An excerpt from

Shortchanged
Life and Debt in the Fringe Economy

by Howard Karger

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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 outright 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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