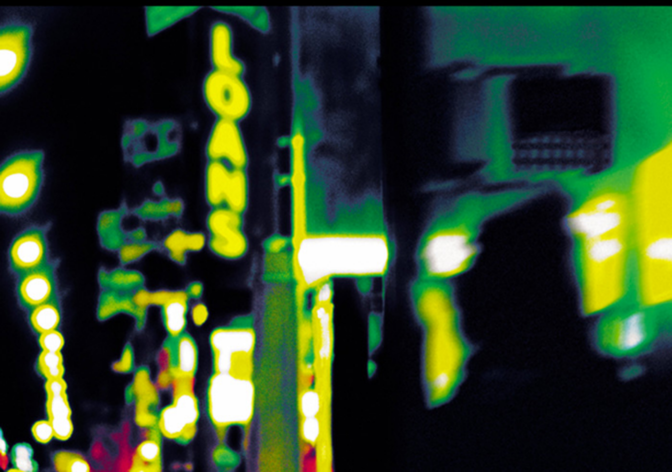
Howard Karger

Short¢hanged

Life and debt in the fringe economy



An Excerpt From

Shortchanged: Life and Debt in the Fringe Economy

by Howard Karger
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Contents

Preface ix
Acknowledgments xix

Part I
Overview of the Fringe Economy

1
America's Changing Fringe Economy 3

2
Why the Fringe Economy Is Growing 17

3
Debt and the Functionally Poor Middle Class 29

Part II
The Fringe Sectors

4
The Credit Card Industry 41

5
Storefront Loans: Pawnshops, Payday Loans, and Tax Refund Lenders 65

6
Alternative Services: Check-Cashers, the Rent-to-Own Industry, and Telecommunications 87

7
Fringe Housing 109

8
Real Estate Speculation and Foreclosure 129

9
The Fringe Auto Industry 145

10
The Getting-Out-of-Debt Industry 173

Part III
Looking Forward

11
What Can Be Done to Control the Fringe Economy? 197

Glossary 215
Notes 218
Index 237
About the Author 249

Preface

Shortly after starting to work on *Shortchanged*, I visited a "buy here, pay here" used-car lot in Houston, Texas. Dressed in blue jeans, a T-shirt, and a baseball cap, I went to the lot to get a feel for how the system worked. The salesman showed me the typical overpriced $3,000–$5,000 used cars that were slightly sporty, with high mileage and interiors that had obviously hosted a few parties. Even the cleaner cars had hardened cola spills, cigarette holes in the seats, and a musty smell reminiscent of smoke and fast-food burgers. I popped hoods, kicked tires, and tried to be enthusiastic about my dire need for a vehicle.

The salesman was affable until I asked about financing. "It's only $60 a week," he said, "pretty good for a car like this."

I nodded and then mistakenly asked, "What's the interest rate?" The negotiations chilled as the salesman turned his back and walked away. I followed him, asking why I was suddenly getting the cold shoulder.

"I don't know who you are, but I know you're bullshitting me."

Sheepishly I asked, "How do you know?"

"None of my customers ever ask about interest rates. All they care about is how much they gotta pay each week." In a nutshell, that's how the fringe economy works.

For many years, I included a small amount of material on the fringe economy as part of my graduate course in social policy. Although I understood the general concept of the fringe economy, I wasn't fully aware of the details.

About five years ago, I arrived early for a dinner at a restaurant in a small, run-down Houston strip mall. With almost an hour to kill, I stopped in at a check-cashing outlet and browsed through the leaflets. Since it was tax season, many brochures advertised "instant tax refunds." Being the only customer, I asked the clerk how these refunds worked. Through a small

hole in the bulletproof glass we chatted about tax refunds, check cashing, and payday loans. After hearing the details I was taken aback. While I understood the economics of higher risk and higher cost, the abuse of unregulated market power in regard to the economically fragile angered and dismayed me. I had always known that the poor got a raw deal in the fringe economy; I just hadn't realized how bad it really was.

Throughout the dinner my feelings alternated between outrage and relief. As a tenured college professor, I felt relieved that I'd never descend into that economic abyss. But, like much of the middle class, I had in the back of my mind that nagging "what if?" I knew that only a few shaky rungs separated me from the bottom of the economic ladder. Perhaps I'd knock the rungs out myself, or maybe they'd break because of events I couldn't control. This brief encounter led to my journey into the dark underbelly of America's fringe economy.

The first question I'm often asked is, "What's the fringe economy?" In the context of *Shortchanged*, I use "fringe economy" to refer to corporations and business practices that have a predatory relationship with the poor by charging excessive interest rates or fees, or exorbitant prices for goods or services. While some consumer groups use the term "alternative financial services sector," I prefer "fringe economy," because it better addresses the marginality of this economy and many of its customers.

After I list the visible parts of this economy—payday lenders, check cashers, rent-to-own stores, buy here, pay here used-car lots, tax refund lenders, and so forth—most people know what I'm talking about. But, as the book illustrates, these businesses are only the tip of a complex financial structure that engulfs virtually every area where people borrow, spend money, or purchase goods and services. At this point, a caveat is necessary. Some financial institutions that serve the poor—especially those in the nonprofit sector—are nonpredatory and are doing a remarkable job. Most for-profit businesses are not.

