The consumer financial-services system – the large industry that consists of (1) mainstream banks, (2) alternative financial institutions (AFIs) such as check cashers, payday lenders, and pawnshops, and (3) informal practices such as structured saving and lending groups – is broken.¹

The number of Americans who either opt out of or are denied access to mainstream banks and financial products is significant and rising. The FDIC’s 2013 “National Survey of Unbanked and Underbanked Households” found that about 8% of Americans are unbanked and 20% are underbanked.² Even more striking: 20% of African American households and almost 18% of Latino households are unbanked. The percentage of Americans with checking accounts (i.e., the gateway to the mainstream financial-services system and a pillar of upward economic mobility) fell during the last recession from 92% in 2009 to 88% in 2013.³ Meanwhile, according to industry studies, check cashing activity jumped from $45 billion in 1990 to $58 billion in 2010, while the payday lending industry grew rapidly between 2001 and 2012, rising from $10 billion in borrowed capital to nearly $30 billion.⁴

It is well known that payday lenders and check cashers charge relatively high prices for some of the same services traditionally offered by mainstream banks. This begs the question: why are so many people leaving banks (or choosing not to utilize them) and going to places such as pawn shops and payday lenders for financial services?

SUMMARY

- Chronic financial insecurity is growing among the middle-class. A recent study conducted by the Center for Financial Services Innovation found that 57% of Americans are struggling financially, and are increasingly turning away from mainstream banks and toward check cashers, payday lenders, and pawn shops to serve their financial needs. Research by the FDIC has found that about 8% of Americans are “unbanked” and 20% are “underbanked.”

- Altering this status quo, however, requires reframing the policy challenge away from the current “banked-versus-unbanked” dichotomy. The fundamental problem is not that people are unbanked but that too many people lack high-quality, safe, affordable financial services and the resources to obtain middle-class stability.

- This brief points out ways in which alternative and informal financial-services providers, such as check-cashing agencies, excel in providing consumers with the things they need—namely, access to immediate capital when money is tight, greater transparency with fees, and superior customer service. It also suggests ways to help the mainstream banking system operate better along these metrics, and thus make it more tenable for the millions of Americans who have come to operate outside it.
instead using alternative financial-services providers when policymakers and consumer advocates are convinced that this is a poor decision? Answering this question requires taking a fresh look at the problem.

REFRAMING THE PROBLEM

Before the construction of any public policy initiative aimed at altering this status quo can begin in earnest, two critical contextual elements must be addressed. The first is, simply, that policymakers and consumer advocates often adopt a one-sided view of banking that reflects unstated value judgments. Labeling people as un- or under- implies that they (and not the system) are somehow deficient, that they have made poor choices. In reality, mainstream banks are doing very little for people who are not already financially stable. AFIs and informal practices often do a better job of meeting people where they are, particularly those who have no savings and/or unpredictable streams of income.

Policymakers understandably tend to zero in on the apparently high costs and the occasionally predatory practices associated with AFIs, and these are serious considerations that warrant investigation. (For example, the Consumer Financial Protection Bureau, or CFPB, developed proposed rules for payday lending in 2016 that, if implemented in the future, likely would protect many consumers from the more unscrupulous practices of some payday lenders.) But when millions of people consistently choose not (or are unable) to maintain a checking account or to qualify for traditional forms of credit, it is evident that an insufficient understanding of the problem hampers the policy conversation surrounding “financial inclusion”. What practical use is the word “alternative” if AFIs are the only institutions providing certain market-demanded services, like instant check clearing or small-dollar loans?

The second crucial element for understanding the prevalence of unbanking in the U.S. is an accurate picture of who exactly utilizes AFIs and informal financial arrangements. Many, without question, are the poorest Americans, those who are the most economically insecure. Some are millennials new to the labor force. But many others have the traditional markers of upward mobility. According to one subprime credit bureau that monitors people who request payday loans, 43% have college degrees, over 33% own their homes, and 20% have annual net incomes over $50,000.

Also, more than 70% of those in the data set had prime credit (650 or higher) at some point. The full picture, therefore, is complex, diverse, and largely immune to one-size-fits-all policy solutions. To truly appreciate the scope of AFI customers, consider that chronic financial insecurity is growing among the middle-class. A recent study conducted by the Center for Financial Services Innovation found that 57% of Americans – 138 million people – are struggling financially, unable to consistently meet their basic needs.

