POVERTY SOLUTIONS
UNIVERSITY OF MICHIGAN

To: Kathryn Linehan, Fund Development Manager, Communities First, Inc
From: Nick Voelkner, Poverty Solutions at University of Michigan
Date: April 17th, 2023
Re: Barriers to Financial Security in Detroit

I. Executive Summary

In this memo, I identify and analyze three barriers to financial security and savings that the financial sector imposes directly on people (consumer reporting agencies, predatory financial institutions, and overdraft fees) and two additional systemic barriers (distrust of financial institutions and low levels of financial literacy). For the purposes of this memo, financial security is defined as the ability of a person to self manage their own finances to make empowered decisions for themselves. I conclude the memo by analyzing perspectives from the financial sector on financial security among low income people. Using bank websites as a proxy for their positions due to the lack of formalized research literature, I find that banks emphasize a holistic view of financial security that centers barriers outside of the financial sector instead of specific technical changes that they could make to existing policies.

II: Barriers to financial security from the mainstream financial sector

Consumer reporting agencies

- Account screening **consumer reporting agencies (CRAs) are an increasingly important key actor in denying access to safe and affordable financial products to consumers across the country and have contributed to the financial system's arbitrary and unfair treatment of low income people from the financial system[1].** Although account screening CRA's were originally developed as an industry protection for responsible consumers against fraudulent bank clients, they are now largely used by financial institutions to pre-judge prospective clients[2]. **Currently over 80% of banks use reports to decide whether a consumer can open a checking or savings account with a relevant financial body[3].**These reports detail information about a consumer's banking history and financial background and ostensibly provide banks with an unbiased arbiter who determines creditworthiness[4]. However, because of existing biases in the financial system against marginalized groups, this can prevent millions from accessing financial products and services from mainstream financial institutions[5].

- CRAs have been repeatedly criticized by watchdog organizations for a lack of transparency in methods, questionable results in the reports themselves, and proportion and consistency in their application[6]. For those reasons, in 2012 the Consumer Financial Protection Bureau (CFPB) issued a rule granting itself supervisory and enforcement authority over CRA's[7]. This built on previous work that CFPB has done to regulate other actors in the financial industry. Regulatory efforts up to this point have focused on ensuring CRA compliance with Fair Credit Reporting Act requirements, conducting examinations of large CRA's, and directing changes in policies and procedures surrounding data accuracy and dispute investigations[8]. Recommendations for regulatory reform from other governmental entities include better communication from CFBP to all CRA's, requiring greater transparency to the public, and gathering data of the impact of CRA's on predominantly low income consumers 9. As of August 2021, these recommendations have not been implemented[10].

Predatory lending

- Predatory lending, broadly encompassing payday lending, fringe financial products, and any abusive high interest loan, has become a large driver of financial inequality and a barrier to savings[11]**.** These practices target low income people by offering critical access to immediate credit and then trapping them in a debt cycle that is difficult to escape[12]. Because low income consumers generally lack access to credit, predatory lending offers a solution when other options have been exhausted[13]. This inhibits savings by forcing consumers who engage with predatory lenders to spend more on debt payments or have their wages garnished because of lack of payment by court order[14]. Unfair, exploitative, or abusive lending practices also target marginalized communities, with lenders in many cities concentrated disproportionately in majority Black and Latinx neighborhoods[15].

- Most consumers interact with predatory lenders by getting a payday loan, the most expensive short term-consumer loan on the market[16]**.** In 2012, 5.5% of adults nationwide had used a payday lender within the prior 5 years[17]**.** Offering relatively low amounts of money but carrying average annual percentage rates of 400%, this type of financial product can force the consumer to pay back more than they earn over time, severely inhibiting the consumer's ability to accumulate savings[18].

- **As predatory lenders have expanded since the 1990s, low income consumers have suffered from high rates of default/foreclosure/repossession and exclusion from the mainstream financial system[19] [20]**.Research shows that loans issued under abusive conditions have greater default rates, increase the likelihood of declaring bankruptcy and contribute to wealth disparities[21]. Payday loans have also been linked to adverse physical and emotional health outcomes[22]. Additionally, predatory lending causes spillover effects by leading to further distrust of the financial system[23]. Directly, it led to a net drain of nearly $1 billion dollars and over 14,000 jobs from the economy in 2012[24].