Despite its bland storefronts, the fringe economy is not composed primarily of family-run pawnshops, payday lenders, and check cashers. On the contrary, it's an industry increasingly dominated by a handful of large, well-financed national and multinational corporations with strong ties to mainstream financial institutions. It's also a comprehensive, mature, and

fully formed parallel economy that addresses the financial needs of the poor and credit-challenged in much the same way as the mainstream economy meets the needs of the middle class. The main difference is the exorbitant interest rates and fees and the onerous loan terms that mark fringe economy transactions.

I had several goals in writing this book. My first was to shed light into this dark and shadowy sector of the American economy. Paradoxically, while the fringe economy is everywhere, it is hidden from public view. For instance, we've all passed the throngs of pawnshops, check cashers, payday lenders, rent-to-own stores, tax refund lenders, and buy here, pay here car lots that are increasingly populating America's cities and towns. While some of us have used these services, most of us don't really know what happens there. For others, fringe economy storefronts are like porn shops. We don't exactly know what goes on inside, but we're pretty sure it's unwholesome. As *Shortchanged* illustrates, this intuition is correct—there's indeed something seedy going on in most parts of the fringe economy. Behind this seediness are economic transactions marked by desperation and exploitation. It's a hidden world where a customer's economic fate is sealed with a handshake, a smile, and fine-print documents that would befuddle many attorneys.

My second goal was to show how poor and credit-impaired consumers are systematically exploited by a subeconomy with few restraints. Lawmakers and government officials have largely ignored much of the untoward activities of the fringe sector, instead focusing on protecting the financial interests of the rich. This has resulted in an economy with one set of rules for the rich and a different set of nonrules for the poor. For example, Wall Street brokers are prosecuted for complex financial crimes that most people can't grasp. At the same time, tax preparers and refund lenders are permitted to skim off $1.3 billion from the Earned Income Tax Credit, a program designed to help the nation's poorest families.[1] These nonrules have allowed a Wild West economy—one with an open season on the poor—to flourish.

My hope is that concerned citizens, advocates, and state and federal officials and lawmakers will be sufficiently alarmed by these activities to bring some measure of justice—or simple economic decency—into this

sector. I am also hopeful that this book will further the ongoing dialogue about the need for alternative forms of credit and financial assistance, such as community banks, credit unions, and community development corporations. To further this goal, I've included suggestions for reform in most of the chapters.

My third goal was to make consumers aware of the inherent dangers of the fringe economy. Despite ads that promise to help people in need, fringe economy transactions are one-sided, and rarely do customers walk away better off financially. In most cases, the financial problems that drew people to the fringe economy are only exacerbated by overpriced goods and services, high interest rates and fees, impossible-to-meet loan terms, and short repayment schedules. This book may help friends, family members, and human-service professionals to steer financially troubled people away from the fringe economy. Some of this assistance might involve helping them find alternative and less predatory forms of financing.

In the avaricious world of the fringe economy, crafty merchants and economic institutions pander to the belief that everyone can have the American dream—only the poor have to pay more for it. In fact, the fringe economy leaves virtually no one without credit as long as they're willing to pay the price. Besides, if a transaction seems unaffordable, the down payment, interest rate, or terms can be adjusted to make it seem manageable, at least in the short run. While the fringe economy makes goods and services available to consumers who can't otherwise afford them, it also traps them in a cycle of debt.

The fringe economy is an unforgiving system that claims to give the poor and credit-challenged relief and a second chance. On the contrary, vulnerable customers are dragged deeper into a quagmire of debt. For most people, the greatest danger of the fringe economy doesn't lie in a single exploitive transaction, although it sometimes can. The real danger is becoming enmeshed in a subeconomy from which escape is difficult. For some at-risk consumers, fringe financial services are like an addiction—there's always money there when they need it. But, like most addictions, it comes at a high price.

A final goal was to show how the modern fringe economy reflects a

break from the past. The availability of high-cost predatory credit is hardly a new phenomenon in the United States. On the contrary, the nation has a long history of indentured servants, debt servitude, company stores, loan sharks, pawnshops, and predatory finance companies. For example, company stores in mill towns, coalfields, and migrant camps have traditionally kept poor workers in a cycle of perpetual debt. Black sharecroppers were held in debt servitude to landowners by land and crop mortgages carrying exorbitant interest rates.[2]

What makes the modern fringe economy different is the level of organization, the corporate control, the presumed legitimacy of these enterprises, the growing appeal to large sectors of middle-income households, and the geographic reach of these companies. While older fringe businesses were local, the new fringe economy is national and even global in scope. And the fringe economy is not just an urban phenomenon. Many small towns and cities across the United States have multiple pawnshops, check cashers, payday lenders, and rent-to-own stores. Even a small town like Bay City, Texas (population 21,000), boasts two pawnshops, two check cashers, and four rent-to-own stores, including three of the biggest—Aaron's, ColorTyme, and RentWay.

