Microfinance and Payday Lending: Are they Solving a Problem or Creating One?

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May 15, 2020

Abstract

Current practices in the payday loan, microlending, and check cashing markets have exposed triple digit interest rates associated with varying default rates. This paper will examine whether default rates associated with payday lending and microlending services warrant such high annual percentage rates. Because small-dollar lending practices vary widely in different regions nationally and abroad, I will present the general composition of micro and payday lending that may expose a novel relationship between interest and default rates. This paper will also explore the ethical nature and predatory lending perspectives of the small-dollar loan industry in the US and abroad. Several alternatives to these financial services will be offered in the hopes of conjuring a discussion about legitimate interest rates, ethical practices, and social good involved with payday lending and microfinance.

*Email address: sophiafaulkner@berkeley.edu. I would like to thank my thesis advisor, Professor Raymond Hawkins, for his invaluable guidance and support during this process.

1 Introduction

Microlending is a financial service that provides individuals with small loans to start an enterprise or build personal wealth (Armendáriz and Morduch, 2010). As an alternative financial service, microfinance institutions, or MFIs, have operations focussed in underdeveloped and poverty-stricken locations worldwide (Rosenberg et al., 2013). In recent years, the notion of microfinance has been especially popular among individuals who believe in the narrative that microloans are an inherent social good. Others suspect that predatory lending practices operate under the guise of microfinance, preying on the most vulnerable individuals in society. Many MFIs advertise their goal to reduce poverty, increase financial independence, and empower oppressed groups. However, high interest rates associated with microloans may offer a different story regarding their true objective.

Payday lending is another type of alternative financial service that provides immediate capital for individuals through small-dollar loans (Bennett, 2019). Payday lenders typically hold a majority of their operations in the United States and other highly developed nations. They are concentrated in lower-income communities and target minority groups and individuals that lack access to an array of banking products and services from large financial institutions. Their notoriously high interest rates have allowed them to be at the forefront of many discussions about predatory lending.

The check cashing market, also prevalent in low-income communities in the US, holds similar characteristics as payday lending (Fox and Woodall, 2006). This type of service has emerged as a response in states where payday lending is illegal. Check cashing provides individuals with immediate access to their funds after a check has been cashed. The enormous fees tacked onto the immediate deposit of checks are reminiscent of the substantial interest rates on payday loans.

Similar to microlending practices, payday lenders and check cashing firms typically im-

pose high fees on their products. There are inevitable questions associated with these services: Do default rates on small-dollar loans warrant triple digit interest rates? Why are some individuals proponents of microlending and the associated social good narrative it projects while the same people detest payday lenders' similar practices? The dichotomy present in these perspectives will be explored. This paper's goals are threefold: 1) provide an overview of current lending practices in the microfinance, payday loan, and check cashing industries, 2) analyze interest and default rates associated with micro and payday loans, and 3) identify the possible alternatives for services in the small-dollar lending market in the US and abroad.

2 Microlending Practices

Microfinance institutions offer financial services to low-income individuals that are typically excluded from traditional banking practices. The exclusion of basic financial services exists mostly in lower-income, rural, and developing nations around the world (Rosenberg et al., 2013). Many MFIs market themselves toward individuals that are categorized as unbanked or underbanked, which refers to the type of access they have to traditional banking services (Servon, 2017). Individuals who are unbanked have virtually no access to financial services that may include a checking account, savings account, and lending services. Underbanked individuals have access to bank accounts but rely on alternative financial services. Microlenders often serve as a bridge to fill the gap between individuals' inability to access capital from a traditional bank.

Many MFIs pride themselves in catering their services towards marginalized groups such as women and the rural poor (Rosenberg et al., 2013). However, an individual's driving force behind taking out a microloan may be more specific. Some borrowers flock towards microloans in order to gain financial tractions for their micro, small, or medium-sized enterprise. Others may use the loan to cover common household expenses or to purchase business

commodities such as textiles, wood, and small animals (Armendáriz and Morduch, 2010).

Most services offered by MFIs comprise of small-dollar loans ranging from $100 to thousands of dollars (Rosenberg et al., 2013). However, specific dollar-amounts and loan terms vary widely depending on the region and MFI. For example, an individual in South Asia might use a $50 loan to buy textiles for their small business while an individual in the US might take out a microloan of $10,000 to jumpstart their small enterprise. The repayment schedule for microloans typically consists of weekly installments that commence one to two weeks after the initial loan disbursement (Field and Pande, 2008). The exact dollar amount that is repaid every week is calculated as such: the interest and the principal divided by the number of weeks until the end of the loan term.

