revolution thus further enhances investments in businesses, housing and job creation, thus resulting in higher government reviews and public investments. It would also generate dramatic economic demand in exactly the most repressed economic zones, generating short and long-term multiplier effects that benefit the entire economy and society. Fighting poverty and unequal access is Win-Win.

An Agenda for Reform:

- The multi-billion dollar industry of high cost financial services is now hooked on high profits from doing business in cash, using backward technologies that keep consumers and local small business dependent on them. Due to their extremely high concentration and commanding control in poor communities, the industry will make the difference between either providing the gateway, or the roadblock, for a quick transition to new low cost technologies and ways of providing a much wider range of financial services.

- The industry must recognize that their business practices repress economic potential in communities they operate in and place excessive burdens on local taxpayers to deal with the consequences of a cash only industry.
    - Thus policymakers at the state and local levels should move to levy a "cash-only financial services surcharge fee" and/or a special "zoning assessment" on business that operate entirely on a "cash-only" basis and do not offer the option of electronic loading and transactions to their customers.
    - Fee and assessment income would dedicate to consumer and citizenship education

- The industry must be encouraged to innovate and replace these old fashioned methods. They are no longer needed and only make their high cost even more abusive of low-income working families. Indeed both customers and business can win through the profitable conversion to lower cost technologies alternatives, such as low-cost reloadable debit card accounts, ATM and POS devices, mobile-to-mobile payments and mobile banking, call center and internet customer support and purchases.
    - Businesses can gain partial waivers on fees and assessments to the extent that they implement electronic payments options for their customers. Full waivers can be granted when more than half the value of financial services are sold electronically

- Governments at the local, state and federal level should also embark upon fully embracing electronic payments methods for all the delivering of benefits and transfers, as well as the facilitation of the collection of all types of fees and payments. Government issued ID cards should include the capacity to conduct all these government related transactions, easily linked to a person's electronic payments accounts.

- Given the huge revenue fees ($7 Billion) and high rates of profit (30+%), a California minimal surcharge of 10%, with exemptions for innovative business, could generate over $200 million dollars in funds to California. The reinvestment of these funds into immigrant integration agenda, including naturalization campaign, Citizenship and English classes, financial literacy and consumer education – can fuel the generation of a powerful cycle of empowerment and prosperity for all Californians..

The Raw Truth about Unequal Access to Financial Services

Like the health care crisis in this country, severely unequal access to financial services is a huge problem hidden in plain sight. Recent studies estimate that there are 28 million unbanked people in the U.S. and another 45 million underserved who lack adequate access to credit and other financial services.[iv] The Federal Reserve has estimated that up to 10 percent of American families are unbanked.[v] Moreover, disproportionate shares of minorities are un-banked – studies have shown that 46 percent of African Americans and 34 percent of Hispanic Americans do not have an account at a federally-insured financial institution.[vi]

It used to be that we were concerned about the practice of "redlining" by financial institutions – drawing a red line around a neighborhood, often low and moderate-income minority neighborhoods, and denying access to credit. The issue now, however, no longer appears to be access to credit, but rather the cost and terms of credit. These same neighborhoods have now become targets for high cost financial services providers such as check cashers, payday lenders, wire transmitters, and subprime mortgage lenders. These companies used to be relatively small and unsophisticated, but today they have grown to be large, highly sophisticated and highly aggressive marketers of high cost financial services and products to these neighborhoods. They have come to dominate the financial services markets in these neighborhoods.

One indication of this development is in the most recent Home Mortgage Disclosure Act (HMDA) data released by the Federal Financial Institutions Financial Examination Council (FFIEC). A 2006 Federal Reserve study relying on HMDA data from 2005 found that 55 percent of blacks and 46 percent of Hispanics received so-called high cost mortgages, defined as mortgages with interest rates that exceeded the Treasury rate by 3 percentage points.[vii] This compared to only 17 percent for non-Hispanic whites. The study indicated that borrower related factors accounted for only one-fifth of this disparity.