Lending money has historically been profitable, and this didn't escape the notice of the underworld. For example, in 2003, six associates of the Colombo crime family were charged with illegal loan-sharking, among other crimes. According to the Justice Department, one underworld crew operated a large-scale loan-sharking and bookmaking operation that preyed upon young employees of stock-brokerage firms. Usurious loans were made at interest rates of 1%–5% a week, or the equivalent of a 52%–250% APR (annual percentage rate).[3] Ironically, a 52% APR loan would be a bargain for many fringe economy customers. Even the 250% APR charged by the Colombo loan sharks is less than the 470% APR charged by many legal payday lenders.[4]

Entrepreneurs soon realized that they could make vast sums of money by providing "legal" financial services to desperate borrowers. In turn, mainstream banks lent entrepreneurs the money to set up check-cashing outlets, rent-to-own stores, and payday lending operations. Illegal loan-

sharking became redundant in many low-income communities as payday lenders took over. Consequently, some poor and middle-class consumers have simply shifted their borrowing habits from illegal to legal loan sharks.

A few notes on the book may be helpful. To begin with, I underestimated the difficulties I would encounter in the research. For example, when I started the book, I phoned an old friend whose daughter worked for a large payday lender in Arizona. Having known the family for 20 years, I was certain that Marcy would return my phone call. She never did. I phoned several more times, and still no return call. Finally, the family admitted that their daughter couldn't talk to me because she had signed an employee loyalty oath promising that she wouldn't discuss the business with anyone. Breaching that oath would result in dismissal, and she needed the income. I encountered the same refusal to discuss "the business" with employees in check-cashing outlets and pawnshops. In another instance, my wife, Anna, talked to a client whose daughter managed a pawnshop. The mother enthusiastically volunteered her daughter for an interview. When Anna followed up, she was told that her client's daughter couldn't discuss the pawnshop, and if I wanted more information, I'd have to contact the owner directly. The lack of transparency was striking, and I couldn't help but suspect that something was being hidden.

Some readers may be put off by the book's focus on the economic straits of the poor *and* the middle class, thinking that it minimizes the true impact on the poor. I had originally titled the book *Scamming the Poor*, but as I dug deeper, I soon realized that the fringe economy is also affecting a growing number of functionally poor households—those with above-average incomes but with little or no assets and high debt. Indeed, many financial transactions have become so tricky that the middle class, especially the functionally poor middle class, is also vulnerable to the predations of the fringe economy. As *Shortchanged* illustrates, the lines between the fringe and mainstream economies are blurred, and the interests of the poor and the functionally poor middle class are growing closer.

Several readers may find details about the fringe economy tedious. In the fringe economy, as in many things, the devil is in the details. Understanding the fringe economy requires a grasp of how financial schemes cir-

cumvent state and federal laws, and how consumers are becoming trapped in a cycle of indebtedness through loan rates and terms that are almost impossible to satisfy. In large measure, the fringe economy exerts its control by carefully manipulating the details of the financial transaction.

Some case examples are taken directly from interviews, while others are composites. Surrogate names are used throughout the book to protect the privacy of the interviewees. A few readers will notice variations in statistical data used in various parts of the book. These are due to the differences in data-gathering techniques used by different non- and for-profit organizations and federal agencies. Data discrepancies are often the most evident between fringe industry trade groups and consumer organizations. In those cases, I chose what I surmised to be the most reliable data.

Finally, the critical reader will certainly ask the challenging question, don't the credit problems of some fringe economy customers justify the high interest rates? The obvious answer is yes. Most of us wouldn't lend money to some fringe economy customers because it would be financially imprudent. But at what point does the profit so overshadow the risks that the transaction becomes predatory?

The answer is obvious in some cases. For instance, consumers who pawn their vehicle for one-third of its value, then pay 300% or more a year in interest to get it back, are exploited. Some consumers are forced to deposit hundreds or thousands of dollars into a low-interest-bearing savings account—which they aren't permitted to use to pay off their balances—to get a secured credit card. These cardholders then pay 30% or more in interest, plus monthly and sundry fees, for the "privilege" of using the card. They are exploited. Customers who take out a $200 payday loan costing almost $40 for 14 days at a 417% APR are exploited. Check-cashing customers who pay 3%—$30 on a $1,000 check—to cash a secure government check are exploited. Homeowners enticed into high-interest refinancing loans that systematically strip equity from their property are exploited. Still others who pay 28% in interest on a 10-year-old overpriced car are exploited.

The list goes on and on. Interest rates in the fringe economy are often in triple digits, and the grossly inflated prices of goods and services have no

relationship to their real market value. The poor and credit-poor live in a world where borrowing means temporarily or permanently losing a valued possession or paying an exorbitant fee for a small cash advance.

The following is a brief roadmap to *Shortchanged*.

Chapter 1 looks at the scope and size of the fringe economy and the characteristics of its customers. It then examines the major players in the fringe economy, including mainstream financial institutions. Chapter 2 explores key factors that explain the phenomenal growth of the fringe sector, including stagnant wages, the rising numbers of working poor, the impact of welfare reform, immigration, and the rise of the Internet. Chapter 3 looks at the functionally poor middle class, an economic group increasingly targeted by the fringe sector. It also investigates the role of household debt in the growth of the fringe economy.