Prejudgments about non-mainstream financial products and services, and especially about the people who use them, often influence the policy proposals aimed at combatting economic immobility and insecurity, but these must be abandoned for productive discourse to occur. Reframing the policy challenge away from the current “banked-versus-unbanked” debate is the first step toward fostering greater economic mobility and security. The fundamental problem is not that people are unbanked but that too many people lack high-quality, safe, affordable financial services, and the resources to obtain middle-class stability. The policy challenge, then,

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1 The primary source for this Issue Brief is Lisa Servon, The Unbanking of America: How the New Middle Class Survives (New York: Houghton Mifflin Harcourt, 2017).
2 Susan Burhouse et al., “2013 National Survey of Unbanked and Underbanked Households,” FDIC, October 2014.
3 This decrease has not been entirely voluntary. Banks have closed the accounts of approximately 6% of Americans, without their consent, after receiving negative information from private-sector databases such as ChexSystems. For more, see Jessica Silver-Greenberg, “Over a Million Denied Bank Accounts for Past Errors,” New York Times, July 30, 2013.
5 One prominent player in the check cashing industry has suggested using the term “transactional” instead of “alternative” to more accurately describe that business. This is based on the common check cashing model in which more transactions (i.e., paying bills, selling money orders, and cashing checks) lead to bigger profits.

8 Erin El Issa, “2015 American Household Credit Card Debt
is one of providing these means, irrespective of institutions, in a way that promotes fair costs, transparency, and service.

INSTABILITY AND THE NEED FOR ALTERNATIVES

Nearly half of all Americans now live paycheck to paycheck and nearly half could not come up with $2,000 in the event of an emergency. Yet the average household carries $129,579 in debt—$15,335 of it on credit cards. Instability is the new normal for America’s 21st century middle-class. More than half of families with incomes between $30,000 and $75,000 report that they are falling behind, as their cost of living continues to increase faster than their income. Housing costs have grown by 10% since 2011 and childcare costs can often amount to more than the average cost of in-state college tuition at public, four-year institutions.

Medical expenses constitute a big part of the problem. Roughly half of all U.S. households carried medical debt averaging almost $1,700 on their credit cards. And nearly one in five consumers have medical debt that has gone to a collection agency for nonpayment. This medical debt makes up over half of overdue debt on credit reports. The average unpaid medical debt in collections is $579, which is problematic because almost half of all Americans struggle to pay off a $400 emergency medical expense.

In order to get by, more and more people rely on credit. Credit makes up about two-thirds of the resources most Americans have at their disposal for spending on immediate needs, but access to credit remains stratified. Over half of African American middle-class households have undergone the cancellation of a credit card, a lowering of credit limits, or a denial of application for credit since 2008. Only 66% report having a credit score over 620, compared with 85% of white middle-class households.

In general, it has become more expensive simply to live. Over the last four decades, inequality has risen, wages have declined, incomes have become more volatile, and workers have continued to receive fewer benefits. With 72% of respondents to a 2015 Pew Research Center study saying that government policies “have done little or nothing to help middle-class people” since the recession, there appears to be significant nonpartisan political support for developing policies that can ease the financial burdens of most Americans. There is no magic bullet and there is no getting around the fact that most people simply do not have enough money. But absent a historic, new economic boom, there is still much that can be done to mitigate current financial struggles.

In the remainder of this Issue Brief, we will address the three dominant benefits of alternative and informal financial-services providers—liquidity-focused cost structures, greater transparency, and superior personal service—and we will consider several policy recourses for extending these benefits to the whole of the U.S. financial-services system.

BENEFIT #1: COSTS INFORMED BY LIQUIDITY DEMANDS

Consider that about 20% of all employed workers today earn a minimum wage, and of those workers, 28% support children. Only 12% of minimum wage workers were teenagers in 2013, compared to 27% in 1979. Many of these workers still receive paper checks each week, so there is strong demand for check cashing services. Check cashers help people pay their bills, send money to loved ones, and gain access to their money immediately. The high, upfront 2.03% transaction fee for check

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clearing is expensive, but it quickly becomes less egregious when one considers that not everyone qualifies for a checking account, or can afford the monthly fees, or is able to absorb one or more overdraft penalties in a given week. For the millions of Americans accounting for every dollar and cent, the “smart” choice is not a practical one. A scarcity mindset, an intense focus on immediate survival when money is that tight, overtakes long-term financial planning every time.

When all resources and credit are gone, but an emergency or some basic need requires immediate capital, people often turn to payday lenders. Payday lenders make small, unsecured loans, generally amounting to less than $500. A typical fee is $15 for every $100 borrowed. There is little to no underwriting (i.e., universally accessible) and lenders have essentially no legal recourse for recovering their loans. If consumers default on payday loans, there is no effect on their credit scores, although some lenders do take advantage of the gap between the law and consumer awareness. And as for sheer convenience, there are more payday lending establishments in the U.S. than McDonald’s and Starbucks locations combined. These services are in high demand, and payday lenders have stepped in to meet the need.

Most banks have determined that the types of small-dollar interactions with lower-income consumers in which payday lenders engage are not worth the cost of providing these services, much less the reputational risk. Of course, banks do still widely offer a short-term loan, but it is more commonly referred to as an overdraft. If overdrafts had a repayment period of 7 days, the typical APR would be 5,000%.