Overdraft fees

- Financial institutions levy overdraft fees on customers when a checking account has insufficient funds to cover a charged expense[25] **Overdraft fees target a small number of low income consumers who regularly overdraft their accounts; 80% of fees were paid by just 9% of account holders[26].** Despite the high costs that overdraft fees impose on consumers (35$ on average) for what is effectively a short term loan from a financial institution, the fees are often charged for extremely low amounts of money withdrawn[27]. Because of this structure, overdraft fees have become an important source of profit for financial institutions disproportionately at the expense of low income consumers[28]**. In 2019, banks and credit unions in the United States collected $15.5 billion from their customers through overdraft and non-sufficient fund fees[29].**

- Outside of the short term, direct financial costs to consumers, **overdraft fees inhibit savings accumulation, push vulnerable groups into the arms of predatory lenders, and price people out of the mainstream banking system[30].** Consistent overdraft charges can lead to people leaving the financial system altogether and becoming unbanked[31]. Additionally, as previously mentioned in this report, overdraft fees are reported back to consumer reporting agencies. This can lead to closure of the customer's account and a permanent black mark on their financial history telling other institutions not to let them open another[32].

- Driven by repeated controversy over their utility to the financial system, pressures from new financial technologies, and skepticism from policymakers and regulators, financial institutions have slowly begun to unwind onerous overdraft fees or offer other alternatives[33]. Revenue collected from overdraft fees peaked in 2009 and many large and medium sized banks now offer accounts without overdraft fees at all, although consumer awareness remains low[34]. **Despite movement away from overdraft fees, they remain a barrier to access to financial services and savings accumulation[35].**

III: Barriers from outside the mainstream financial sector

Distrust of financial institutions and P2P (peer to peer) lending

- **Although trust in the financial system has fluctuated significantly over time, research shows that distrust of banks remains prevalent among the unbanked population[36].** While not unexpected given the financial sector's long history of discrimination towards low-income and marginalized groups, distrust in the financial system is a key driver for lack of participation in it[37]. In a 2019 survey conducted by the FDIC, distrust of banks was the second most cited reason (36.3%) unbanked households did not have a bank account[38]. Additionally, most unbanked consumers express further distrust that financial institutions care about their financial well being or to do the right thing[39].

- Because the financial system is undergirded by trust between various disparate actors like brokers, insurance companies, banks, and investment firms, distrust in financial institutions by consumers can have profound effects. **Consumers who are distrustful of the financial system are less likely to participate in banking, more likely to turn to predatory financial products, and have lower incomes than the general population[40].** Public distrust in the financial system is also correlated with financial crises and economic recessions[41].

- **Distrust in financial institutions has directly led to the rise of crowdfunding platforms and peer to peer lending as skeptical individuals turn away from mainstream financial services[42].** Peer to peer lending is a form of financial technology that allows people to lend or borrow money without going through a bank[43]. These loans have substantially higher default rates from those in traditional finance, raising risks for a vulnerable population that already experience severe financial struggle[44]. Distrustful consumers who are driven to participate in P2P markets by exclusion from the traditional financial system are more exposed to further financial risk through riskier borrowing alternatives as their primary options[45].

Low levels of financial literacy

- As technological advances have led to financial systems and products growing in complexity, financial literacy levels among Americans remain low. **Only 57% of US adults measured as financially literate in a 2014 S&P Global Financial Literacy Survey**, with significant variation across income groups (people with higher incomes exhibited higher levels of financial literacy than people with lower incomes)[46]. This ranks the United States behind peer countries such as the United Kingdom, Canada, and Germany in terms of financial literacy[47].

- **Depressed levels of financial literacy can lead to consumers unknowingly committing financial mistakes and make them less likely to engage in financial practices or to be able to cope with sudden economic shocks, inhibiting savings and wealth accumulation[48].** While a lack of financial literacy can prevent consumers from engaging with the mainstream financial system, the reverse is also true; a lack of financial literacy can lead to consumers making poor investments or banking decisions as they try to understand or prematurely engage with complex financial products[49].

