POLICY STUDIES

Access to Credit and Financial Services Among Black Households

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Consumer Issues Research Series
Consumer and Community Affairs Division
June 2000 (2000-1)

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Abstract

Based on findings from a survey of Black households, this paper highlights socioeconomic and demographic factors that may influence the utilization of different financial markets. In addition, it discusses the potentially important role that informal financial networks can play in racial/ethnic communities. We propose that education programs, proactive community participation, and partnerships between financial institutions and community organizations are important for greater access to credit and financial services among Black households.

Access to Credit and Financial Services Among Black Households[1]

INTRODUCTION

Programs and initiatives undertaken to enhance credit access and community development efforts, especially among minority and lower-income communities, will be more successful when there is a clear understanding of the need for and availability of credit and financial services. Although several national surveys collect household financial information, extracting definitive statements of fact about the use of financial markets among specific racial or ethnic groups often has been problematic.

In response to the paucity of information on Black household financial behavior, the Federal Reserve Bank of Chicago conducted a survey in Chatham, a long-standing Black community on the south side of the City of Chicago between 1997 and 1998.[2] Uniquely, this survey includes questions designed to explore the household's use of *informal* networks of family, friends, and ethnic/community organizations as well as the use of *formal* financial sources such as banks, savings and loans, credit unions, and mortgage and finance companies. Information also is collected about the household's patronage of *alternative financial service* (AFS) businesses such as check cashing outlets, currency exchanges, and pawnshops.[3] This paper presents facts concerning the use of these financial market sources by Black households and proposes several programs and initiatives aimed at encouraging community development activities through greater access to credit and financial services.[4]

POLICY OVERVIEW

In a perfect world, a consumer’s decision among financial service providers reflects optimizing behavior driven by the availability of accurate and timely information for a given level of income. In practice, however, consumers may have difficulty in obtaining the information needed to make the most favorable choice among financial service providers. Historical perceptions and/or negative experiences (e.g., loan denial) with a formal institution also may have an important influence on a minority consumer's choice toward non-mainstream, alternative financial services. Consequently, public policies that encourage access to credit and other financial services are important to a household's financial decisions, and ultimately to community development opportunities.

Beginning with the Fair Housing Act of 1968 and further elaborated on in the Equal Credit Opportunity Act of 1974, policies have been adopted to ensure access to credit for *all* creditworthy individuals.[5] Although not an anti-discrimination law, the Community Reinvestment Act of 1977 (CRA) encourages financial institutions to help meet the credit needs of their local communities, including low- and moderate-income neighborhoods, consistent with the institutions’ safe and sound banking practices. In a policy statement made in October 1986, the Federal Financial Institutions Examination Council encouraged individual depository institutions and trade associations to offer basic banking services such as low-cost checking and savings accounts.[6] Pursuant to the Debt Collection Improvement Act of 1996, banks are encouraged to offer low-cost deposit accounts, including electronic transfer accounts or free government check-cashing services, to increase access to financial services for lower-income individuals. Taken together, these policies have been established to enhance credit availability, encourage the use of financial services and promote community development opportunities wherever possible.

FINANCIAL MARKETS

The availability of financial services is an essential element of a healthy community. Several benefits are derived from holding a deposit account and establishing a credit relationship with a formal financial institution. Households are shielded from risks associated with holding uninsured cash reserves. Having access to credit also is important for the home purchase process and the potential to build equity and wealth. Participation in mainstream financial markets also sets into motion at least 20 consumer protection laws and regulations to help ensure that consumers are safeguarded from unfair, discriminatory, or predatory lending practices in formal financial markets.[7]

Despite these potential benefits, many households remain unbanked, especially lower-income and minority households. These households may tend to rely on AFS businesses to meet their liquidity and credit needs. As an alternative to formal financial markets, patronage of AFS businesses is of particular policy interest because of the lack of comparable consumer protections against unfair, discriminatory or predatory pricing practices.[8]

As pointed out by Bond and Townsend (1996), credit and other financial services can be obtained not only from formal financial markets but also through informal networks of family, friends, and ethnic/community organizations. Cost advantages in information gathering, ability to utilize effective enforcement mechanisms, and the potential willingness to share greater risks related to implicit or explicit credit contracts are strengths associated with informal markets unlikely to be present in formal financial markets. Access to short-term financing or smaller dollar loans from informal sources also may be of particular benefit to lower-income individuals or persons residing in credit-constrained minority neighborhoods.

