POLICY STUDIES

Increasing Participation in Mainstream Financial Markets by Black Households

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Abstract

A relationship with a formal financial institution offers many benefits to the consumer. This paper summarizes the findings from a unique survey of Black households which was designed to obtain a better understanding of the Black consumer's needs for and availability of credit and financial services. Based on the facts drawn from this survey, we propose specific ways that policy makers can help increase participation in mainstream financial markets and assist minority consumers in making informed financial decisions.

[1] Both authors are economists in the Consumer and Community Affairs Division at the Federal Reserve Bank of Chicago. 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.

Increasing Participation in Mainstream Financial Markets by Black Households

The availability of credit and financial services is essential to consumers and promotes vitality in the communities in which they live. Consumers gain numerous advantages from holding a deposit account and establishing a credit relationship with a formal financial institution. For example, the cost to consumers in making financial payments through a deposit account is often less both in terms of time and actual expense. In addition, by placing liquid assets in a deposit account, consumers are shielded against risks associated with holding uninsured cash reserves. A deposit account can also be a useful tool used to more effectively manage personal finances and can provide a financial cushion against unforeseen events. By having a deposit relationship with a financial institution, the consumer has greater access to credit and can more easily purchase or refinance a home. As a homeowner, the consumer can build equity and wealth while enhancing neighborhood stability and growth. Ultimately, a household's participation in mainstream financial markets sets into motion at least 20 consumer protection laws and regulations to help ensure that individuals are safeguarded from unfair, discriminatory, or predatory lending practices.

Despite these advantages, roughly 10 million households in the U.S. are unbanked. Over 57 percent of the unbanked are in minority households. As a racial/ethnic group nationwide, Black households rank highest among the unbanked, with 37 percent of these households without either a checking or savings account. Lower-income households, especially those located in urban areas, are likely to have easy access to check cashing outlets (e.g., currency exchanges), short-term lenders (e.g., payday and title loan companies) or pawnshops to meet their financial transactions needs. Studies have shown that these consumers pay considerable more for financial services (e.g., Consumer Federation of America, 1997). It is often claimed by consumer advocacy groups and community organizations that unbanked consumers are vulnerable to market exploitation because of a lack of sufficient competition in the supply of alternative sources of financial services. Whether this is true continues to be heavily debated

Bond and Townsend (1996) have shown that informal financial markets are a viable, but often less documented, source of financing for minorities. Informal financial markets are comprised of networks of family, friends and social organizations that provide credit and other financial assistance at a lower cost with greater flexibility than that provided by formal financial markets. The degree by which minority consumers, especially Black households utilize informal financial markets needs to be better understood.

The Federal Reserve Bank of Chicago sponsored a survey in Chatham, a predominantly Black community on the south side of the City of Chicago to gain a better understanding of the Black household's need for and availability of credit and financial services. Based on the facts drawn from this survey, we propose specific ways that policy makers can help increase participation in mainstream financial markets and assist minority consumers in making informed financial decisions.

SURVEY DESCRIPTION AND HOUSEHOLD CHARACTERISTICS

For the nation, almost 60 percent of all Black households reside in urban areas. As such, the urban community of Chatham is of particular interest because of its distinct and long-standing racial/ethnic heritage. According to the U.S. Bureau of the Census, Chatham is a middle-income community with a population of approximately 39,280. Median family income is $35,000, 13 percent higher than the estimated median family income of $30,959 for the City of Chicago. Chatham's homeownership rate is comparable to that for Black families nationwide (roughly 40 percent). The housing stock in this community is comprised primarily of single-family and two- and three-flat apartment buildings.

The survey instrument used in our study was adapted from a survey funded by the Center for the Study of Urban Inequality at the University of Chicago.[1] The household survey universe was constructed by using a multistage full probability sample model based on the U.S. Census block groups for this community. In 1996, field staff held face-to-face interviews that resulted in 194 randomly selected households completing the survey (with a response rate of 64 percent).[2]

The household's link to the formal financial market was captured through information collected about their use of deposit accounts and holdings of credit products including mortgage-related loans and consumer debt. The survey also has detailed questions related to the household's use of informal financing sources and patronage of check-cashing outlets (known as *currency exchanges* in the Chicago metropolitan area and the rest of the state of Illinois). Selected sample characteristics are provided in Table 1, Column 1.

Use of Deposit Accounts and Credit Products

In this middle-income community, we found that one out of every five households were unbanked (Column 3). Consistent with previous studies, a higher proportion of unbanked households had lower income and tended to be less educated, younger, female and unmarried (Hogarth and O'Donnell, 1997; Caskey, 1997; and the U.S. Department of the Treasury, 1997).

Close to 30 percent of the Chatham households surveyed experienced a financial setback (e.g., loss of employment and unusually low income) during the five years prior to the survey (Rhine and Toussaint-Comeau, 1999). The most frequent response made by these households was the liquidation of existing assets such as savings and checking accounts. Clearly, these consumers benefited from using these deposit accounts as a financial cushion when unforeseen events occurred.

