

Predatory Financial Practices **and the Impact on the Poor**

Washington and Lee University

Taylor B. Murray
Professor Harlan Beckley
Poverty 423: Seminar
Capstone Paper
4/20/08

I. Introduction

Breaking the cycle of poverty that is pervasive throughout America's low-income communities is one of the most difficult challenges our society faces. The ability to build wealth is a key element for successfully bringing oneself out of poverty. Unfortunately people in low-income communities have continuously been the victims of numerous types of predatory financial practices for many years, which prevent them from ever building the wealth necessary to improve their lives. In addition, America's low-income population's fundamental lack of basic financial knowledge is an enormous obstacle to successfully saving money and building the wealth that will lead to a better quality of life.

Predatory lending can be defined as knowingly making loans to borrowers who will be unable to repay on time, or perhaps ever. Predatory lenders take advantage of the lack of financial knowledge and resources in low-income communities to advance their own business interests. This paper will explore two methods of exploitation that have been particularly harmful to America's low-income residents: check cashing/payday lending businesses and the sub-prime mortgage market. The effects of these two predatory lending practices exacerbate the growing disparity between the incomes of our country's rich and poor.

Lakisha M. Thomas, a 29 year old single mother of five, is a low-income resident employed in the service industry of Hilton Head, SC. Unfortunately for Thomas, she had to learn about the pitfalls of using predatory financial services the hard way. Thomas has moved back and forth between government assistance checks and low-paying jobs catering to the wealthy of Hilton Head for most of her adult life. Her most recent job was a cashier's position at a jewelry store earning \$8.50 an hour, but she was laid off last April. Because of her tenuous economic situation

Thomas lives in a dimly lit four bedroom apartment in a public housing project that is ironically close to the million dollar resort homes of Hilton Head's beach resorts (Grow).

Thomas finances the majority of what she buys, but has very little understanding of the financing terms. This is reflected in her statement made to BusinessWeek reporters when she confusedly asked "What do you call it - interest?" (Grow). In order to pay for rent and food for her children, Thomas borrowed \$400 from Advance America Cash Advance Centers Inc. (a national payday lending chain) in the May of 2005. She renewed the original loan every two weeks until November 2006, accumulating payments of over \$2,500 in fees for an initial loan of just \$400, plunging her deep into debt. Later, in an attempt to pay off this accumulating debt Thomas took out a refund-anticipation loan from Jackson Hewitt to have access to her \$4,351 earned-income tax credit more quickly. She badly needed to pay overdue rent and utility bills, and thought this loan would get her back on her feet. Quite to the contrary, the tax preparation service had actually pared \$453, or 10.4% in tax prep fees and interest from Thomas' anticipated refund (Grow). She had no idea that there were many **free** public services in her area for low-income consumers that prepare taxes and promise their refund in as little as a week. The lack of financial education reflected by Thomas' story is widespread throughout America's low income communities. It is through exploiting low-income residents for the little capital they have that has allowed the predatory financial service industry to expand so rapidly over the past twenty years.

Predatory financial services take many different forms other than the two I am focusing on in this paper, as is evident from Lakisha Thomas' story about Jackson Hewitt. In recent years a range of businesses that traditionally avoided low-income markets are now joining the growing trend of exploiting them, offering high interest financing to even the riskiest of borrowers. These

include, but are not limited to car dealerships, credit card companies, computer retailers, student loans, and tax services (Grow). Greater access to these modes of credit has allowed numerous members of low income communities to believe they can live beyond their means. Items such as cars, computers, credit cards, and homes are now more accessible to the working poor than ever before. Some economists commend the fact that the spread of credit to low-income communities has raised home and auto ownership rates among the poor. However, when you look at the fact that wages for the working poor have been stagnant for the past three decades while spending among the working poor has consistently increased, actually exceeding their income since the mid-1980's, it is obvious that in the long run America's poor are going to be much worse off. This increased spending trend has not slowed because the poor have been making up the difference by continuously borrowing more than they earn. In period between 1989- 2004, the total amount of debt for households earning under \$30,000 a year grew an astounding 247% (Grow).

The growing prevalence of debt among America's poor is only exacerbated by the fact that debt is become increasingly expensive, and the poor are feeling the brunt of it. The disparity in the cost of auto loans provides one example. In 1989 households who earned less than \$30,000 a year paid a 16.8% higher annual average interest rate on auto loans than households who earned over \$90,000 a year (Grow). By 2004, the disparity on interest rates for auto loans between these income groups had grown to 56%. With mortgage loans the trends are the same. What was a 6.4% disparity between these groups in 1989 had grown to 25.5% as of 2004 and is even greater in 2008 (Grow).