INSIGHTS FROM A UNIQUE BLACK HOUSEHOLD SURVEY

Use of Deposit Accounts

One out of every five respondents in Chatham is without a checking or savings account. The proportion of households without a deposit account declines as household income increases, ranging from 42 percent in the lowest income quartile to 7 percent in the highest income quartile. In addition, these households are more likely to be less educated and to be unemployed.[9] Similar characteristics for the unbanked exist in the Chicago metropolitan area and nationwide.[10] These findings suggest that education can play a pivotal role in bringing lower-income and less informed households into mainstream financial markets.

Use of Credit Products

Mortgage-related credit activities are found to be modest in the Chatham community. In general, 40 percent of all households surveyed are homeowners. According to national figures, 71 percent of White households are homeowners in comparison to 45 percent among minority (primarily Black) households.[11] Over a five-year period between 1992 to 1997, less than 7 percent of all Chatham households surveyed obtained a home purchase, refinance, improvement or equity loan --although this percentage is somewhat larger for households at higher income levels. These racial/ethnic differences in lending are consistent with annual mortgage lending patterns in the Chicago metropolitan area.[12] While the age profile (relatively older population) of this community may be contributing to the lackluster activity in these credit markets, it remains unclear that life-cycle effects alone can fully explain the modest level of credit activity observed.

Use of Alternative Financial Services

Over 75 percent of the Chatham households surveyed patronize AFS businesses. Fifty-four percent of these households have a checking account, suggesting that AFS use is not confined to unbanked households. By comparison, 28 percent of the Blacks, 32 percent of the Latinos, and 2 percent of the Whites surveyed in the City of Chicago patronized AFS businesses.[13] The high concentration of AFS businesses in Chicago's minority (Black and Hispanic) and lower-income neighborhoods has been argued to be a contributing factor to the observed racial/ethnic differences in AFS use and merits further investigation.[14]

Use of Informal Financial Networks

A consistent pattern emerges concerning the use of informal markets in Chatham. Close to 30 percent of the households who experienced a financial setback over the previous five-year period utilized informal financial markets. In addition, 23 percent of the Chatham homeowners obtained financial assistance from family, friends, or ethnic/community organizations when purchasing their home. In general, lower-income households in need of small dollar loans or gifts most frequently sought assistance from informal sources. Informal markets, therefore, may be an especially important source of funds among lower-income households confronted with important financial decisions.

PROPOSED PROGRAMS AND INITIATIVES

This research takes an important step toward understanding the socioeconomic and demographic factors that may influence the utilization of formal financial markets. At the same time, it highlights the potentially important additional role that informal financial networks can play for particular individuals, especially in racial/ethnic communities. Programs and initiatives that draw from the strengths of both formal and informal financial markets appear to be warranted and should be useful for increased access to credit and financial services. Consumer education programs also are crucial to help these households make informed financial choices.

What Communities Can Do

Community social groups, church organizations and business associations can be effective in disseminating relevant information and making educational programs available in their communities to enhance community development opportunities. Community leaders can proactively seek to develop mutually beneficial partnerships with financial institutions, consumer counseling organizations, and university extension programs to bring educational programs and resources to their neighborhoods and to encourage residents' participation in formal financial markets. Examples of relevant educational topics include: establishing and maintaining a good credit history, managing transaction or deposit accounts, and assessing the costs and benefits of deposit accounts relative to AFS services and short-term *payday* or car title loans. Overall, these activities can help residents make more *informed* choices among financial service providers.[15] In addition, communities can promote informal financing and credit networks by organizing micro-lending associations, investment clubs, and other creative credit and financial arrangements, as deemed fit, to help meet some of the short-term liquidity needs of families.

