

ACCESSING AFFORDABLE AND APPROPRIATE CREDIT

A Background Paper Prepared for the
Annie E. Casey Foundation

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Introduction

The Annie E. Casey Foundation is dedicated to helping build better futures for disadvantaged children in the United States. One of the ways that the Casey Foundation accomplishes this goal is through its Family Economic Success (FES) strategy, which is designed to help families build strong financial futures for themselves and their communities. The FES framework helps families earn, keep, and save assets. As part of this framework, the Casey Foundation is incorporating a focus on helping low-income people access affordable and appropriate credit.

This report examines the key issues and trends for low-income consumers accessing credit. The report is based on a literature review and a scan of industry programs addressing credit issues. Key issues addressed in this report are 1) the U.S. credit system, 2) consumer motivations and methods for accessing credit, and 3) the link between individual and community wealth. Although there are additional issues that affect a low-income person's ability to access affordable and appropriate credit, this report focuses solely on these three issues. The paper highlights additional topics that can be considered for future research and includes an appendix of national and local resources to help low-income families access affordable, appropriate credit.

The U.S. Credit System

Beginning in the late 1970s, the banking and financial industry has been steadily deregulated. Industry deregulation has expanded the availability of credit to low-income consumers, but often at a very high cost. Prior to deregulation, the primary issue for low-income people was lack of access to the credit system. After deregulation, the primary issue shifted from *access* to credit to *cost* of credit. The high cost of credit is primarily due to finance charges and penalty fees.

Deregulation of the banking and financial industry was spurred by a Supreme Court ruling in 1978. In *Marquette National Bank of Minneapolis v. First Omaha Service Corporation*, the court ruled that a national bank can charge its credit card customers the highest interest rate permitted in the bank's home state as opposed to the state in which the customer resides.¹ As a result, regional and national banks moved their operations to more lender-friendly states with no usury limits on credit card interest rates.

In response to this ruling, states began loosening their usury laws, limiting the chances for consumers to get a better deal from a local or state bank.² Essentially all of the major credit card issuers are located in states without usury laws and without interest rate caps. These issuers can charge any interest rate they wish, as long as they comply with consumer disclosure rules.

This ruling had a profound impact on the growth of the credit card industry and on the availability of credit for low-income consumers. Riskier borrowers, or those with lower incomes, were permitted into the market by the lenders because of their new ability to charge a higher interest rate to compensate for this risk.³

Consumer credit card debt

The wide availability of credit has led to record levels of consumer credit card debt. During the last two decades of the century, credit card debt increased by more than \$500 billion. From 1980 to the end of 1998, credit card debt grew from \$55.1 billion to nearly \$600 billion.⁴

Between 1989 and 1998, average balances among all families increased by 66 percent—from \$2,482 to \$4,129. This increase is attributed to consumers accumulating higher balances, rather than to growth in the number of cardholders.⁵

The percentage of low-income families with credit cards has not increased dramatically since 1989, when approximately 28 percent of families with incomes under \$10,000 had one or more credit cards. This percentage was about the same in 1998. Among families with incomes between \$10,000 and \$24,999, about 48 percent had credit cards in 1989, compared with 59 percent owning credit cards in 1998. The main change during this timeframe was that more low-income families were carrying balances on their cards in 1998 than in 1989. In 1989, about half of low-income families revolved their balances, compared with 64 percent in 1998.

Credit cards are not the only form of high-interest, short-term loans that are utilized by low-income people. Individuals often use more expensive forms of short-term loans, including payday lenders and pawnshops, once they reach their credit card limits.⁶

Credit scoring

Credit scores became widely used in the 1980s as a way to determine who should receive credit. Long before credit scores, human judgment was the sole factor in deciding who received credit. Lenders used their past experience at observing consumer credit behavior as the basis for judging new consumers. Not only was this a slow process, but it was also unreliable because of human error. Lenders eventually began to standardize how they made credit decisions by using a point system that scored the different variables on a consumer's credit report.

A credit score is a number that reflects credit risk level, typically with a higher number indicating lower risk. A credit score is generated through statistical models using elements from a credit report. A credit score is a fluid number that changes as the elements in a credit report change. For example, payment updates or a new account could cause scores to fluctuate. There are many different credit scores used in the financial

service industry. Scores may be different from lender to lender (or from car loan to mortgage loan), depending on the type of credit-scoring model used.

There are primarily two types of scores: generic bureau-based scores and custom scores. Among bureau-based scores, the most widely used score in the financial services industry is the FICO score generated by the Fair Isaac Corporation. Among the three major credit bureaus, the FICO score is referred to as the Experian/Fair, Isaac score at Experian, the Beacon score at Equifax, and the Emperica score at Trans Union. Each credit bureau can also generate its own credit score, such as the Experian Credit Score. The bureau-based credit scores draw on statistics from a large number of consumers across a variety of accounts. Custom scores are generated by individual lenders, who rely on credit bureaus and other information, such as account history, from their own portfolios.