Another indication is in a Brookings Institution study published last year that compared the prices paid by lower income families in urban neighborhoods for fifteen types of consumer goods, including eight financial services such as home and car loans, check cashing, payday loans, and remittance services.[viii] The study found that lower income families in these neighborhoods pay higher prices for all fifteen goods, including the eight financial services, than higher income families in suburban neighborhoods. There is an urgent need for greater competition in these markets, particularly from insured financial institutions – banks, thrifts, and credit unions – that may be able to offer borrowers a wider range of lower cost banking products. This would be of great benefit to borrowers, and offers significant potential market opportunities for the financial institutions.

The Case of Los Angeles

Like many such areas, the City of Los Angeles has challenges in terms of access to low cost financial products and services, particularly in lower income neighborhoods. Los Angeles County is reportedly among the highest ranking in the nation in terms of percentage of un-banked residents.

The Brookings study mentioned earlier examined Los Angeles and found that high priced check cashers and alternative loan providers are very densely concentrated in its poor neighborhoods, far more so than in other areas of the city.[ix] The study found that a significant share of low income residents in Los Angeles utilize high-priced refund anticipation loans and are more likely than other households to get high-priced mortgages. The study also reported that the ratio of high cost financial service providers to residents in Los Angeles's low income neighborhoods was about one to 6,000 compared to about one to 156,000 in high income neighborhoods.

Industry Revenues and Profits in California

California is a “golden zone” for high cost, cash based financial businesses. Recent estimates put the total of fee collected by check cashers, payday lenders and remittance senders as high as $5-7 billion, with average industry rates of profits at 30%. This includes remittance income of $1.5 billion, over $1 billion just from Latino immigrants.

Check cashers and payday lenders crowd the streets of lower-income neighborhoods seeking to lure consumers through their doors with charming customer service while they dramatically overcharge them. In California communities like West Oakland or Pacoima or National City, banks are scarce and fairly-priced alternatives are few for the residents. Instead there are financial price-gougers:

• Check cashers that charge two percent or more to cash payroll checks that could be deposited for free into a mainstream checking or savings account.

• Payday lenders that charge 500 plus annual percent rate (APR) when an expensive credit card charges interest of 20 percent annually or less.

A California Reinvestment Coalition study of check cashers and payday lenders in five California counties reveals the growing inequities between these two economies and the role that mainstream bank financing of price gougers has played in their growth as shown by public financial reports and other data. The study's core findings are:

• Financial institutions have removed their bank branches from most lower-income communities while they profit from financing high-priced and highly profitable check cashers and payday lenders in these same neighborhoods.

• The lack of retail competition from bank branches in these communities has created this lucrative opportunity for price-gouging check cashers and payday lenders.

This loss of opportunity in lower-income neighborhoods is reflected in individual financial hardships at the local level. An average user of check cashers and payday lenders spends one thousand additional dollars ($1,000) annually more than the cost of mainstream products. But, when the picture broadens to the state level, it exhibits immense and devastating economic disadvantages for the daily lives of lower income Californians:

• An estimated 5.2 million[x] Californians use check cashers and are charged at least a two percent fee to cash their checks. Using the California average income of $47,493, this costs Californians $4.9 billion ($4,900,744,729) annually.[xi]

• An estimated 1.5 million California households use a payday lender[xii] 11 times annually for a $300[xiii] advance[xiv] at a $45 fee ($15 per $100) each time at a cost of $757 million ($757,291,590) annually.[xv]

This means that at least $5.7 billion comes out of lower-income Californians' pockets annually just due to the high charges of check cashers and payday lenders. This $5.7 billion does not even include probable further loss of funds due to high charges from refund tax loans, rent-to-own stores, subprime mortgage lenders, pawnbrokers, and others. These billions go to unscrupulous finance companies and are lost to families who are struggling on limited budgets.

In addition, remittance agents for money transfer organizations, MTOs, generate large amounts of revenue from fees allocated with sending remittances. A large number of remittance agent's customers are immigrants who have no alternative means to safely send remittances to their family members and friends in their home countries. As a result they are at their mercy of these agents who charge high fees to generate hefty profits. They charge an average fee of 8.02% to send a remittance from the U.S. to Latin America.[xvi]

An analysis of California reveals that $45billion was sent from the United States to Latin America in 2006[xvii] with an estimated global total of $75 billion.[xviii] Annual fees from Latin American remittance agents accumulated in 2006 was $3.6 billion for the U.S. and approximately $1 billion for California.

