

The Use of Formal and Informal Financial Markets Among Black Households¹

Employing unique household data, this article documents the use of banking services, the role of informal financial networks, and the patronage of alternative financial service businesses in Chatham, a predominantly Black community in the city of Chicago.

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A household gains several advantages from holding a deposit account with a financial institution. In terms of time and actual expense, payments for home production and personal transactions often can be made at a lower cost. Households are shielded from risks associated with holding uninsured cash reserves and are availed with important consumer protections. In fact, there are approximately 20 laws and regulations safeguarding the consumer from unfair, discriminatory and predatory lending practices. (Board of Governors of the Federal Reserve System, 1997).

Still, a large number of households remain unbanked. These households tend to be disproportionately lower-income or minority families. Hogarth and O'Donnell (1997) find that almost 37 percent of all U.S. Black households are without either a checking or saving account. Among White households, however, they determine that less than 8 percent fall into this category. Unbanked households often rely on alternative financial services (AFS) such as check cashing outlets, currency exchanges or pawnshops to meet their liquidity and credit needs (Swagler, et al., 1995). The cost of these services have been shown to be almost twice as large as comparable banking services (Green and Lechter, 1998). It is unclear that consumers using AFS are adequately protected against unfair lending or predatory business practices, as evidenced by the increase in class action lawsuits against major check cashing companies for alleged full disclosure violations (e.g., Chicago Defender, 1999). A better understanding of consumer behavior and decision making among financial sources is needed for more effective policies aimed at meeting the needs of consumers.

As pointed out by Bond and Townsend (1996), credit services can be provided by a diverse set of institutions ranging from "informal" networks of family, friends, and social organizations to mainstream financial markets. Informal networks provide relationship-based financing often predicated on criteria different than formal financial markets. Cost advantages in information gathering, ability to utilize more effective enforcement mechanisms and potential willingness to share greater risks related to implicit or explicit credit contracts are factors associated with informal markets unlikely to be present in formal financial markets. Informal networks may be particularly well suited as a source of short-term or smaller dollar amount of funding often unavailable from formal sources. These funds, at the margin, may be quite important to lower-income households. A potentially important limitation of informal market sources, however, is its greater likelihood of being more liquidity constrained than the formal markets. As a consequence, informal markets may be circumvented or otherwise limited in their effectiveness in making credit accessible to households.

This article provides information about the use of these various sources of financing among Black households. Although a majority of households possess a deposit account, we find that a substantial number remain unbanked. Use of credit accounts, especially home-related loan products is quite limited. Informal financing appears to play an important role among households in need of income smoothing or additional assistance for the purchase of a home. In general, households patronized AFS businesses extensively. Somewhat surprising was the finding that the majority of AFS users already have a pre-existing relation with a bank. Drawing upon the findings of this study, we outline several policy implications and recommendations.

Survey Description

Chatham was chosen as the site of this study due to its distinct and well-recognized ethnic neighborhood. Chatham, located on the south side of the city of Chicago, became predominantly Black during the 1950s (Chicago Fact Book Consortium 1995). According to the 1990 U.S. Census, this community had a population of 36,779

persons. In our survey, all households are Black with an average family income of \$37,726 in 1996. Median family income was \$35,000, classifying Chatham as a middle-income community.

The survey instrument was adapted with very minor modifications from a survey developed for a study of Little Village, a predominantly Hispanic community situated on the southwest side of the city of Chicago.⁴ The Federal Reserve Bank of Chicago sponsored the survey conducted in Chatham between 1996 and 1997.⁵ 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. The fieldwork resulted in the completion of 194 randomly selected household interviews.

Use of Credit and Financing

A unique feature of our survey is its collection of information about a household's response to events that caused financial distress. These responses included seeking financial assistance from formal and informal sources as well as the household's labor market and other behavior responses. The most frequently cited events resulting in financial distress included substantial unemployment or periods of unusually low income, death or illness of a family member, and large increases in living expenses.

Table 1
Household Responses to Financial Setback

Responses	All Sources of			
	Financial Setback	Illness or Death	Unemployment	Increase Expenses
Formal Financing	8	3	6	5
Informal Financing	16	17	17	6
Use Existing Assets	20	12	11	9
Increase Labor	8	2	13	9
Reduce Consumption	13	5	12	7
Delay/ Fail to Pay	16	7	16	3
Total Number of Households Responding	56 (100%)	23 (41%)	29 (52%)	14 (25%)

Notes:
Sum of responses is greater than total number of households responding due to multiple responses. Number in parentheses indicates percent of total households that experienced financial setbacks. There were 5 households that cited responses as "other."