The factors that impact a credit score vary depending on the score used. Generally, credit scores are affected by elements in credit reports, such as:

- Number and severity of late payments
- Type, number, and age of accounts
- Total debt
- Recent inquiries

Credit scores are based on information that is voluntarily reported to credit bureaus. In some cases, the voluntary nature of credit reporting can be problematic. When creditors do not report on-time payments to credit bureaus, consumers do not receive the benefit of a higher credit score. A recent study showed that underreporting negatively affects 33 percent of consumers who make consecutive on-time mortgage payments. Underreporting negatively affects approximately 95 percent of renters who pay their rent on time.⁷

Another issue that can negatively affect a credit scores is errors in credit reports. Credit reports should be accurate, but errors can occur. It is important to review credit reports for errors or outdated information. Errors and incorrect information can affect credit scores and the consumer's ability to qualify for a loan at competitive rates. Errors can be corrected by sending the credit-reporting agency a letter notifying them about the error. The agency must investigate the complaint within 30 days and respond with its results. If the agency finds that the information in the report is inaccurate, the creditor must notify the other major credit-reporting agencies of the error. If the credit reporting agency does not find an error, but the consumer still believes the report is inaccurate, they can contact the creditor directly to resolve the problem. Consumers also have the right to submit a written statement of up to 100 words that will appear on their credit report to explain the problem.

Credit scores are not used solely to rate the creditworthiness of consumers. Lenders also use scores to predict consumer response to offers sent in the mail, the likelihood that

account holders will file for bankruptcy, or likelihood that a consumer will move their account to another lender.

In addition to banks and lenders, there are landlords, employers, merchants, and insurance companies that are also using credit scores. Of all of these, the fact that insurance decisions are being determined by credit scores is causing consumers the most alarm.⁸ To most, it seems that credit histories and driving records have little in common. Insurers, on the other hand, have found that using credit scores to predict how likely someone is to pay premiums has helped them cut their losses. They don't use the same score that banks and lenders use; they use an insurance score, which is generated based on a slightly different formula. According to the American Insurance Association, having a good insurance score does not necessarily mean you are a good driver or a more responsible homeowner. However, research has shown that consumers with better insurance scores generally file fewer claims and have lower insurance losses.⁹ Insurers' use of credit histories to determine rates is under scrutiny nationwide. Many states are passing laws restricting this practice.

Consumer Motivations and Methods for Accessing Credit

There are numerous motivations for accessing credit, including succumbing to the aggressive marketing tactics of credit card issuers, desiring to finance a lifestyle beyond normal financial means, or using credit cards as a means of supplementing income.

The credit card industry has transformed American consumer attitudes about credit—the industry has successfully penetrated American culture and achieved the social acceptance of consumer debt. The acceptance of credit cards as a tool to provide immediate gratification is largely due to the successful marketing efforts of credit card issuers.¹⁰

The aggressive marketing of consumer credit reached an all-time high in 2000. Typically, marketing campaigns emphasize that credit cards can simplify the stresses of modern life by providing universal access to money as well as other “exclusive” membership services. In recent years, the aggressive marketing techniques have expanded to target low-income consumers. Marketing credit card offers to low-income consumers is noted as one of the factors contributing to the record-high direct-mail volume in 2000.

Credit card debt has typically been viewed as a problem of weak-willed individuals who succumb to materialistic pressure. This perspective holds that individuals use credit to finance material possessions beyond their financial means, such as vacations, designer clothes, and other material possessions. The view is that they routinely use credit cards to finance “wants” instead of “needs.”

An examination of the spending patterns and behaviors of low-income families shows that many families are actually using credit cards to pay for basic needs. Low-income families spend comparatively more of their incomes on basic needs than the rest of the

population. The lowest 10 percent of families in income spend 70 percent of their budget on food and housing, compared with 53 percent of other families. Low-income families also spend more on health care than other families. Spending on discretionary items is quite constrained for most low-income families.¹¹

Recent restructuring of the labor market—with the resultant massive layoffs and shifts to part-time and contingent work—has contributed to increasing credit card debt among low-income families as they resort to using credit cards to pay for routine household expenses. Additionally, increased housing, health, and education costs have forced many low-income people to use credit cards to pay for basic needs. Most recently, the use of credit cards among seniors to purchase prescription drugs, or to fill the gap between Social Security income and the amount needed to meet routine expenses, has made headlines.¹²

Marketing methods—direct-mail credit offers

In 2000, the volume of credit card marketing mail soared to an all-time high of 3.5 billion pieces. The record direct-mail volume started to slowly build early in 2000 and then surged to a new high because of a remarkably strong fourth quarter, when over one billion solicitations were sent to U.S. consumers.¹³

The all-time high credit card marketing mail volume is the result of several important trends, including a new trend to target the subprime market of low-income consumers. Other trends include: the launch of new card products with Internet-related features, the resurgence of Gold card offers, and aggressive marketing campaigns from monoline companies (firms that engage primarily in issuing credit cards).¹⁴

An important factor in driving mail volume up was the significant number of solicitations targeting low-income consumers in 2000. These offers are identified as having an annual percentage rate (APR) of over 19 percent. One-fourth of all credit card solicitations offered in 2000 had APRs of over 19 percent, which indicates a clear subprime strategy by issuers. This marketplace niche grew in importance to many issuers in 2000 as they sought to acquire new cardholders.¹⁵

Marketing methods—credit and the Internet

During 2000 there was also an increase in Internet-related card offerings, which issuers promoted via direct mail to attract new cardholders. American Express, VISA, and MasterCard launched smart card products with several issuers in the fall of 2000. Smart cards feature an embedded computer chip capable of storing and transmitting data when used online or in a store.

