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Protecting Lending Services for Unbanked, Low-Income Americans

By Carrie Sheffield, Senior Policy Analyst

HIGHLIGHT

Especially during record inflation, unbanked and underbanked populations in America are among the most vulnerable. Financial regulatory policies—however well-intentioned—should not erect backfiring barriers to financial products that fulfill pressing needs for these households. Families needing products like short-term installment lending and check protections are harmed by heavy handed regulatory interventions, including interest rate caps. Policymakers can pursue better approaches to give community banks and other financial institutions the ability to utilize technology and compete for unbanked consumers with larger banks that already have tech infrastructure.

INTRODUCTION

While the vast majority of Americans possess checking and savings accounts, use credit cards, and finance major purchases with loans, a surprisingly large share of Americans struggle with barriers to opening and maintaining financial accounts. This makes daily life more difficult in an increasingly cashless society—particularly during rising inflation. The lack of access to financial services doesn't mean they are not desired or needed, particularly by lower-income households. A variety of lending services fill in market gaps, including check protection services and installment loans. The public—and policymakers—should be aware of the vital role these services play. While it's tempting to criticize those specializing in serving this population, and to view the fees charged and practices employed as exploitative, these services fill a critical need and must take into account the short-term nature of the loans plus the higher risks and costs of providing these services. In fact, some of the most heavily-criticized financial services practices—so-called installment loans or "payday lending" and check protection services—enable vulnerable communities to participate more fully in today's tech-heavy economy. Without them, people are forced to turn to the black market and be even less likely to have access to banking and loan products. Policymakers should consider policy reforms to encourage continued innovation in the financial sector and recognize that consumers are best positioned to decide which services meet their needs at any given time, because—despite regulators' best intentions—interventions often restrict consumer choice, ultimately resulting in fewer options and higher costs.

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UNDERSTANDING UNBANKED AMERICANS

The **Federal Deposit Insurance Corporation Survey of Household Use of Banking and Financial Services reports** that 94.6 percent of U.S. households (approximately 124.2 million) were "banked" in 2019 (most recent FDIC data available), meaning that at least one member of the household had a checking or savings account.

Non-Asian minorities, low-income households, less-educated households, young households, and households with disabled members are more likely to be unbanked than others, according to the FDIC. An estimated 5.4 percent of U.S. households (approximately 7.1 million) were unbanked in 2019.

In 2011, the unbanked rate peaked at 8.2 percent, while in 2019, the unbanked rate fell by 2.8 percentage points, corresponding to an increase of approximately 3.7 million banked households, according to the FDIC. About two-thirds of the decline in the unbanked rate between 2011 and 2019 was associated with improvements in the socioeconomic circumstances of U.S. households over this period.

Unbanked households sometimes rely on alternative financial service providers such as short-term installment loans (sometimes pejoratively known as "payday loans" because they might fill a financial gap until an individual's next payday) and check-cashing stores for transactional services. These providers' fees for cashing a check is typically between 1 percent and 3 percent of the check's face value (though they can be larger), according to the "**Handbook of Behavioral Economics: Applications and Foundations**," whereas the holder of a traditional checking account can typically deposit a check without paying a fee.

Why do some households rely on alternative financial service providers instead of traditional financial institutions? According to the FDIC survey, "Don't have enough money to meet minimum balance requirements" was cited by 29.0 percent of unbanked households as the main reason for not having an account—the most cited main reason. "Don't trust banks" was cited by 16.1 percent of unbanked households as the main reason for not having an account—the second-most cited main reason.

Personal experiences with the banking sector seem to play a role, according to **Handbook of Behavioral Economics**, which reported that immigrants in the U.S. who lived through a systemic banking crisis in their native country are 11 percentage points less likely to have a checking account than immigrants from the same country who did not live through a banking crisis.

However well-intentioned, policymakers' plan to establish a national interest rate cap is counterproductive for people in need and could very well push them to underground financial products in an unregulated, shadow economy. The national interest rate cap plan would hurt low-income Americans'—especially racial minorities, immigrants and young people—ability to tap loans that pay for bills like water and electricity.

COMMON PRODUCTS USED BY UNBANKED HOUSEHOLDS

- **Check protection or check fraud protection programs.** These programs prevent check "bouncing." They often advance funds to a client within 72 hours, sometimes to a maximum of $25,000 for all checks, regardless of the number of checks.

