CCEDA

ALTERNATIVE FINANCIAL SERVICES

Community Economic Development Toolkit
by
California Community Economic Development Association (CCEDA)

2020 Update by
Donovan Jacobs

Edited by
Jahmeel Walker &
Roberto Barragan

Disclaimer

This fact sheet was produced by the California Community Economic Development Association (CCEDA), in partnership with the Community Action Partnership National Office, as part of the U.S. Department of Health and Human Services, Office of Community Services, and updated in partnership with the State of California Community Services and Development Division. This publication series is designed to increase the knowledge, processes and performance of community economic development projects nationwide. The contents of this manual are presented as a matter of information only. Nothing herein should be construed as providing legal, tax, or financial advice. The materials referenced and the opinions expressed in this product do not necessarily reflect the position of the U.S. Department of Health and Human Services, Office of Community Services, and no official endorsements by that agency should be inferred.

Support for the Community Economic Development project and this toolkit is provided by the Department of Health and Human Services Administration for Children and Families, Office of Community Services (OCS), grant award number: 90ET0426/01, and the California State Department of Community Services and Development.

ALTERNATIVE FINANCIAL SERVICES

TABLE OF CONTENTS

ALTERNATIVE FINANCIAL SERVICES TOOLKIT

The Alternative Financial Services Guide is intended for use by community development organizations for the following purposes:

1. Organizations wanting to learn about alternative financial services
2. Organizations considering development of alternative financial services for their community

BACKGROUND & INTRODUCTION

Alternative financial services (AFS) refers to products and services that provide basic financial transactions utilized by low-income individuals and households. Retail businesses such as check cashers, pawn shops, and payday advance lenders are frequently found in low-income neighborhoods where few bank or credit union branches are located, and are jointly referred to as Alternative Financial Service Providers (AFSPs). These alternative financial services providers offer an array of services that are popular with low-income consumers who do not have bank accounts or who choose not to use banks for their daily financial transactions. Services include check cashing (for a fee that is typically a percentage of the check's face value), payday advance loans, money orders, prepaid cards, wire transfers (including international remittances), utility bill payments, and sale of public transit passes.

Criticism over the fees charged by these businesses, especially for check cashing and payday advance loans, and concern over their 'predatory' nature and potential to lock low-income families in a cycle of debt, has led to experimentation with a variety of models to meet the same basic transactional needs of low-income households in lower cost, more responsible ways, with an eye toward helping them become more financially stable, as well as access more mainstream financial services, begin to save money/build assets, and ultimately become more self-sufficient.

A variety of efforts have been launched by community economic development organizations, particularly community development financial institutions (CDFIs) and community development credit unions (CDCUs), as well as by private sector banking institutions and retail stores to better meet the transactional needs of the low-income population without relying on check cashers and similar alternative financial services providers.

This guide will examine the size of the check cashing/alternative financial services industry as well as estimates of the unbanked and underbanked populations in the U.S. by way of documenting the market size for alternative financial services. It will also explore the various models being used by CDFIs and other nonprofits to provide check cashing and other alternative financial services to low-income families in responsible and sustainable ways. It will then walk through the possibilities and considerations for a community development organization just beginning to explore engaging in providing alternative financial services as a new program or line of business.

INDUSTRY/PROGRAM INFORMATION

A. Size of the Retail Alternative Financial Services Industry

According to market research firm Marketdata LLC, in 2019 AFS industry's transaction volume exceeded $37.6 billion annually, down from a high of $43.8 billion in 2013. This figure is likely understated, as estimates are not always available or updated for all industry segments. Moreover, precise data on many AFS transactions are not available due to the absence of a single agreed-upon definition and scope of the industry, and because this sector is highly fractured among many different providers that are often small or privately held.

