

High-Cost Loans among the Unbanked

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When it comes to making financial decisions and planning for the future, researchers have found that individuals who are banked behave differently from those unbanked. Though having an interest-bearing savings or checking account may not ensure economic stability, it is highly correlated with a number of good financial decisions and behaviors. For instance, children in banked households have a greater likelihood of college completion (Zhan and Sherraden 2009), and banked individuals are more likely to feel secure and to plan ahead for savings, work, and family (Lusardi and Beeler 2006; Sherraden et al. 2005).

In this fact sheet, we provide further evidence regarding the behavioral differences between the banked and the unbanked in their use of high-cost loans. In general, the very act of being unbanked implies less access to low-cost transaction accounts. When they need money, therefore, one would expect that the unbanked would rely on alternatives: pawnshop loans, auto-title loans, rent-to-own products, payday loans, check cashing outside banks, money orders, and nonbank wire transfers. These products' fees and compounded accumulated interest can cost consumers a great deal of money over time and they usually come without credit or savings components.

Our new evidence shows that banked individuals are significantly less likely to use another alternative, instant tax refunds. Refund anticipation loans (RALs) and refund anticipation checks (RACs) enable individuals to pay for tax preparation through their anticipated refunds and RAL users receive a loan against that refund: filers can walk out the same day with a tax refund, which is much faster than waiting for the IRS. However, compared to other filing options, RALs and RACs are costly and, like the products above, much more likely to be used by those in the lowest income quintiles (Theodos et al. 2010).

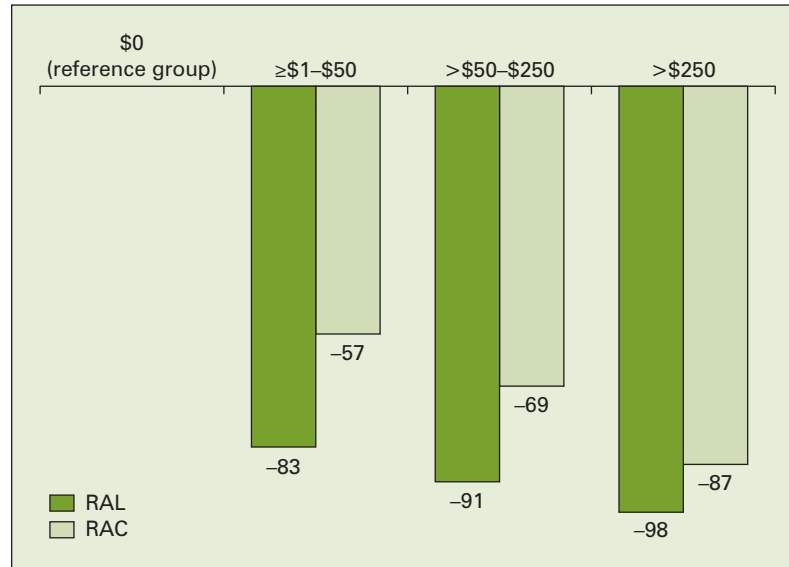
Utilizing interest and dividend income as a proxy for banking status or the holding of some liquid assets,¹ we find that one-quarter of unbanked tax filers use a RAL or RAC compared with only 7 percent of tax filers who hold between \$1 and \$50 worth of interest and dividends, and with just 5 percent of tax filers with \$50 to \$250 in interest and dividend income.

Even after we control for income (through regression analysis), use of the earned income tax credit, and other characteristics, almost any interest and dividend income is associated with a dramatic decrease in use of RACs and an even greater decrease in use of RALs (figure 1). Individuals who have just \$1 to \$50 in interest and dividend income are 57 percent less likely to use a RAC and 83 percent less likely to use a RAL than individuals with no interest or dividend income.

The direction of causation, of course, cannot be determined by this research. People most economically capable of making cost-conscious decisions may decide both to be banked and to avoid RALs and RACs. But being banked may lead to more cost-conscious consumer decisionmaking; bank accounts per se reduce the need for RALs and RACs because they provide a place to deposit any refund. Most likely, all three relationships hold to some degree.

This research does suggest that regulation of debt is not the only means to discourage reliance on borrowing patterns considered excessive, risky, or expensive. A broader strategy would look at the savings or asset side of the household balance sheet. For instance, reduced reliance on RALs and RACs might be an additional payoff of policies that aim simply to get individuals banked (such as child accounts, saving vehicles for students, and even some split refunds for tax returns). Though such asset-oriented efforts are not aimed directly at encouraging judicious use of RALs and RACs, they might produce such a result simply by increasing financial savvy.

FIGURE 1. Percent Likelihood of RAL and RAC Use by Interest and Dividend Income Claimed



Source: Theodos et al. (2010).

Universe: Randomly selected sample of 1 percent of all U.S. tax filers in TY 2008 with a return.

Note: The graph represents the increased/decreased probability of RAL/RAC use compared to the reference group. It depicts the graphed coefficients (odds ratios) resulting from the multinomial regression.

Note

1. That is, individuals with at least \$1 to \$50 of worth of assets; those with \$1 of interest or dividend earnings have the equivalent of \$50 in a bank account that yields a 2 percent annual return. Of course, some individuals could hold banking accounts that paid no interest.

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