II. Check Cashing/Payday Lenders

The first predatory lending practices that cause disproportionate harm to low-income communities that this paper will discuss are the alternative financial services of check cashing and payday lending. Many low-income communities lack traditional financial institutions such as banks and credit unions. The absence of legitimate financial institutions in their communities combined with the lack of knowledge about financial matters in general lead members of low-income communities to use costly fringe financial outlets and check cashing services. This is a distressing reality that has arisen through historical and contemporary discrimination on the basis of race and ethnicity and/or socio-economic status in both the financial and real estate markets. (Fox 1).

The fees charged by these services have increased. Over the last decade the cost to cash government benefit checks (e.g. social security, welfare, etc.) at check cashing services has risen sharply. As of 2006, the average charge to cash a social security check at one of these institutions was 2.44% of the check's value. For a \$1,002 social security check this would amount to a charge of \$24.45, totaling \$293.00 annually, almost a third of the value of a monthly check. The 2006 rate was 15.6% more expensive than it was a decade earlier at 2.11%, and 53% more expensive than the average 1.59% charged in 1987 (Fox 1). The extraneous cost to cash these benefit checks is felt significantly by the poor because many low-income people depend on these checks to get them through everyday life. Because the poor have been cornered into paying increasingly large proportions of their benefit checks to the check cashing services, the actual level of benefits deemed necessary by the government for these low-income families to scrape by are not received.

The cost of cashing a normal paycheck has risen as well. As of 2006, the average charge to cash a paycheck at a check cashing service was 4.11% of the check's value, 75.6% more expensive than it was in 1997 at 2.34%, and 152.7% more expensive than the 1.62% charged in 1987 (Fox 2). A low-income community member who uses these services would have to pay an average of \$19.66 every week to cash a \$478.41 paycheck. At 50 paychecks a year that would cost \$983.16, the equivalent to two weeks pay every year. At the most expensive check cashing businesses it could cost over \$1300 per year (Fox 11).

In poverty class we have focused on the idea of "Work over Welfare." This principle asserts that commitment to honest hard work can lead to earning a living wage and an improved quality of life for a poor person, far better than reliance on welfare. While this principle is valid, it is hard to convince a poor person that work truly works if they are paying such a large portion of the small amount of money they earn just to have access to that money.

When you compare these costs to those low-income citizens would face at traditional banks the difference is clear. As of the fall of 2006 the average monthly checking account service fee is just \$2.52 or just \$30.24 annually (Fox 11). The cost of a keeping an average checking account at a traditional bank is about 1/10 the cost of cashing a years worth of Social Security checks at a check casher and 1/20 the cost of cashing a years worth of computer generated paychecks (Fox 11).

Who are the users of check cashing services? The victims of these predatory financial institutions are typically members of low-income communities, urban, suburban, and rural, who conduct most of their basic financial transactions outside of our mainstream banking system. Check cashing outlets are the most widely used fringe financial institution and are typically

found in low-income urban neighborhoods, but have recently branched out into poor suburban and rural communities.

It is not only the un-banked members of low-income communities who use check cashing and similar services. Consumers with bank accounts will use check cashing services for a variety of reasons. For example, consumers with low balances in their checking accounts may be unable to cash checks at their bank or credit union, so must instead deposit their checks and wait for them to clear. They may then have to wait for an additional check hold period to expire before they can convert their money to cash. This is an unacceptable option for a person who needs cash to pay bills immediately. Instead of using their bank, these consumers will use a check cashing service who can provide them the immediate cash they need but at a greatly inflated price. There are better alternatives through traditional banks and credit unions (e.g. Direct Deposit) that would allow these people to have access to their money as rapidly as they need it. However, most members of low-income communities have little awareness of these alternative options so end up choosing the costly check casher.

These predatory financial institutions are a key part of the larger divergence of financial services into a two-tiered system. While middle and upper class consumers have access to a wide range of federally regulated financial institutions including banks, thrifts and credit unions, low-income consumers have access only to lower-level, higher-cost services from shaky storefront operations that fall between regulatory cracks and severely lack consumer protections. This polarizing trend is illogical when you look at the unrealized market opportunity the un-banked and under-banked community offers to legitimate financial institutions. In 2005, this population spent \$3 trillion on goods and services with cash and money orders from predatory financial institutions (Fox 7). Despite these strong financial incentives for legitimate banks and credit

unions to establish themselves in low-income communities, the rapid growth of the check cashing industry continues.

The check cashing industry has continued to grow steadily over the last quarter century with a rapid expansion in the last decade. The industry more than doubled in size between 1994 and 2000 and again between 2001 and 2005 (Fox 3). In 2000 there were a little over 6,000 check cashing outlets in the U.S. which generated over \$1.5 billion in fees. By 2005 there were around 13,000 check cashing outlets (Fox 3). It is estimated that over 180 million checks totaling over \$55 billion are processed by check cashing outlets annually (Fox 3).