Marketdata estimates that there are 12,000 check cashing stores, 14,000 payday loan outlets, 800,000 money transfer agents, 11,000 pawn shops and 10,000 rent-to-own stores in the U.S., serving an estimated nine million banked or underbanked households (note that this number of households is far fewer than other estimates). Currently check cashing store revenues are at $1.7 billion, payday loan outlets bring in $4 billion, money transfer agents deliver $7.8 billion, pawn shops generate $13 billion and rent-to-own stores take in $11 billion.

Check-cashing firms vary widely in size and scale from very small mom-and-pop outlets to publicly traded companies. Advance America, with about 1,425 stores, is the largest check-cashing company. Dollar Financial Corporation is the largest publicly traded check-cashing company, with about 700 stores in the United States.

B. Products, Services, and Fees

In addition to check cashing, AFS providers offer an array of other products and services, including money orders, automated teller machine (ATM) access, electronic bill payment, payday advance loans or pawnbroking services, and electronic tax preparation and filing. Check cashers also sometimes sell public transit passes, postage stamps, and phone cards; issue motor vehicle license plates and titles; process parking tickets; and provide photocopying and faxing services. In other words, AFS outlets seek to offer the full range of daily financial transactions that may be needed by lower-incomes households. This convenience is frequently touted as one of the attractions and advantages of AFS providers over traditional financial institutions.

Check cashers typically charge up to 5 percent of the face value of the check, depending on the check issuer and subject to limitations of state law. The largest check cashing businesses in the country tend to charge around 3 percent of the check amount. About two-thirds of checks cashed at nonbank outlets are payroll checks; another 18 percent are state or federal benefits checks.

Payday advance loans are another of the major (and most controversial) services provided by AFS retailers. These are high-cost-, small-dollar, short-term loans, due in full on the borrower's next payday. In the thirty-two states where these are legal (APR not regulated or defined as being constrained by the state's usury cap) and interest rates unrestricted, effective APRs average nearly 400 percent. In addition, AFS providers offer car title loans and six-month and one-year unsecured installment loans at often unlimited interest rates.

C. Other Retail Providers of Alternative Financial Services

Retailers are increasingly recognizing the revenue-generating potential of check cashing and other transaction-based financial services. In particular, Wal-Mart, the world's largest retailer, began operating MoneyCenters inside its stores in 2002 to provide check-cashing services. As with its typical pricing, Wal-Mart undercuts the competition on check cashing fees; it charges a flat $4 fee for checks written for up to $1,000 and $8 for checks over $1,000.

Wal-Mart is also a key player in the prepaid card market, offering its own money card featuring cash back and no monthly fee if a minimum of $1,000 is loaded onto the card each month. Convenience store chain 7-Eleven Inc. also offers check cashing, money orders, bill pay, and money transfer services in select stores. Currently, no single company dominates the prepaid card market. According to the FDIC's 2019 survey on banking and financial services behavior, prepaid card use is on the decline, with 8.5% of U.S. households using the cards, down from 10.2% in 2015. These cards are used far more in households where annual income is under $15,000 (13.5%) as well as where the residents are Black (14.8%), ages 15 – 24 (11.6%) and have not completed high school (10.3%).

D. ***Banks Offering Check Cashing and other Alternative Financial Services***

A decade ago, only a relatively few banks offered fee-based check-cashing services for non-accountholders, frequently with the goal of migrating check-cashing customers to more traditional bank products. These included KeyBank, based in Cleveland, Ohio, which provided check cashing, money orders, and other transactional services; Birmingham, AL-based Regions Financial Corp., which delivered expanded check cashing services (fee between 1.5 percent and 3 percent of the check amount, with a minimum fee of $3), and reloadable prepaid cards, money transfers, and walk-in bill payment services; and Union Bank of California (UBOC), which offered low-cost check cashing to non-accountholders through teller windows in some of its branches and dedicated service windows inside Nix Check Cashing outlets to provide access to UBOC account services.

