

The Operations, Appeals and Costs of the Alternative Financial Sector: Implications for Financial Counselors

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Lower-income consumers use a growing number of financial services including pawn shops, rent-to-own programs, check-cashing outlets, and rapid-refund tax services as alternatives to traditional financial services. These services constitute the Alternative Financial Sector (AFS). Compared to the traditional financial sector, AFS services are very expensive. This article describes services offered through the AFS, appeals utilized to attract customers, and the cost of using the AFS. The article provides financial counselors with information to help them work with AFS users.

KEY WORDS: *alternative financial sector, lower-income consumers, pawn shops, rent to own*

Financial counselors working with lower-income consumers have probably encountered expenditure notations such as *Furniture - rent, \$18* or *Pawn - loan, \$40*. Rent-to-own programs and pawn shops are among the most common alternatives to traditional credit but with effective annual percentage rates often exceeding 300% (Swagler & Wheeler, 1989). There are also other services that lower-income consumers use as alternatives to traditional financial services. The alternatives to traditional financial services stress immediate access to small amounts of money and are very expensive. They constitute the *alternative financial sector (AFS)*.

Parts of the AFS -- pawn shops, for example -- have been around for centuries. The emergence of the AFS as an identifiable sector, however, reflects the recent growth of rent-to-own programs, pawn shops, rapid-refunds from income tax preparers, post-dated checks, money orders, and check-cashing services. Few of these services are covered in conventional personal

finance texts or financial counseling manuals. Yet, as the AFS expands, lower-income consumers face the growing possibility of finance charges which are so high that keeping up financially maybe difficult and getting ahead is nearly impossible. Reliance on the AFS may indicate financial dysfunction and financial counselors need to be familiar with the methods, mechanisms, and cost of the AFS. This article introduces the AFS and its operation; demonstrates the manner in which AFS firms use advertising to attract consumers who need immediate cash; and compares the cost of the AFS to the cost of using traditional financial services.

The Alternative Financial Sector

Although practitioners may be familiar with the range of AFS services, researchers have examined the various elements individually and not as part of a larger entity (Brown & Richardson, 1973; Caplovitz, 1963, 1967; Caskey, 1991, 1994; Chandler, 1993; Goldman, 1976; Jones, 1968; Martineau, 1958; Meyers, 1970; Rent-to-Own, 1993; Roper, 1989; Stein, 1980; Stein & Brown,

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1988; Swagler & Baschon, 1989; Swagler & Wheeler, 1989; Taterka, 1987). The recognition of the sector by scholars has lagged behind the growth of the market. The AFS is in fact an interrelated set of services designed to meet many short-term financial needs. The various elements of the AFS grew in response to the same factors, serve similar clientele, and pose similar problems for consumers (Andreason, 1975). Table 1 contains a brief description of various elements of the AFS.

Costs in the AFS are substantially higher than costs for comparable services through traditional financial outlets. Because the AFS is patronized largely by lower-income consumers, the high costs are incurred by individuals who are least able to pay (Stein & Brown, 1988; Taterka, 1987).

The typical transaction, which usually involves a small amount of debt extended over a short period of time, leads some observers to conclude that the AFS represents an insignificant "fringe" (Caskey, 1994; Marino, 1993). This is a mistaken notion because even small amounts of money may be significant for low-income consumers, and when numerous AFS services are used, large totals may accumulate quickly. Moreover, AFS transactions are frequently carried over, so the customer either continues paying interest to maintain the same loan, or, when one debt is retired, assumes another.

An additional problem with the AFS is the difficulty of regulating the industry. The patterns described above are typical, but considerable variation exists and change is ongoing. Some stores offer either rent to own or small loans for jewelry only. Services are sometimes packaged in ways that defy classification. When one activity is limited, a new version develops or the focus shifts from formal to informal transactions.

Table 1
Description of Elements of the Alternative Financial Sector (AFS)

Regular check cashing is available at check-cashing outlets which cash personal, government and pay checks. Many consumers who use check-cashing outlets do not have checking accounts with banks; fees range from 1 to 10% or more, but vary by state and type of check.