Five percent of consumers applied for a credit card online in 2000, compared to two percent in 1999. Although this may appear to be a small increase, it is a significant one, as more and more issuers are offering potential customers the option of applying online.

Direct mail solicitations remain the most important channel for attracting new cardholders in the United States today—generating 68 percent of all new card applications. But, as consumer access to and comfort with the Internet grows, Internet solicitations are predicted to increase.

Financial institutions

In addition to accessing credit offers through the mail and the Internet, consumers can access a wide variety of credit products from financial institutions, which offer consumer credit cards, consumer loans, home equity loans, and home equity lines of credit. They also provide a variety of other services free or for a low fee with a deposit account, including direct deposit, money orders, wire transfer, telephone banking, ATM access, debit cards, and loans.

Lack of credit

Although there are many strong motivations to access credit, there is a segment of the population that does not access credit at all. Many immigrants are accustomed to conducting business in cash and face-to-face. The credit culture that Americans take for granted is quite foreign to those for whom borrowing money from relatives is the norm. The thought of borrowing from a bank or other lending institution seems strange to many new immigrants. Many of them dislike being indebted to anyone other than a relative because it puts them at the mercy of a stranger and adds the cost of interest.¹⁶

Because many immigrants do not utilize credit, it is often difficult for them to demonstrate conventional credit histories. Instead, they have to create nontraditional credit histories to demonstrate their creditworthiness. A nontraditional credit history can be created to show lenders that rent, telephone, and other bills were paid on time. By providing a lender with copies of paid bills and canceled checks used to pay bills, a borrower can document their ability to manage credit.

In many immigrant communities, people obtain financial assistance from family, friends, or ethnic/community organizations. In general, lower-income households in need of small dollar loans or gifts frequently seek assistance from informal sources. Informal markets are an especially important source of funds among lower-income households confronted with important financial decisions. Informal types of lending have been around for years. Korean immigrants, for instance, make wide use of a system called kye (pronounced kay), in which members contribute to a savings pool and take turns borrowing. Some Latino communities use a similar system known as tanda or sociedad.

Credit sources

Credit is available from many sources. Most sources are legitimate, but some are designed to prolong the debt and make the most money off the borrower. The following are the common credit sources:

- Banks—Banks make secured and unsecured loans. Secured loans require a guarantee of personal property (such as a car or home). Unsecured loans are typically for smaller amounts and only require a contract agreeing to repay the loan as promised, not a guarantee of personal property.
- Car-title lenders—A person who has clear title to his or her car can borrow up to 25 percent of the car's value by giving a lender power of attorney to transfer the title in the event that a payment is not made. If the borrower defaults on the loan, the company takes ownership of the car.
- Charge accounts—Some businesses allow customers to buy goods on credit. The store then sends a bill, which must be paid immediately. If the bill is not paid in full, an interest charge is added to the next bill.
- Check cashers—Fees for cashing checks can range from 1.5 to 3 percent of a check's value for payroll and government checks. Personal checks can have fees as high as 20 percent.
- Credit cards—These cards issued by banks and credit unions may be used to buy goods and services or receive cash advances. Some credit cards have an annual fee. All cards have a credit limit and if the card's balance is not paid in full each month, interest accrues. Late payments are assessed if the credit card bill is not paid by the due date.
- Credit unions—Credit unions offer accounts, credit cards, and secured as well as unsecured loans. Credit unions often have lower interest rates on loans than banks.
- Debt consolidation loans—In return for giving a loan to pay off creditors, these companies may charge very high interest rates and fees.
- Finance companies—These for-profit businesses make consumer and commercial loans. They are a source of credit for people who are considered high-risk borrowers because of their credit ratings. Many finance companies offer auto and home equity loans at rates that tend to be much higher than banks' rates.
- Home equity loans—Banks and other reputable companies allow homeowners to borrow money against their home's equity. But there are unscrupulous lenders who make loans that are difficult to repay and, as a result, the borrower could lose their home.
- Installment plans—Some stores allow consumers to buy things, such as household appliances, over time. Consumers are required to make a down payment and then pay

the balance plus interest on a monthly basis. If the consumer fails to make a payment, the store can repossess the purchased item.