2.1 Interest Rates

The pervasiveness and popularity of microfinance does not come without its challenges and contentious practices. The most controversial dimension of microlending has been the interest rates charged by MFIs (Rosenberg et al., 2013). Many MFIs charge higher than average (compared to traditional bank loans) interest rates on small-dollar loans. Similar to payday loans, the interest rate on microloans can reach triple digits. Because microlending policies and practices vary widely from region to region, the average interest rate could be anywhere from 10% to 500%. Interest rates on microloans are typically charged as a per month flat interest rate (Armendáriz and Morduch, 2010). Typical bank loans, from large financial institutions, may charge, for example, 3% interest on a $1,000 loan. However, the borrower only pays interest on the remaining balance of the loan. This practice is considered the declining balance method. With flat interest on the other hand, the borrower will be charged 3% on the original amount of the loan, even as they begin to pay off the principal. When 3% continues to compound on the principal amount of the loan, this could lead to an annualized percentage rate, or APR, of anywhere from 100–500%.

Because lending regulations in many countries are not enforced, most MFIs can charge triple digit interest rates without catching the attention of the government (Armendáriz and Morduch, 2010). Even in areas where regulation on microlending is enforced, many MFIs find loopholes around the law that allow them to charge such high rates. Regulation in some countries includes transparency on the cost of the loan. However, firms can utilize these loopholes to not reflect the real price of the loan. Because prices of microloans are often hidden, there is very little price competition among microlenders in the same region. Even in the existence of full price transparency, the same interest rate on a loan from two different MFIs may not reflect the same level of profit. For example, if one lender charges 80% on a $300 loan, they may arrive at the break-even point while another firm might charge the same interest rate on a $300 loan and generate huge profits.

Interest rates (R) on microloans are dependent on several factors that include administrative expenses (AE), loan loss (LL), cost of funds (CF), capitalization rate (real profit) (K), and investment income (II) (Rosenberg, 2002). The equation below (Eq. (1)) can be used to determine the interest rate on a microloan. It offers up a quantitative method that displays the true cost of the loan with profits factored in.

$$R = \frac{AE + LL + CF + K - II}{1 - LL} \tag{1}$$

In a more simplified approach, Eq. (2) is offered below (Rosenberg et al., 2013). This equation, formulated about 11 years after the previous one, gives a more realistic approach to how most microfinance institutions might price their loans.

$$\begin{aligned} \text{Income from loans} = {} & \text{Cost of funds} + \text{Loan loss expense} \\ & + \text{Operating expense} + \text{Profit} \end{aligned} \tag{2}$$

2.1.1 Components of Equation (2)

First, the cost of funds is a main feature that determines interest rates on microloans (Rosenberg et al., 2013). Microlenders typically fund their loans with a combination of their own equity and debt. While their own equity is "free" to borrow, the borrowed funds may include a cost in the form of interest. When microlenders rely on their own equity for microloans, they do not have to borrow funds with interest rates attached. Mature microlenders, who can fund a larger percentage of their loans with their own equity, may see a decline in their cost of funds because they won't accrue as much interest as they would have if they borrowed money from a large bank. Regulated MFIs may realize a cost savings of about 1.5% on large loans because they are licensed and regulated by the banking authority in that country. They are seen as less risky because there is more oversight involved in their operation.

Second, loan loss expense is a key component of interest rates on microloans (Rosenberg et al., 2013). MFIs typically do not require collateral on the loan. If they do require collateral, the amount sold from the asset (collateral) is unlikely to cover the cost of the defaulted loan. When a borrower begins to fall behind on several installments that may put the collection of the principal and interest payment in doubt, the lender may realize the loss in value of the loan. Thus, lenders include a loan loss provision. This practice is carried out in the loan agreement, which is why this is an element of the initial interest rate. Instead of the lender waiting for the entirety of the loan term to realize the potential loss of collection, the borrowers are instead given notice of this provision at the beginning of the loan period. However, the informal and unregulated nature of many MFIs does not lend itself to transparency in the makeup of the interest rate on the loan. Thus, a borrower may be unaware that this component of the interest rate exists.

Third, operating expenses are another key element that contribute to microloan interest rates. One piece of justification offered for higher than average rates comes from the notion

that there are sizable operating costs for the firms providing the loans (Rosenberg et al., 2013). Operating expenses typically include supplies, travel, cost of implementing a loan, personal compensation, and depreciation of fixed assets. These expenses tend to consume a large majority of the costs taken on by MFIs. Because there are so many components of operating expenses, they are one of the largest determinants in how much a borrower will pay to take out the small loan. The hope for microlending practices is that firms will become experienced and efficient in their implementation of loans so that operating costs will fall over time. The projected result is that interest rates on the loan will fall with the decline in operating costs. Standard economic theory explains that efficiency, in the absence of technological advancement, will improve slowly over time. However, firms continue to charge high interest rates despite arriving at a point where they could use an increased level of efficiency and economies of scale to charge lower rates (Rosenberg, 2002).