Having a credit card is almost a necessity in America's plastic-driven society. Without one you can't rent a car, book a room or flight, or order goods online. Chapter 4 examines credit and the credit card industry. Specifically, it explores how the credit industry makes the unaffordable seem affordable by artificially manipulating interest rates and terms, how creditworthiness is determined, and how the credit card industry works. It also investigates how aggressive marketing lures young adults into a credit card trap. Finally, the chapter examines the high costs of alternative credit and debit cards.

Rows of payday lenders, pawnshops, and tax refund lenders are increasingly lining the streets of American communities. Chapter 5 explores cash loans. One of the fastest-growing segments of the fringe economy is the payday loan industry. Despite the keen competition among payday lending corporations, the spectacular rise in consumer debt—around $9 trillion in 2004—portends a rosy future for this multibillion-dollar loan industry.

Pawnshops have historically assumed the role of the neighborhood banker, lending money to those frozen out of the economic mainstream. This chapter examines the high cost of pawn transactions and its economic effects on borrowers. In addition, it looks at the important role that mainstream and federally insured banks are playing in the fringe economy.

Tax time is feeding time for the fringe economy. From January to April, newspapers, television, and radio are buzzing with ads about "instant tax refunds." Brochures are placed in thousands of convenience stores and supermarkets. Abandoned stores are suddenly occupied, at least for a few months. Appliance stores, car dealers, and other merchants advertise "instant money" if you promise to buy their wares. Chapter 5 explores the real costs of this instant money.

Chapter 6 investigates check cashing and auxiliary financial services (money orders, electronic bill paying, and so forth) that are lucrative parts of the fringe economy. The chapter also looks at how the fringe economy provides consumers with necessities such as appliances and furniture by way of the rent-to-own industry. Like furniture and appliances, telephone service is a necessity for many people. Without phone service it is difficult to secure employment interviews, contact relatives, or be available for family emergencies. The chapter examines the alternative telecommunications sector, including prepaid home and cell phone service.

While payday lenders, pawnshops, and check cashers can boast high earnings, the biggest revenues come from housing. Simply put, it would take 500 payday loans of $200 each to equal one $100,000 home mortgage. Not surprisingly, the rapaciousness of the fringe economy is clearly evident in the housing area. Chapter 7 investigates the fringe housing sector, the difference between subprime and predatory mortgage lending, various kinds of risky home mortgages, and home equity and refinancing loans. Chapter 8 looks at housing speculation and foreclosures.

Those who live in urban or rural areas without adequate public transportation need a reliable vehicle for arriving at work on time, for picking up children from school or day care, for exercising family responsibilities, and for shopping in low-cost stores. Vehicle ownership is also an area where fringe economy abuses are evident in everything from car purchases to insurance. Chapter 9 investigates the fringe auto economy and explores the obstacles faced by the poor in finding and keeping basic transportation.

Americans are besieged by two contradictory messages: get more and cheaper credit, and get out of debt. Unfortunately, the first message appears to be the most compelling. If the getting-into-debt industry is growing, the getting-out-of-debt industry is following closely on its heels.

Chapter 10 examines the latter, including collection agencies, the organization and evolution of consumer credit counseling agencies, the structure and limitations of debt-management plans, the corruption of "nonprofit"-agency status, debt settlement, and debt dispute and file segregation.

Chapter 11 looks at what can be done to control the fringe economy. It examines various strategies for reforming the fringe economy, including government regulations, consumer education, the need for mainstream banks to better serve the poor, and the creation of alternative lending institutions. Finally, the chapter looks at the future of the fringe economy.

He That Goes a-Borrowing Goes a-Sorrowing.

–Benjamin Franklin

1

America's Changing Fringe Economy

Driving through low-income neighborhoods, you can't help but notice the large number of pawnshops, check cashers, rent-to-own stores, payday and tax refund lenders, auto title pawns and buy-here, pay-here used-car lots. We are awash in "alternative financial services" directed at the poor and those with credit problems. These fringe economy services are equivalent to an economic Wild West where just about any financial scheme that's not patently illegal is tolerated.

Elise and Bernardo Rodriguez are typical fringe economy customers. The Rodriguezes emigrated from Honduras to San Antonio, Texas, in the middle 1990s. Elise works for a company that cleans office buildings, and Bernardo owns a small landscaping company. They have two school-age children. Although the Rodriguezes are paid by check, they don't have a checking or savings account. Instead, they use ACE Cash Express to cash their checks and to electronically pay bills. When electronic bill paying is not available, the Rodriguezes use money orders. They also wire money back to their family in Honduras through ACE. In fact, ACE is an important part of the Rodriguezes' banking system. Occasional trips to pawnshops and check cashers round out their informal banking system.