- Pawnshops—These businesses accept personal property, such as jewelry, electronics, cameras, musical equipment, or guns, as collateral for loans based on the value of the goods. Most pawnshops lend less than half of an item's resale value. Borrowers have several months to repay the loan and are charged very high interest rates until they do. Many pawnshops also charge storage costs and insurance fees. If the loan is not repaid, the pawnshop keeps and sells the borrower's pawned property.
- Payday lenders—Payday loans are relatively small loans, typically between \$100 and \$500, and are repaid in one payment within a short time period (usually 13 to 17 days). These loans or cash advances are secured by a postdated personal check from the consumer or by their next direct deposited benefits check or paycheck. The price of such loans is very high. Check cashers routinely make payday loans at effective annual interest rates of well above 250 percent.
- Rent-to-own stores—These stores have new and used household items that can be rented by the week or month or can be purchased by making a set number of payments. This is a very expensive way to buy things. If the borrower misses a payment, the store takes the item back and the borrower loses any money paid toward owning it.

Bifurcated U.S. financial system

Many of the credit sources listed above are expensive, but low-income families often turn to them after exhausting their credit card lines. High-cost forms of credit—payday lending, rent-to-own stores, pawnshops, etc.—are offered through the fringe financial services market. The United States has a bifurcated financial system made up of fringe financial institutions and mainstream financial institutions—two distinct financial services infrastructures that are markedly different. The asset-eroding business practices of fringe financial services contrast significantly with the asset-building services provided by mainstream financial institutions.

In healthy middle- and upper-income communities, consumers have access to loans and credit cards at competitive rates, and branch offices of mainstream banks and savings and loans offer a full array of banking services. In many low-income and minority communities, by contrast, the absence of capital can deter entrepreneurs and limit the expansion of neighborhood businesses. Low-income consumers are forced to patronize fringe financial service providers that charge exorbitant rates for personal loans and limited banking services. And because these transactions are not recognized by credit-rating agencies, consumers cannot build credit histories accepted by traditional credit sources.¹⁷

The fringe financial services industry is a growing business. For years, the Federal Reserve Board has estimated that about 10 million households in the United States lack access to basic bank accounts. However, a recent study by the General Accounting Office (GAO)—*Electronic Transfers: Use by Federal Payment Recipients Has Increased but Obstacles to Greater Participation Remain*—puts the true figure of unbanked households at over twice the Federal Reserve’s estimates. GAO estimated that there are as many as 22.2 million unbanked households—comprising 56 million adults.¹⁸

The number of unregulated and unlicensed financial services providers is growing nationwide, but the increase is exponential in low- and moderate-income minority communities. Fringe services engage in at least 280 million transactions each year for gross revenues of more than \$168 billion.¹⁹

Households without bank accounts are disadvantaged in several ways. They may be unable to establish a credit history, which has implications for future credit applications, employment, and insurance coverage. These households also typically spend up to three times as much for basic services as do consumers with accounts at mainstream financial institutions.²⁰

Utilizing fringe financial services can greatly undermine the asset-building capacity of lower-income households. Fringe services for cash conversion and bill paying would cost an average \$20,000-income household between \$86 and \$500 per year, while the same services at a bank would cost only \$30 to \$60 (assuming that low-cost banking services are available and the prospective customer is not disqualified for an account by lack of credit). Yet, \$500 per year saved for a period of 10 years at a modest interest rate of only 4 percent would grow to more than \$6,000.²¹

Furthermore, the costs for low-income consumers to utilize fringe services would be even higher if those consumers also utilized payday loans, pawnshops, rent-to-own stores, or car-title loans. An example that Manning offers in *Credit Card Nation* is of a \$196 Magnavox television that costs \$9.99 a week for 78 weeks from a rent-to-own shop, for a total of \$779. Compare it to buying the same television with a credit card at 22.8 percent interest from a national discount electronics store over the same time period for a total of \$231. The difference in finance charge would be \$548.²²

Accessing mainstream financial services helps families begin to build assets and manage their resources. Funds at mainstream financial institutions are safe from theft, are federally insured, and may earn interest. Managing an account allows consumers to build a credit history that can qualify them for credit cards, other credit products, and a mortgage loan. Research shows that lower-income people with deposit accounts are more likely to have a major credit card, a first mortgage, or a car loan than low-income people who do not have accounts.²³ There are many benefits to utilizing mainstream financial institutions; however, low-income people need to be aware of the terms and fees of the account. If a consumer does not have enough money to meet the minimum balance

requirement or lacks the acumen to manage their account, they may accrue costly fees for insufficient funds and monthly maintenance fees.