Fourth, profits are arguably the most contentious component associated with microloan interest rates (Rosenberg et al., 2013). Many argue that MFIs should not be focussing on profits if their social mission is to help the poor. Others argue that a profit-driven model will encourage innovation and exploration in microlending practices offered by the firm. Arguments from both sides make it very difficult to arrive at one particular profit margin that microloan firms should set. The Consultative Group to Assist the Poor, or CGAP, found that when measured against assets, average profits are slightly higher for microloan firms than large financial institutions. In other words, MFIs are charging such high rates that they are actually generating greater profits than large banks. This staggering observation underscores the level to which interest rates on microloans are inflated. Large financial institutions, which are generally more efficient and have competitive rates on loans, have significantly more resources to implement loans and leverage their capital to reduce risk. Essentially, big banks have the means to make more money on small-dollar loans, yet MFIs take the lead in profits. Perhaps this observation exposes the unreasonably high interest

rates charged by many MFIs (Mader, 2013).

2.2 India and the US

In the United States, the Small Business Administration (SBA) is just one firm that offers microloans to businesses and nonprofit institutions. In the fiscal year 2019, the SBA provided 5,533 loans amounting to $81.5 million (Dilger, 2020). The average dollar amount for each microloan was $14,752. The default rate for this microloan program was 12% and the interest rate on loans offered by the SBA was 7.5%. This rate is based on the five-year treasury rate adjusted to the nearest 1/8th percent. There are about 362 microfinance institutions in the US that exist either online or in a storefront (Lieberman et al., 2012). US-based MFIs do not include loans from payday lenders and large financial institutions.

On the other hand, some financial markets often have a very different story to tell when it comes to microloans. In India, for example, the average interest rate on a microloan varies widely by institution, loan term, and principal amount (Field and Pande, 2008). Many MFIs hide default rates by "rolling over" loans and replacing them with new loans (Mader, 2013). This process could also take the form in the practice of individuals using a microloan from one MFI to pay off the microloan from another MFI. Thus, default rate data might be misleading given this behavior.

2.3 Conclusion

While microfinance has been a popular avenue for poor and marginalized individuals to obtain capital for their business or family, predatory lenders may be particularly attracted towards such a vulnerable group. In areas where education about personal finance and business is very low, it is inevitable that someone might capitalize on this trend. The microfinance industry claims to be helping poor individuals by providing necessary capital

to support their business or family. However, the relatively high interest rates on these loans paves the way for the question: why do advocates for financial inclusivity not scrutinize microlending practices like they do for payday lending? Essentially, there is a double standard between payday loans and microloans. Each has similar practices, with a different narrative, yet one is often treated as a social good while the other is looked down upon by financially inclusive advocates. There is not a question as to whether microlending firms charge high interest rates, but whether they should (Rosenberg, 2002). While many MFIs claim to help the poor and not maximize profits, it is clear that many individuals cannot afford the interest rates that would effectively cover all costs associated with the loan. Some argue that the discussion about interest rates on these loans translates into a value judgement: people or profits?

3 Payday Lending Practices

Payday lending is a popular financial service offered in many low-income communities in the US. There are five groups of individuals in the US that are more likely to utilize payday lending services: home renters, those without a college degree, African Americans, individuals who earn below $40,000 per year, and people who are separated or divorced from their partners (Bourke et al., 2012). While lower income individuals are usually associated with a higher likelihood of taking out a payday loan, there are other factors, rather than income, that might be more predictive of one using payday lending services. For example, about 8% of home renters within the income range of $40,000–$100,000 use payday lending services while only 6% of renters earning $15,000–$40,000 have received a payday loan. In other words, high-income home renters have a higher likelihood of payday loan usage than low-income renters.

The familiarity of this service might emanate from the prevalence of these brick-and-

mortar stores in many shopping plazas. Their bright neon signs catch the attention of onlookers while many individuals pay a routine visit to these establishments. In fact, nearly 5.5% of adults nationwide have used payday lending services, with of borrowers using storefront lenders and the other using online outlets (Bourke et al., 2012). These borrowers spend about $9 billion per year on payday loan fees. Around 70% of payday customers use the capital to cover recurring expenses such as grocery bills, rent, mortgage, utilities, credit card bills, and car loan payments. On the other hand, about 16% of payday borrowers use the loans to cover emergency expenses that might include a car repair or a trip to the hospital. This behavior conveys the type of simple financial products needed by low-income individuals. However, this basic necessity is hard to come by. Enter payday lending markets: a deceptively helpful solution to the problem.