Money orders are alternatives to personal checks and are widely available through the post office, convenience stores, and check-cashing outlets. The cost of money orders ranges from \$.75 to over \$3. There is a limit to the maximum amount of any one money order.

Rental-purchase agreements are credit alternatives offering ownership when merchandise is rented on a weekly or monthly basis for periods of 12 to 18 months. Although these "rent-to-own" programs stress low periodic payments, total costs are high. Based on data collected for this paper in Salt Lake City, Utah and Athens, Georgia, a sofa which costs \$700 at a furniture store may cost approximately \$1,700 through a rent-to-own program. As long as the merchandise is rented, free repair or replacement is provided, but if customers fail to make payments on time, the merchandise is taken back and no equity is accrued.

Pawn-shop loans are credit alternatives which in some states include car-title loans. With the former, the customer leaves the merchandise (30-day loans are typical); with the latter, the customers surrender the car title and a key to the car as collateral for the loan (loans of up to 90 days are typical). The typical cost of a car-title loan is \$25 per month per \$100 borrowed. Using rates collected for this study, consumers who obtain loans at pawn shops encounter annual percentage rates above 300%.

Refund-anticipation loans (RALs) are offered by many income tax preparers and other outlets. RALs are not typically marketed as loans, but as "fast," "quick," or "rapid refunds." In fact, they are short-term loans through traditional financial institutions and are secured by the taxpayer's refund check. The cost of the loan ranges from \$29 to \$150, depending on the size of the refund.^a

Post-dated checks, sometimes called "pay-day loans," are unsecured loans from check-cashing outlets. The customer can cash a check dated up to two weeks later. Typical charges range from \$15 to \$20 for a two-week loan of \$100, with APRs ranging from 300% to over 500%. These are illegal in some states.

The Research

The immediate need for small amounts of money is one of the most important reasons that consumers use the AFS. Firms within the AFS are certainly aware of their customers' short time horizons and focus their appeals accordingly. Yellow Page advertisements were analyzed for this research because businesses in the AFS would likely advertise in the Yellow Pages and because the Yellow Pages are available in all geographic areas.

This research analyzed the Yellow Page advertisements in eight medium and large cities in different regions of the country.⁴ Only display advertisements were analyzed because they offer promotional, as well as basic, information about business firms. Commercial banks that cater to consumers were also analyzed so that traditional financial services could be compared to AFS.

Content analysis was used to determine frequency of four possible messages: *immediacy*, *convenience*, *friendliness*, and *cost*. These messages could appear in either the copy of the advertisement or in the name of the establishment (e.g., Quick Cash or E-Z Pawn). Any word or phrase which conveyed the message that cash could be obtained *quickly* was included in the *immediacy* category. Advertisements in which the word *cash* was emphasized in the text or in the name of the business were counted in the *immediacy* category because they convey the message that either the property or signature of the customer can be converted to cash immediately.

The *convenience* category included factual statements or puffery that suggested convenience such as extended hours, offering services to Spanish-speaking individuals or loans by telephone.

The *friendliness* category included any wording which either expressed or implied that customers would feel comfortable and welcome doing business at the establishment.

The *cost* classification included specific references to the cost of the service.

Immediacy was emphasized most often, with

⁴One of the cities (San Antonio, Texas) had a significant military population.

convenience ranking second for all types of AFS services except for check-cashing outlets, where immediacy and convenience were almost equally likely to be emphasized.^b Fewer lenders geared their advertisements to friendly service and cost. When cost was mentioned, comparisons were generalized (e.g., low cost, highest loans on pawns). Only a few commercial banks in the sample featured any of the four elements in their advertisements.

Table 2
Content Analysis of AFS and Commercial Banks' Yellow Pages Advertisements*

	Message Conveyed:			
	Immediacy	Convenience	Friendliness	Cost
Check Cashing (n=30)	12	13	--	2
Pawn Shops (n=148)	63	19	13	23
Loan Companies (n=94)	54	41	11	8
Banks (n=168)	1	8	10	4

*Anchorage, Atlanta, Boston, Brooklyn, San Francisco, Kansas City, MO, Miami, New Orleans, and San Antonio.

