Promises & Pitfalls:
As Consumer Finance Options Multiply, Who Is Being Served and at What Cost?
Federal Reserve System Research Conference
Washington, D.C., April 7-8, 2005

Consumer Behavior, Session 1

Moderator's Introduction: Studying Low-Income Financial Services Behavior

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Introduction

Recently, researchers have begun to examine the financial service patterns of low- and moderate-income individuals in the U.S. As I described in an article last year entitled "Banking the Poor,"[1] these behaviors are of interest because high-cost financial services, barriers to saving, the lack of insurance, and credit constraints may contribute to poverty and other socio-economic problems. More specifically, low-income individuals often lack access to financial services from banks and thrifts and turn to alternative financial service providers such as check cashers, payday lenders, and money transmitters. Low-income households may also face high costs for these kinds of services, and some may find it more difficult to save and plan financially for the future.

Living paycheck to paycheck may leave them vulnerable to emergencies that may endanger their financial stability, given the lack of insurance for key life events, and the lack of longer term savings may undermine their ability to invest in human capital, purchase a home, and build assets. High-cost financial services may reduce the value of government income transfer programs and may also diminish the effectiveness of welfare-to-work strategies and the earned income tax credit. Recently, empirical work has begun to focus on understanding these issues with field surveys, building on the foundations laid by John Caskey a decade ago in his seminal book, *Fringe Banking*.

Theoretical Enquiry for the Detroit Area Study on Financial Services

For my part, I have begun an empirical project to study these issues as the faculty investigator for the 2005 Detroit Area Study.[2] Working with the Survey Research Center at the University of Michigan, I am conducting an in-depth household survey regarding financial services, with a random, stratified sample of low-, moderate-, and middle-income households in the Detroit metropolitan area. We expect to have 1,000 interviews completed by fall 2005. In addition to detailed questions regarding financial services behavior and attitudes, the survey includes a range of questions regarding asset holding and borrowing levels, employment history, and income. The survey also includes a choice-based or conjoint component to analyze household preferences for payment products. This in-person survey of households is supplemented with key data on the supply of financial services in the area. I have geocoded all financial services firms (check cashers; pawn shops; payday lenders; tax preparation firms; and banks, thrifts and credit unions) in the area. I will be using a mail survey to gather information on prices and products of alternative financial services firms and a telephone survey to gather information from banks, thrifts, and credit unions.

Broadly speaking, my research aim is to develop a comprehensive understanding of the financial services behaviors of low- and moderate-income households and the financial services constraints they face and to inform the theoretical debate on key questions regarding household financial decision-making. Traditional economic models of rational choice view decisions as made by optimizing rational agents with perfect foresight. By contrast, research in psychology and behavioral economics provides alternative explanations for decision-making, such as the importance of default rules, framing, and heuristics.[3] The public debate regarding the poor is largely consumed by a "culture of poverty": social network theories of social deviance, laziness, imprudence, and impatience as descriptions for the behavior of the poor.

These differing frameworks affect how one views a wide range of phenomena, such as savings behavior, risk-taking in investment, and insurance. The behavioral economics insight, for example, regarding default rules, can be used not only to understand individual choice but also, perhaps, to design institutions to influence individual decision-making.[4] That is, our understanding of how individuals make decisions can have profound implications for differing approaches to the role of law in such areas as consumer protection, disclosure, bankruptcy, and national savings policy.

Little empirical work has attempted to translate these theories into the world inhabited by low-income households in the United States. Bertrand argues that "the poor may exhibit the same basic weaknesses and biases as do people from other walks of life, except that in poverty, with its narrow margins for error, the same behaviors often manifest themselves in more pronounced ways and can lead to worse outcomes."[5] By contrast, Duflo suggests that the stress of poverty "almost certainly affects the way people think and decide" and that "[w]hat is needed is a theory of how poverty influences decision-making, not only by affecting the constraints, but by changing the decision-making process itself."[6] These theories can and should be informed by empirical studies that provide information on household financial behavior and attitudes and the constraints that such households face.