This rapid period of growth has been fueled by the trend of low-income consumers using check cashing services more frequently. Forty-nine percent of the patrons of check cashing businesses report using check cashing services 1-2 time a month while over 29% use check cashing services at last once a week (Fox 4). Additionally over 25% of check cashing customers said they were using these services more often now than in the past (Fox 4).

Due to advances in technology, the cost for a check cashing business to process its customer's checks has declined over the last decade, and is now substantially lower than the cost the consumers pay for the service, which has increased per transaction over the same period. The average cost for a check cashing business to process a government benefit check from the Federal Reserve is only 4 cents, yet fees on such checks can range from 1%-5% of the checks value. (Fox 5,6)

In addition to the low cost of processing the checks, there is very minimal risk taken by the businesses. Check cashing business process paychecks at different rates and with different fees depending on the type of check and the associated risk. Almost all (94.2%) of outlets cash government benefit or tax refund checks because they carry little risk and produce significant

revenue (Fox 6). Similarly, 93% of check cashing services processed computer-generated paychecks at an average of 2.52% of the checks value, slightly higher than on government benefit checks. Only 62% of check cashing businesses processed hand-written paychecks, and charged an outlandish average of 4.11% on such transactions (CFA 6). The fee for hand-written paychecks can be as high as 10% of the checks value at some businesses. They rarely agree to process riskier personal checks, and if they do, charge a much higher fee.

Check cashing businesses offer a wide variety of services to appeal to their customers. In addition to cashing checks these business offer short-term payday loans at extraordinarily high interest rates. Many check cashing businesses have branched out even further to offer other services widely used in low-income communities. These include selling money orders, making wire transfers, pawn shop services, paying utility bills, selling public transportation fare cards, selling pre-paid phone cards, currency exchange services, and lottery tickets (Fox 4). Many businesses require customers to pay a membership fee to use their services, on average around \$3.61, and some charge and additional first time use fee after that (Fox 5). While some of the services offered are fair and beneficial for the customer most are exploitative and detrimental to both the customer and the community as a whole.

Payday loans are a very lucrative practice for check cashing services because they are among the industries' most exploitative. About two-thirds of check cashing services offer payday loans to consumers. Payday loans are essentially cash loans based on a personal check provided by the customer that is held for future deposit by the check cashing business. The loan is typically required to be paid back on the customer's next payday with the additional fee based on a ridiculously high interest rate (Fox 8). The average payday loan size for check cashers is \$696 but can range anywhere from \$250 to \$5000. A typical loan of \$300 dollars for two weeks costs

an average of \$46.85, which is a 406% annual percentage rate (Fox 8). Payday loans are one of the easiest and fastest ways for low-income residents to accumulate debt, and fall into bankruptcy.

To qualify for a payday loan a customer obviously needs a job or source of income, but in most cases is also required to have a bank account from which they can write the initial personal check. Many payday loan customers write this initial check for the loan knowing they do not actually have the required funds to back it. In order to keep the check from bouncing they renew the loan every two weeks, accumulating more and more debt. While the bank account requirement does exclude a portion of the low-income population, there are still many under-banked, financially vulnerable people in these communities who are cornered into using payday loans.

The payday loan industry has evolved to include publicly traded national chains of payday lenders such as ACE Cash Express and Dollar Financial Group. Over half (53%) of check cashing services offer payday loans, but there are many payday lenders who do not cash checks (Fox 8). These business often advertise themselves as check cashing services in phone books to attract low-income customers, but are not actually licensed to cash checks and so don't really provide the service. In states such as Georgia, Massachusetts, Maryland, North Carolina and New York payday lending has been prohibited by state usury laws. Despite these regulations, a majority of the check cashing businesses in these states still offer payday loans (Fox 8).

As mentioned above, another lucrative aspect of the check cashing industry is its wire-transfer services. Many check cashers (83%) offer wire transfers that low-income customers use to pay their bills or to support families in other cities or abroad (Fox 7). These services are especially popular in low-income immigrant communities where individuals are supporting

families in other countries. The average fee for a \$200 money order remittance to be wired to Mexico in one business day was \$11.71, but could be as high as \$30.00 (Fox 7). Wire transfers can be purchased from legitimate banks or specialized businesses at much lower rates, however these institutions are rarely found in low-income communities.

A third service now being offered by many check cashing outlets in an effort to keep up with new financial technology are pre-paid debit or stored value cards. Right now about 40% of check cashing businesses offer pre-paid debit cards (Fox 9). These products allow customers to load cash onto a card which functions essentially the same way as a debit card connected to a bank account. The customer is able to withdraw cash from ATMs and make purchases at most stores and businesses. Customers can also load their checks directly onto their cards. This innovation seems to be beneficial for the consumer in many ways. Low-income citizens have the convenience and added security of a debit card rather than keeping all their money in cash. They also have what would be considered in many low-income communities the positive stigma of carrying a Visa or MasterCard logo.