There are several reasons why the Rodriguezes use check cashers. For one, they can't wait for checks to clear. Because they make so little money, they live hand-to-mouth, and waiting a week or more for a check to clear the banking system means not having food on the table. Second, their account balances are so small after the rent and car payments that there's almost nothing left after the second week of the month. Third, the Rodriguezes live in a cash economy, and many of the small shops where they buy food, clothing, and other necessities accept only cash. Checks are viewed skeptically and generally not accepted. The Rodriguezes don't trust banks, and they don't feel welcome there. They are also reluctant to write checks for fear of bounced-check fees from banks and merchants. All told, the Rodriguezes spend almost 10% of their net income on alternative financial services, which is average for unbanked households that rely on the fringe economy for their financial needs.[1]

Defining the Fringe Economy

There is no generally agreed-upon definition of the fringe economy or of predatory lending. In fact, if a broad definition is applied that includes high-interest home refinancing and credit cards, then the fringe economy is used as frequently by the financially troubled middle class as by the poor. Nevertheless, in a public relations spin, the industry uses "subprime lending" to refer to "loans made to borrowers with credit problems by charging higher, but still fair, fees."[2] The Federal Reserve Board defines subprime lending as "extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers."[3]

Although a continuum supposedly exists between subprime and predatory lending, the delineation between the two is unclear. For example, what differentiates "expensive" or "very expensive" from "predatory" lending? When does an interest rate go from subprime to predatory? While not all subprime loans are predatory, all predatory loans are subprime. As Citigroup concedes, "There is no standard industry-wide approach to the definitions of either subprime loans or subprime lending programs, indicating that the meanings of these terms are institution specific."[4]

Under the Home Ownership and Equity Protection Act (HOEPA), a mortgage is considered high interest if the annual percentage rate (APR) is 8 points (8%) for first mortgages and 10 points for subsequent loans above the rate of return on Treasury securities for the same period, or if the fees and points at closing are 8% or more of the loan amount. This definition of a high-cost loan would be a bargain for the many fringe economy customers whose interest rates are measured in the hundreds of percent. A clear definition of predatory lending is important, since without it all manner of abuses can be overlooked.

The Scope and Profitability of the Fringe Economy

The spartan and often shoddy storefronts of the fringe economy mask the true scope of this economic sector. In 2003 government spending on social welfare programs included the following:

- $29 billion for Temporary Aid to Needy Families (TANF), the replacement for Aid to Families with Dependent Children (AFDC)
- $35 billion for Supplemental Security Income (SSI)
- $33 billion for food stamps, the Special Supplemental Food Program for Women, Infants, and Children (WIC), and school lunch programs
- $25 billion for the U.S. Department of Housing and Urban Development's (HUD) low-income housing programs

Altogether, the bulwark of America's public-assistance programs cost less than $125 billion. By comparison, check cashers, payday lenders, pawnshops, and rent-to-own stores engaged in at least 280 million transactions in 2001, generating about $78 billion in gross revenues.[5] If we add subprime home mortgages and refinancing, as well as used-car sales, revenues in the combined sectors of the fringe economy are several times higher than federal and state spending on the poor.[6]

About 22,000 payday lenders extended more than $25 billion in short-term loans to millions of households in 2004.[7] The 11,000 check-cashing stores alone processed 180 million checks in 2002, with a face value of $55 billion.[8] The sheer number of fringe economy storefronts illustrates the scope of this sector. For example, McDonald's has 13,500 U.S. restaurants, Burger King has 7,624, Target has 1,250 stores, Sears has 1,970, J.C. Penney has about 1,000 locations, and the entire Wal-Mart retail chain includes about 3,600 U.S. outlets. These combined 29,000 locations are fewer than the nation's 33,000 check-cashing and payday lenders, just two sectors of the fringe economy.[9]

ACE Cash Express, the nation's largest check casher, is an example of the scope, growth, and profitability of the fringe economy. In 1991 ACE had 181 company-owned stores; by 2003 that number had risen to 1,230 company-owned and franchised stores in 37 states and the District of Columbia. (ACE plans to add another 500 stores by 2008.) In 2000 ACE's net income was $8.3 million; by 2004 that had risen to $17.1 million. ACE claims about 1.2 million new customers a year, and in 2004 it served 38.2 million customers, or about 11,000 an hour. The company's revenue corresponded to its growth. In 2000 ACE's revenues were $141 million; by 2004 they had jumped to $247 million. In 2004, ACE

- engaged in 41 million total transactions worth over $8 billion,
- cashed approximately 13.2 million checks with a face value of $5.1 billion,
- made 1.9 million payday loans and earned $77 million in fees,
- completed 9.7 million bill-payment transactions,
- made 2 million wire transfers (worth $581 million) and sold 8.8 million money orders with a face value of $1.2 billion,
- added 53 new stores, compared with 14 in 2003.

ACE expects its total revenue for fiscal 2005 to range between $265 million and $270 million.[10]

Advance America, Cash Advance Centers, Inc., is the nation's leading payday lender, at least as measured by the number of its stores. By 2004 Advance America had 2,290 stores in 34 states. In 2003 it employed 5,300 people and had $489.5 million in sales with a net income of $96 million.[11] Advance America allied with out-of-state banks in 2002 to evade limits that some states imposed on the industry's excesses. After the federal Comptroller of the Currency cracked down on a bank that helped Advance America evade state regulation, the company affiliated with Federal Deposit Insurance Corporation (FDIC)–regulated state-chartered banks to further dodge regulation.