The Yellow Pages data suggest that AFS patrons place a high value on immediacy. For persons with short-time horizons, time takes precedent over cost. These findings will come as no surprise to those who work with the financially distressed. The need, then, is for educators and counselors to convey the true cost of immediate gratification of financial needs to this population in an effective manner.

The Price of Immediacy: Added Cost of the AFS

While state and federal truth-in-lending regulations require that the annual percentage rate (APR) and, when possible, the dollar cost of a loan be disclosed to the consumer prior to applying for a loan, the APR is an abstract figure. Dollar costs are useful as comparisons, but debtors also need to be aware of the opportunity cost of using the AFS.

Table 3 presents a comparison of three types of financial services: regular check type services, credit services, and occasional credit services. The comparison of a household with a checking account and one that relies on the AFS for checking services illustrates the AFS

household would pay \$576 more per year. Costs in the AFS are so much higher that fee structures alone seems to be an inadequate explanation of why lower-income consumers rely less on checking accounts.⁶

A comparison of the costs of continuous credit use, reveals the premium consumers pay when using the AFS. Credit which would cost \$300 annually from traditional sources would cost over \$4,000 more from the AFS, even though the former traditional credit cost is based upon relatively expensive credit card debt.

The comparison of non-continuous, or occasional, credit use shows the amounts are relatively small because of limited use, but the differential is pronounced. Overall, AFS use comes at a high premium.

The magnitude of the cost differentials between the AFS and traditional financial services provides graphic evidence of higher costs in the AFS that clients may pay attention. Using the AFS for credit obviously carries great potential costs. Data on actual use of the AFS are unavailable, but the trend appears to be upward. The potential economic loss is significant.

In the face of specific cost information, clients may say that they know the AFS is more expensive, but they still choose to use it because of other perceived advantages. Table 4 compares the advantages of AFS and traditional services. Traditional and alternative services are not perfect substitutes. Nevertheless, a comparison of Tables 3 and 4 makes it clear that any advantages of the AFS come at a very high price.

Implications and Conclusions

For the financial counselor, a client's reliance on the AFS can be taken as a warning signal. The warning applies both to the injurious behaviors and to the attitudes which underlie them. AFS use imposes high costs on the segment of the population which can least afford them. These high costs reduce the amount of discretionary income available to families. AFS use can become a vicious circle. When it is difficult to meet immediate obligations, there is little time for longer-term considerations. It becomes difficult for a family to extricate itself from AFS dependency and ultimately improve its economic status.

Table 3
Cost Comparison of the Alternative Financial Sector and the Traditional Financial Sector for Selected Services

	AFS	Traditional	Difference
<i>I. Checking Services (3 Months)</i>			
Maintain checking account	---	45	
Cash checks	159	---	
Buy money orders	30	---	
Total checking: 3 months	189	45	144
<i>II. Credit Services (3 Months)</i>			
Rent to Own	180	---	
Credit card #1	---	36	
Credit card #2	---	14	
Pawn of goods	150	---	
Auto loan	---	25	
Car title pawn	750	---	
Total credit: 3 months	1080	75	1005
<i>III. Occasional Credit Services</i>			
Refund Anticipation Loan	59	---	
Unsecured credit union loan	---	6	
Pay Day loans [#]	160	---	
Cash advance from credit card	---	16	
Total occasional services	199	22	177

Traditional Financial Services Assumptions

The cost of the checking account is based on a Consumer Federation of America study (1993) and includes a bounced check and ATM use.

Credit Card #1 is the charge for \$800 borrowed at an APR of 18% to buy a 27" television.

Credit Card #2 assumes an average balance of \$200 at 18% APR, plus a \$5 prorated portion of the annual fee.