- Although financial literacy among Americans has improved in recent years, continuing to build up financial skills is highly relevant to the unbanked and underbanked population and a key way to secure financial inclusion and improve savings[50]. **Efforts to address financial literacy among Americans have focused on three policy buckets: early education/adoption, mitigation, and retirement planning[51].** Early adoption deals with promoting financial knowledge to youth, mitigation on addressing negative impacts of financial illiteracy, and retirement planning on retirement objectives and goals[52]. The federal government commits around $300 million annually on financial literacy, while state policy changes have primarily focused on altering education standards in k-12 schools[53].

IV: The banking perspective on financial security

Banks adopt a holistic approach to financial inclusion, security, and diversity

For this analysis, I examined the financial inclusion/diversity/social impact website sections from the five largest banks in the United States to ascertain what perspective they have adopted towards financial security and equity in the financial system. These financial institutions are: Bank of America, Wells Fargo, JPMorganChase, Citigroup, and Goldman Sachs[54 55 56 57 58]. Collectively these financial institutions hold trillions of dollars in assets and make important financial decisions that affect everyday consumers regularly.

- **Four out of five websites examined adopted an all encompassing and holistic perspective towards financial inclusion, security and diversity.** They often cover large interlocking policy issues like affordable housing, small business creation and funding, and jobs and skills training. The sole exception of the five (Wells Fargo) focused primarily on technical changes the bank has made towards financial products like overdraft fees[59]. Every website displayed examples of the bank's community led investments and initiatives. Many of these focused specifically on diversity, equity and inclusion.

- **Every bank's website (with the exception of Citigroup's) focused on an American perspective towards financial security and mentioned financial education as a solution to increasing participation in the financial system.** This aligns with a positive research literature that finds financial education is effective at improving personal finance behaviors[60]. **Additionally, banks generally avoid public conversations about specific financial regulation or financial policy changes that could benefit consumers[61].** Banks instead focus on monetary led investments, diversity initiatives, and sustainability goals[62].

Endnotes

1. Wu, C. C., & Plat, K. (2015, October 1). Account screening consumer reporting agencies: A banking access perspective. National Consumer Law Center.

2. Oubre, M., Cohen, M., Lindquist, J., Dumez, J., & Carly Bertolozzi. (2021, July 9). *Blacklisted: How ChexSystems contributes to systemic financial exclusion.* San Francisco Office of Financial Empowerment.

3. Wu, C. C., & Plat, K. (2015, October 1). Account screening consumer reporting agencies: A banking access perspective. National Consumer Law Center.

4. Wu, C. C., & Plat, K. (2015, October 1). Account screening consumer reporting agencies: A banking access perspective. National Consumer Law Center.

5. Wu, C. C., & Plat, K. (2015, October 1). Account screening consumer reporting agencies: A banking access perspective. National Consumer Law Center.

6. Oubre, M., Cohen, M., Lindquist, J., Dumez, J., & Carly Bertolozzi. (2021, July 9). *Blacklisted: How ChexSystems contributes to systemic financial exclusion.* San Francisco Office of Financial Empowerment.

7. *Consumer reporting agencies: CFPB should define its supervisory expectations.* (2019, July 16). Government Accountability Office.

8. *Consumer reporting agencies: CFPB should define its supervisory expectations.* (2019, July 16). Government Accountability Office.

9. *Consumer reporting agencies: CFPB should define its supervisory expectations.* (2019, July 16). Government Accountability Office.

10. *Consumer reporting agencies: CFPB should define its supervisory expectations.* (2019, July 16). Government Accountability Office.

11. Carr, J. H., & Kolluri, L. (2001). Predatory lending: An overview.

12. Carr, J. H., & Kolluri, L. (2001). Predatory lending: An overview.

13. Bourke, N., Horowitz, A., & Roche, T. (n.d.). *Payday lending in America: Who borrows, where they borrow, and why.* Pew Charitable Trusts.