The company is a strange bird in the world of payday lending. William "Billy" Webster IV, Advance America's CEO and cofounder, was former president Clinton's director of scheduling and advance. Despite lending money to working people at exorbitant interest rates, Advance America partnered with seven nonprofit organizations in 2004 to "get out the vote." These nonprofits included the League of Women Voters, the National Urban League, the National Association of Latino Elected and Appointed Officials Educational Fund, People for the American Way Foundation, the League of United Latin American Citizens, the Southwest Voter Registration Education Project, and the Georgia Coalition for the People's Agenda. The drive signed on 110,000 new voters—double its original goal of 50,000—partly because of the availability of voter-registration forms in more than 2,000 Advance America locations in 29 states.[12]

Dollar Financial Corporation operates 1,106 stores—including 630 company stores—in 17 states, the District of Columbia, Canada, and the United Kingdom. Company stores operate under names like Money Mart, Loan Mart, and Money Shop. Dollar's 2004 revenues from its U.S. and international operations were $246.5 million. Unlike most fringe economy sectors, Dollar lost $28 million in 2004. Check into Cash has more than 700 stores, and CIC, its financial subsidiary, makes personal loans up to $1,000 in select markets.

In 1985 there were 4,500 pawnshops in the United States; by 2000 that number had risen to 14,000, including five publicly traded chains. The three big chains—Cash America International, EZ Pawn, and First Cash—had combined annual revenues of nearly $1 billion in 2003.[13] Cash America is the largest pawnshop chain, with 750 total locations in 17 states. It also offers payday loans through Cash America Payday Advance stores. In addition, Cash America provides payday loans and check cashing through Cashland and Mr. Payroll stores. In 2003 Cash America had revenues of almost $438 million, with a net income of $30 million. From 2001 to 2003 its revenues rose 23%, and net income was 60% higher from 2002 to 2003.

EZ Pawn owns 275 pawnshops in 11 states. Its 2003 revenues were $206 million, with a net income of almost $8.9 million. First Cash Financial Services, the nation's third-largest publicly traded pawnshop chain, has 280 pawnshops and check-cashing outlets in 11 states and Mexico. Its revenues totaled about $164 million in 2004.

The $6 billion–a–year furniture and appliance rent-to-own industry serves 3 million customers annually.[14] Rent-A-Center is the largest rent-to-own corporation in the world, employing 15,000 people. The company owns or operates more than 2,800 stores in the United States and Puerto Rico under the names of Rent-A-Center, Rent Rite, Rainbow Rentals, and Get It Now. It also controls 320 franchises through its subsidiary ColorTyme. In 2003 Rent-A-Center's sales were about $2.3 billion, with $181.5 million in net income. Aaron Rents has almost 900 stores across the United States and Canada. In 2003 its gross revenues were $767 million, reflecting a net income of $36.4 million. In 2004 RentWay operated 753 stores in 33 states and had revenues of almost $504 million.[15]

Low-income consumers paid almost $1.75 billion in fees for tax refund loans in 2002, and the nation's largest tax preparers earned about $357 million from fringe economy "fast-cash" products in 2001, more than double their earnings in 1998.[16] All told, about 12 million consumers received tax refund anticipation loans in 2002, almost half through H&R Block, whose revenues jumped from $2.4 billion in 2000 to $3.8 billion in 2003.[17]

The fringe economy is also buoyant in the housing market, where subprime home mortgages rose from 35,000 in 1994 to 332,000 in 2003, a growth rate of 25% a year and an almost tenfold increase in just nine years. In 2003 these mortgages accounted for almost $300 billion[18]; by that year, almost 9% of all mortgages were subprime.[19]

One reason for the profitability of the fringe economy is the relatively low cost of starting and running these businesses. For example, few of the check-cashing and payday stores I visited had more than one employee working at a time. Usually I was the only customer, and I was hard-pressed to imagine a restaurant or retail operation surviving with so little traffic. I suspected that the profit margin was so high that it compensated for the slow traffic.

Unlike typical retail businesses that require a substantial inventory and a large number of employees, a new payday or check-cashing store can open with a relatively modest investment, although that varies based upon the size and type of store. For instance, starting a new check-cashing store requires about $65,000–$75,000, which is counterbalanced by incentives from corporations like MoneyGram. The basic startup costs include property improvements, computer equipment, and a security system. In addition, the typical check-cashing and payday storefront requires working capital of $80,000–$100,000 for operating expenses and to fund the store's loan portfolio. According to ACE, it takes about one year for a store to break even.[20]

There's considerable money to be made from the financial misery of the poor and credit-challenged. And if the fringe economy squeezes its customers, it's certainly generous to many of its CEOs. According to *Forbes*, salaries in many fringe economy corporations rival those at much larger companies. Sterling Brinkley, chairman of EZ Pawn's board of directors, earned $1.26 million in 2004. Cash America's CEO, Daniel Feehan,

was paid almost $2.2 million in 2003 plus the $9 million he had in stock options. Feehan is also on the board of Radio Shack. James Kauffman, executive vice president of Cash America's international operations, received a paltry $932,000 but had $2 million in stock options. In 2003 First Cash Financial Services' board chairman, Phillip Powell, made $1.4 million along with the $19 million he had in stock options. Rick Wessel, vice chairman of First Cash's board, received $1 million in salary and owned $3.9 million in stock options.