Table 1 provides some insights into the response patterns of households facing financial distress as well as the response pattern conditioned on a specific financial setback. Overall, 29 percent of all households (56) reported having experienced a financial setback over the previous 5-year period. The most common reaction by households was the liquidation of existing assets (e.g., savings and checking accounts). Seeking financial assistance from informal sources and delaying or failing to pay debts also were frequently utilized responses. Formal sources were infrequently used when a financial setback occurred.

The household's link to the formal financial market is captured through information collected about the use of a checking and savings account, various investments and longer-term savings accounts, and holdings of credit products including various home mortgage-products and car loans. In Table 2 we highlight the use of these financial instruments by household income to ascertain whether this relation varies at different income levels. As shown, 62 percent of all households surveyed possessed a checking account and 65 percent had a savings account. In combination, 79 percent of all respondents reported having either a checking and/or a savings account. At higher income levels the proportion of households using a checking and/or a savings accounts increases from 58 percent among households in the lowest quartile to 92 percent of the households at the highest income levels. By contrast, 21 percent of the respondents had neither a checking nor a savings account. The proportion of households without a saving or checking account decreases with household income from 42 percent of households in the lowest income quartile to 7 percent among those in the highest income quartile.

In general, the proportion of households holding various types of longer-term investment/savings or retirement accounts increased with household income. A certificate of deposit (CD), an individual retirement account (IRA) or a mutual fund account was possessed by 19 percent of all respondents, while 32 percent had a retirement fund account. Although a retirement fund represents a compensation arrangement between the respondent and his/her employer, it also reflects an important long-term investment/savings linkage to the formal financial market.⁶

Over the previous five-year period, respondents had not made wide use of credit accounts, especially those related to home financing. While the age profile of this community (relatively older population) may contribute to the lackluster activity in these credit markets, it remains unclear that life-cycle effects alone can fully explain the level of credit activity observed. As shown in Table 2, 9 percent of all households had a home mortgage or refinance

loan, 6 percent had a home equity loan, and 3 percent had a home expansion loan. Car loans were the most frequently reported loan type possessed, ranging from 8 percent among households at the lowest income quartile to 45 percent of the households at the highest income quartile. Appliance/furniture loans were held by 5 percent of all households and fell to 2 percent among the highest income households. This finding may reflect the lack of need by higher-income households to make durable goods purchases using credit and/or the unwillingness of these families to assume more costly credit terms.⁷ Finally, almost 50 percent of all respondents held at least one credit card, although we are unable to determine whether credit balances were held on these cards. The proportion of credit card holders increased with family income from 16 percent of the households in the lowest income quartile to 72 percent among families in the highest income quartile.

Table 2
Formal and Informal Financial Sources
By Household Income Quartile

	Total Number of Households	Percent of Sample	1st Quartile	2nd Quartile	3rd Quartile	4th Quartile
Formal Source						
Financial Instruments						
Checking Account	121	62%	23%	64%	71%	85%
Savings Account	126	65%	42%	64%	71%	85%
Checking and/or Savings	153	79%	58%	82%	84%	92%
No Checking or Savings	41	21%	42%	18%	16%	7%
CD, IRA, mutual funds, etc	36	19%	8%	13%	24%	35%
Retirement Funds	63	32%	8%	23%	55%	54%
Credit Accounts - Last 5 years						
Credit Card	95	49%	16%	31%	60%	72%
Home Mortgage/Refinance	18	9%	3%	8%	18%	15%
Home Equity Loan	11	6%	0%	8%	5%	10%
Home Expansion Loan	6	3%	3%	0%	3%	7%
Appliance/Furniture Loan	10	5%	3%	10%	10%	2%
Student Loan	6	3%	0%	0%	3%	10%
Car Loan	50	26%	8%	23%	29%	45%
Informal Source						
Personal Setback -Last 5 years	16	8%	13%	8%	10%	5%
Investment (home purchase)	18	9%	5%	8%	13%	10%
Alternative Financial Services						
Pawnshop	9	5%	8%	5%	3%	5%
Currency Exchanges or CCOs	148	76%	87%	74%	66%	73%
Sample Size	194	100%	24.5%	25.2%	24.5%	25.8%

Notes:

Quartile 1 includes households with family income < 17776 (n = 38). Quartile 2 includes households with family income, 17776 <= family inc. < 35000 (n = 39). Quartile 3 includes households with family income, 35000 <= family inc. < 50000 (n = 38). Quartile 4 includes households with family inc. >= 50000 (n=40). Percentages may not add up to 100 due to rounding.