- **Prepaid creditor debit cards.** These products enable consumers to load a card from a recognizable payment provider (Visa, Mastercard, or American Express) with cash at a point of purchase—which are widely available at convenience stores and gas stations. By using the card, consumers no longer have to carry large amounts of cash with them, streamlining shopping for basic goods and services.

- **Short-term installment loans.** Be they through so-called "payday lenders," title loans, or something similar, these can be a way for individuals to obtain access to a greater amount of capital than they might otherwise be able to access from friends and family. These products often come with nominally high Annual Percentage Rate (APR) interest rates, and as such, can get very expensive if they're not paid back in a timely fashion; they are not intended to be a long-term solution. This higher rate is directly correlated with the risk of lending to someone with poor or nonexistent credit. So while some installment borrowers take a whole year to pay off their payday loans, **the Competitive Enterprise Institute cites data suggesting** most borrowers pay back the initial amount borrowed within six weeks, "so it is highly unlikely that most borrowers would end up paying anywhere near the purported APR of the loan."

HARM CAUSED BY RATE CAPS

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Currently, the U.S. Senate Banking Committee has **revived a proposal for a national interest rate cap of 36 percent**. **Reuters reports** that "an industry group representing payday lenders said such a cap would effectively eliminate small dollar loans by making them unprofitable," and data from the the Consumer Federation of America shows that "while the median interest rate on small-dollar loans is between 25% and 38%, rates on some short-term loans of hundreds of dollars can be as high as 251%."

But Tom Lehman, associate professor of economics at Indiana Wesleyan University, points out the real-world intellectual sleight-of-hand when using these inflated annualized, triple or quadruple digit interest rates. **At the Mises Institute, he gives the example of a typical payday loan fee**, of $15 per $100 borrowed for a typical loan term of just 14 days, making the annualized compound interest rate "easily in the triple-digit range."

Lehman also writes about an academic analysis estimating that the median payday loan fee in North Carolina is $36, with a median, two-week loan of $244, which is an effective annual percentage rate of 419 percent.

"The critics of payday lending view these relatively high interest rates with much alarm, arguing that the fees charged are exploitative of poor borrowers lacking in personal financial management skills," Lehman writes. "Yet, the effective annual interest rate on the payday loan may not even enter the mind of the borrower. In all likelihood, the borrower cares not what the 'effective APR' is on the loan. The real price signal to which the borrower responds is the flat fee that is charged to hold the postdated check. If the value attached by the borrower to the immediate cash advance exceeds the value of the principle plus the fee one or two weeks hence, then the borrower will undertake the transaction, pure and simple."

Similarly, economist **Thomas Sowell has written**, "Using this kind of reasoning—or lack of reasoning—you could ... say a hotel room rents for $36,000 a year, [but] few people stay in a hotel room all year."

If lawmakers successfully kill off short-term lending in its current form, these borrowers will still need access to credit–this would force them to use even more pricey avenues, including even higher-priced overdraft protection, bouncing personal checks or underground market alternatives. For lower-income Americans, these alternatives to installment or "payday" lending could push them over a financial edge.

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Thomas Miller Jr., professor of finance at Mississippi State University, wrote that "a 2013 Pew Charitable Trusts survey found that more than 60 percent of payday loan users would have to delay paying other bills without access to these loans. The alternative to short-term loan debt is being indebted to existing creditors—where failure to pay might mean losing access to utilities, like water and electricity."

Everyone—including the poor—benefits from having access to financial services that enable them to finance small and large purchases and pay for emergencies.

If policymakers are successful at passing this measure, they could literally be leaving America's most vulnerable people out in the cold.

PROBLEMS WITH "TRUE LENDER" FINTECH REGULATION

Besides products serving the unbanked, historically marginalized communities disproportionately benefit from the services of community banks. To better allow a level playing field for community banks to compete with larger banks (which might reject poorer clientele), in October 2020, the Trump administration's **Office of the Comptroller of the Currency (OCC) issued a rule** clarification known as the True Lender Rule. This Rule states that when banks followed clear rules, they would be able to serve as the "true lender" when partnering with third-party groups, frequently including financial technology companies, or "fintech" firms.

These online fintech platforms serve as intermediaries with customers, providing otherwise unattainable financial services to community banks and their clientele. The phrase "true lender" is meant to clear up any confusion about who is offering a loan to a consumer—it's the bank, not the fintech or any other third party.