Despite these positives, check casher's pre-paid debit cards are loaded with risks and fees that exploit their customers. The first drawback is that stored value cards are not subject to the same federal regulations and consumer protection laws as real credit and debit cards, including limits on consumer liability when a card is lost or stolen. To open a card account, customers must first pay a number of high fees. On average a card will cost around \$10.86 with initial fees ranging from \$1.00 to \$30.00 and average monthly fees as high as \$5.00 (Fox 10). In addition, eighty-four percent of check cashing outlets offering pre-paid debit cards charge a fee every time a customer loads money on the card that averages about \$3.09, and half charge a fee every time a

transaction is made, usually about \$1.22 (Fox 10). Check cashers also receive a commission on all sales made using the cards.

It is certain that in the 21st century there is a need for low-income citizens to have access to the convenience and security of electronic transactions. However, the seemingly inexpensive alternative offered by check cashing outlets can make low-income people subject to exploitative and unsafe financial practices that will hurt them in the long run. (Fox 10). Ultimately, while the wide range of fringe financial services offered by check cashing businesses is growing, in every instance the fees charged will cause disproportionate harm to the low-income customers who use them.

III. Sub-Prime Mortgages

The second type of predatory lending this paper will discuss is the sub-prime mortgage market. Over the last ten years sub-prime mortgage loans have become prevalent as an option for renters who are unable to qualify for mortgages at the prime interest rate, the lowest and therefore preferred rate available from financial institutions. Now these same people who were previously denied credit are being offered sub-prime mortgage loans, which require them to pay higher interest rates, a greater number of points, more in fees, and typically have to accept additional prepayment penalties.

Sub-prime mortgage lenders have been irresponsible by extending credit to low-income people at clearly unaffordable terms. As a result, the entire United States real estate market has experienced one of its worst years in recent memory. Some may argue that sub-prime mortgage lending provides low-income people with an attainable path to home ownership. However, many

of these loans, like those offered by payday lenders, are usury and exploitative of the people they claim to help (Leigh 1).

Homeownership has long been touted as a key to building wealth and escaping the cycle of poverty that America's poorest citizens face. For America's poor, owning a home is a powerful symbol of success and security. It reflects their larger goal of movement from public housing and/or low income neighborhoods plagued by crime, lack of access to good education, and constant tension towards a successful, comfortable life in a stable home, which for many embodies the American dream.

Owning a home can have tremendous civic benefits for low-income individuals and/or families. It has been shown that children of homeowners have greater educational attainment than children residing in low cost rental or public housing. Additionally, homeownership encourages participation in voting, local politics, and investment in ones community. It is understandable then that people in low-income communities strive for homeownership.

However, the sub-prime mortgage market has ultimately failed as a vehicle through which low-income people can achieve sustainable homeownership.

Take for example the story of Glenda Ortiz, a cook at a hotel living in Northern Virginia. In August 2005 Ortiz, who had been living with her husband in a cramped apartment in a low-income neighborhood in Arlington County became a homeowner. By March of 2008, her home was in foreclosure. "It was all a mistake. One hundred percent," recalled Ortiz in Spanish to reporters from the Washington Post, "I had such a burning desire to have my own house. I didn't think about anything else" (Schulte). Ortiz's story is an example of what can happen when a competitive real estate market such as that in Northern Virginia collides with cheap credit, lax lending standards, and little oversight.

Ortiz speaks very little English, and admits that she has very little knowledge about the U.S. banking system. When a Mary Kay saleswoman came to her door offering help to buy a house, Ortiz completely believed her. The saleswoman, Maria Esperanza Salgado, carried a business card with a blue Realtor logo, but in reality she was not licensed with the Virginia Real Estate Board. Along with a business partner, Salgado sold Ortiz on a sub-prime mortgage that was well beyond her means to pay. Ortiz even protested that she and her husband had bad credit and only a few thousand dollars in savings, Salgado assured her that she could still help her become a homeowner. Ortiz looked at only one house before buying it. She paid \$430,000 for a run-down one story duplex in neighboring Alexandria, VA. This price was triple what the house had sold at the year before, as well as being \$5,000 above the asking price (Schulte). Ortiz agreed to mortgage terms in English she did not understand, costing her over \$3,000 a month, which was 70% of her households' \$4,200 monthly income (Schulte). Essentially, she trusted her entire financial future to someone she hardly knew, and sought no advice from other sources. Of course, her loan application breezed through the originator and was accepted by a mortgage company who claimed to specialize in customers with "less than ideal" credit. This is just one of the hundreds of thousands of similar stories that have driven the sub-prime mortgage collapse.