One important area for analysis of these differing frames involves savings. The dominant rational choice model is the "life cycle" theory, which suggests that savings are used to smooth the marginal utility of consumption over one's life.[7] An extension of the rational choice model posits that precautionary motives also influence saving; that is, rational individuals with full foresight save as a form of insurance in the face of uncertainty.[8] Behavioral models suggest that although these rational choice theories may be useful at the aggregate level, individual choices regarding saving are profoundly affected by psychology: mental accounting, starting points, endowment effects, and other frames. For example, groundbreaking empirical research by Richard Thaler at the University of Chicago has demonstrated the importance of framing, starting points, and default rules in determining whether and how much individuals will save in employer-sponsored retirement plans.[9]

Little empirical research is directed at savings among low- and moderate-income households in the United States. How and why do low-income households save? Which households are able to save? A "culture of poverty" theory would suggest that low-income households that do not save have preferences or values (thrift, prudence, work ethic) different from those of other households. A behavioral theory would suggest that access to different forms of financial institutions or the opportunity for direct deposit at work might affect saving by affecting individual choices through institutional channels. That is, having a bank account or using direct deposit at work may contribute to saving apart from rational choice models of saving. A demonstration project involving "individual development accounts" for low- and moderate-income households suggests that institutional structure affects savings.[10] The life cycle theory predicts higher savings-to-income ratios than data suggest that the poor exhibit, but failures in measuring how low-income people save may be at fault. Moreover, under plausible assumptions regarding the hard budget constraints of poverty, a rational choice theory would explain that low-income households do not save because they are poor; there are simply insufficient funds to set aside each month after necessities. Put another way, no current savings could be the rational choice in smoothing the marginal utility of consumption over one's life. Other rational choice models predict lower savings because social safety net programs reduce the need to save as a precautionary measure against income shocks.[11]

Yet the rational choice model is confronted with a puzzle: Lots of households that should save don't, and evidence from other studies suggests that some low-income households do save. Why do these households save, and how are the able to do so? Do families save out of a precautionary motive, to build human capital through education, to save for retirement, or for other goals? What is the effect of saving on the ability of households to weather hardships, such as job loss or injury? How are households able to save? What is the role of "mental accounting," in which different sources of income are used for different functions? Are tax refunds, including from the earned income tax credit, an important form of saving, and do households view tax refunds as a time to commit to future saving? Answers to these questions can inform debates over pension law reform and Social Security, as well as private-sector initiatives to encourage savings.

A second important area involves credit. Liquidity constraints can affect consumption, savings, work incentives, insurance, and time horizons for financial decision-making. Yet little empirical work has been done until recently on the credit constraints facing low-income households.[12] What kind of liquidity constraints do low- and moderate-income households face? What are the causes and consequences of such constraints? To what extent do the choices among different credit channels used by households, for example, banks, payday lenders, pawnshops, and refund anticipation lenders, reflect credit constraints, different preferences (for example, convenience), or other factors? Why do such households borrow? For example, do households take out refund anticipation loans because they are impatient, need to pay off their bills, or have to pay the tax preparer? What are consumer attitudes toward credit, the consequences of delinquency, and bankruptcy, and to what extent are differing attitudes, if any, reflected in behavior? To what extent do consumers understand credit terms, such as minimum payment terms on credit cards? Answers to these questions could lead to better disclosures and could inform the debate over bankruptcy reform.

A third important area involves transactional services. One theory suggests that use of check cashers is simply a rational response to those with preferences for convenience and impatience. A behavioral economics approach focuses on the role of social networks in a neighborhood in conditioning individual choice. Economic network theory suggests instead a focus on conflicting payments systems: Employers pay by check, while landlords and other businesses in low-income communities accept cash. An institutional focus combines these insights to suggest looking at the structure of banking to explore these transaction costs.

Welfare economics largely treats income as if it were cash (or a fully liquid intangible) for purposes of determining utility. What happens to the model if the transaction costs of converting income into useable form are high relative to income? As a normative matter, as I argued in "Banking the Poor," the costs of converting income into cash may be grounds for a nonincome form of redistribution of financial services. But these theories require knowing the size and direction of some key parameters. For example, does proximity to different types of financial services affect financial services usage patterns, preferences, and needs? Do price and product offerings explain such matters? Are other factors, such as hassle, habit, or employment patterns, really at work? Does access to a bank account affect saving and credit?