Overall, we do not observe extensive use of informal networks as a source of financing in the Chatham community. While not widely used in absolute terms, there is evidence to suggest that informal networks play an important role among households in need of income smoothing due to financial shocks or as a means of obtaining additional assistance for home financing purposes. Of those households faced with financial distress (56 households), 29 percent (16 households) obtained loans or gifts from family, friends, or social organizations. Households at the lowest income quartile used informal networks the most, reflecting the relative importance of informal financial sources to lower-income families (Table 2).

Twenty-three percent of all homeowners in the sample (representing 18 of 77 households) obtained informal financing to purchase their home. Households in the upper-income quartiles used informal networks (primarily relatives) the most. Table 3 displays selected information about the largest financial sources used by households in the home purchase process. The majority of home-buying activity was financed primarily through the formal sector. Twenty-two bank loans were made, while 13 loans were obtained from a mortgage company. Personal savings represent the second most important primary source of funds for purchasing a home. Twelve households (representing 18 percent of those who disclosed their largest funding source) reported having purchased their home entirely from personal savings.

Table 3
Primary Sources of Home Financing

	n	Mean Interest Rate (nominal) (%)	Mean Loan Amount (\$1996)	Median Purchase Price (\$1996)	Mean Household Income (\$1996)
Formal					
Bank	22	7.3 (19)	82211 (21)	102110 (19)	43589 (21)
Mortgage Company	13	10.4 (11)	82613 (13)	97006 (13)	67380 (10)
Finance Company	3	10.7 (3)	61948 (3)	74221 (3)	57500 (2)
Government Agency	3	6.7 (3)	57340 (2)	76829 (3)	47500 (2)
Other Formal	5	30.5 (2)	61370 (3)	116896 (5)	37429 (4)
Undeclared Formal	1	-	-	144928 (1)	76000 (1)
Total Formal	47	9.6 (38)	78215 (42)	92734 (44)	50612 (40)
Informal					
Relatives	3	0 (1)	72962 (2)	160861 (3)	39500 (2)
Social Organization	2	4 (2)	111532 (2)	11532 (1)	1185 (1)
Undeclared Informal	3	-	-	119595 (2)	34333 (3)
Total Informal	8	2.7 (3)	92247 (4)	50272 (6)	10531 (6)
Personal Savings	12	-	-	137818 (11)	50986 (8)
No Source Reported	10	-	-	82870 (3)	49750 (8)
Total	77				

Notes:

Median year of all house purchases is 1970. Figures relate only to the single largest loan used by each household. Number in parentheses indicates reported observations used to construct means.

The informal sector plays a more limited role in home financing. A few respondents (three) obtained financing solely from relatives. An even smaller number of households (two) financed their homes through social organizations. Because the number of informal loans is relatively small, caution should be exercised when making direct comparisons. Even so, we observe that some of the loan terms differ between the formal and informal markets (e.g., lower interest rates for informal loans). Households receiving a loan through informal sources also had a much lower mean income level than households financed by the formal sector.

Alternative Financial Sources

Respondents that utilize a currency exchange, check cashing outlet, or a pawnshop are categorized as AFS business users.⁸ As shown in Table 2, 76 percent of all households surveyed used a currency exchange or check cashing facility. Among households in the lowest income quartile, 87 percent utilized a currency exchange or a check cashing facility. Interestingly, 73 percent of the households in the highest income quartile also used these services, suggesting that AFS use is not limited to lower-income households.

Table 4 compares the characteristics of households based on their use of selected formal and alternative financial service sources. Column 2 displays the characteristics of households holding a checking or a savings account, while Column 3 reflects households with neither type of account. Households that patronized AFS businesses are separated according to whether or not they also possessed a checking account. In this table the AFS-related services include currency exchange or check cashing services, referred to as CCO services. Pawnshop services are excluded because of dissimilarities in services. Column 4 shows the characteristics of CCO users without a checking account, while Column 5 reflects the characteristics of CCO users with a checking account.

Consistent with other studies, these households tended to have higher incomes and were more likely to be employed, more highly educated, older, male, married, and owners of a home, car or other large assets (Column 2). Conversely, unbanked households were inclined to have lower incomes and were more likely to be unemployed, less educated, younger, female, unmarried, and without a home, car or other large assets (Column 3).

Among households in the lowest income quartile, we find that 82 percent (Column 4) are CCO users without a checking account. As expected, the proportion of these households declines at higher income levels, falling to 20 percent of all households in the highest income quartile. Overall, these findings are consistent with the view that CCO users are primarily among lower-income households without a checking account.