Today, every major U.S. bank now offers check cashing to non-customers. According to MyBankTracker.com in February 2020, the banks charge a wide range of fees for the service, ranging from completely free check-cashing at Capital One Bank and free for checks under $5,000 at Citibank to a $10 flat fee at BBVA Compass Bank and percentages of the check amount as high as 2% at several banks. In addition, Wells Fargo (along with most other major banks) now offer prepaid debit cards, with several banks and other financial service companies specifically gearing prepaid cards to teens and college students to help them learn how to budget money.

While several major banks previously offer small-dollar loan 'checking account advances' or 'direct deposit advances' to accountholders, the practice has mostly died out, possibly due to criticism of the advances as carrying an effective APR of 365% and as evading and undermining state restrictions on payday lending as well as federal protections from payday lending for military families. One financial product (not in and of itself a bank) that offers a cash advance program is Level, a mobile bank app that offers interest-free cash advances of up to $500 to customers enrolled in a membership program. The loan must be repaid within 15 business days.

E. Size of the Market for Alternative Financial Services

Customers who utilize alternative financial services are typically ‘unbanked’ – meaning they have no checking or savings account, or ‘underbanked’ – meaning they may have a bank account, but do not utilize it to conduct their basic household transactions, using instead alternative financial services. In 2019, the FDIC conducted its most recent biennial study of banking and financial services behavior in the nation. Key overall findings of this study include the following.

- An estimated 5.4 percent of U.S. households – approximately 7.1 million – are unbanked. These households do not have a checking or a savings account.
- The proportion of U.S. households that are unbanked varies considerably among different racial and ethnic groups, with certain racial and ethnic minorities more likely to be unbanked than the population as a whole. Minorities more likely to be unbanked include African-Americans (an estimated 13.8 percent of Black households), Hispanics (12.2 percent), and American Indian/Alaskan Natives (16.3 percent). Racial groups less likely to be unbanked are Asians (1.7 percent) and whites (2.5 percent).
- In addition to the unbanked households, an estimated 17.2 percent of U.S. households, roughly 22.6 million, are underbanked. These households have a checking or savings account but rely on alternative financial services. Specifically, underbanked households are defined as having used one of three services: non-bank money orders, non-bank check cashing, and bill payment services such as Western Union or Money Gram. As with the unbanked population, certain racial and ethnic minorities are more likely to be underbanked than the population as a whole.
- Taken together, at least 22.6 percent of U.S. households, close to 29.6 million, are either unbanked or underbanked. Approximately 60 million adults reside in these households.
- A substantial percentage of lower-income households are unbanked. Nearly 33.7 percent of lower income U.S. households – earning below $30,000 per year – do not currently have a bank account.

Disaggregated data on the characteristics and behaviors of unbanked and underbanked are available from the FDIC in a supplemental report, including breakdowns of the use of AFSPs by demographics and use of particular AFSs by state. In addition, the data can be examined at city and county levels, including demographic data and census tract-level maps, at http://webtools.joinbankon.org/community/search.

In addition to examining the rates of un- and underbanked nationwide, the FDIC explored the use of alternative financial services by households, finding that approximately 56% of unbanked households utilize alternative financial services such as check cashing, pawn shops, and payday loans. This is on top of all underbanked households (17% of all households), who are defined as such by their reliance on alternative financial services.

F. Reasons Low-Income Consumers Choose Alternative Financial Services

The FDIC survey further inquired into the reasons for un- and underbanked households’ choices to conduct their financial transactions through alternative financial services providers rather than banks.

The majority of underbanked households cited necessity as their primary reason for utilizing alternative financial services providers for basic transactions such as check cashing and money orders; a significant plurality of unbanked households who were surveyed note that they lack the money to meet bank minimum balance requirements. The number two reason given is a lack of trust in banks, with number three being the unbanked's claim that avoiding a bank gives the individual more privacy in their financial transactions. In contrast, FDIC surveys from a decade ago revealed that a majority of un- and underbanked households cited convenience as their primary reason for utilizing alternative financial services, though in other studies liquidity – the need to access cash quickly – was cited as a key factor in AFS use.