Forty-nine percent of respondents had a credit card. The average credit balance was $1,434, somewhat less than the $1,700 balance reported among families nationwide (1995, Survey of Consumer Finances, (SCF)). Twenty-two percent reported having major household debt, averaging $47,313. The most common source of debt was installment borrowing at 44 percent, which included vehicle payments, student loans and furniture payments. Other sources included home-secured debt at 23 percent, credit card debt at 19 percent, and miscellaneous debt, such as utility payments outstanding at 14 percent. For families nationwide, home-secured debt was the main source of indebtedness, accounting for almost 76 percent of all debt (1995, SCF). By comparison, home-secured debt in Chatham was rather modest. The debt-to-income ratio was 34 percent, compared to 55 percent for all U.S. families (1995, SCF).

Consistent with the relatively low debt for households in this community, respondents reported moderate use of home-related loans over the previous five-year period prior to the survey. Nine percent had a home mortgage or refinance loan, 6 percent received a home equity loan and 3 percent obtained a home expansion loan. The most frequently reported loan was for vehicles (33 percent of households), which was similar to the 31 percent reported for all U. S. families (1995, SCF). The relatively modest mortgage-related lending and home-secured debt observed may have been a result of dampened demand for mortgage lending due, in part, to the relatively older population. As shown in Column 1, 23 percent of the households were retired, which is about twice the percentage of retired households at the state or national level. Alternatively, some of these consumers also may have experienced difficulty in obtaining credit either because of uncertain credit worthiness and/or credit barriers. Fully accessing the housing market activity (i.e., housing demand and supply) and credit availability in this and other minority communities, while beyond the scope of this study's focus, deserves further attention.

Use of Alternative Financial Services

Column 4 reports that over 75 percent of the Chatham households surveyed (148 of 194) patronized AFS businesses (currency exchanges). A comparison of banked and unbanked AFS users shows that a higher proportion of the unbanked had lower income and less education. They also tended to be more heavily represented among the unemployed and those receiving public assistance. Interestingly, 74 percent of AFS user households (Column 6) were banked, suggesting that AFS use is not confined to unbanked households. Whether households obtained financial and/or non-financial services from currency exchange businesses could not be determined from the data. This prompted a further investigation by Rhine et al (2000) who found that, in the Chicago metropolitan area, the use of financial services (e.g., cashing checks or purchasing money orders) from currency exchanges is dominated by unbanked consumers, minorities, and consumers residing in lower-income neighborhoods.[3]

Use of Informal Financial Networks

Lower-income households in need of small dollar loans or gifts most frequently sought assistance from informal networks (Rhine and Toussaint-Comeau, 1999). These networks were primarily used to either help finance a home or to cope with a financial setback. For example, over 21 percent of the homeowners (18 of 84) obtained financial assistance from family, friends, or ethnic/community organizations when purchasing their home. In addition, almost 29 percent of the households who experienced a financial setback over the previous five-year period (16 of 56) gained assistance from informal financial markets. These findings suggest that informal markets may be especially important funding sources.

SUMMARY OF FINDINGS AND POLICY IMPLICATIONS

Our study finds that Black households that are unbanked and AFS users tended to have lower income and were less educated, younger, female, and unmarried. These consumers are unable to take advantage of the numerous benefits offered from a relationship with a financial institution and are less likely to have the needed cushion against unforeseen events. We also observed modest mortgage-related credit activity and found that informal networks played a role in the home purchase process and in coping with financial distress. Although specific to the Chatham community, these facts offer useful insights about particular ways that policy makers can help increase participation in mainstream financial markets and assist minority consumers in making informed financial decisions. From a policy perspective, we believe that consumer education, relationship building, and implementation of specific consumer laws and regulations play a key role in this process.

Consumer Education

Consumer education programs that explain the substantial benefits from having an established relationship with formal financial markets should be targeted especially to unbanked and AFS-user minority consumers. Topics of particular usefulness to these consumers are: maintaining a household budget, managing a checking and savings account, assessing the costs and benefits of using deposit accounts relative to alternative financial services, establishing and maintaining good credit, and financing options in the purchase of a home.

Community centers, block clubs and church organizations can be an effective vehicle to bring educational programs to their communities and to encourage resident participation. These community-based organizations also can leverage resources by establishing partnerships with financial institutions, consumer counseling organizations, educational institutions, and government-sponsored programs to help bring these programs to their neighborhoods.

The efficacy of consumer education and financial literacy programs will likely depend on the delivery method used. To better gauge how these programs might be more effectively delivered to consumers, the Federal Reserve Bank of Chicago held focus groups attended by more than 20 local community leaders. Several recurring themes were identified by these focus groups.[4] In particular, using radio and television media are a very effective way to provide information to consumers but are expensive delivery mechanisms. Information offered through a web site may be less effective for lower-income individuals if they do not have convenient access to the Internet. Consumers are more receptive to informal seminars held in their community. Resource materials such as pamphlets, booklets and videos are more useful to consumers when disseminated at these informal programs. Finally, consumer education should be targeted to students at an early age.