Table 4
Household Characteristics
By Selected Financial Services

	Total Sample (1)	Checking or Savings (2)	No Checking and No Savings (3)	CCOs Users without Checking (4)	CCOs Users with Checking (5)
N	194	153	41	68	80
Percent of Total	100%	79%	21%	46%	54%
Gender					
Male	71	83%	17%	47%	53%
Female	123	76%	23%	45%	55%
Marital Status					
Married	71	84%	15%	33%	67%
Not Married	123	76%	24%	53%	47%
Age					
18-24	9	55%	44%	89%	11%
25-34	29	76%	24%	46%	54%
35-44	50	72%	28%	47%	53%
45-59	49	88%	12%	39%	61%
60-64	16	87%	13%	36%	64%
65 up	41	80%	20%	43%	57%
Education					
Less than HS	15	80%	20%	36%	64%
HS or equivalent	109	81%	19%	47%	53%
College and Above	43	91%	9%	20%	80%
Household Income					
1st Quartile	38	75%	25%	82%	18%
2nd Quartile	39	86%	14%	45%	55%
3rd Quartile	38	93%	7%	44%	56%
4th Quartile	40	89%	11%	20%	80%
Employment Status					
Employed	120	84%	16%	40%	60%
Retired	44	84%	16%	39%	61%
Other/Not employed	18	56%	44%	67%	33%
Unemployed	10	40%	60%	80%	20%
Assets					
Home/land/other	84	93%	7%	28%	72%
Car	127	90%	10%	31%	68%
Credit Cards	95	96%	4%	67%	32%

Notes:
The percentages reported in columns 2 and 3 are based on the total number of households in the sample, N = 194. The percentages reported in columns 4 and 5 are based on the total number of CCO user households, N = 148.

The majority of households patronizing AFS businesses also have a relation with the formal financial sector. As Column 5 of Table 4 shows, 54 percent of all households utilizing CCO services (a total of 148 households) also have a checking account, while 46 percent do not (Column 4). Our findings indicate that having physical access to a deposit institution does not appear to be a deterrent from patronizing AFS businesses. We are unable to identify from the survey specific products or services obtained or the reasons why banked households sought AFS businesses.⁹ Clearly, additional research is needed to disentangle these somewhat puzzling results.

Summary and Conclusion

A number of facts are highlighted from our study. First, informal networks are an important potential source of financing for households in need of income smoothing or financial assistance when purchasing a home. Second, home finance-related credit from the formal market is limited. Third, a substantial proportion of households are unbanked, with neither a checking and/or savings account. Finally, AFS businesses are extensively used among households with a deposit account.

While caution must be exercised regarding the policy implications that can be drawn from any one study, our research supports several potential policy initiatives for the 21st century. We are only beginning to understand how informal networks might operate or the potentially important role that informal markets may play for particular groups of individuals. Hence, further research is needed to gain a better understanding of effective networks, especially in racial/ethnic communities. Moreover, we confirm the need to learn more about the demand for and use of formal financial products. Community development lending opportunities as prescribed by the Community Reinvestment Act (CRA), flexible consumer loan programs, and low-cost deposit accounts could prove useful in meeting the financial service needs of lower-income individuals. Educational programs that convey the benefits from having a deposit relationship and inform consumers about AFS costs appear to be warranted. Additional consumer education also may help lead lower-income households toward the formal financial market and may aid consumers in making informed financial choices.

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Endnotes

- 1 The opinions expressed in this study are the authors' and do not necessarily represent the opinions of the Federal Reserve Bank of Chicago or the Federal Reserve System.
- 2 Economist and Manager, Consumer Issues Research Unit.
- 3 Economist, Consumer Issues Research Unit.
- 4 The Little Village survey was originally developed and funded by the Center for the Study of Urban Inequality at the University of Chicago. For a discussion of the survey instrument, see Bond and Townsend (1996).
- 5 The Chatham project also included a random survey of small business owners. See Huck, et al., (1999).
- 6 Increasingly, employer-provided retirement/savings accounts are investment accounts from various equity and bond markets directly managed by the employee.
- 7 It is not uncommon for a finance company to offer credit terms for these types of products. The credit terms offered by these companies are often more costly than those offered by credit card companies.
- 8 As discussed by Caskey (1994), in several states including Illinois, firms that cash customers' checks for a fee are referred to as 'currency exchange' businesses. Hence, a currency exchange firm and a check cashing outlet function in virtually the same way, with the majority of revenues derived from check cashing fees.
- 9 As pointed out by Caskey (1997), it is possible that services provided by AFS business are uniquely different than the services offered by a deposit institution. Also, consumers may not be fully aware of the cost differential between these two types of financial service providers. This view also is supported by Fontana (1997). Other researchers such as Koonce, et al., (1996) present evidence, however, to suggest that consumers do know that price differentials exist between AFS businesses and the formal financial services markets.