

# 1 / Four Themes

The following chapters investigate in depth how pawnshops and CCOs function, who uses these institutions, and for what reasons. They also discuss the factors behind the recent rapid growth in fringe banking and examine the case for regulating pawnshops and CCOs. This initial chapter, however, steps back from the details and sets out the four major themes that emerge in the book.

The first theme is that households without financial savings must often pay more than other households for basic financial services. This observation includes financial markets in a pattern that has long been recognized in markets for nonfinancial goods and services (see Caplovitz 1963). For example, people living in areas with high concentrations of low-income households must often patronize a small number of local retail outlets that charge more for their products and offer a more limited selection of products than do retail stores in middle- and upper-income areas (Andreassen 1975). Stores in low-income urban areas that sell consumer durables commonly offer less favorable credit terms or market their products through rental-purchase agreements that greatly increase the effective price of the goods. While there is

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little disagreement that retail prices are higher in low-income urban areas, there is much disagreement over why this is so. Community activists often charge that the retailers in low-income areas use local monopoly power to exploit their customers. The retailers respond that their costs are significantly higher than those of retailers in more affluent areas.

Financial markets are no exception to the rule that the poor pay more. But the relevant measure of poverty in financial markets is not household income; rather, it is the household's ability to maintain financial savings.<sup>1</sup> Although these two measures are closely related, they are not perfectly correlated. A family's ability to maintain savings depends on its income level as well as its structure, stability of income, special needs, and lifestyle choices.

Families that do not maintain financial savings often have bad credit records or debt to income ratios that exclude them from mainstream sources of consumer credit. This is true for several reasons. Such families have no financial margin of safety; even temporary disruptions in family earnings or unforeseen expenditure needs can interfere with their ability to service outstanding debts. Families without financial savings are often headed by individuals with low incomes and low education levels who may experience periods of unemployment and drastic earnings fluctuations. Other families cannot maintain savings because of expensive special needs, such as major medical bills, and may be forced to accumulate substantial debts. Paying for necessary medical care can understandably claim a higher priority than servicing accumulated debts. Finally, households that do not maintain savings because of lifestyles that are expensive relative to their incomes are likely to be near the limit of their debt service capacity and may not have had the financial discipline or foresight to meet past debt service obligations.

In addition to being cut off from major consumer credit sources, households without financial savings are often excluded from mainstream payment services. One must maintain a deposit account at a bank or similar institution to write a check. Similarly, banks generally cash checks drawn on other banks only for their

<sup>1</sup>In another context, Michael Sherraden (1991) discusses this distinction in detail in *Assets and the Poor: A New American Welfare Policy*.

own depositors. Even those with deposit accounts must commonly wait for a check to clear through the banking system before withdrawing the cash if they do not maintain a sufficient balance in their account to cover the check.

Since households without financial savings are often excluded from the credit and payment services of mainstream financial institutions, many must turn to pawnshops and CCOs to meet these needs. Fringe banks, however, are a costly alternative. Pawnshop credit is commonly ten to fifteen times more expensive than consumer loans from banks. The payment services of CCOs are four to six times as expensive as those of banks. Although local monopoly power may account for a part of these fees, this is not the major factor. Rather, fringe banking fees are high because the cost of providing the credit or payment service is high relative to the size of the transaction.

The second theme that emerges in this study is that the 1980s boom in fringe banking and the increasing segmentation of consumer financial markets reflected the increasing polarization in the economic well-being of American families. The incomes of millions of households at the lower end of the income distribution fell or stagnated. Combined with other socioeconomic changes, the percentage of the population living from one paycheck to the next with no financial savings of note increased over the 1980s. Since bank payment services are largely restricted to bank depositors, people without financial savings had to turn elsewhere for basic payment services. Similarly, the falling standards of living of many lower-income households meant that more of them were cut off from mainstream credit sources, forcing them to turn to pawnshops to meet credit needs.

Changes in banking regulations and bank policies, which indirectly reflected changes in ideology, technology, and the inflation of the 1970s, also contributed to the fringe banking boom.<sup>2</sup> Toward

<sup>2</sup>In economic history there are numerous examples to reinforce the notion that changes in social conditions, technology, ideology, and macroeconomic conditions shape financial systems. The development of bond and stock markets in the first half of the nineteenth century was closely related to the technological advances that led to the steam engine, large factories, railroads, and the telegraph (Krooss and Blyn 1971). In the late nineteenth century, the rise of huge business trusts and industrial giants with massive financial needs increased the importance of Wall Street and led to the creation of chains of retail brokerage houses to sell stock and bond instruments to

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the end of the 1970s, economists, policymakers, and the public became much more critical of regulation, viewing it as largely serving special economic interests. At the same time, historically high inflation and accompanying high interest rates placed banks at a competitive disadvantage to securities markets, since legal ceilings existed for interest rates on bank deposits but not for interest rates on commercial paper or bonds. The diffusion of low-cost computer technology played a vital role in the development of money market mutual funds and interstate banking by "nonbank" banks, accentuating the competitive disadvantage of traditional banks. These developments led the government to lift controls on bank deposit interest rates and to promote competition in consumer financial markets (Litan 1987). The resulting increase in competitive pressures forced banks to pay higher interest rates to attract large deposits and to eliminate some money-losing services that they had previously cross-subsidized, such as the provision of low-cost, small-balance deposit accounts. The increased cost of small-balance deposit accounts encouraged many households with limited financial savings to abandon the banking system. And, in response to competitive pressures, banks closed unprofitable or marginally profitable branches, many of which were in low-income areas. These developments combined to spur the demand for fringe banking services.