As the Ortiz story suggests, there can be substantial downsides to homeowners with sub-prime mortgages. As we defined it earlier, predatory lending means knowingly making loans to borrowers who will be unable to repay them. As we have seen so poignantly in the past year and a half, sub-prime loans are predatory because they so often end in foreclosure. Sub-prime loans, like other types of predatory loans, almost always have excessive and hidden fees, and are sold using high-pressure tactics, or even blatant fraud and deception (Leigh 1). Moreover, lower-income families are less likely to claim home-ownership tax advantages, making homeownership

relatively more expensive. In addition, homeownership brings with it many additional costs, including the initial transaction costs of the home purchase, the threat of market downturns, and home upkeep costs. It should be noted that not all sub-prime loans are predatory, but many are.

Throughout our country's history people have been excluded from homeownership in a multitude of ways. Practices such as redlining, discriminating on the basis of race or ethnicity, a low credit score, or a non-traditional credit history are all ways in which are all ways in which low-income citizens and minorities have been excluded from the mortgage market (Leigh 1). Despite its importance, homeownership has remained persistently out of reach for many African and Hispanic Americans. For example, in 1940, 45.6% of white Americans owned homes versus less than 22.8% of African Americans. It was not until 2000 that the homeownership rate among African Americans (46.3%) surpassed that of white Americans in 1940 (Leigh 1). Conversely, white homeownership rates in 2000 exceeded 70%. This disparity represents a 60-year gap of homeownership acquisition for African Americans versus whites.

Over the last 50 years, awareness of this persistent gap has prompted the creation of programs at all levels of government as well as mortgage market innovations like the sub-prime loan. The rates of homeownership among African Americans and Hispanic Americans have risen sharply since 1995, but the sub-prime mortgage crisis may ultimately reverse these gains. Among all the racial/ethnic groups in the United States, African Americans have been the most likely to get sub-prime mortgages. For example, in 2006, 52.9% of all home purchase loans received by African Americans were sub-prime (Leigh 1). Hispanics are also disproportionately at risk as well. About 47% of home purchase loans received by Hispanic Americans in 2006 were sub-prime. This is in comparison to white and Asian Americans whose sub-prime purchasing rates are roughly 25% of all loans received (Leigh 1). This means that the 2007 sub-

prime mortgage market collapse will cause major setbacks for the African and Hispanic American subpopulations..

Recent statistics show that the size of the population of homeowners with mortgages they can not afford who are subsequently at risk for foreclosure is on the rise (Leigh 1). This is due to the fact that the rates of an increasing number of adjustable-rate mortgages are being continually re-set. In combination with falling housing prices and sluggish home sales, these struggling homeowners may not be able to sell their homes to avoid financial collapse. Refinancing a mortgage is not a viable option for most because most refinance loans would not really be affordable for such households.

Institutions that offer sub-prime mortgages often justify the disparity in prices from prime mortgages as a way to account for the additional risk for the lenders in lending to low-income citizens. However, studies have shown that even after accounting for risk, a disproportionate number of minority families have sub-prime mortgages (Fellowes 2). Studies also show that one-in-five holders of a sub-prime loan could have qualified for a prime interest rate loan (Fellowes 21). Thus, it is hard to argue that these practices are not influenced by unlawful racial discrimination, opportunistic pricing, and predatory lending.

In summary, it appears that homeownership, when funded by a sub-prime loan, may not, in fact, be the most advantageous choice for many low-income consumers. Given the high initial transaction costs, the high proportion of the poor's earned income consumed to service the mortgage debt, and the costs of home upkeep, there is little money left at the end of the day for other investments, such as educational or small business start-up funds, that may be as, or more, critical to the escape from poverty as homeownership. .

IV. Macro Effects of Predatory Financial Institutions on the Poor

This paper has argued that those in low income communities are disproportionately affected by the negative impacts of fringe financial services providers, such as check-cashing businesses, and are represented in the sub-prime mortgage market in numbers that exceed their share of the population of homeowners overall. This inequality exists even when the impact of the financial risk associated with lower incomes is factored into the equation. In formulating solutions, it would be useful to have a sense of the scope and depth of the problem.

The number of unbanked Americans remains significantly high. In the United States there are currently at least 12 million households who are unbanked (Fox 17). This enormous unbanked population has a disproportionately high tendency to use check cashing businesses to perform the basic financial transactions of every day life. This has resulted in the telling statistic that about a quarter (24.5%) of households in the lowest income quintile (under \$18,900 annually) and 12.7% of households in the second lowest income quintile (between \$18,900 and \$33,000 annually) do not have any relationship with a depository financial institution (Fox 17). This statistic is compounded by the fact that minorities are much more likely to be unbanked. Twenty-four percent of minorities were unbanked as compared to only 5% of whites (Fox 17). Among the unbanked population, 59% use check cashing business for some financial service and 71% of the unbanked who receive payroll and/or government benefit checks used check cashing services to cash their paychecks. On top of the population of unbanked consumers there are an additional 28 million Americans who are under-banked (Fox 18).