There is a marked disparity in the number of low-income people who access mainstream financial services. This is partly the result of financial institutions' failure to offer appropriate accounts to modest-income people, but there are many other reasons why many low- and moderate-income consumers are unbanked, including the following:

- **Cost**—It can be prohibitively expensive for low-income people to maintain bank accounts. They may face high minimum balance requirements, initial deposit requirements, or monthly service fees.
- **Credit status**—Some banks conduct credit checks and scoring for applicants. Consumers with little or no credit or a slightly blemished credit record can be disqualified from opening a bank account.
- **Inconvenience**—Banks often have hours that are inconvenient for low-income people because they are not accessible in the evenings and on weekends.²⁴
- **Lack of financial sophistication**—Utilizing mainstream financial services requires education on balancing checkbooks, planning monthly finances, etc. Without the skills to manage accounts, consumers might be faced with high fees for insufficient funds and other transactions. In addition, some consumers are uncomfortable using electronic technologies that are associated with many lower-cost accounts, including ATMs, point-of-sale terminals, and Internet banking.
- **Physical proximity**—Bank branches have abandoned many inner-city communities. Bank mergers involving institutions with overlapping branch locations have caused a decline in the number of bank branches per capita in lower-income communities as the newly merged institutions close branches to reduce costs.
- **Poor outreach and marketing**—Many banks have affordable accounts that are accessible to lower-income consumers, but the account features often are not well marketed to lower-income communities.
- **Privacy issues**—Some may worry that financial institutions share account information with others, including creditors. The unbanked may be concerned that their deposits will be attached to pay for outstanding judgments. In fact, a study showed that one in five respondents indicated that lack of privacy was the major reason they did not have a checking account.²⁵ This is especially true for recent immigrants and refugees from countries with unreliable banking systems.

- Trust issues—Some unbanked consumers may have attempted to access bank services in the past and were repelled for a variety of reasons. In addition, poor communication regarding account guidelines can lead to misunderstandings for account holders. Some consumers may feel uncomfortable continuing a relationship with an institution that has denied them a loan.

Using credit productively

Utilizing mainstream financial service providers helps low-income people to manage their finances and begin to build assets. But as they build assets, it is imperative to manage them wisely. Part of effective asset management is using credit productively.

There are many instances in which it is wise to utilize credit and there are times when using credit is not productive because it undermines a person's ability to build assets. Although a home mortgage and a revolving credit card balance are both liabilities, one is a productive use of credit and the other is not. Credit is used productively on items that increase in value, have reasonable interest rates, have a life expectancy of more than three years, and provide the borrower a sound alternative to get out of the loan. The following example describes the differences between productive and nonproductive uses of credit.

Productive credit is used for things that will increase in value. Real estate is commonly considered an appreciating asset even though specific property values may decline during economic cycles. As a general rule, real estate gains in value over time. In contrast, using revolving credit to purchase a wide-screen television would not be a productive use of credit because the item begins to depreciate as soon as it is purchased.

When credit is used productively, the borrower has a sound alternative to get out of the obligation. A mortgage loan has an escape for both the borrower and the lender. If the borrower cannot handle the monthly payments, or wants to get out of the loan for other reasons, the borrower can choose to sell the house and pay the lender from the proceeds of the sale. Using a revolving credit card loan to purchase a wide-screen television does not afford any escape for the borrower. Although the borrower can sell the television, it is highly unlikely that they can sell it for the purchase price. If the borrower can no longer make the payments, the credit card company will pursue payment through the collections process.

Another factor in utilizing credit productively is to ensure that the interest rate is reasonable. In nearly all situations, the rates for mortgage loans are lower than other types of consumer loans, sometimes by as much as two-thirds.²⁶

There are several specific strategies and initiatives to help people use credit productively, but perhaps the most powerful approach is to demonstrate the impact that effective credit and money management will have on a person's future financial situation. If a person believes that resolving a credit issue will help them qualify for a mortgage loan or enable them to save more money for their children's education, they are much more motivated to

use credit productively. There are numerous strategies that individuals can use to take control of their credit as well as special programs that help people to manage their credit and financial resources effectively. The following list provides examples of strategies and programs that help people manage their credit and financial resources effectively.

Strategies for individuals to use credit productively

- Pay bills on time—Paying bills on time every month is one of the best ways to build good credit.
- Borrow no more than you can comfortably pay back—Try not to charge more than you can pay off in three months. If you need a long-term loan, contact a local credit union, bank, or savings and loan, and compare interest rates.
- Pay off credit cards first—Concentrate on reducing your credit card debt. Paying off credit accounts is one of the best investments you can make.
- Beware of impulse buying—If you are an impulse buyer, limit the number of cards you carry.
- Be suspicious of card companies offering low introductory rates—Often, the low rates last only for the first three months, after which they become higher.
- Order a copy of your credit report annually—Your credit report is like an academic report card—it evaluates your performance as a credit customer. Check your report to be sure it is accurate.
- Save for major purchases instead of putting them on a credit card—If you must borrow for that item, seek less expensive loans from banks and credit unions.
- Always pay more than the minimum balance due—If at all possible, pay off the balance each month.
- Seek assistance if necessary—If you are having problems paying your debts, contact a nonprofit credit-counseling organization.

Sample programs to help individuals use credit productively

There are a variety of programs that help low-income people use credit productively and build assets. The following list is a sample of programs that focus on saving and asset development.

- *America Saves*—America Saves is a nationwide campaign through which a broad coalition of nonprofit, corporate, and government groups helps individuals and families save and build wealth. Through information, advice, and encouragement,

they assist those who wish to pay down debt, build an emergency fund, save for a home, save for an education, or save for retirement. Many believe that low- and moderate-income families cannot afford to save and build wealth. Yet, research shows that there are “savers” and “spenders” in all income classes. Although those with modest incomes cannot save as much as the affluent, almost all have the ability to build wealth over time.