Table 1.1: Remittances sent from the U.S. to Latin America in 2006

Location	Remittance Amt. (mil)	#Transactions (mil)*	Fee Income 8.02% (mil)	Avg. Fee Income	Global Fee Income (mil)
USA	$45,000	150	$3,609	$24.06	$4,616
CA	$13,191	44	$1,057.9	$24.04	$1787.04

*Average remittance: 2004 $240, 2006 $300

References

1.) California Reinvestment Coalition. "The Financial Divide: An Uneven Playing Field: Bank Financing of Check Cashers and Payday Lenders in California Communities." March 2005. http://www.calreinvest.org/system/assets/17.pdf

2.) Financial Service Centers of America, Inc. "Check Cashers are Good Bank Customers." http://www.fisca.org/FiSCA%20Check%20Cashers%20Broch.pdf

-Check Cashers process 180 million checks annually with revenues of $60 billion and generate $1.5 billion in fee revenues. (pg.1)

-Roughly 80%-90% of these checks are payroll checks with an average size of between $500 and $600. (pg. 8)

-The check cashing business is estimated to continue growing at a rate of approximately 11% per year. (pg.8)

-Although figures by state and store vary, on average a bank can expect a typical check cashing location to generate in excess of $21,000 a month in direct service charges and interest income. (pg.2)

-Not uncommon for banks who make a business of supporting check cashers such as Corus Bank to report fee revenue of over $200,000 a month. (pg. 2)

-Professional check cashers derive 10-12% of their revenue from money transfer activities. (pg.6)

-Check cashers account for roughly 10% of U.S. money transfers worth about $4 billion. (pg.8)

-Money transmission business is estimated to continue to grow at a rate of approximately 15% per year. (pg.8)

3.) California Reinvestment Coalition. "The Financial Divide: An Uneven Playing Field: Bank Financing of Check Cashers and Payday Lenders in California Communities." March 2005. http://www.calreinvest.org/system/assets/17.pdf

- An estimated 5.2 million Californians1 use check cashers and are charged at least a two percent fee to cash their checks. Using the California average income of $47,493, this

costs Californians $4.9 billion ($4,900,744,729) annually.

- An estimated 1.5 million2 California households use a payday lender 11 times annually3 for a $3004 advance at a $45 fee ($15 per $100) each time at a cost of $757 million

($757,291,590) annually.

-The three Check Cashing Giants are: Dollar Financial Group (operates as Money Mart in CA), Advance America (operates as Advance America Cash Advance Centers in CA), and ACE Check Cashing (operates as Ace America's Cash Express in CA). (pg. 4)

-Dollar Financial Group Revenue for 2004: $246.4 million

-Advance America Revenue for 2004: $489.5 million

-ACE Check Cashing Revenue for 2004: $253 million

-Dollar Financial Group reports that its profit margin per store is 32.3% (pg.1)

-**California has 6,446 locations licensed by the state to do check cashing or payday lending.** One-half of these licenses are liquor stores, groceries, and convenience stores for whom this is a secondary business. (pg. 4-5)

-Remaining 3,106 are retail consumer outlets whose primary business is predatory finance. (pg. 4-5)

***U.S. check cashing revenue is more than $60 billion annually** (pg.5)

***U.S. PayDay lending is $40 billion annually** (pg. 5)

4.) Tony Pugh. "Rivals for Payday Lenders: Banks, credit Unions Aim for A piece of Check-Cashing Market." December 12, 2007. http://www.sacbee.com/103/story/554905.html

-Dynamic growth of the alternative finance industry has provided the dire need among many Americans for convenient small-dollar loans and immediate check cashing without bank delays.