Payday lenders offer small-dollar loans that are borrowed against one's paycheck (Montezemolo and Wolff, 2015). For example, when a borrower takes out $100 from a payday lending service, they must repay the principal loan amount, with interest, on their next paycheck. Because most payday loans have a quick turnaround time, anywhere from 1 hour to a few days, some do not require credit checks at all (Bennett, 2019). Others require credit checks but may be more lenient in their requirement on the status of the score. Payday loans are typically secured with post-dated paychecks or electronic access to the borrower's bank account (Montezemolo and Wolff, 2015). Government regulation in some states has put a cap on the interest rate charged on the loan. However, firms find loopholes to this regulation by advertising their interest rates as dollar amounts instead of percentages (Bourke et al., 2012).

As of 2017, there are more payday lenders in the US than Starbucks and McDonalds combined (Servon, 2017). They typically operate in lower-income communities in the US where unbanked and underbanked individuals reside (Bennett, 2019). In America, there are approximately 20% underbanked and 8% unbanked individuals. The large portion of

unbanked and underbanked people in the US is demonstrative of the lack of financial services available in poor areas of the country. Essentially, there is a bank "desert" in these areas. Not only do individuals in these areas have little to no access to small loans, but many large banks refuse to extend their operation to these communities. The premise of this behavior stems from the fact that large financial institutions would rather spend their resources lending larger amounts of capital to individuals deemed as less of a financial risk (Montezemolo and Wolff, 2015). They also have stringent requirements on existing loan products, making it difficult for someone who may not have a satisfactory credit score and borrowing history (Bennett, 2019). This is why one may not find a Chase or Wells Fargo on any street corner in a poor neighborhood.

3.1 Interest Rates

The average dollar amount borrowed by a payday lending customer is about \$250–300 (Flannery and Samolyk, 2005). However, some establishments lend upwards of \$1,000 in payday loans. Typical fees are \$15–\$20 per \$100 borrowed. With compounding fees, the loan repayment amount can have an annualized percentage rate of 400–500%. Thus, compounding over several weeks or months can translate into repaying \$400 on an \$80 loan. The Uniform Consumer Credit Code, adopted by 9 US states (many other states have implemented some aspects of the code into their law), sets a maximum interest rate that may be legally charged on consumer loans of varying amounts (Buerger, 1974). However, because some payday lenders charge a flat fee on a loan, they may be exempt from mandated interest rate ceilings.

Over 80% of payday loan recipients apply for another loan within 14 days of the original one while 90% of loans are re-borrowed within 60 days (Burke et al., 2014). This displays borrowers' high propensity to re-engage in re-borrowing within a short period of time after receiving the first loan (Servon, 2017). The Center for Responsible Lending found that 33% of payday borrowers defaulted on their loans within 6 months of the loan disbursement

(Montezemolo and Wolff, 2015). In 12 months of receiving the loan, 39% defaulted and within 18 months, 44% defaulted on their loan. In the context of the payday lending market, a default on a loan indicates that a borrower's paycheck is returned for insufficient funds.

3.2 Projection and Present Bias

Projection bias refers to an individual's tendency to falsely assume their tastes and preferences will be the same over time (Loewenstein et al., 2003). Optimal decision making usually requires a prediction of future utility. For example, when an individual is making summer plans during the wintertime, they must predict what activities will be the most enjoyable during the hot temperatures. Many borrowers who take out a microloan engage in projection bias which, when applied to payday lending, refers to their tendency to falsely project their desire for the loan in the future. When an individual borrows money from a payday lender, they most likely believe that their preference for the payday loan will remain over time. Yet, many borrowers find themselves without the means to pay off their loan and in regret that they took out the loan in the first place.

Present bias may be another factor that contributes to borrowers' propensity to take out payday loans. Present bias refers to the notion that the perceived cost and benefit of an action can differ based on the time when the action is pursued (Menger et al., 2018). Individuals have a high tendency of avoiding immediate costs but pursuing immediate rewards. For example, a present bias study found that sports fans were willing to pay about twice as much for third row tickets to the Celtics-Heat game when paying with credit card versus cash. Paying for the tickets in cash represents an immediate cost while paying with credit card delays the cost. The desire to avoid the cost is now so great that individuals were willing to pay more in the future (credit card) just so they could avoid paying in the present. In payday lending, borrowers engage in a similar behavior. When an individual is loaned money from a payday firm, they may be considering the immediate benefit (money) over the

future cost (loan plus interest rate). Despite having to pay more in the future for the money they borrow, the individual is willing to take out the loan now because they will realize an immediate reward.