- *Get Checking*—Get Checking helps people to become financially literate and be informed users of mainstream financial products and services such as checking accounts. People who use alternative services, like check cashing services, pay hundreds of dollars a year more in fees than they would at a bank or credit union. Get Checking teaches “banking basics” through a six-hour course. Graduates of the course who pass a competency test receive a certificate of completion that is recognized by participating financial institutions that offer special products and services to the graduates.

Account problems are typically reported to Chex System, a national tracking system that banks use to assess new account applications. Through the Get Checking program, people who complete the banking basics course, satisfy their outstanding debt, and have not had an account closed because of fraud can open an account with participating financial institutions.

- *Extra Credit Savings Program*—The Extra Credit Savings Program was launched in 2000 by ShoreBank to provide free tax preparation assistance to low-income families. They are also offered financial education and encouraged to open a bank account into which their tax refund can be directly deposited. The partnership has generated 222 new savings accounts and \$200,000 in initial deposits in the first two years for which data was collected. ShoreBank estimates it now has about 500 accounts.²⁷
- *Individual Development Accounts*—Individual Development Accounts (IDAs) are dedicated savings accounts, similar in structure to Individual Retirement Accounts (IRAs), that can only be used for purchasing a first home, education or job training expenses, or capitalizing a small business. They are managed by community organizations and accounts are held at local financial institutions. Contributions for lower-income participants are matched using both private and public sources. Additionally, all participants receive economic literacy training that helps them to clean up their credit, establish a budget and savings schedule, and manage their money over the long term.

Individual and Community Wealth

These programs and others help people begin to build a stable financial foundation and accumulate assets. Another key consideration in helping low-income people build assets is the role between individual and community wealth.

Individual wealth can be derived from community wealth. The most common example of this is home equity appreciation. If a home is purchased in a community that is thriving and increasing in value, the value of the home in that community is also likely to increase in value. This enables the homeowner to achieve increased personal wealth through their increased home equity, which resulted from the increased wealth of the community.

While homes are not guaranteed to appreciate, homeownership has proven to be the single greatest contributor to wealth accumulation for most Americans.²⁸ Homes in wealthy communities usually appreciate in value, but lower-income people sometimes own homes in unhealthy communities and thus fail to build equity. There are a number of factors that inhibit home equity appreciation. The economy may decline or the neighborhood where the home is located may worsen. If the home is purchased when demand drives up home prices, the consumer may overpay for the home. If the consumer overpays and home prices decrease over time, the consumer may not recoup their investment.

In most cases, home equity is a powerful way to build wealth. Home equity helps to build wealth because it facilitates tax-subsidized consumer borrowing and spending and capital accumulation that is sheltered from federal or state taxation. As a result, homeowners enjoy, on average, much higher net wealth per household than those who rent. At the end of 2001, the median homeowner household had a net wealth of nearly \$172,000. The median household net wealth for renters, by contrast, was \$4,810.²⁹

For lower-income homeowners, the role of home equity in household wealth is even more important. The median net wealth of homeowners in the bottom 20 percent of all income-earning households was \$68,000; for half of that group, home equity represented 80 percent or more of their total wealth. For renters in the bottom 20 percent of incomes, the median household net wealth was just \$500.

There are currently efforts under way to develop strategies that will enable low-income people to participate in the wealth gains that ownership provides. This is being accomplished by linking community development efforts for addressing poverty with people-based strategies. Historically, development initiatives, such as tax incentives and government grants, have encouraged private investment in low-wealth communities. However, these publicly financed incentives rarely include explicit mechanisms to provide economic benefits to community residents. As a result, investors, developers, and entrepreneurs gain wealth as real estate values appreciate and businesses earn profits—but residents who do not own homes, businesses, or property have little to gain. In fact, they are sometimes forced out of neighborhoods they have lived in all their lives, due to the rising rents and property tax assessments that accompany gentrification.³⁰

There is a widely acknowledged need to link low-income residents in revitalizing neighborhoods to distinct asset-building mechanisms to ensure that they continue to be a

part of their revitalizing environment. Community reinvestment efforts that do not include distinct asset-building mechanisms often lead to gentrification and destabilization of the traditional community.³¹

Mechanisms to link individual and community wealth

Only recently has there begun to be interest in linking place- and people-based policies and practices. There are some mechanisms and strategies to ensure that residents benefit financially from community development. These mechanisms link low-income residents to the growing fortunes of revitalizing communities. One such mechanism is Resident Ownership Mechanisms (ROMs), which give residents a vested interest in the growth and prosperity of their community's economic institutions. They forge new civic relationships in which residents are partners with business and political leaders. And they give residents a voice as stakeholders and shareholders in the decisions that affect their lives. ROMs come in many forms and serve many purposes. New models are being developed in the areas of commercial real estate development, new business development, and homeownership.³²