14. Carr, J. H., & Kolluri, L. (2001). Predatory lending: An overview.

15. Bourke, N., Horowitz, A., & Roche, T. (n.d.). *Payday lending in America: Who borrows, where they borrow, and why.* Pew Charitable Trusts.

16. Brown, C., & Robinson, L. (2015). *Breaking the cycle: From poverty to financial security for all.* PolicyLink.

17. Bourke, N., Horowitz, A., & Roche, T. (n.d.). *Payday lending in America: Who borrows, where they borrow, and why.* Pew Charitable Trusts.

18. Bourke, N., Horowitz, A., & Roche, T. (n.d.). *Payday lending in America: Who borrows, where they borrow, and why.* Pew Charitable Trusts.

19. Sweet E, Kuzawa CW, McDade TW. Short-term lending: Payday loans as risk factors for anxiety, inflammation and poor health. SSM Popul Health. 2018 June 7;5:114-121. doi: 10.1016/j.ssmph.2018.05.009. PMID: 29922711; PMCID: PMC6005810.

20. Wolff, S. D. (2015, June). *The state of lending in America & its impact on U.S. households.* Center for Responsible Lending.

21. Wolff, S. D. (2015, June). *The state of lending in America & its impact on U.S. households.* Center for Responsible Lending

22. Sweet E, Kuzawa CW, McDade TW. Short-term lending: Payday loans as risk factors for anxiety, inflammation and poor health. SSM Popul Health. 2018 June 7;5:114-121. doi: 10.1016/j.ssmph.2018.05.009. PMID: 29922711; PMCID: PMC6005810.

23. Wolff, S. D. (2015, June). *The state of lending in America & its impact on U.S. households.* Center for Responsible Lending

24. Wolff, S. D. (2015, June). *The state of lending in America & its impact on U.S. households.* Center for Responsible Lending

25. Examining Overdraft Fees and Their Effects on Working Families: Hearings before the Senate Finance Committee, 117th Congress (2020) (testimony of Aaron Klein).

26. Examining Overdraft Fees and Their Effects on Working Families: Hearings before the Senate Finance Committee, 117th Congress (2020) (testimony of Aaron Klein).

27. Examining Overdraft Fees and Their Effects on Working Families: Hearings before the Senate Finance Committee, 117th Congress (2020) (testimony of Aaron Klein).