Because present and projection bias exist in the minds of many individuals, it can make it difficult for them to escape the vicious cycle of loans and compounding interest rate if they are met with instant gratification from the money. The combination of mispredicting future utility and favoring an immediate benefit can cause nearly any financially sound person to become wrapped up in the world of immense debt and frequent default.

3.3 Conclusion

Once individuals engage in payday borrowing, it is difficult to stop. The intention of carrying individuals through a short-term cash deficiency has translated into a service that many individuals rely on to keep themselves afloat when traditional banking services might not give them the products they need. High interest rates on payday loans can turn a small amount of capital into a potential financial burden on individuals and families. Expecting to receive a one-time loan, they are tacked with the possibility of having to repay thousands of dollars if they continue to delay making payments while interest continues to accrue. This phenomenon is the controversial aspect of payday lending. When analyzing current payday loan practices, it may seem unreasonable for individuals to engage in such lending behaviors. They are desperate and find that payday loans may be their lender of last resort when they have no other options. The high interest rates on these small-dollar loans conjure many questions about the ethical nature of them. Despite default rates being high for some individuals, such high interest rates may not be warranted in this case when the rates exceed, by a large margin, the costs associated with the loan.

4 Check Cashing Practices

Many states, where payday lending is illegal, have opened check cashing firms to fill a similar need. Check cashers serve as an alternative financial service that allows individuals to cash their paychecks with an immediate turnaround of their funds (Fox and Woodall, 2006). At check cashing outlets, individuals can deposit their paycheck for instantaneous access to their money. While traditional banking institutions have enacted a holding period of 1-3 days on check deposits, this industry allows individuals to have immediate access and withdrawal capabilities of their funds. For example, if an individual were to take their $100 check to Wells Fargo, it may take them 1 to 3 days for these funds to be available for withdrawal. The difference between immediate capital and 72 hours could be catastrophic. It could mean the difference between housing security and eviction . . . the difference between a business owner paying their employees and losing everything. The additional services offered by check cashing firms include use of an ATM, the payment of utility bills, extracting funds from EBT (electronic benefits transfer) cards, top-ups on metro transportation cards, and parking ticket payments (Servon, 2017). Individuals also utilize check cashing firms to withdraw dollar amounts from their bank account that do not fall within the typical $10, $20, or $100 denominations typically given through ATMs at large banks. The need to withdraw $8 from a checking account leaves individuals with the choice of keeping the funds in the account or taking their debit card to a check cashing outlet to withdraw the funds. The latter option is a common occurrence for low-income individuals that find themselves in need of liquid capital to cover basic necessities such as food and bills.

At check cashing outlets, individuals can expect to pay high fees in order to utilize services offered (Fox and Woodall, 2006). For example, if an individual would like to withdraw the remaining $9 balance on their EBT food stamps card, they may be charged $1. This amounts to 11% of the entire balance in the account. Many check cashing firms display

a menu of prices for each service offered. Each transaction price is typically advertised in dollar amounts, rather than percentages, to give the allusion of inexpensive services.

4.1 RiteCheck

Lisa Servon, a professor of City and Regional Planning at the University of Pennsylvania, has devoted her research to analyzing the current practices in the check cashing markets. In order to diagnose the problems with these lending practices, Servon spent 4 months working as a clerk at RiteCheck in the Bronx, NY (Servon, 2017). RiteCheck is a check cashing outlet that offers customers services like immediate check deposits, paying rent, and withdrawing funds from an electronic benefits transfer card (food stamps, cash benefits, or other types of welfare payments). They serve a population of low-income, underbanked, and unbanked individuals in New York. Not only are these individuals lacking traditional banking products, but they do not have access to payday lending due to New York's strict regulation against the operation of payday lenders.

Servon spent countless hours developing strategic relationships with customers who utilize RiteCheck's services on a daily or weekly basis (Servon, 2017). She found that many individuals had no other choice but to bring their paycheck to the outlet in order to be deposited. On Fridays, many individuals would deposit paychecks and use the immediate funds to pay their bills and other essential expenses. The amount charged per transaction would not deter individuals who were in desperate need to have instantaneous access to the funds they had just received from an employer or client. Some individuals would otherwise lose their apartment if they could not have access to their funds. Others would lose their business, sending them into deeper financial instability had they not used services at RiteCheck.