Fourth, low- and moderate-income households face risks to their health, income, employment, household structure, and the like. To what extent are such households insured against such risks? Measures of insurance include formal insurance mechanisms, such as unemployment, disability, and health insurance, as well as informal mechanisms and credit, such as borrowing from friends and family, or self-insuring through savings, holding durables, or other means. Empirical research can contribute to our understanding of the extent to which low-income households are underinsured and can begin to tease out the links among insurance, savings, and credit as substitutes in providing a cushion against hardship for low- and moderate-income households. To what extent can financial hardships be understood as insurance failures?

Fifth, empirical research can contribute to a better understanding of household preference parameters,[13] such as risk tolerance and orientation to the future, and their influence on decision-making with regard to savings, insurance, credit, and the like. To what extent does heterogeneity of preferences explain behavior? Alternatively, to what extent are household preferences and behaviors shaped by how available choices are framed for them? How predictive are economic measures of risk tolerance? What is the relationship between risk tolerance and income? Are low-income households more risk tolerant because they have little to lose, or more risk averse because they have no cushion to fall back on? Does risk aversion contribute to lower levels of borrowing and lower returns to capital? Are low-income households more impatient than others?[14] To what extent do households save because of an underlying propensity to plan and to what extent because of the savings choices they are offered? Is the lack of self-control an important factor explaining saving and borrowing decisions, or are such matters driven by hard budget constraints? Understanding heterogeneity in preferences can lead to better modeling of economic behavior under both rational choice and behavioral models.

The Papers in this Session

The papers on this panel make important contributions to this debate. We have four papers and two comments. We heard a pair of papers from Ellen Seidman and Sherrie Rhine using survey data to understand the financial services choices that low-income consumers make and a comment from John Caskey. We then had papers from James

Sullivan and Cheryl Long, who discussed, respectively, problems from having too little credit, on the one hand, and too much credit on the other, with a comment by Wenli Li.

Seidman's paper, based on Shorebank's survey work in Los Angeles, Chicago, and Washington, D.C., explores the heterogeneity of the "unbanked" population and paints a nuanced portrait of low-income households. Seidman suggests that many unbanked households are motivated by convenience rather than cost. Seidman also suggests that there may be a network effect regarding the use of checks because survey respondents noted that their landlords do not accept checks. The survey also suggested that low-income households had low levels of borrowing and that low-income households that were able to save had higher asset holdings and higher asset-based debt, for example. As with any empirical project, Seidman's paper leaves us thirsting for more, which is part of the motivation for the Detroit study. In particular, for example, full exploration of the link between financial services and employment, income, asset holdings, and preference parameters were not possible with the MetroEdge instrument. To what extent do preferences shape behavior? Why and how do some low-income households save? To what extent is behavior shaped by the financial services offered to low-income households? What products and services would better serve these households?

Rhine's paper, based on data from a community-based, free tax-preparation organization, focused on whether receipt of the earned income tax credit is a "savings moment" at which time households can set aside significant lump sum payments for longer-term savings. Rhine's preliminary results suggest caution in that regard. She reports that only 15 percent of unbanked households that wanted to save set up a bank account when offered the chance to do so at the time of tax filing. She noted that most EITC recipients use their refund to pay down debt. To what extent would households benefit from smoothing their EITC receipt over time, for example, through a reformed advance earned income credit that is easier to use? Would the ability to split EITC refund checks, as now proposed to be implemented by the IRS in 2007, help households to manage their refund better and save more? Rhine intends to follow up this research with additional survey analysis to explore these and other questions.

Sullivan's paper, based on a melding of data from the Panel Study of Income Dynamics (PSID), the Survey of Consumer Finances (SCF), and the Survey of Income and Program Participation, suggests that households with assets are able to borrow in order to smooth food and housing consumption during unemployment spells, while households without assets face liquidity constraints that result in material hardships during unemployment. Sullivan argues that these households are not just debt averse but are rather credit constrained because they are turned down more for loan requests and obtain lower credit limits on loans than households with assets. Sullivan's paper suggests the need for further research. To what extent do households face earlier credit constraints that prevent them from building up their assets that could serve as s cushion in times of economic distress? Given that savings, credit, and insurance can be functional substitutes, how do households make decisions about the appropriate mix of financial instruments, and how should public policy take account of these household decisions?