This move was important in expanding financial offerings to customers because it gave legal clarity to both fintech firms and banks. **A survey by banking consulting firm Cornerstone Advisors** found that 65 percent of banks and 76 percent of credit unions said fintech partnerships were important to their business strategies in 2020. Small community banks are most desperately in need of third-party fintech partnerships. They can't afford to acquire technology companies or hire the requisite full-time staff, so they struggle to offer the range of tech products and services that consumers need and expect.

But in April 2021, the Senate Banking Committee held a hearing titled "**The Reemergence of Rent-a-Bank?**" The goal was to start the process of reversing the progress made under the Trump administration to help those with less access to the banking system than others, e.g. younger people, people of color, and immigrants.

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While Committee members claimed they wished to help society's most vulnerable, these efforts to roll back the True Lender Rule leave the unbanked and underbanked further behind. They hurt small, community banks, which struggle to compete with large, well-funded banks that possess the deep pockets to build technology platforms that reach new customers. In June 2021, President Biden **signed a repeal of the True Lender Rule.**

Despite this action, consumers increasingly demand these online financial services. A **survey by the Federal Deposit Insurance Corporation** found that the share of Americans primarily using online or mobile means for their banking rose from 38.6 percent in 2013 to 51.6 percent in 2017. The COVID-19 pandemic has likely accelerated this trend.

Without the clarity offered by the True Lender rule, fintech companies are less able to partner with smaller financial institutions, keeping smaller banks at a disadvantage to larger banks. This lack of competition is bad for all financial consumers, but especially those on the margin.

Industry experts believe that if policymakers create a nationwide interest rate cap, create additional barriers for installment lending or because they rolled back the True Lender Rule, vulnerable customers are more likely to turn to potentially costlier alternatives such as overdraft fees or payday loans, which have much higher interest rates and steep balloon payments. Reviving the True Lender Rule, or providing additional regulatory relief, would assist consumers in accessing community banking and affiliated technology services.

Community banks have struggled in recent years to stay afloat rather than shut down or be acquired by big banks. Yet community banks are just what many communities need right now. They are more likely to have personal relationships with their customers, especially helping customers when they are struggling. Because the True Lender Rule was reversed, these community banks will struggle even more.

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CONCLUSION

Unbanked and underbanked consumers are among the most vulnerable populations in America. With this understanding, public policies should be developed which improve, rather than hinder, access to financial services. Overheated rhetoric through inaccurate analogies and demonizing financial service providers does not solve the issue of unbanked and underbanked Americans' financial needs. While consumer protections are obviously important and necessary, in today's regulatory climate, too often the supposed treatment to protect consumers ends up harming consumers instead.

Some well-intentioned policymakers claim they want to help people of color, immigrants, and young people. Instead, particularly during a painful time of record inflation, by limiting options for the unbanked and underbanked, they are doing the reverse.

WHAT YOU CAN DO

Get Informed
Learn about Lending Services for Unbanked Americans. Visit:

- **Federal Deposit Insurance Corporation**
- **Independent Women's Forum**
- **Handbook of Behavioral Economics – Applications and Foundations**
- **Competitive Enterprise Institute**

Talk to Your Friends
Help your friends and family understand these important issues. Share this information, tell them about what's going on and encourage them to join you in getting involved.

Become a Leader in the Community
Start an Independent Women's Network chapter group so you can get together with friends each month to talk about a political/policy issue (it will be fun!). Write a letter to the editor. Show up at local government meetings and make your opinions known. Go to rallies. Better yet, organize rallies! A few motivated people can change the world.

Remain Engaged Politically
Too many good citizens see election time as the only time they need to pay attention to politics. We need everyone to pay attention and hold elected officials accountable. Let your Representatives know your opinions. After all, they are supposed to work for you!

ABOUT INDEPENDENT WOMEN'S FORUM
Independent Women's Forum (IWF) is dedicated to building support for free markets, limited government, and individual responsibility. IWF, a non-partisan, 501(c)(3) research and educational institution, seeks to combat the too-common presumption that women want and benefit from big government, and build awareness of the ways that women are better served by greater economic freedom. By aggressively seeking earned media, providing easy-to-read, timely publications and commentary, and reaching out to the public, we seek to cultivate support for these important principles and encourage women to join us in working to return the country to limited, Constitutional government.