It is important to understand the new nature of mainstream banking. Most modern large bank revenue is generated from fees and penalties (e.g., ATMs and overdrafts), not from interest. The biggest banks have also become more complex, relying less and less on borrowing and lending. The number of very small banks (<$100 million in assets), which largely took care of local customers, decreased by 85% between 1985 and 2013, while the number of very large banks (> $10 billion in assets) nearly tripled. The four largest banks hold about half of all U.S. bank assets ($6.8 trillion), while the remaining 6,395 banks hold the other half.

Banks have practiced “financial exclusion” for most of the nation’s history, and policy has supported them. This includes everything from “redlining” entire neighborhoods (i.e., red lines drawn around areas on a map, usually home to immigrants and people of color, denoting locations where banks would not lend) and denying women access to credit prior to corrective legislation in 1974. Moreover, some current standard practices are unfavorable to all bank customers. They deposit funds into customers’ accounts only five days a week, but withdraw funds seven days a week. They take several days to clear checks, and 44% of them engage in “debt resequencing” to maximize overdrafts. The liquidity needs of consumers are not valued in this regime.

As mainstream banking becomes ever more untenable for millions of Americans, people are choosing the only options accessible to them. But despite the convenience and willingness of AFIs to cater to small-dollar needs, alternative products are nevertheless open to abuse. Payday loans were designed to be short-term, intermittent loans, but in practice they are often used as high-cost lines of credit (see Figure 1). In fact, 85% of borrowers use these loans to pay for everyday expenses and small dollar emergencies that frequently arise in

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3. This is the current maximum fee allowed by the state of New York. Check cashers are regulated at the state level, and other states’ fees differ.
4. In many observed cases, consumers have left some credit available on their credit cards while they take out payday loans, effectively using the credit card as a safety net, despite its comparatively cheaper rates.
8. Regulation has favored banks for decades. The early-1980’s shift in state laws that allowed for bank branching and 1999’s Gramm-Leach-Bliley Act, which effectively nullified Glass-Steagall, are primary contributors to the recent explosion in big bank size and operations.
9. Debit resequencing is a practice that involves processing debits and credits to an account in such a way that causes account balances to fall faster, thereby boosting potential overdraft fees. For more, see Pew Charitable Trusts, “Checks and Balances, 2014 Update,” Pew, April 2014, p. 3.
10. These choices will continue to evolve. Even though AFIs have grown tremendously in recent years – as big banks
daily life. With APRs ranging from 300-600%, payday loans are undoubtedly expensive, but the question is whether expensive credit is better than no credit at all. The demand for these loans provides a fairly compelling answer.

**Recommendation:** The federal government could facilitate the extended reach of mission-oriented banks and credit unions, or it could go so far as to subsidize customers who are unprofitable. In other words, new policy can curb the exclusionary practices that established policy has reinforced for decades. The current mainstream regime is one where bank profits and efficiency are valued over public needs, and banks are no longer a basic service industry. It may seem counterintuitive to pay banks for what many argue they should be ethically bound to do, but there are precedents for this kind of policy. The Reagan administration’s Lifeline program is one example. Banks could be incentivized to offer free or subsidized savings and checking accounts. This is effectively a recommendation to “make banking boring again,” but the market clearly demands these products and services.

**Benefit #2: Greater Transparency**

There are many differences between mainstream banks and AFIs when it comes to transparency, but two examples succinctly illustrate the divide. First, checking account disclosure statements presented by banks have a median length of 44 pages, written in fine print and highly technical language, excluding addenda and supplementary material. In these pages, discerning customers can find information about opting into/out of overdraft protection, fees, penalties, and limits. Alternatively, payday loans require forms that are typically only

## Notes

- have devoted fewer and fewer resources to lower-income individuals – alternative businesses are not immune to broader forces. Direct deposit very well may challenge the viability of check cashers, and any significant federal regulations on payday lenders, like those proposed by the CFPB in 2016, would inevitably shrink that market.
- Payday loans are illegal in 14 states and the District of Columbia, but in these states, rates of personal bankruptcy are higher, as are incidences of bounced checks and FTC complaints about debt collectors (see Donald Morgan and Michael R. Strain, “Payday Holiday: How Households Fare After Payday Credit Bans”). To meet the demand in these states, online lenders have emerged. Their illegality is difficult to police and their anonymity and convenience are in high demand. Consumer advocates and some policymakers want rules that would require payday lenders to determine a borrower’s ability to repay before approving a loan. Other major proposed reforms include installment repayments, instead of the common practice of demanding full repayment after 7 or 14 days (i.e., “lump sum” loans), as well as limiting the number of loans a borrower can have at one time.
- During the deregulation period of the 1970s and 1980s, many states eviscerated their usury caps, and six states currently have none.
- Lifeline provides discounted landline and wireless telephone service to 13 million Americans. The program enjoys bipartisan support and is funded partly by contributions from telecommunications companies.
draft increased much faster than inflation, from $21.57 in 1998 to $31.26 in 2012. Similarly, average ATM fees more than doubled between 2001 and 2014. In 2014, Americans paid nearly $32 billion in overdraft fees, and $6 billion of it went to the three biggest banks (Chase, Bank of America, and Wells Fargo). All of this helps to explain some of the recent trends in unbanking.