After spending a considerable amount of time at RiteCheck, Servon identified the three reasons why people tend to use check checking services: cost, transparency, and service

(Servon, 2017).

First, depositing a check accompanied with high fees might be a cheaper option for an individual who might otherwise be penalized by overdraft fees on a traditional deposit account (Servon, 2017). This is where the low-cost alternative of check cashing services comes into play. Servon discovered that individuals generally found that the benefit of having immediate cash far outweighed the cost of waiting several days for the funds to appear in their account.

Second, transparency is a competitive factor that check cashing firms bring to the table (Servon, 2017). Once individuals deposit their check and withdraw the funds, they know exactly where their money went. Check cashing firms do not put a hold on deposited funds and instead, allow for customers to have immediate access to their money. Customers no longer have to be in the dark for the whereabouts of their capital. They enter a check cashing storefront, deposit the check, and are immediately handed the money. It's as simple as that.

Third, people use check cashers because of the service (Servon, 2017). Servon recalls her time at RiteCheck and states that individuals formed relationships with the employees and would often tip them, much to her surprise. Customers felt like they were being treated better than they would if they went to a large bank. They felt like the service provided was solving a need in their life, despite the high fees.

4.2 Conclusion

While check cashing holds some differences with payday lending, the general features remain the same: high interest rates, or fees in this case, on small amounts of capital. While interest rates are similar, check cashing may not pull individuals into a vicious cycle like payday lending if there is not a principal amount that needs to be repaid. However, the ease of capital access might incentivize people to use check cashing services when they find themselves in need of quick cash. Servon appears to be highlighting the apparent need for a

service like RiteCheck in New York. However, the term “need” seems malleable in this case. The question over whether RiteCheck is solving a need remains unknown. Many individuals who seek services at a check cashing firm believe they are paying for a product that is needed by them. However, one might be led to believe that ulterior motives are involved when such high fees on each transaction are present.

4.3 Implications

After exploring three types of alternative financial services, the similarities and differences of each is clear. The flat fee interest rates charged on microloans are very similar to the rates charged on payday loans. Both loans may result in interest rates in upwards of 500%. However, advocates for financial inclusivity typically praise the efficacy of microloans, discussing their need in rural places where women are often oppressed. On the other hand, like-minded individuals might detest the high interest rates offered by payday lenders. Controlling for the difference in the objectives of payday lenders and microlenders, the practices are nearly identical. Individuals are charged triple digit interest rates on small-dollar loans. Both are the same, the narrative behind each is just different. Thus, alternatives must be considered to replace these unsustainable financial services that claim to fill a need in the communities they reside in.

5 Alternatives

There are several small-dollar loan informal alternatives that already exist in many parts of the world. Aside from one firm, which is discussed below, many of these alternatives have not been translated into commercial practices to be used by the masses. In this section, several alternatives will be analyzed and considered as potential solutions for microlending, payday lending, and check cashing services.

5.1 Rotating Savings and Credit Association

Rotating savings and credit association, or ROSCA, is an informal financial group that uses a forced savings mechanism as a way to help poor and low-income individuals who generally do not have access to traditional savings accounts (Sijia and Horita, 2019). ROSCA is considered one of the most widespread informal financial institutions in developing countries and has been practiced for several centuries.

ROSCA comprises a group of individuals that pool their money into a single fund every month and take turns collecting the sum of the funds until each person has received the entire sum (Sijia and Horita, 2019). One member of the group is typically assigned as the bookkeeper and will keep track of the funds and distribute them to the designated individuals every month. For example, in a group of 10 individuals, each person might deposit \$10 every month. Each month, one person receives all \$100. If just one person in the group "defaults" and does not contribute to the fund, the entire system will collapse.

ROSCA groups are common among church communities and extended family members (Sijia and Horita, 2019). The familiarity of individuals creates an innate sense of accountability for each person to deposit their share of the pooled capital. If one does not deposit their funds for a particular month, they face the grim reality of living and interacting with other members of their ROSCA group on a daily basis.

Because ROSCA operates on an informal and unregulated basis, there are no interest rates or fees associated with any deposit or withdraw (Sijia and Horita, 2019).Thus, individuals do not have a net gain or loss with the use of ROSCA, but can guarantee that, given full cooperation from all members, they will be able to benefit from persistent savings. The funds in the pool are also free from taxes, making this savings/investing option particularly attractive to individuals looking for an avenue of fixed income, derived from savings, every month.