In neighborhoods such as Queensbridge, NY, where the community development corporation I worked for, the East River Development Alliance (ERDA) is located, there is a serious lack of any financial institutions from the traditional financial sector. As a result these neighborhoods

have a much higher concentration of fringe financial outlets. Thirty-two percent of check cashers, pawnshops, rent-to-own stores and payday lenders are located in inner city neighborhoods and 56.4% are in predominantly minority areas (Fox 18).

This translates to massive financial losses for America's low-income citizens. Under-banked citizens account for more than \$1.1 trillion in annual income, of which unbanked citizens represent almost \$510 billion each year. The Center for Financial Services Innovation has shown that Americans spend at least \$10.9 billion on more than 324 million alternative financial transactions a year (FDIC). A study by the Brookings Institute of the higher costs paid by lower-income families across a broad range of goods and services shows that reducing the cost of living for such families by just 1% could add \$6.5 billion in new spending power (Fellowes).

The burden of debt associated with sub-prime mortgages has resulted in more low income families reporting that they are having trouble paying their bills on time and occasionally falling behind on their payments (Fellowes 2). Over 55% of low income households held debt in 2004, a 10 % increase since 1989. Total debt held by these households increased by 308% during this period, now adding up to \$481 billion (Fellowes 1). Over one-fourth of lower income borrowers now devote at least \$4 out of every \$10 earned for debt payment. Homeownership-related debt accounts for about \$7 out of every \$10 owed by low-income families, and is the fastest growing type of debt held by these families (Fellowes 10).

Combining the funds lost to usury and exploitative fees charged by check cashing businesses, with the household-related debt consuming a large portion of their earned income, it appears that many low income families are highly leveraged, and may be overextended. The consequence of falling behind on payments is particularly dire for lower-income families

because of the small margin of error in their budget. (Fellowes 7) Thus, they can easily fall into a downward spiral of debt.

IV. Solutions

There are a number of alternatives to check cashing outlets that can be used by low-income people to save money, in addition to federal and state regulations and laws that can be passed to restructure this industry for the benefit of the poor. The first and most important step for all low-income citizens is to open a low-cost check or savings account at a traditional bank or credit union that will provide a debit card with overdraft protection. Even if low-income citizens feel inconvenienced by traveling to a different neighborhood or area to use a bank or credit union, the ultimate benefits received through the use of such an institution are well worth it. Low-income citizens should acquire debit cards to manage this bank account because they give you federal consumer protections while avoiding high fees, and the convenience of electronic financial transactions. Debit card protections include security against lost or stolen cards and liability limits. Low-income customers should also be sure to understand their bank or credit union's policy on check hold times for deposits. This will allow them to deposit paychecks responsibly and plan to save accordingly instead being cornered into using payday lenders for financial emergencies. By following these steps, low-income citizens will have a better chance to accumulate savings or a significant balance in a checking account that will allow them to cash checks more easily and quickly. Organizations such as ERDA are establishing non-profit community credit unions in low-income communities across the country which are owned and run by the members of the community. The expansion of services like these in low-income

communities is progressing through the growth of the Community Economic Development movement.

An easy alternative to check cashing services that some unbanked citizens have been utilizing to save money is to redeem their paycheck at the bank from which it was issued. For example, in Washington, DC, half of the issuing banks will cash checks on site for free, and among those who charge the average fee was a low \$4.60, 1.5% of the face value of a \$300 paycheck (Fox 19). By redeeming a check at the bank from which it is issued, low-income citizens will save a substantial amount of money as compared to using check cashing businesses.

Another alternative that low-income citizens can take advantage of is Direct Deposit. If it is possible, low-income people should arrange that their paycheck or government benefit check be directly deposited into an account at a legitimate bank or credit union. Direct Deposit allows you to access your paycheck the next business day without having to pay ridiculously high check cashing fees. Many banks will even offer free or low cost checking accounts if Direct Deposit is used. Low-income people who use Direct Deposit will have the convenience of speedy access to their paychecks without the long wait period. This will prevent low-income citizens from using check cashers or payday lenders for their speed in access to funds.

Finally, low-income citizens should avoid payday lenders at all costs. When low-income citizens borrow money from payday lenders they are typically doing so by writing unfunded checks as security on the loan. These loans often lead to a cycle of repeat borrowing to prevent the original unfunded check from bouncing. This process almost inevitably ends in expounding debt for payday loan customers. Instead of using payday lenders for financial emergencies low-income residents can purchase small loans from community credit unions at significantly lower

rates. These loans offer the advantage of less late payment penalties and a greater period of time in which to repay.

While check cashers are subject to federal financial privacy, money laundering and security laws, the primary regulations regarding check cashing businesses are drawn from state laws. There is a wide variety among the states on the regulations placed on check cashing businesses as well as a range in their level of enforcement. Because of this inconsistency in laws and regulations among states, some check cashing services are able to exploit the poor with hardly any interference or regulation by the government. To counteract this problem states should first create more effective consumer protection safeguards against the check cashing industry.