Research by Lisa Servon, chair of the City and Regional Planning Department at the University of Pennsylvania, offers anecdotal insight into why low-income individuals choose alternative financial products that backs up the necessity rationale. To write her book "The Unbanking of America", Servon worked at a check-cashing business in the Bronx and a payday lender in Oakland. She found that many customers would cash checks and incur heavy fees in order to have access to the cash as soon as possible instead of depositing a check in a bank and having to wait for the check to be processed. While some customers undoubtedly cash checks for convenience, one example Servon provided was a contractor who cashed a large check in order to pay his workers (many of whom required cash immediately, possibly for legal reasons related to immigration status) as soon as possible. Other customers chose payday loans instead of maxing out credit cards with lower interest rates and incurring damage to their credit scores. Servon notes that mainstream banking has offered few replacements for the quick, small-dollar loans provided by payday establishments.

COMMUNITY DEVELOPMENT MODELS TO PROVIDE ALTERNATIVE FINANCIAL SERVICES

A. Community Development Engagement in Financial Education and Asset Building

At its root, concern over use of alternative financial services among low-income communities is concern over those families' resulting lack of access to the financial mainstream and inability to build assets and become financially stable and self-sufficient. Community development organizations recognize that families who utilize AFSPs are paying too much for their day-to-day financial transactions and thus become stuck in a cycle of inability to save for their future, or even for unexpected expenses. This recognition has led to numerous efforts characterized as falling under the 'asset building' umbrella. These efforts include financial literacy/education, credit counseling, individual development accounts (IDAs), and free tax preparation (VITA), geared primarily toward Earned Income Tax Credit (EITC) outreach.

Community development organizations have also partnered with financial institutions to connect low-income clients with basic banking accounts through "first accounts" program intended to help federal benefits recipients join the banking system, as well as efforts to encourage tax preparation clients to utilize direct deposit and save a portion of their EITC tax refund. In recent years, many community development agencies have become partners in local "Bank On" efforts. These city- and region- wide collaboratives (found in Los Angeles, Oakland, Sacramento and San Francisco among local governments, financial institutions, and nonprofits to provide financial education and connect low-income unbanked with low-cost basic bank accounts the financial institutions partners have agreed to offer.

Community development credit unions have sought to respond directly to the retail banking needs of low-income customers in a variety of ways – in some cases competing with AFSPs to offer check cashing and small-dollar loans and in other cases partnering with check cashers to provide improved access to credit union deposit accounts and financial education. These efforts are detailed below.

B. Community Development Check Cashing Models

Community Development Finance (CDF) launched Community Check Cashing, the first non-profit, full- service check-cashing store in the nation, in the Fruitvale section of Oakland, California, in 2009. The store offers financial services at lower cost than traditional check cashing outlets, including check cashing (with a 1.25% fee), bill payment, money orders, personal installment loans, money transfers, and debit cards. In 2010, CDF rolled out an alternative payday loan product that costs $7.50 per $100 borrowed (assuming 14-day loan period), compared to market rate of $15/$100 borrowed. CDF tries to mitigate default risk by using more careful screening and application processes than payday lenders. In addition, CDF offers low-cost financial coaching and training for households as well as support for small businesses, social services referrals, and creation of checking and savings accounts through bank and credit union partners.

C. Community Development Credit Union AFS Services

Seattle-based Express Credit Union is a credit union that offers innovative payday alternative loans. Payday alternative loans, or PALs, allow members of Express and some other federal credit unions to borrow small amounts of money at a lower cost than traditional payday loans and repay the loan over a longer period. In the case of Express, the loans are for up to $750. The member must pay a flat 15% fee and pay off the loan within 90 days. Those who pay off the loan in time get a $25 refund.