The third theme of this study is that, although many households patronize fringe banks because they have no practical alternatives, a significant share of pawnshop and CCO customers use these institutions on a discretionary basis. It is not unusual, for example, for a pawnshop customer to borrow to pay for a vacation, an evening's entertainment, or other discretionary expenditures. Many people using check-cashing outlets could wait 3 to 5 days for their checks to clear through a bank, but they prefer to pay a fee to get the cash immediately, or they value the convenient

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the public across the country. In the early twentieth century, the mass marketing of the automobile and other consumer durables to the growing middle class led to rapid growth in casualty insurance and consumer finance companies. The Depression and associated congressional hearings led the public to demand greater safety and stability in the financial system, especially for financial institutions or markets used by the middle class. This resulted in new laws that radically restructured the financial system by separating commercial banking from investment banking, creating the Securities and Exchange Commission, and insuring deposit accounts in banks.

location and operating hours of a CCO. In other words, some people turn to fringe banks out of necessity, but others do so because they believe that the services these institutions provide are worth the fees.

Critics argue that many of the low- and moderate-income households who patronize fringe banks on a discretionary basis exhibit poor judgment; that these households either base their decisions on incorrect information about the relative convenience and cost of fringe banks or that they demonstrate an irrationally short time horizon in budgeting expenditures. Such critics claim that many people patronizing fringe banks on a discretionary basis are wasting their money without regard to the longer term consequences. These criticisms of the economic behavior of lower-income families can be socially divisive and controversial, but any comprehensive analysis of fringe banking must acknowledge them. If the discretionary use of fringe banks arises from mistakes in judgment, an increased emphasis on consumer education would be an appropriate response to the problem.

The fourth and final theme that emerges from this study is that insufficient resources are devoted to regulating and monitoring fringe banking markets. Our society devotes substantial resources to protecting consumers in the financial markets and institutions serving middle- and upper-income households. These measures are justified by a number of considerations. Bank depositors, for example, cannot obtain the information that they would need to evaluate the riskiness of a bank's loan portfolio. Even if the information were available, most depositors would not know how to use it. In addition, it can be more cost-effective to have a regulator set limits on bank risk-taking and insure deposits rather than rely on market mechanisms to limit bank risk-taking. In securities markets, where it is assumed that more sophisticated investors interact, regulations insist on disclosure of relevant information and the prevention of insider trading.<sup>3</sup>

In the case of fringe banking, there are similar justifications for

<sup>3</sup>The stability of banks and securities markets is linked to aggregate economic stability. These institutions and markets are also critically important in allocating savings to productive investment projects. In addition to consumer protection issues, these considerations are used to justify many of the regulations governing banks and securities markets.

regulation. The vast majority of customers are far less sophisticated in economics than are the owners or managers of fringe banks. In fact, many customers would have difficulty converting a fee, stated in percentage terms, into a dollar figure. As in mainstream financial markets, customers also cannot obtain information that should be relevant to their decision to patronize a particular fringe bank. Pawnshop customers, for example, must leave their collateral with a broker without knowing how well the broker cares for the collateral or what steps the broker takes to protect against losses from fire or theft.

Despite these similarities to mainstream financial markets, very few resources are devoted to regulating fringe banks. The federal government does not specifically monitor or regulate pawnshops or CCOs. Most states do regulate pawnshops. The vast majority, however, do not collect any data on the industry and devote almost no resources to enforcing the regulations. A minority of states regulate commercial check-cashing outlets. Of those that do, even fewer monitor practices in the industry or devote meaningful resources to enforcing the regulations. Undoubtedly, much of the disparity between the resources devoted to consumer protection in mainstream financial markets and those devoted to regulating and monitoring fringe banks is explained by differences in the economic and political power of their customers. In a just system, however, the recognition that most pawnshop and CCO customers have little economic or political power should increase the priority of consumer protection measures in these markets.

The subsequent seven chapters present the data and analyses behind these four themes. To place recent developments in an historical context, Chapter 2 discusses the evolution of pawnbroking and commercial check cashing in the United States from the colonial period through the early 1970s. Chapter 3 examines the operations of contemporary pawnshops and CCOs and documents the rapid growth in fringe banking over the 1980s. Chapter 4 describes who uses pawnshops and check-cashing outlets and why they choose to do so. Chapter 5 studies the factors responsible for the 1980s boom in fringe banking. Chapter 6 explains why pawnshop and check-cashing fees are high compared to fees for similar services from mainstream financial institutions and exam-

ines the case for regulating fringe banks. Chapter 7 briefly reviews public policy proposals aimed at improving the access of lower-income households to mainstream deposit institutions. The final chapter speculates on future growth prospects for pawnshops and check-cashing outlets and discusses some of the broader economic and social policy implications raised by the increased segmentation of consumer financial markets.