The AARP Model Check Cashing Law created in 1999 offers a more effective regulation of check cashing businesses and caps fees for cashing checks (Fox 19). This model law combines many of the most effective state laws regulating check cashing services to target those businesses with high fees and deceptive practices. This model provides check cashing customers with an explicit private right of action against a check cashing business for unfair practices as well as allowing for the recovery of damages, fees and costs. The AARP model also places a cap on fees for payroll and government benefit checks charged at check cashing services at 1% of the face value of the check or \$5, whichever amount is less. The rate is 2% or \$5 for all other types of checks (e.g. personal, insurance).

In addition to following the AARP model for check cashing business regulation, states should prohibit check cashing businesses from providing payday loan service unless they earn a separate license as a supervised small loan company. Additionally, states should include payday lenders in their regulation of usury and small loan rate caps. The combination of the check cashing and payday lending services into single businesses allows predatory financial institutions

to present a façade of convenience that ultimately lures more low-income people into their traps. If the state government placed much stricter regulations on payday lending it could be made both less prevalent and less exploitative.

In recognition of the growing problems within the financial world of low-income communities, the FDIC has launched a Community Affairs Program through their consumer protection division (FDIC). The Community Affairs Program is a broad-based initiative whose goal is to encourage financial institutions to invest in and meet the credit needs of the communities they serve while promoting laws, regulations, policies and programs that protect and inform consumers. The FDIC began this program because they recognized that the goals of the Community Reinvestment Act of 1977 were not being met (FDIC). As a response they have created various programs to promote fair banking and financial education for the unbanked and underserved.

Washington and Lee University

One such program is called Money Smart. Money Smart is a training program that helps adults outside the financial mainstream enhance their money skills and create positive banking relationships (FDIC). The FDIC is working with other major entities, including financial institutions, bank trade associations, national non-profit organizations, community- and consumer-based groups (e.g. ERDA), and federal, state and local agencies to make Money Smart accessible to everyone across the country. Financial education in low-income communities is vital to promoting change in the community because it generates financial stability for individuals and families. The more people know about credit and banking services, the more likely they are to increase savings, buy homes, improve their financial health and well being and ultimately escape the cycle of poverty. Anyone can take the Money Smart course for free online at the FDIC's website or from an instructor in their community if the program is offered there.

The FDIC's Community Affairs Program has also created The Alliance for Economic Inclusion (AEI). AEI is a national initiative with the purpose of establishing broad-based coalitions of financial institutions, community-based organizations and other partners across the country to bring all unbanked and underserved populations into the financial mainstream (FDIC). The Alliance will improve the poor's access to the U.S. banking system by working with legitimate financial institutions and other community based and corporate partners to offer low-cost products and services and expanded financial education efforts (FDIC) in low income communities. To do this they have divided the country into nine regions through which they will have a better understanding of the issues on a local scale.

Finally, the FDIC has launched a Small Dollar Loan pilot program to offer low-income citizens a safe alternative to payday lenders. They hope to develop replicable business practices that will allow banks across the country to incorporate affordable small-dollar loans into their mainstream banking services. The FDIC has set some preferred guidelines on these loan products including limiting loans to under \$1,000, annual percentage rates below 36%, no prepayment penalties, repayment periods longer than a single payment cycle (e.g. two weeks). This two-year study is set to begin in 2008 and will hopefully yield results in providing this much needed service to the low-income citizens across the country (FDIC).

What can be done to help low-income citizens who are in danger of losing their homes because of sub-prime lending, and how can the housing market be stabilized overall? In order to minimize future fallout from the 2007 collapse we need to establish enforceable guidelines for sub-prime mortgage lenders. Ultimately, lenders must be prohibited from offering sub-prime mortgage loans to low-income or financially irresponsible borrowers without realistically assessing the likelihood that these borrowers will repay the loan. This includes an assessment

not only for the initial rate on adjustable-rate mortgages, but also any higher rates to which the mortgage may be re-set. On the other end of the spectrum, borrowers should be aware of the complete terms of the loan, and not accept loans they will not be able to repay. This will require low-income borrowers to obtain knowledge about how to manage their finances and to be educated on how to understand the features of the sub-prime mortgage loans which could make them unaffordable.

The first step is for the Federal government to enact legislation to restructure and regulate the sub-prime lending market in the same way they regulate the prime mortgage market. This could be done in a number of ways. The Home Owner Equity Protection Act (HOEPA) of 1994 could be restructured to include many more sub-prime loans. HOEPA's fair practice standards for business making high-cost sub-prime loans could be expanded to require lenders to verify a borrower's ability to repay a sub-prime loan before issuing it, or banning prepayment penalties that last longer than five years (Leigh 2). Additionally, the Federal government could freeze the initial rates on all outstanding adjustable-rate mortgages which are held by low-income borrowers who consistently paid their loan on time, but who would be unable to pay if the rates were increased. The Federal government could use CRA to enforce responsible lending by refusing credit to financial institutions who practiced predatory lending under the Community Reinvestment Act of 1977 (CRA). This law was passed initially to combat redlining. It requires banks and other financial institutions to appropriate a given share of their deposits to mortgages for low-income individuals in exchange for the benefits received from the FDIC (Leigh 2). Finally, the federal government could create legislation that would mandate sub-prime lenders to make publicly available all information about their rates and fees. If potential borrowers had information about costs, interest rates, points, fees and penalties clearly presented to them in

comparison to those of prime loans the negative behavior of both the lenders and the consumers could be remedied.