The auto loan assumes a \$1,000 balance remaining on a loan with a 10% APR.

The unsecured credit union loan is \$1,000 for 21 days at 10% APR.

The cash advance on the credit card is \$400 for one month at 18% APR, plus a 2½% cash advance fee.

Alternative Financial Services Assumptions

Check-cashing charges assumes that \$5000 in payroll checks and \$300 in government checks are cashed with a 3% charge.

Money order fees are based on 10 per month at \$1 each. The rent-to-own charge is for a 27" television at \$60 per month.

Items are pawned for \$200 at an APR of 300%.

The car-title loan is for \$1,000 with an APR of 300%.

The refund-anticipation loan is for 21 days at 101% APR.

"Pay-Day" loans cover two consecutive 14-day loans of \$400 at 520% APR.

Even those who can meet their obligations to the AFS

have little or nothing to show in terms of an improved credit record. AFS transactions are typically not part of a formal credit history, which can leave consumers without access to traditional sources of credit, a situation which may have forced them to use the AFS in the first place. Indeed, there is no *long term* in the AFS. This becomes particularly important with respect to mortgage lending. The AFS has no equivalent service and does not prepare the consumer to seek such financing from traditional sources.

Thus, the AFS is often a dead end for consumers. Effecting a change in behavior, however, requires a change in attitudes and approaches. There is an insidious kind of circularity to the AFS. The focus on meeting current obligations reinforces the tendency toward a short-time horizon, which may have initially attracted the family to the AFS. The pattern is very difficult to break, but comparative cost information may help clients realize that they are wasting large amounts of money.

For clients who realize the expense and change behavior, benefits go beyond the money saved. A checking account facilitates basic financial planning. To the extent that poor planning forces families to patronize the AFS, even minimal planning should represent an improvement. With planning comes the possibility of a longer-time horizon, goal setting, and a willingness for a family to take responsibility for its financial situation. There is also an element of stability associated with managing a checking account. That stability is necessary for the family to qualify for services from traditional financial institutions.

It is not difficult to see why families opt for the AFS when the choice is between the slow and often difficult repair of financial management practices on one hand, and offers of "quick cash," "low payments" and "have it now" on the other. Even those committed to the former will still face the temptations of the latter. Counselors who are better acquainted with those temptations, and the consequences of giving in to them, will be better positioned to help clients map a strategy which avoids the dead ends of the alternative financial sector.

The same is true of consumer educators, particularly those in outreach or community-based programs.

Because the AFS is often ignored in textbook treatments, its significance may be underestimated. It would be easier to offer truer estimates, of course, if additional research on the AFS were available. Such research should promote a fuller understanding of the AFS and the potential hazards its patrons face.

Table 4
Differences in Quality of Financial Services Between the Alternative Financial Sector and the Traditional Financial Sector

Advantages of the Alternative Financial Sector

- No maintenance and repair costs for rent-to-own goods.
- More flexibility in terminating agreement or updating equipment for rent-to-own goods.
- Credit checks and extensive applications are not typically required.
- Receipt of cash or goods (rent to own) with minimal or no waiting period.
- More AFS outlets in poorer communities.
- More convenient hours of operation.
- More respectful treatment of customers.

Advantages for the Traditional Financial Sector

- Checking accounts offer services beyond check writing and cashing (e.g., ATM use).
 - Do not have to spend time and other resources buying individual money orders.
 - Have use of goods that are bought on credit, whereas, goods that are pawned (except for car-title loans) are held by the lender as collateral.
 - Customers establish a credit history that is useful in future transactions.
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Endnotes

- a. *New rules from the U.S. Internal Revenue Service aimed at curbing questionable claims for earned income credits had the unintended effect of sharply limiting RALs in 1995.*
- b. *The slight difference with respect to check-cashing outlets may be significant. Checks, by nature, give immediate access to cash. However, check-cashing outlets compete with banks in terms of convenience by longer operating times and neighborhood locations.*
- c. *However, checking account fees have continued to rise sharply; recent increases are not reflected in these figures.*

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