If an individual makes very little money per month, saving just a few dollars can amount

to a large percentage of their overall income in just a short amount of time. In some cases, the use of ROSCA might prevent an individual from taking out a microloan or payday loan. While the use of ROSCA may not be appropriate for every individual, saving a small amount of money per month may at least decrease their likelihood of taking out a loan. In other words, not every individual has the luxury of saving money every month, but setting aside just a few dollars every month or week could be the difference between taking out a loan and relying on personal wealth.

Susu is a form of ROSCA that offers a forced savings service to individuals. The term Susu, which means "to plan," is a method of pool savings that is commonly practiced in West Africa and the Carribean (Faulkner and Wemimo, 2019). Esusu, an online platform based out of New York, allows individuals to force save their money by automatically withdrawing a specified amount from their account every month.

In an effort to learn more about ROSCA groups, I conducted a phone interview with Abbey Wemimo, the founder and CEO of Esusu. In the interview, Mr. Wemimo illuminated the need for a service like Esusu in the microfinance and payday lending landscape (Faulkner and Wemimo, 2019). He also shed light on the notion that payday lending and microlending industries remain relatively uninterrupted, especially in the US. Mr. Wemimo's co-founder of Esusu personally experienced the impact of high interest rates when receiving a microloan in Africa. They found that the high interest rates either kept them from borrowing money in the first place or paying back the loan. Either option left them in financial struggle and without the ability to access capital in a time of emergency. This anecdote is the driving force behind the goals of the company. Similarly, Mr. Wemimo found that many individuals who are customers, or potential customers, of Esusu utilize the service as an alternative to microloans and payday loans to avoid high interest rates. There are other apps available on the market that help individuals save their money by automatically withdrawing funds from the customer's checking account every month. However, Esusu is specifically designed

to function like a ROSCA group. This online savings scheme is not an exact replacement for payday and microlending. The funds are not being loaned to the customer because the individual acts as both the borrower and the lender since they already deposited the funds by making an investment every savings period.

5.2 Accumulating Savings and Credit Association

Accumulating savings and credit association, or ASCA, is another type of informal finance group that allows individuals to force saving their money (Tchuindjo, 1999). Similar to ROSCA, all members will save a fixed amount every month and deposit the total funds into the "account." In an ASCA group, individuals do not take turns withdrawing the money each month. Instead, members can withdraw funds when needed. For example, if one has a health emergency and needs funds to cover the costs, they can withdraw from the account instantly. They simply contact the bookkeeper and record the withdrawal amount. However, another individual might not run into any financial hardships for several months and may choose to keep the money in the account. This flexibility gives individuals the benefit of forced savings without having to take out funds when they don't need them. All other functions of ASCA are very similar to ROSCA groups. This informal savings group is unregulated and remains free from taxes and interest rates.

An important aspect to note about ROSCA and ASCA is that they are both based on trust and social forces. When individuals voluntarily contribute funds to the money pool every month, they trust that other members will do the same. Essentially, their faith in each other to follow through on the investment is what keeps the savings scheme going. In homogenous communities, where family and friends are well acquainted, it might be easy for some individuals to engage in such savings groups. However, the use of technology and incentives like credit scores and collateral requirements might be a great addition for the implementation of ROSCA and ASCA groups in financial markets where levels of trust are

not as high.

5.3 Postal Savings

The postal savings system is another alternative that must be considered as a solution to small-dollar loans for unbanked and underbanked individuals. The postal savings system, established by the UK in 1861, was initially created to serve small-scale depositors (Sprick Schuster et al., 2019). The US was another early adopter of the postal savings system, allowing individuals who had lost confidence in the banks to safely deposit their money. The US Postal Savings System was initially designed as a more convenient and safe alternative for people to deposit their money. Congress, at the time, wanted individuals, who tended to keep money hiding or under their mattress, to deposit their funds at the post office. The postal savings system was especially attractive to immigrant individuals who were accustomed to saving their money at post offices in their home countries. After customers would deposit their funds, the post office would invest them in a large bank where they would receive about 2.5% interest. Consequently, the post office would pay 2% interest on all funds deposited. Most individuals found this rate to be higher than if they took their money directly to a large bank. Once an individual had deposited their money, they would receive a certificate of deposit that verified their funds were invested in the US Postal Savings System. After World War II, most US banks began offering competitive interest rates that met the same rates of the postal system. In July of 1967, the US Postal Savings System officially ceased operations. However, very limited banking delivery services still remain such as money orders and electronic funds transfers (Despard et al., 2017).