As public subsidies and market forces draw investment into low-wealth communities, commercial real estate often has the greatest potential for appreciation. ROMs can give residents ownership in local commercial real estate ventures launched by community development corporations, and real estate investment trusts. Market Creek Plaza in San Diego, CA is an example of a ROM in the real estate arena—the shopping center was designed, planned, and partially purchased by community residents. The project included a community ownership strategy, which enabled hundreds of committed community residents to invest their own capital in the project and build individual wealth by rebuilding their neighborhood.³³

ROMs in the business arena include worker-owned cooperatives and employee stock ownership plans. The development of these businesses creates employment opportunities and builds financial assets among workers and community-based owners. B.I.G. Wash, a Laundromat in Washington, DC, is an example of a business with shared resident equity.

Although home equity is the most traditional way to build assets among low-income people, it is often difficult, particularly in gentrifying neighborhoods where home values are skyrocketing. ROMs such as community land trusts (CLTs) and limited-equity housing co-ops have a long and proven track record of helping low-income families to access affordable housing while building home equity. CLTs acquire real estate and sell the homes to residents while maintaining ownership of the land on which the homes are built. Residents build equity by paying down a mortgage rather than renting, and they receive a significant share of the home's appreciating value. Burlington Community Land Trust is one of the most successful examples of CLTs.

Conclusion

Deregulation of the banking and financial industry expanded the availability of credit to low-income people, but often at a very high cost. Prior to deregulation, the primary issue for low-income people was lack of access to the credit system. After deregulation, the primary issue shifted from access to credit to cost of credit. The high cost of credit is primarily due to finance charges and penalty fees. Most people (59 percent) with incomes between \$10,000 and \$24,999 have credit cards and continually carry balances. Credit card issuers target low-income consumers with offers of high-cost credit cards.

Credit cards are not the only form of high-interest, short-term loans that are utilized by low-income people. Once they exhaust their credit card limits, people often use more expensive forms of short-term loans, including payday lenders and pawnshops. As many as 22.2 million households are unbanked and typically patronize payday lenders, pawnshops, and other fringe financial services. These services typically cost up to three times more than banking services at mainstream financial institutions.

Although many low-income people utilize high-cost credit services, there are several programs and organizations to help them use credit wisely and begin to build assets. Additionally, it is widely acknowledged that individual wealth can be derived from community wealth. Homeownership remains the single most important factor for household wealth accumulation, but there have been recent efforts to develop mechanisms that will help low-income people build assets by linking them to the growing fortunes of their communities. Resident Ownership Mechanisms are an example of a method to give low-income families a vested interest in the growing prosperity of their community's economic gains. ROMs and other methods and strategies that help low-income people build assets by linking them to the wealth in their communities should be further explored and replicated where possible to help low-income people build wealth.

Future Research Needs

This report outlined key issues and trends for low-income consumers accessing credit by examining the U.S. credit system, consumer motivations and methods for accessing credit, and the link between community wealth. Although this report only focused on these three issues, there is a myriad of topics that should be researched more fully to provide a comprehensive understanding about credit issues for low-income consumers.

Three broad areas emerged as critical to low-income consumers' ability to access affordable, appropriate credit: fringe financial services, credit and debt management, and asset-protection strategies.

This report explored ways that wealth is stripped from low-income consumers when they patronize fringe financial services instead of mainstream financial institutions. Better information is needed regarding the true cost and risk associated with providing these

products to low-income consumers. This information could potentially lead to the development of a risk assessment model for the pricing of fringe financial service products.

As low-income people begin to access credit, they are confronted with a variety of credit and debt management issues. Examining the credit needs of low-income consumers and the extent to which current products meet this need would yield important information that could inform the development of new, innovative credit products. In addition to exploring low-income consumers' product needs, there may be specific credit issues that need to be examined further. For example, medical emergencies commonly lead to credit and debt management issues for low-income consumers. The link between credit and healthcare should be explored in greater detail since people who can least afford medical expenses often pay the most for it. Research should also be conducted to identify effective approaches to improving impaired credit records and providing credit and financial education at an early age.

As low-income people access credit and begin to build assets, information about effective asset-protection strategies will become increasingly important. Information should be provided to consumers to inform them about ways to best protect their assets. Research that informs consumers about ways to utilize homeownership as an asset-building strategy will help them protect their assets and begin to build wealth.

Appendix:

National and Local Resources to Help Families Access Affordable and Appropriate Credit

National Organizations

American Savings Education Council (ASEC)

ASEC is a nonprofit national coalition of public- and private-sector institutions undertaking initiatives to raise public awareness about what is needed to ensure long-term personal financial independence. ASEC works through its partners to educate Americans on all aspects of personal finance and wealth development, including credit management, college savings, home purchase, and retirement planning. ASEC has developed tools and resources to help consumers begin to save money. For more information, log on to www.asec.org.

Consumer Action

Consumer Action is a nonprofit, membership-based organization. It runs the National Consumer Resource Center, operates a free consumer hotline, and offers free multilingual publications on consumer and personal finance issues. For more information, log on to www.consumer-action.org.