According to ACE, "We also take great pride in being an active and empowering force in the communities in which we operate. That is why we give 1% of net income annually to support children's causes, education and financial literacy. We call it: Giving Back—The ACE Community Fund. . . . During fiscal 2004, ACE donated over $200,000 to various charities across the U.S."[21] In contrast to ACE's "generosity," its CEO, Jay Shipowitz, received $2.1 million in total cash compensation in 2004 on top of his $2.38 million in stocks.

Dollar's losses in 2004 didn't stop CEO Jeffrey Weiss from earning $1.83 million, of which $1 million was a bonus. Rent-A-Center's CEO, Mark Speese, made $820,000, with total stock options of $10 million. R. Charles Loudermilk, Aaron Rents' CEO, received a total cash compensation of $1.17 million in 2003 and had stock options of $5.8 million.[22] He also controls 60% of the company's voting power.

Billy Webster, Advance America's CEO, earned only $650,000 in 2003. However, the 4.6 million shares he owns in the company were worth almost $101 million in early 2005. (Webster's wife also owns considerable stock in Advance America.) Not to be outdone, George Johnson Jr., chairman of Advance's board and its other cofounder, indirectly owns about 10 million shares in the company worth $218 million in early 2005.[23] Inducted into the South Carolina Business Hall of Fame, Johnson served three terms in the South Carolina House of Representatives, having been elected as an independent, a Democrat, and a Republican. From 1984 to 1985 he was also a director of the Federal Reserve Bank of Richmond.[24]

America's fringe economy is clearly not a mom-and-pop industry composed of small storefronts that generate moderate family incomes. Instead, it is a fast-growing and highly developed parallel economy that provides

low-income and credit-impaired consumers with a full spectrum of cash, commodities, and credit lines.

Fringe corporations argue that their high charges represent the heightened risks of doing business with an economically unstable population. While fringe economy businesses have never made their criteria for determining prices public, some risks are clearly overstated. For example, ACE Cash Express assesses the risk of each check-cashing transaction and reports losses of less than 1%.[25] Because tax refund loan companies prepare and file the borrower's taxes, they are reasonably assured that loans will not exceed refunds. To further guarantee repayment, tax refund lenders often establish an account into which the Internal Revenue Service (IRS) directly deposits the customer's refund check. Pawnshops lend about 50% of a pledged collateral's value, which leaves a large buffer if it goes unclaimed (according to industry trade groups about 70% of customers redeem their goods). Repayment of credit card debt by high-risk borrowers is guaranteed by a credit line secured through an escrowed savings account (see chapter 4). The rent-to-own furniture and appliance industry charges well above the "street price" for furniture and appliances, which is generally more than sufficient to offset losses. Payday lenders require a postdated check or electronic debit transfer to ensure repayment. In any case, losses are obviously not severe given the phenomenal growth of the payday lending industry.

While risks exist—as in all industries—they are mitigated by loan collateral, excessive markup in prices, and the socialization of losses among a class of borrowers. Put another way, enough people will make good on their payday loans to compensate for the bad ones—not difficult, given the extremely high industry-wide profit margins. In short, industry claims about the high risks associated with serving marginal populations are exaggerated.

The major profit in the fringe economy generally doesn't lie in the sale of a product, but rather in the financing. For example, if a used-car lot buys a vehicle for $3,000 and sells it for $5,000, its profit is $2,000. But if it finances that vehicle for two years at a 25% APR, the profit jumps to $3,242. This dynamic is true for virtually every sector in the fringe economy. A customer's paying off a loan or purchasing a good or service out-

right is far less profitable than an ongoing financial relationship. Consequently, the profitability of the fringe economy lies in keeping customers continually enmeshed in an expensive financial system.

Mainstream Financial Institutions and the Fringe Economy

By 2000 there were no banks left in Southwest Baltimore. They wanted no part of a neighborhood where the median income was $19,000 and 58% of the residents lived below the poverty line. When the last bank left in the late 1990s, the 21,000 residents were forced to make due with check-cashing outlets, payday lenders, and pawnshops. The same phenomenon exists in South Central Los Angeles, a low-income community of 400,000 that has 133 check-cashing outlets and 19 bank branches.[26] For Southwest Baltimore, South Central Los Angeles, and hundreds of other low-income communities across the nation, the fringe lending sector has become the modern equivalent of a local community bank.[27]

The consolidation in the banking industry over the past 20 years has reduced the number of banks in low-income neighborhoods, increased the focus of banks on corporate and high-income customers, and limited banks' interest in serving consumers with small accounts or less-than-perfect credit. To counter this trend, some scholars and community activists are encouraging mainstream banks to set up branches in low-income neighborhoods.