What Financial Institutions Can Do

Our findings suggest that Black families are an underutilized market niche for financial institutions. By participating in educational programs and launching targeted marketing and multimedia advertising campaigns to minority families, financial institutions can more effectively reach these households. Research shows, for example, that Black families have greater intergenerational risk aversion and inexperience with formal financial institutions due in part to negative historical experiences and/or perceptions.[16] As such, attracting minority customers will be more successful if programs and initiatives are developed to build long-term trust and commitment. In addition, by reinvesting in their lower-income service areas, financial institutions can assist residents with increasing their participation in the mainstream financial system while taking important steps toward earning CRA credit.[17]

A Comprehensive Approach to Community Development

The benefits and strengths of formal and informal financing arrangements can be incorporated into initiatives and programs aimed at improving access to credit and other financial services to households in lower-income and minority communities. This can be achieved through a community-based financial institution such as a community development credit union or a community development financial institution (CDFI). While more formal in structure, these types of financial institutions can incorporate or mimic some of the characteristics of informal financial arrangements such as originating smaller dollar value loan products and offering flexible credit terms.

Financial institutions can invest in limited partnerships/community development corporations (CDCs) and/or CDFIs. They also can support minority- or women-owned financial institutions and low-income community development credit unions and other entities whose mission is to promote community development. They can in addition, make equity investments by creating wholly-owned CDC subsidiaries and/or participating in multi-investor, consortium CDCs. These partnerships may be better able to design flexible loan programs needed in lower-income neighborhoods.[18] In the spirit of CRA, these programs and partnerships are examples of ways in which financial institutions can help meet the credit needs of their lower-income service areas.

SUMMARY

We propose several educational programs and community development initiatives that can be undertaken by neighborhood organizations and financial institutions to promote access to credit and financial services. Partnerships between financial institutions and nonprofit community organizations, that combine the strengths of formal and informal financing, also are encouraged to help meet the financial needs of minority and lower-income communities. These recommendations are offered to improve the effectiveness of present fair lending, financial services and community development policies.

NOTES

[1] The opinions expressed in this study are the authors' and do not necessarily represent the opinions of the Federal Reserve Bank of Chicago or the Federal Reserve System.

[2] The Chatham household survey instrument was adapted with minor modifications from a survey funded by the Center for the Study of Urban Inequality at the University of Chicago. For a discussion of the survey instrument, see Bond and Townsend (1996). Results from a small business survey also conducted in Chatham are reported in Huck, *et al.* (1999).

[3] As discussed by Caskey (1994), in several states including Illinois, firms that cash customers' checks for a fee are referred to as 'currency exchange' businesses. A currency exchange and a check cashing outlet function in virtually the same way, with the majority of revenues derived from check cashing fees.

[4] A detailed description of the findings from the Chatham household survey is reported by authors (1999).

[5] The Fair Housing Act of 1968 prohibits discrimination in the sale or rental of housing and in real estate transactions, including the provision of mortgage credit, while the Equal Credit Opportunity Act of 1974 disallows discrimination in credit transactions based on race, color, religion, national origin, sex, or marital status.

[6] The member agencies of the Federal Financial institutions Examination Council (FFIEC) are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision (formerly, the Federal Home Loan Bank Board), and the National Credit Union Administration.

[7] Board of Governors of the Federal Reserve System (1997).

[8] As evidenced by the emergence of class action lawsuits against major check cashing companies for alleged full disclosure violations (e.g., Chicago Sun-Times, 1999).

[9] Our household profile also indicates that the unbanked tend to be younger, female, unmarried, without a car, home, or other large assets. Caskey (1997), Hogarth and O'Donnell (1997), and U.S. Department of Treasury (1997) report similar results.

[10] Hogarth and O'Donnell (1997) and MCIC (1998).

[11] Huck and Segal (1997).

[12] See the *Annual HMDA Profile Publication Series*, Consumer and Community Affairs, Federal Reserve Bank of Chicago.

[13] MCIC (1998).

[14] Woodstock Institute (1997).

[15] Educators may draw from the resource guide, *Helping People in your Community Understand Basic Financial Services* prepared by the Financial Services Education Coalition, a community-based program involving federal agencies, trade associations, and community groups.

[16] For example, see Truell (1998); Loury (1998); Hurst, et al. (1998).

[17] For a listing of eligible loans, investment, and services that financial institutions can do to help meet some of their CRA requirements, see the Federal Financial Institutions Examination Council (1999).

[18] See Rhine (1997) for examples of creative and flexible mortgage products offered by three partnerships in the Chicagoland areas.

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