Long's paper, using the PSID and the SCF, explains that the decision about whether to file for bankruptcy depends not only on the loss of one's home and lower access to credit post-bankruptcy but also on the loss of the option value of bankruptcy filing. As with the other papers, Long's article raises important questions in need of further research. How much of aversion to bankruptcy can be explained by option value and how much by lower access to credit post bankruptcy? How has increased access to credit reduced barriers to bankruptcy, which in turn increases liquidity constraints in a dynamic model? How much do preferences matter in decisions to file or not to file? How does bankruptcy decision-making intersect with problems in home mortgage and consumer borrowing?

Conclusion

The research presented on this panel provides us with insights into the financial services behavior of low- and moderate-income households and is an important part of recent research directed at understanding their financial services decision-making. Future research will help us to understand better the behavior, needs, and preferences of these households across a full range of financial services—transactional services, credit, insurance, and saving. Such research can contribute to critical debates in behavioral psychology and economics that are critical to consumer financial services.

Notes

[1] *Yale Journal on Regulation* 21(1): 121-237 (2004). Portions of this introduction also appear in the University of Michigan's *Law Quad Notes* 48(1): 72-77 (Summer 2005).

[2] For details, see http://www-personal.umich.edu/~msbarr/ and click on "Detroit Area Study."

[3] See, e.g., Daniel Kahneman and Amos Tversky, Choices, Values, and Frames (2000).

[4] See, e.g., Cass R. Sunstein & Richard Thaler, "Libertarian Paternalism Is Not an Oxymoron," 70 *University of Chicago Law Review*, 1159 (2003); Richard Thaler & Cass Sunstein, "Libertarian Paternalism," 93 *American Economic Review*, 175 (2003); Colin Camerer, et al., "Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism," 151 *University of Pennsylvania Law Review*, 1211 (2003); Michael Sherraden and Michael S. Barr, "Institutions and Inclusion in Savings Policy," in Nicolas Retsinas and Eric Belsky, eds., *Building Assets, Building Credit: Creating Wealth in Low-Income Communities* (2005).

[5] Marianne Bertrand, Sendhil Mullainathan, and Eldar Shafir, "A Behavioral-Economics View of Poverty," 94 American Economic Review, 419 (2004).

[6] Esther Duflo, "Poor but Rational?," in A. Banerjee et al., eds., *What Have We Learnt About Poverty?* (2004).

[7] F. Modigliani and R. Brumberg, "Utility Analysis and Aggregate Consumption Functions: An Interpretation of Cross-Section Data," in K. Kurihara, ed., Post-Keynesian Economics (1954); Milton Friedman, *A Theory of Consumption Function*, NBER (1957).

[8] Christopher D. Carroll, "The Buffer-Stock Theory of Saving: Some Macroeconomic Evidence," Brookings Papers on Economic Activity, No. 2 (1992).

[9] See Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," 112 *Journal of Political Economy* (2004); James J. Choi, et al., "Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance," in James M. Poterba, ed., 16 *Tax Policy and the Economy* 67 (2002); Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," 116 *Quarterly Journal of Economics*, 1149 (2001).

[10] See Sherraden and Barr, supra.

[11] James P. Ziliak, "Income Transfers and Assets of the Poor," 85 *Review of Economics & Statistics* 63 (2003).

[12] See Barr, “Banking the Poor,” supra; Michael S. Barr, “Credit Where it Counts: The Community Reinvestment Act and Its Critics,” 80 *New York University Law Review*, 513 (2005).

[13] See, e.g., Robert B. Barsky, F. Thomas Juster, Miles S. Kimball, and Matthew Shapiro, “Preference Parameters and Behavioral Heterogeneity: An Experimental Approach in the Health and Retirement Study,” *Quarterly Journal of Economics*, 537 (May 1997).

[14] See, e.g., Emily Lawrence, “Poverty and the Rate of Time Preference: Evidence from Panel Data,” 99 *Journal of Political Economy*, 54 (1991).