Consumer Federation of America

The Consumer Federation of America sponsors America Saves, a nationwide campaign through which a broad coalition of nonprofit, corporate, and government groups help individuals and families save and build wealth. Through information, advice, and encouragement, America Saves assists those who wish to pay down debt, build an emergency fund, save for a home, save for an education, or save for retirement. Campaigns are conducted in 18 cities and on the Internet. For more information, log on to www.americasaves.org.

Cooperative State Research, Education, and Extension Service

State extension programs, which are run by the U.S. Department of Agriculture and housed in public universities around the country, promote family economics, financial literacy, and consumer education in urban and rural locations. For more information, log on to www.reeusda.gov.

Corporation for Enterprise Development (CFED)

The Corporation for Enterprise Development promotes asset-building and economic opportunity strategies—primarily in low-income and distressed communities—that bring together community practice, public policy, and private markets in new and effective ways. CFED is working with several community organizations from across the country to launch local Individual Development Account programs. For more information about local IDA programs, log on to www.idanetwork.org.

Fannie Mae Foundation

The Fannie Mae Foundation creates affordable homeownership and housing opportunities through innovative partnerships and initiatives that build healthy, vibrant communities across the United States. The Foundation provides free, multilingual information on credit, borrowing basics, homeownership, and getting a loan. For more information, log on to www.homebuyingguides.org.

Freddie Mac

Freddie Mac is a stockholder-owned corporation chartered by Congress in 1970 to create a continuous flow of funds to mortgage lenders in support of homeownership and rental housing. Freddie Mac provides information and tools on credit and homeownership. For more information, log on to www.freddiemac.com.

National Consumer Law Center (NCLC)

NCLC advocates for low-income consumers nationwide, produces bilingual consumer education materials, and distributes them through a network of legal services providers. For more information, log on to www.consumerlaw.org.

National Foundation for Consumer Credit (NFCC)

Founded in 1951, the National Foundation for Credit Counseling, Inc., through its member agencies, sets the national standard for quality credit counseling, debt-reduction services, and education for financial wellness. With more than 1,300 community-based agency offices across the country, NFCC members help over 1.5 million households annually. NFCC Members, often known as Consumer Credit Counseling Services or by other names, can be identified by the NFCC member seal. This seal signifies adherence to high standards for agency accreditation, counselor certification, and policies that ensure free or low-cost confidential services. NFCC member offices can be reached in communities nationwide. For more information, log on to www.nfcc.org

NeighborWorks Network

This network of almost 200 agencies promotes homeownership programs for low- and moderate-income people. Local Neighborhood Housing Services agencies that are part of the NeighborWorks Network offer one-on-one counseling for prospective homebuyers. The Network also has a foreclosure prevention program and a Home Buyers Club. For more information, log on to www.nw.org.

One Economy Corporation

One Economy is a national nonprofit organization created to be a catalyst for innovation and change. Its mission is to maximize the potential of technology to help low-income people build assets and raise their standard of living. One Economy sponsors an Internet-based portal of information and tools to help low-income people build assets. For more information, log on to www.thebeehive.org.

Local Organizations and Resources

Atlanta

- CCCS of Greater Atlanta
- Georgia Saves
- ACORN Housing
- Atlanta Center for Homeownership
- Atlanta Urban League
- Fulton Atlanta Community Action Authority
- Dekalb Fulton Housing Counseling Center

Baltimore

- CCCS of Maryland and Delaware

Denver

- CCCS of Greater Denver
- Del Norte Neighborhood Development Corporation
- Colorado Housing Assistance Center
- Southwest Improvement Council

Des Moines

- Consumer Credit Services
- Citizens for Community Improvement
- Home Opportunities Made Easy

Hartford

- CCCS Credit Advisors
- Co-Opportunity, Inc.
- Housing Education Resource Center, Inc.

Indianapolis

- CCCS of Central Indiana
- Indianapolis Saves
- Indianapolis Neighborhood Housing Partnership

Louisville

- CCCS of Louisville
- CCCS of Kentucky
- Neighborhood Housing Services of Louisville
- Louisville Urban League
- Kentucky Saves

Milwaukee

- CCCS of Northeastern Wisconsin
- CCCS of Milwaukee
- United Community Center
- GreenPath Debt Solutions

New Haven

- CCCS Credit Advisors
- Neighborhood Housing Services of New Haven, Inc.
- Hill Development Corporation

Oakland

- CCCS of the East Bay
- ACORN
- City of Oakland Housing Counseling
- Home Buyer Assistance Center

Providence

- CCCS Credit Advisors
- Elmwood Foundation
- Housing Development Corporation of the North End

San Antonio

- CCCS of Greater San Antonio
- Avenida Guadalupe Association
- Neighborhood Housing Services

Seattle

- Credit Counseling North West
- Community Homeownership Center
- El Centro de la Raza
- International District Housing Alliance
- Urban League of Metropolitan Seattle

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