[28.] Valenti, J. (2022, March 30). *Overdraft fees can price people out of banking.* Consumer Financial Protection Bureau.
[29.] Examining Overdraft Fees and Their Effects on Working Families: Hearings before the Senate Finance Committee, 117th Congress (2020) (testimony of Aaron Klein).
[30.] Examining Overdraft Fees and Their Effects on Working Families: Hearings before the Senate Finance Committee, 117th Congress (2020) (testimony of Aaron Klein).
[31.] Valenti, J. (2022, March 30). *Overdraft fees can price people out of banking.* Consumer Financial Protection Bureau.
[32.] Account screening consumer reporting agencies: A banking access perspective. National Consumer Law Center.
[33.] Bernard, T. S. (2021, June 22). *Banks slowly offer alternatives to overdraft fees, a bane of struggling spenders.* The New York Times.
[34.] Examining Overdraft Fees and Their Effects on Working Families: Hearings before the Senate Finance Committee, 117th Congress (2020) (testimony of Aaron Klein).
[35.] Examining Overdraft Fees and Their Effects on Working Families: Hearings before the Senate Finance Committee, 117th Congress (2020) (testimony of Aaron Klein).
36. Federal Deposit Insurance Corporation (FDIC), *How America Banks: Household Use of Banking and Financial Services, 2019 FDIC Survey* (October 2020).
[37.] City of San Francisco Office of Financial Empowerment. *Systemic Barriers to Banking the Unbanked*. (2020, December).
[38.] Federal Deposit Insurance Corporation (FDIC), *How America Banks: Household Use of Banking and Financial Services, 2019 FDIC Survey* (October 2020).
[39.] Federal Deposit Insurance Corporation (FDIC), *How America Banks: Household Use of Banking and Financial Services, 2019 FDIC Survey* (October 2020).
[40.] Federal Deposit Insurance Corporation (FDIC), *How America Banks: Household Use of Banking and Financial Services, 2019 FDIC Survey* (October 2020).
[41.] Saiedi, E., Mohammadi, A., Broström, A., & Shafi, K. (2022). *Distrust in Banks and Fintech Participation: The Case of Peer-to-Peer Lending.* Entrepreneurship Theory and Practice, 46(5), 1170–1197.
[42.] Saiedi, E., Mohammadi, A., Broström, A., & Shafi, K. (2022). *Distrust in Banks and Fintech Participation: The Case of Peer-to-Peer Lending.* Entrepreneurship Theory and Practice, 46(5), 1170–1197. https://doi.org/10.1177/1042258720958020
[43.] Klein G, Shtudiner Z, Zwilling M. *Why do peer-to-peer (P2P) lending platforms fail? The gap between P2P lenders' preferences and the platforms' intentions.* Electron Commer Res. 2021 Jun 17:1–30.
[44.] Reddy, S., Gopalaraman, K., & Reddy, S. (2016). Peer to peer lending, default prediction-evidence from lending club. Journal of Internet Banking and Commerce.
[45.] Klein G, Shtudiner Z, Zwilling M. *Why do peer-to-peer (P2P) lending platforms fail? The gap between P2P lenders' preferences and the platforms' intentions.* Electron Commer Res. 2021 Jun 17:1–30.
[46.] Klapper, L., Lusardi, A., & van Oudheusden, P. (2014). *Financial literacy around the world: Insights from the Standard & Poor's Ratings Service global financial literacy survey.*
[47.] Klapper, L., Lusardi, A., & van Oudheusden, P. (2014). *Financial literacy around the world: Insights from the Standard & Poor's Ratings Service global financial literacy survey.*
[48.] Hung, A. A., Parker, A. M., & Young, J. K. (2009, September). *Defining and measuring financial literacy.* RAND.
[49.] Klapper, L., Lusardi, A., & van Oudheusden, P. (2014). *Financial literacy around the world: Insights from the Standard & Poor's Ratings Service global financial literacy survey.*
[50.] 45. Antonia Grohmann, Theres Klühs, Lukas Menkhoff. *Does financial literacy improve financial inclusion? Cross country evidence*. World Development. Volume 111, 2018, Pages 84-96,ISSN 0305-750X.
[51.] Contreras, O., & Bendix, J. (2021). Financial literacy in the United States. Milken Institute.
[52.] Contreras, O., & Bendix, J. (2021). Financial literacy in the United States. Milken Institute.
[53.] Contreras, O., & Bendix, J. (2021). Financial literacy in the United States. Milken Institute.
[54.] *Advancing racial equality & economic opportunity*. (n.d.). Bank of America.
[55.] *Banking Inclusion Initiative.* (n.d.). Wells Fargo. https://www.wellsfargo.com/jump/enterprise/ banking-inclusion-initiative/
[56.] *Our commitment*. (n.d.). Goldman Sachs. https://www.goldmansachs.com/our-commitments/community-engagement/index.html
[57.] *Strengthening community.* (n.d.). Citigroup. https://www.citigroup.com/global/our-impact/ strengthening-community
[58.] *Impact.* (n.d.). JPMorgan Chase. https://www.jpmorganchase.com/impact

[59.] *Banking Inclusion Initiative.* (n.d.). Wells Fargo. https://www.wellsfargo.com/jump/enterprise/ banking-inclusion-initiative/

[60.] Martin, Matthew, A Literature Review on the Effectiveness of Financial Education (June 15, 2007). FRB Richmond Working Paper No. 07-03, Available at SSRN: https://ssrn.com/abstract=2186650 or http://dx.doi.org/10.2139/ssrn.2186650

[61.] *Impact.* (n.d.). JPMorgan Chase. https://www.jpmorganchase.com/impact

[62.] *Our commitment*. (n.d.). Goldman Sachs. https://www.goldmansachs.com/our-commitments/community-engagement/index.html