PALs are regulated by the National Credit Union Administration (NCUA), which created the program in 2010. The loans must be:

- Issued to borrowers who have been credit union members for at least one month.
- Granted in amounts between $200 and $1,000.
- Affordable, with a maximum annual percentage rate of 28% and an application fee of no more than $20, which reflects the actual cost of processing.
- Repaid fully after one to six months of installments; no rollovers allowed.
- Provided to borrowers one at a time.
- Borrowers may not receive more than three PALs within a six-month period.

In 2019, the NCUA added a second PAL option, known as PALs II, which has similar rules with the following exceptions:

- They can be any amount up to $2,000.
- Terms are one to twelve months.
- They can be taken out when membership is established, without a month-long waiting period.

PROCESS: EXPLORING ALTERNATIVE FINANCIAL SERVICES ENGAGEMENT

A. Due Diligence/Market Research

1. Existing Alternative Financial Services

To understand the local market for alternative financial services, community development organizations (CDO) must be thoroughly aware of the existing retail financial services within their target communities, both as possible competition and as potential partners in an effort to serve low-income families in a more affordable and responsible way. CDOs should do an exhaustive inventory of check cashing and other AFSPs, as well as existing bank and credit union branches within their footprint. This will include understanding the services and fees offered by each of these kinds of businesses. For check cashers, CDOs will want to fully understand services offered, fees, hours, and operating methods. It is important to be fully aware of the checking and savings account options offered by local banks and credit unions, and their accessibility and feasibility to serve a low-income client base. Furthermore, this inventory will need to include the availability and rate structure of small-dollar loans as well as check cashing and other fee-based services offered by the financial institutions. For credit unions in particular (especially geographically-defined community development credit unions), it is advisable to do an assessment of capacity to adequately serve the CDO's existing client community.

2. Market Demand for Alternative Financial Services

It will also be essential to have a thorough knowledge of the unbanked and underbanked population within the target community – their number, household characteristics, and financial services behaviors, preferences, and needs. As mentioned earlier in this toolkit, the FDIC findings on the rate of un-underbanked consumers are available at the city level through the Bank On network website (link available in the 'Resources' section at the end of this document). The FDIC also provides specific data on the overall use of alternative financial services products by demographic characteristics at state level, as well as use of particular AFS products (not demographically disaggregated) at the state level.

CDOs may also wish to obtain a more nuanced understanding of the financial services needs and preferences of their particular client communities by conducting surveys or focus groups, and/or by communication with other agencies working in the same area regarding the observed needs for financial services within the community. This examination should attempt to estimate the current costs to the target client population for conducting their basic household financial business.

3. Gap/Opportunity Analysis

Due diligence ultimately means that the organization must consider where, within the market assessed above, it might be positioned and able to offer a service that will provide lower-cost financial services or serve as an intermediary to connect clients with available lower-cost financial services that will help them to keep more income, enter the financial mainstream, and build assets.

B. Organizational Considerations – Questions to Ask

1. **Does program work in alternative financial services fit with the organization's existing mission and organizational culture?**

- Is engaging in providing alternative financial services (or connecting clients to them in some way) consistent with the organization's mission and core values?
- Is a focus on alternative financial services appropriate for the organization's target client base? Will it expand the organization's client base, or might it shift focus to a different client base?
- Would an alternative financial service focus support and enhance, or detract from the organization's overall community economic development approach and strategy?

2. **What is the "value added" for this organization to engage in offering alternative financial services?**

- How can the organization build on its existing and unique assets (knowledge of or access to specific neighborhood or client base, etc.) to capitalize on unmet demand for financial services as identified in opportunity analysis?
- Does/has the organization engaged in other asset-building efforts such as financial education/counseling, tax preparation, IDAs, etc.? How might expanding this work or integrating it with other asset building or financial services efforts create more value for the clients served?