In addition to having the federal government use its legislative and regulatory power to restructure the sub-prime lending markets, the State governments should also take a greater role in the regulation of sub-prime lending. While many states (including Virginia) have recently taken action to address the problem of predatory payday lenders and check cashing services, they generally defer to the federal government to regulate the home mortgage market. This is counterintuitive because the monitoring and licensing of the brokers who have developed and grown the sub-prime lending markets is a state government function not federal. By combining proposed Federal legislation that will establish minimum standards for broker behavior with better state statutes to monitor and control licensing of sub-prime mortgage businesses the entire structure and functioning of the sub-prime loan market could be improved.

One of the main issues for sub-prime loan customers is an inability to understand the information available to inform their decisions when shopping for loans to purchase, refinance or improve their homes. Both private sector financial institutions and the government at all levels should make financial education, financial counseling, and housing counseling more widely available. Many CDCs like ERDA offer education on these very subjects to members of low-income communities looking to build wealth and possibly buy homes. The federal government and private industry can both work to ensure that organizations such as ERDA continue to expand and reach more low-income people. Sometimes low-income people have good enough credit to receive a mortgage at prime rates, but because they lack financial education are duped into taking a sub-prime loan. This problem can only be solved if we make financial education more widely available to the poor.

In addition to the changes to the existing sub-prime mortgage lending market, both public and private sector entities could develop alternatives or strengthen existing ones that would provide home purchase financing to low-income individuals. One such alternative is publicly supported mortgage revenue bonds or housing trust funds which would be immensely more effective if they received funding from consistent and dedicated investors such as private business or state or local government. Expanding rental housing options for low-income citizens beyond public housing and similar options could reduce the number of borrowers who fall prey to sub-prime lending abuses.

In summary, the solutions for breaking the cycle of poverty presented by this paper focus heavily on reducing the exorbitant costs of financial services paid by low-income families. This is in contrast to the long-standing public policy emphasis on putting more money into the hands of the poor by means such as increased government aid, raising the minimum wage, and expanding tax credits. This new approach is driven by the astounding increase in credit made available to the low income population in the past decade. It recognizes that without establishing principals of fairness in lending to the poor, accompanied by increasing their financial literacy and attracting legitimate banks into their communities, the newly available debt may push some low income households over the financial edge.

Works Cited:

- "FDIC: Community Affairs Program." FDIC. 17 Jan. 2007. FDIC. 18 Apr. 2008
<<http://www.fdic.gov/consumers/community/index.html>>.
- Fellowes, Matt. From Poverty, Opportunity: Putting the Market to Work for Lower Income Families. The Brookings Institution. Washington DC: The Brookings Institution, 2008. 20 Apr. 2008
<http://www.brookings.edu/reports/2006/07poverty_fellowes.aspx?p=1>.
- Fellowes, Matt, and Mia Mabanta. Borrowing to Get Ahead, and Behind: the Credit Boom and Bust in Lower-Income Markets. The Brookings Institution: Metropolitan Policy Program. Washington, DC: The Brookings Institution, 2007.
- Fox, Jean Ann, and Patrick Woodall. Cashed Out: Consumers Pay Steep Premium to "Bank" At Check Cashing Outlets. Consumer Federation of America. Washington, DC: Consumer Federation of America, 2006.
- Grow, Brian, and Keith Epstein. "The Poverty Buisness: Inside U.S. Companies' Audacious Drive to Extract More Profits From the Nation's Working Poor." BusinessWeek 21 May 2007. 25 Jan. 2008
<http://www.businessweek.com/magazine/content/07_21/b4035001.htm>.
- Schulte, Brigid. "My House. My Dream. It Was All and Illusion: Latina's Loss in Va. Epitomizes Mortgage Crisis." The Washington Post 22 Mar. 2008. 18 Apr. 2008
<<http://www.washingtonpost.com/wp-dyn/content/story/2008/03/21/ST2008032103607.html>>.
- Wilhemina, Leigh A., and Huff Danielle. "The 2007 Sub-prime Lending Experience: Picking Up the Pieces." Focus (2007): 4-6.
- Wilhemina, Leigh A. "The Sub-prime Saga: African Americans and Homeownership." FTC Bureau of Consumer Protection. Black History Month Brown Bag. Washington, DC. 27 Feb. 2008.