-About $10 billion in fees are collected each year on these services from some 47million households, or roughly 81 million people-said H. Leon Majors III, the President of ESP Payments Research Group.

http://www.consumerfed.org/pdfs/CFA_2006_Check_Cashing_Study111506.pdf

Endnotes

[i]Teller Vision; "Business for 'Unbanked' are Booming." Sep2005 Issue 1337, p4-4, 1/3p. http://search.ebscohost.com/login.aspx?direct=true&db=buh&AN=17906696&site=bsi-live

[ii] Punch, Linda; "Beckoning the Unbanked." Credit Card Management; Oct2004, Vol. 17 Issue 7, p28-34, 5p. http://search.ebscohost.com/login.aspx?direct=true&db=buh&AN=14606048&site=bsi-live

[iii] Tescher, Jennifer. "Problems and Promise in Prepaid Debit." American Banker; 4/27/2007, Vol. 172 Issue 81, p11-11, 3/5p, http://search.ebscohost.com/login.aspx?direct=true&db=buh&AN=24886346&site=bsi-live

[iv] "Private-Label Card Program From GE Offers 'Road to Credit' To Tap Greater Portion of Market," citing statistics from Bearing Point, *The Wall Street Journal*, July 7, 2006.

[v] The Board of Governors of the Federal Reserve System, in its *Survey of Consumer Finances*, has reported that from 9 to 13 percent of U.S. households lack transaction accounts. See Federal Reserve Bulletins dated January 1997, January 2000, January 2001, and January 2004

[vi] Sherrie L. W. Rhine, "A Closer Look at the Unbanked," May 22, 2006, and Sherrie L. Rhine and William H. Greene, "The Determinants of Being Unbanked for U.S. Immigrants," *Journal of Consumer Affairs*, summer 2006, Vol. 40 Issue 1, p. 21-40; and Sherrie L.W. Rhine, Katy Jacob, Yazmin Osaki, and Jennifer Tescher, "Cardholder Use of General Spending Prepaid Cards: A Closer Look at the Market," January 2007.

[vii] Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "Higher-Priced Home Lending and the 2005 HMDA data," *Federal Reserve Bulletin*, September 2006.

[viii]"From Poverty, Opportunity, Putting the Market to Work for Lower Income Families," The Brookings Institution Metropolitan Policy Program, 2006.

[ix] "From Poverty, Opportunity, Putting the Market to Work for Lower Income Families," The Brookings Institution Metropolitan Policy Program, 2006; http://www.brook.edu/metro/pubs/20060718_LosAngeles.pdf.

[x] Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives, September 2002, on Electronic Transfers states that twenty-eight percent of all U.S. adults are unbanked. So, it is estimated that 5,159,439 Californians are unbanked.

[xi] California Reinvestment Coalition. "The Financial Divide: An Uneven Playing Field: Bank Financing of Check Cashers and Payday Lenders in California Communities." March 2005. http://www.calreinvest.org/system/assets/17.pdf

[xii] "As many as 14 million of the 105 million U.S. households used payday lenders in 2003, according to analyst Dennis Telzrow of Stephens Inc., a Little Rock, Arkansas–based investment bank." "Preying on the Poor" by Edward Robinson, Bloomberg Magazine, January 2005. This is 13.3 percent of U.S. households. Applied to California, it is 1,529,882 households.

[xiii] California Financial Code Section 23035 limits the face value of the check to $300.

[xiv] "California: Stop legal loan sharks" Editorial, Los Angeles Times, p.B10, May 14, 2001.

[xv] California Reinvestment Coalition. "The Financial Divide: An Uneven Playing Field: Bank Financing of Check Cashers and Payday Lenders in California Communities." March 2005. http://www.calreinvest.org/system/assets/17.pdf

[xvi] Manuel Orozco. "Changes in the Atmosphere? Increase of Remittances, Price Decline and New Challenges." Inter-American Dialogue Research Series. June 2005/2004. http://www.microfinancegateway.org/files/21604_changes_markets.pdf

[xvii] Inter-American Development Bank Multi Lateral Investment Fund. "Sending Money Home-Leveraging the Development Impact of Remittances." 2006. http://www.iadb.org/news/docs/remittances_EN.pdf

[xviii] Inter-American Development Bank Multi Lateral Investment Fund. "Sending Money Home-Leveraging the Development Impact of Remittances." 2004.