Does Community Access to Alternative Financial Services Relate to Individual's Use of Services?

December 2015

Terri Friedline and Nancy Kepple

Center on Assets, Education, and Inclusion
The University of Kansas
www.aedi.ku.edu

There is concern that the increasing accessibility of alternative financial services in communities across the US is risking individuals' financial health by increasing their use of these high-cost services, potentially trapping them into carrying burdensome debt, damaging their credit scores, or delaying payments on rent or utilities. This study uses restricted-access, zip code data from a nationally representative sample of nearly 24,000 adult individuals to examine whether the concentration of alternative financial services within communities relates to individuals' use of these services. Generally, the assumption holds that increased access is associated with increased use; however, there are differences in how individuals use alternative financial services based on their annual household income. Modest and highest income individuals are more likely to use these services when they live in communities with higher concentrations of alternative financial services. For lowest income individuals, higher concentrations are associated with their more frequent or chronic use of these services. Local, state, and national policies are needed to provide safe and affordable financial services within communities and to regulate the expanding alternative financial services industry.

Alternative financial services are becoming more accessible in communities across the US, leading to concerns that individuals are risking their financial health due to increased reliance on these high-cost financial services.

- The accessibility of alternative financial services—including auto title lenders, payday lenders, tax refund and anticipation lenders, pawn shops, and rent-to-own stores—is increasing within communities across the US, due in part to policy interventions that have shifted the financial services landscape over the last few decades. A series of policies in the 1990s allowed mainstream banks to serve larger

geographic regions and, as a result, they began to withdraw from smaller, local communities.[1]

- These policies provided alternative financial services with opportunities to expand into the communities once served by mainstream banks. The number of alternative financial services increased five-fold in the 1990s and these services have grown 15% per year since that time.[2]
- Alternative financial services are estimated to earn around $300 billion annually by charging high interest rates on products and services from customers who are more often poor and have limited credit histories.[3]
- To address concerns regarding the expansion of high-cost services, states have increased their regulation of alternative financial services over the last few years. Twenty percent of states in 2006 specifically prohibited payday lenders from operating within their borders, rising to 29% in 2011.[4]

Individuals tend to have poorer financial health when they live in communities with more highly concentrated alternative financial services. However, despite concerns about their accessibility, there is limited evidence that individuals' increased access to alternative financial services actually relates to their increased use of these services.

- While alternative financial services fill a void for those who need money, individuals may risk their financial health when they use these high-cost services.[5] Individuals living in communities with higher concentrations of these services also tend to have poorer financial health.
- Individuals tend to have lower credit scores, delay medical treatment, struggle to pay their bills, and move more frequently when they live in communities with more payday lenders, for example.[6] Additionally, alternative financial services tend to concentrate in poor communities, suggesting that these services target individual who are struggling financially.[7]

---

[1] Federal Deposit Insurance Corporation. (1997). *An examination of the banking crises of the 1980s and early 1990s*. Washington, DC: Federal Deposit Insurance Corporation.
[2] Apgar, W. & Herbert, C. (2006). *Subprime lending and alternative financial service providers: A literature review and empirical analysis*. Washington, DC: US Department of Housing and Urban Development.
Caskey, J. (1994). *Fringe banking: Check cashing outlets, pawnshops, and the poor*. New York, NY: Russell Sage.
[3] Federal Deposit Insurance Corporation. (2009). *Alternative financial services: A primer*. Washington, DC: FDIC.
[4] Bhutta, N. (2014). Payday loans and consumer financial health. *Journal of Banking & Finance, 47*, 230-242.
[5] Baradaran, M. (2015). *How the other half banks: Exclusion, exploitation, and the threat to democracy*. Cambridge, MA: Harvard University Press.
[6] Melzer, B. (2011). The real costs of credit access: Evidence from the payday lending market. *The Quarterly Journal of Economics, 126*(1), 517-555.
Morgan, D., Strain, M., & Seblani, I. (2012). How payday credit access affects overdrafts and other outcomes. *Journal of Money, Credit, and Banking, 44*(2-3), 519-531.
Morse, A. (2011). Payday lenders: Heroes or villains? *Journal of Financial Economics, 102*, 28-44.
[7] Gallmeyer, A., & Roberts, W. (2009). Payday lenders and economically distressed communities: A spatial analysis of financial predation. *The Social Science Journal, 46*, 521-538.

- Existing studies test an important link between access to these services and individuals' financial health; however, these studies have been unable to directly measure the link between access to alternative financial services and individuals' use of these services.