**Recommendations:** Create simple and transparent ways to compare financial products and make decisions.

1. Financial information boxes – akin to the nutritional information required on all packaged food – could provide consumers with clear, standardized information about fees, penalties, interest rates, and other important considerations, enabling them to compare various products without combing through long documents written in fine print. These boxes may be more sophisticated than the large signs of a check cashier, but they represent a movement in that direction.

2. An easy-to-understand, official seal or symbol could identify financial institutions judged as offering safe and affordable financial products and services. Returning to the world of food, we already use consistent demarcations to determine the cleanliness of restaurants or the organic status of produce. Similar standards could be developed for high-quality, transparent bank accounts.

3. Even with perfect information, consumers still need well-developed skills and knowledge in order to make sound decisions, so investments in proven financial literacy interventions, such as one-on-one coaching, may be worth the cost.

**BENEFIT #3: SUPERIOR SERVICE**

Let’s revisit check cashers one more time. The customer-teller relationship at check cashers creates remarkable loyalty. Tellers often have the authority to use their discretion when a customer is having difficulty repaying a debt or affording a certain service or if they need help with navigating a financial issue. There is a direct benefit to check cashing business (i.e., fostering future transactions) from assisting in relatively small matters and offering pure advice, which at large banks do not factor into profit-centered metrics. If banks do not provide these services, as they once did, it is unclear why becoming banked would benefit people currently relying on providers like check cashers.

**Recommendations:** Improve the flexibility of consumers and the

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freedom of innovators, with the goal of creating a less sticky financial services system.

(1) Enhance consumers’ ability to move to/from financial institutions with ease by developing universal, portable financial identities for everyone. The CFPB could provide consumers with information about their use of financial services in a standard format. Consumers could then use this information to shop better deals and to switch accounts more easily than they can currently.

(2) Create a sandbox for innovators: a temporary relaxing of regulations meant to facilitate experimentation and increase access to investment funding. This could lead to the development of products better suited for people with little to no savings or volatile income streams. Currently, there are many new firms seeking to improve this large industry in myriad ways, from creating new types of loan products and relationship-based banking models to improving the speed at which money is transferred and the ways in which credit scores are calculated. Many of these firms are reviving the notion of banking as a service for consumers. Advances in technology, changes in consumer behavior, and the consequences of the current regulatory environment have created a unique moment for change. The consumer financial-services industry is ripe for innovation.

CONCLUSION

The policy recommendations in this Issue Brief are not cure-alls. People still need to earn more money. Rising inequality, declining wages, a threadbare social safety net, decreased worker benefits, and increased costs of living, especially health care-related costs, all contribute to the financial struggle of millions of Americans. When we discuss the statistics and problems of banking and saving in the United States in 2017, the policy challenge is emphatically not that people are merely unbanked or underbanked. The fundamental problem in the consumer financial-services industry is that people lack high-quality, safe, affordable financial services and the resources to obtain middle-class stability. By applying the benefits gleaned from alternative and informal financial practices, the entire system can adjust to meet the high demand needs of today’s citizens.
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Prior to her appointment as Professor of City and Regional Planning at PennDesign, Professor Servon was Professor of Management and Urban Policy at The New School, where she also served as Dean of the Milano School of International Affairs, Management, and Urban Policy. Professor Servon conducts research in the areas of urban poverty, community development, economic development, and issues of gender and race. Specific areas of expertise include economic insecurity, consumer financial services, and financial justice. She holds a BA in Political Science from Bryn Mawr College, an MA in History of Art from the University of Pennsylvania, and a PhD in Urban Planning from UC Berkeley. Her work has been funded by the Open Society Institute, the Aspen Institute, the Ford Foundation, the Annie May Foundation and others. Professor Servon spent 2015-2016 as a scholar at the Russell Sage Foundation, and 2004-2005 as Senior Research Fellow at the New America Foundation in Washington, DC. Professor Servon is the author or editor of numerous journal articles and five books: The Unbanking of America: How the New Middle Class Survives; Bridging the Digital Divide: Technology, Community, and Public Policy; Bootstrap Capital: Microenterprises and the American Poor; Gender and Planning; A Reader, and Otra Vida es Posible; Prácticas Económicas Alternativas Durante la Crisis.

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