While the postal savings system does not exist in the US, there are many aspects of this program that warrant a consideration as an alternative for small-dollar lending. First, in rural US communities, there are more post offices than there are branches of large banks (Despard et al., 2017). More specifically, there are about .89 post offices for every 1,000

individuals in rural communities, compared to .04 post offices for every 1,000 individuals in cities. Regardless if the future postal savings system has high interest rates, providing simple checking and small-dollar loans might allow individuals to avoid payday lenders and check cashing outlets altogether. Because the US Postal System (USPS) is an independent agency of the executive branch of the federal government, the financial services within the post offices could be regulated with ease compared to private financial institutions. This regulation might be the grounds for competitive interest rates in the financial products that the USPS would provide. Many postal workers already agree that because the postal system is already profitable, the offices might be less reliant on charging high fees to generate a profit.

While there is evidence of the postal savings system's previous success in the US, this program would also be appropriate for countries where individuals lack adequate access to financial institutions. In India, there are approximately 150,000 post offices with nearly 90% of them operating in rural, poor areas (Malakar, 2013). Their post offices already provide individuals with a system for savings and insurance. India is just one example where the implementation of a postal savings system would be an appropriate alternative for individuals looking for simple financial services who might otherwise turn to a microlender or payday lender.

While implementing a new version of the US Postal Savings System will require a signed piece of legislation, the groundwork from the mid-20th century already exists (Sprick Schuster et al., 2019). Adopting previous features of the postal savings system could allow underbanked and unbanked individuals to access safe and affordable financial products that aid in universal financial stability.

5.4 Other Alternatives

The expansion of current banking practices (for large commercial banking institutions) is another alternative that must be considered. In communities with a high percentage of low-income and low-middle class individuals, there is a great need for an expansion of lending and traditional banking products. With interest rates that match the national average for personal loans, large financial institutions could make big waves in this market. Big banks already have the opportunity of entering low-income communities and regions of the globe, but carefully decide to place their operations in other areas, which does not include poor individuals. Thus, they would have to heavily reconsider their scope of operations in the lending space if they expand their market to reach low-income communities.

Large banks, like Wells Fargo and Chase, could also eliminate or reduce the holding period on cashed checks on special accounts. If someone is a low-income earner, perhaps they could have this waiting period waived in light of their financial situation. An elimination of this could allow individuals to have immediate access to their capital. It could replace the need for them to resort to a payday lending outlet or pay large fees to cash a relatively small check. However, implementing these policies at large banks requires a complete dismantling of current practices. If banks are not making money on these small-dollar loans or cashing of checks then the incentive for them may no longer exist.

6 Conlusion

While this paper discussed several solutions to alternative financial products, many points of discussion still remain. Without the implementation of small-dollar loan substitutions, the potential effects of an alternative remains unknown. Financial greed, power, and abuse continue to plague the system of financial products that many people in the US and around the globe interact with on a daily basis. It is imperative that large financial institutions

position themselves to enter the small-dollar loan industry for individuals who cannot afford to pay upwards of 300% on a $100 loan. The implications of this compounding interest rate reach beyond one loan of an individual who made a careless decision. Their seemingly "careless decision" was weighed against the alternatives presented to them-none! When a single mom needs to put food on her table on a Wednesday night, her only option may be to walk across the street and withdraw the remaining $12 she has left on her food stamps card. Or, she may need to go to her local payday lender and take out $100 to keep the lights on in her home. She is desperate, not careless. She is considerate, not mindless. If desperation breeds creativity, solutions to this problem should have been considered years ago.

Several questions also arise from the topic of this paper: what are appropriate interest rates on loans? In the US, conversations about legitimate interest rates fail to occupy the discussion of small payday lending firms and large financial institutions. The intersection of social good and capital gain seems to be lost in regions where capitalizing on desperation is simultaneously easy and obvious. When individuals are faced with a crisis, they often resort to solutions they once deemed predatory.

Another question that must be proposed is: why is a 400% interest rate on a small-dollar loan for a struggling family in the Bronx considered predatory, but the same amount is justified by "social impact" when a businesswoman in Africa receives a similar loan? A starting place might be to identify microfinance and payday lending as similar practices. Whether one believes these alternative financial services are a social good or a form of predatory lending, it is important to identify similar characteristics in each product and to consequently treat each practice the same. Then, we can have a real discussion about alternatives to each. This understanding may give financiers, or perhaps someone like myself, the opportunity to see a major gap in the finance industry that can potentially be solved with just one new product or service. Individuals are not necessarily looking for elaborate or long-term investing methods. They are looking for affordable, prevalent, and universal

solutions to small-dollar loans. That is it.

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