After examining the financial behaviors of almost 24,000 individuals residing in over 9,500 communities across the United States, a new study finds that increased access to alternative financial services within communities does indeed relate to individuals' increased use of these services.[8]

- Individuals are more likely to use alternative financial services and do so with greater frequency when they live in communities with higher concentrations of these services. There are differences in this relationship by individuals' annual household income.
    - Modest and highest income individuals are more likely to use alternative financial services when they live in communities with higher concentrations of these services. With greater access in their communities, these individuals are more likely to step foot into an alternative financial service at some point in their lives.
    - For lowest income individuals, higher concentrations are associated with more chronic alternative financial services use. In other words, lowest income individuals who choose to use these services are more likely to be repeat customers when alternative financial services are more accessible within their communities, more frequently rolling over their original payday loan or pawning their belongings for extra cash.
- State regulation that prohibits payday lenders from operating within their borders has been somewhat effective. State regulation protects modest and highest income individuals from using alternative financial services, but has no effect for lowest income individuals. Lowest income individuals may use different types of services like auto title lenders or pawn shops when payday lenders are prohibited.
- Owning a checking account from a mainstream bank helps individuals to avoid using alternative financial services. That is, owning a checking account may give

---

Smith, T., Smith, M., & Wackes, J. (2008). Alternative financial service providers and the spatial void hypothesis. *Regional Science and Urban Economics, 38*(3), 205-227.

[8] This study used restricted-access zip code files from the 2012 National Financial Capability Study (NFCS) and merged in the concentration of alternative financial services from 12 codes from the 2011 North American Industry Classification Systems (NAICS) that included auto title loan, payday loan, tax refund, pawn shop, and rent-to-own services. The samples included individuals whose reported annual household incomes were lowest (< $15,000; *N* = 2,952), modest ($15,000 to < $50,000; *N* = 8,807), and highest (≥ $50,000; *N* = 11,831). The analyses controlled for such things as an individual's race, gender, education level, and employment status and a community's population density, percent of the population identifying as a racial or ethnic minority, percent of the population living at 150% of poverty, and the percent of the population that was unemployed. Zero-inflated negative binomial (ZINB) regressions separately examined the probability that individuals had ever used alternative financial services and the frequency at which they used these services.

individuals another resource for getting money when they need it and protect them from relying on alternative financial services.

- Individuals are vulnerable to using alternative financial services when they need money. Individuals tend to use alternative financial services more often when they experience an unexpected drop in income and have difficulty paying monthly bills, suggesting that individuals rely on these services when they experience emergencies.
- Higher levels of financial literacy are associated with protecting modest and highest income individuals from using alternative financial services; however, this protective relationship does not exist among lowest income individuals. In other words, financial literacy may not be effective for lowest income individuals who are already struggling to make financial ends meet.

Local, state, and national policies that are complementary, scalable, and effective may be able to increase access to safer and more affordable financial services within communities across the US and curb the increasing number of alternative financial services and their potentially harmful effects on individuals' financial health.

- Communities may need support for providing their residents with access to safe and affordable financial services. This support may come from local and state policy interventions. For example, several community economic development interventions may be effective, including the Community Development Financial Institutions Fund (CDFI Fund) that supports community-based financial services operating in lower income communities, the Cities for Financial Empowerment (CFE Fund) and their Bank On coalitions that leverage local partnerships to advocate for safer and more affordable financial services within communities, and the California Reinvestment Coalition (CRC) that advocates for local policies that protect consumers from high-cost alternative financial services.
- Policy interventions should be designed at varying levels of scale—local, state, and national—and to work in harmony with one another in order to achieve effectiveness. National policies for regulating alternative financial services like those being considered by the Consumer Financial Protection Bureau (CFPB) can be combined with local policies like the community economic development interventions undertaken by the CDFI Fund, CFE Fund and Bank On coalitions, and CRC. Complementary policies such as these can be both scalable and flexible, taking into advance consideration both efficiency and individual variability.
- Ultimately, policy interventions should address the conditions that have allowed alternative financial services to operate and expand in the first place. Such interventions can provide stronger regulation and oversight of the financial services industry, use incentives to encourage mainstream banks to improve services within their local communities, and create new options for financial services that are safer and more affordable than alternative financial services. Two examples include leveraging Community Reinvestment Act (CRA) credits to incentivize mainstream

banks' service to poor communities and returning to offer basic, safe, and affordable financial services through the US Postal Service.[9]

Recommended Citation:

Friedline, T., & Kepple, N. (2016). *Does community access to alternative financial services relate to individuals' use of these services (AEDI Research Brief)?* Lawrence, KS: University of Kansas, Center on Assets, Education, and Inclusion.

[9] Getter, D. (2015). *The effectiveness of the Community Reinvestment Act*. Washington, DC: Congressional Research Service.