3. **What is the organization's capacity to engage in an alternative financial services program or project?**

- Does the organization have any background in or understanding of providing financial services?
- Does it/has it ever operated as a retail or walk-in demand service? Is that in keeping with its business approach?
- Does it have facilities or technology (or access to these elements) to offer retail financial services?
- Does the organization have CDFI or other financial services certification? Is it interested in pursuing certification?
- Does the organization have any partnerships with financial institutions it can leverage to offer financial services?
- Does the organization have capacity to provide education?
- Could the organization effectively serve as a conduit connecting existing clients to improved financial education and services?
- How does the organization work collaboratively with partners and stakeholder organizations?

C. Selecting an Approach

As detailed in Section III of this guide, there are a variety of existing efforts to improve the quality and affordability of financial services available to low-income communities, as well as a core of CDFIs already active in and knowledgeable of the market, available technology, and promising trends. Given this, community development organizations are strongly encouraged to explore partnerships with existing CDFIs within their service area, and/or to tap into regional or broader efforts to serve the unbanked/underbanked market. Possible approaches are outlined below.

Note that the options presented fall along a continuum from a relatively simple and logical extension of services offered to more significant and challenging. Organizations moving into the area of targeting the needs of the un- and underbanked are urged to consider pursuing a progressive path through these options.

1. **Provide financial education and link low-income clients to appropriate, non-predatory financial services.**

Engage with existing community/regional "Bank On" or other collaborative effort to bank the unbanked/underbanked by providing education regarding financial choices and linkage to affordable and viable financial services products. If one does not exist, organizations may seek to convene organizations with similar interests in order to initiate such an effort. If the organization has not previously been engaged in asset building services, their effort is likely to begin with financial education and/or free tax preparation sites/EITC outreach in order to establish a baseline connection to clients and their needs.

2. **Collaborate with financial institution partner to target products/services to low-income client community.**

Utilize financial education as a gateway to mainstream/affordable financial services; and use access to financial services as an incentive to complete financial education/counseling/coaching. Connect client base directly with innovative, affordable financial products offered by a CDCU or bank partner; possibly work with financial institution partner(s) to offer new products, services, or approaches to better serve low-income families in the target community. This approach would also include improving the accessibility of affordable financial services for the target neighborhood or community. Encouraging a bank or credit union to establish a new presence within the community and co-marketing its location and products might achieve this. Alternatively, CDO offices or service facilities might serve as a full- or part-time 'micro-branch' where clients can conduct some basic banking transactions.

3. **Create a hybrid check casher-credit union partnership.**

Using existing alternative financial service provider infrastructure and technology may provide an effective way to draw consumers who typically utilize check cashing services into financial education and more traditional banking relationships by meeting them where they are. Here, a nonprofit CDO might serve as broker to identify appropriate financial institution and private sector check cashing partners, establish the terms of a shared facility and services agreement, and provide connections to appropriate financial education and products for customers.

4. Independently offer alternative financial services

Organizations working in isolated or very underserved areas may choose to establish a retail financial services presence such as a nonprofit check cashing outlet, based on the lessons and best practices of existing network of organizations engaging in financial services innovation. However, the startup burden for this approach is extremely high, and agencies should consider it only if no other feasible options for partnership or leveraging other resources exist. Moreover, in order to provide effective asset building opportunities, organizations will still need to establish financial institution partnerships in order to have both deposit and longer-term lending options to which to connect clients. Alternatively, organizations may seek to acquire CDFI status themselves in order to offer a comprehensive array of banking products, but this option is also extremely cumbersome and recommended only as a last resort.

Resources

Center for Financial Services Innovation - www.cfsinnovation.com

Provides research, best practices on full range of efforts to draw low-income and underbanked into the financial mainstream and build assets. Serves as the major network/intermediary for CDFIs (primarily) engaged in alternative financial services.

FDIC – www.fdic.gov

Has conducted the most detailed research and analysis unbanked/underbanked consumers nationwide and their use of alternative financial services, as well as documented banks' efforts to serve underbanked.

Bank On – www.joinbankon.org

National network of local and regional efforts to connect low-income communities to financial mainstream; also offers searchable community-level database of FDIC unbanked survey data.