John Caskey argues that mainstream banks should develop innovative programs to help low-income households build savings, improve credit profiles, lower bill-payment costs, and gain access to lower-cost sources of credit.[28] He suggests that banks can open conveniently located branch offices, targeted at low-income households, that offer nontraditional services such as basic low-cost savings accounts that include access to money orders; deposit accounts designed to help low-income people accumulate savings; secured loans to individuals whose credit histories make them ineligible for mainstream credit; and budget-management and credit-repair seminars. Despite Caskey's optimism, when traditional banks serve low-income communities, they are frequently as predatory as fringe economy businesses.

Rob Schneider, staff attorney for Consumers Union, maintains that banks have neglected low-income communities for years to concentrate on branches in more affluent areas. "Nowadays, banks are returning to the same neighborhoods to claim a piece of the pie once reserved for check-cashers, pawnshops, and payday lenders."[29] He says that the same banks now competing with check cashers had a hand in developing the industry. For example, many banks fulfilled their obligations under the 1977 Community Reinvestment Act (which required banks to serve low-income and minority communities) by investing in check cashers and other fringe economy businesses. To remain competitive in today's financial-services market, some banks are also tapping directly into the low-income market by providing check-cashing services and low-cost deposit accounts (see chapter 6).

Today's fringe economy is heavily dependent on mainstream financial institutions. For instance, ACE Cash Express has a relationship with a group of banks, including Wells Fargo and JP Morgan Chase Bank, to provide capital for its acquisitions and other activities.[30] Advance America has relationships with Morgan Stanley, Banc of America Securities, Wachovia Capital Markets, and Wells Fargo Securities, to name a few. Similar banking relationships exist throughout the alternative financial-services industry.

A growing number of mainstream financial institutions also serve high-risk consumers through their affiliates. Citigroup (the largest U.S.-based bank holding company) acquired Washington Mutual Finance in 2003, giving it 400 subprime lending offices in 25 states. Through its subprime flagship, CitiFinancial, Citigroup engages in subprime lending, and by 2000 it was America's largest subprime lender, with more than $16 billion in outstanding loans.

Subprime lending is clearly profitable. While Citigroup reported a 3% increase in income in 2001, CitiFinancial boasted 39%.[31] In 2002 CitiFinancial's income grew by 21% (more than $1.3 billion) and accounted for almost 10% of Citigroup's revenue.[32] Citigroup's 2004 net revenue was a staggering $21.89 billion.[33]

Some observers believe that the entry of mainstream financial institutions into subprime lending will help neutralize some of the worst features

of the fringe economy, an optimism that may not be justified. In one of the largest consumer protection settlements in Federal Trade Commission history, CitiFinancial paid $240 million in 2002 to resolve charges that its units Associates First Capital and Associates Corporation systematically engaged in widespread deceptive and abusive lending practices.[34] In 2003 a $51 million verdict was awarded in a class action suit filed against Lehman Brothers, First Alliance Corporation, and MBIA on behalf of 7,500 homeowners. The plaintiffs claimed that First Alliance defrauded them on home equity loans and that Lehman Brothers assisted in fraudulent activities when it financed the lender.

Wells Fargo is involved in subprime lending through its subsidiaries Wells Fargo Financial and Wells Fargo Funding. The California Department of Corporations found Wells Fargo Financial, prominent on the Association of Community Organizations for Reform Now (ACORN) list of predatory lenders, guilty of charging predatory interest rates to 15,000 customers in 2001. After refunding more than $533,000, Wells Fargo Financial turned around and overcharged many of these same customers another $338,000 in 2002.[35] EquiCredit, a former subsidiary of Bank of America (BofA), was forced to pay back $2.5 million to 12,000 Philadelphia homeowners because of predatory lending practices. BoA's former subsidiary NationsCredit was stung with a $2.5 million verdict by an Alabama jury for fleecing a couple on a home repair loan.[36] In 2001 the cost and embarrassment of these lawsuits led BofA to supposedly divest itself of subprime lending and liquidate its $26.3 billion subprime real estate portfolio, losing about $1.25 billion. However, BofA reentered the subprime market in 2004 when it purchased Oakmont Mortgage Company, a subprime lender.

Although the current concern that federal and state officials have shown toward the fringe economy is partly triggered by a desire to protect the public interest, it is also motivated by the pressure exerted by mainstream financial institutions to appropriate important parts of this market. For example, the Financial Service Centers of America (FiSCA), an industry trade group representing check cashers and payday lenders, came out strongly against BofA's proposed acquisition of Fleet Boston. FiSCA demanded that "the Federal Reserve Bank should require, as a condition

to approving the acquisition, that Bank of America make commercial banking facilities available to check cashers and prohibit the bank from enforcing its discriminatory blanket withholding of services from the entire industry."[37] Lest one believe that BofA's refusal to provide financial services to the check-cashing industry is grounded in corporate social responsibility, the bank charges $5 to cash checks in many states, which is the same as, if not more than, what many commercial check cashers charge. The fringe economy is clearly too profitable to be overlooked by mainstream financial institutions.

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by Howard Karger

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