Relationship Building

For generations many Black families have been distrustful or wary of formal financial institutions because of negative historical experiences and/or perceptions. Lack of confidence in these institutions has likely contributed to the number of Black households who are inexperienced with formal financial markets. This may partly explain the modest use of mortgage-related credit and the tendency to use informal networks among Chatham households. To more effectively serve minority customers, financial institutions can actively participate in educational and outreach programs by establishing partnerships with community-based organizations and agencies that work directly with these consumers. To help educate minority consumers about the products and services available, financial institutions can launch marketing and multimedia advertising campaigns targeted to these consumers. Moreover, a culturally diverse financial institution may be better able to attract and serve minority consumers residing in their market area. By fostering a solid relationship with minority consumers, financial institutions can benefit from tapping into this growing demographic group.

Public Policies to Assist Low-Income Consumers

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. There are a number of ways that financial institutions can help meet the credit and financial service needs of lower-income communities, while promoting community development and encouraging consumers' participation in mainstream financial markets.[5] For example, financial institutions can make loans or investments in financial intermediaries, which includes community development corporations (CDCs) or community development financial institutions (CDFIs) that provide lending to low- and moderate-income individuals; provide credit counseling and other financial services such as low-cost checking; and use of flexible underwriting approaches to facilitate lending to low- and moderate-income consumers, consistent with safe and sound lending practices.[6] As an additional option, community-based organizations can take advantage of informal network attributes by creating programs such as micro-lending associations and investment clubs to help meet short-term liquidity needs of consumers.

Public policies that promote greater savings and low-cost deposit accounts also are important ways to help consumers meet their financial needs. For example, the Debt Collection Improvement Act of 1996 encourages banks to offer low-cost deposit accounts, including electronic transfer accounts or free government check-cashing services, to help increase access of financial services to lower-income individuals. The SAVER Act of 1997 has advanced the public's knowledge about the importance of savings by establishing an ongoing educational program. A five-year demonstration project to determine the effectiveness of policies to help the poor accumulate assets was initiated through the Assets for Independence Act of 1998.

Our study affirms the importance of these types of regulatory policies to enhance credit availability, encourage savings, and increase the use of mainstream financial services among low-income and minority consumers.

ENDNOTES

[1]The original survey instrument was developed for a study conducted in Little Village, a predominantly Hispanic community situated on the southwest side of the City of Chicago. Richard Taub, Marta Tienda, and Robert Townsend were the principal investigators, Bond and Townsend (1996).

[2] Chatham research project also included a random survey among small business owners. See Huck et al., (1999).

[3] The data source was the 2000 Metro Chicago Information Center annual survey of approximately 3,000 households in the Chicago six-county metropolitan area.

[4] Full report of the Financial Literacy Focus Group, including a list of financial literacy programs is available upon request from authors.

[5] For a listing of eligible loans, investment, and services that financial institutions can do to help meet some of their CRA requirements, see the FFIEC (1999).

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

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Table 1

CHATHAM HOUSEHOLD CHARACTERISTICS

	Total Sample	Banked	Unbanked	AFS users Total	AFS users Unbanked	AFS users Banked
	(1)	(2)	(3)	(4)	(5)	(6)
Number	**194**	**153**	**41**	**148**	**38**	**110**
			Percentages			
Total	**100**	**79**	**21**	**100**	**26**	**74**
Gender						
Male	**37**	**39**	**29**	**37**	**32**	**39**
Female	**63**	**61**	**71**	**63**	**68**	**61**
Maritul Status						
Married	**37**	**39**	**27**	**36**	**29**	**39**
Not Married	**63**	**61**	**73**	**64**	**71**	**61**
Age						
18-34	**20**	**18**	**27**	**22**	**29**	**20**
35-59	**51**	**51**	**49**	**56**	**53**	**57**
60 and higher	**29**	**31**	**24**	**22**	**18**	**23**
Education						
Less than HS	**11**	**6**	**29**	**13**	**32**	**6**
HS or equivalent	**30**	**29**	**34**	**31**	**36**	**30**
College and Above	**59**	**65**	**37**	**50**	**32**	**64**
Household Income[1]						
1st Quartile	**20**	**17**	**50**	**28**	**50**	**21**
2nd Quartile	**20**	**26**	**22**	**25**	**20**	**26**
3rd Quartile	**20**	**26**	**19**	**21**	**20**	**22**
4th Quartile	**20**	**30**	**9**	**30**	**10**	**31**
Public Assistance	**11**	**6**	**29**	**14**	**29**	**8**
Employment Status						
Employed	**62**	**66**	**46**	**66**	**50**	**72**
Retired	**23**	**26**	**29**	**20**	**24**	**19**
Other/Not employed	**10**	**5**	**7**	**5**	**8**	**5**
Unemployed	**5**	**3**	**15**	**7**	**16**	**4**
Assets						
Home/land/property	**45**	**54**	**15**	**37**	**11**	**46**
Vehicle	**65**	**75**	**32**	**64**	**34**	**75**
Debts						
Credit Card	**49**	**59**	**10**	**43**	**11**	**55**

[1]**Chatham's median household income was $35,000, while the average household income was $37,726.**