HARD CHOICES:
FINANCIAL EXCLUSION, FRINGE BANKS,
AND POVERTY IN URBAN CANADA

When low-income city dwellers lack access to mainstream banking services, many end up turning to 'fringe banks,' such as cheque-cashers and pawnshops, for some or all of their financial transactions. *Hard Choices* examines this predicament of 'financial exclusion' faced by those underserved by conventional financial institutions.

In this book Jerry Buckland thoroughly integrates economic and social data on consumer choice, bank behaviour, and government policy to determine the nature and causes of financial exclusion. He demonstrates why the current two-tier system of banking is becoming increasingly dysfunctional, especially in the context of new credit products that exacerbate financial inequality and stifle local economic growth. The first study of its kind in Canada, *Hard Choices* also presents policy recommendations on both the public and private levels to promote financial inclusion for all.

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JERRY BUCKLAND

Hard Choices

Financial Exclusion, Fringe Banks, and Poverty in Urban Canada

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To Elizabeth and Daniel

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As the big door swung behind me I caught the echo of a roar of laughter that went up to the ceiling of the bank. Since then I bank no more. I keep my money in cash in my trousers pocket and my savings in silver dollars in my sock.

Stephen Leacock, *My Financial Career*

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Contents

Illustrations

Tables

Figures

Foreword

Many low-income urban residents in Canada obtain basic financial services from cheque-cashing outlets, payday lenders, and pawnshops. Yet the payment services and loans offered by these 'fringe banks' are much more expensive than comparable services offered by banks and credit unions. Why do the poor pay more? Are they economically irrational? Are there barriers excluding them from mainstream banks? Furthermore, are there policy measures that the federal and provincial governments or banks might take that would improve the financial service options for those who use fringe banks?

Exploration of these questions is at the heart of this engaging, well-informed book. Jerry Buckland's approach is to frame the issues and draw on a broad range of research conducted in Canada, the United States, Great Britain, and other countries that yields essential insights. In the case of the research focusing on Canada, Buckland himself conducted or participated in the majority of the projects. In fact, over the past decade he has undoubtedly been the most prolific scholar focusing on financial exclusion in Canada, and *Hard Choices* provides a comprehensive account of what he has learned about the reasons people turn to fringe banks and what policies he thinks might improve financial services for many marginalized members of society. As someone who has conducted research for over twenty years on these issues as they relate to the United States, I have often turned to Buckland's writings to understand the Canadian context and to challenge my thinking about the subject.

The research that Buckland draws on in *Hard Choices* ranges from classics in the field, such as David Caplovitz's 1967 book, *The Poor Pay More*, to articles published as recently as 2010. The work also varies by methodology. Much of it is quantitative. Buckland, for example, reviews what we know from formal household surveys addressing the use of financial services by various demographic groups. He provides data on the relevant financial services offered by banks and fringe banks in Canada and the associated fees and regulations. He documents changes over time in the numbers of fringe banks and mainstream bank branches. In addition to this quantitative analysis, *Hard Choices* includes an overview of what Buckland learned from field research that he and others conducted in low-income communities in Toronto, Vancouver, and Winnipeg. In this research they talked with about a hundred socially and economically marginalized individuals about the financial services they use, their rationales for their choices to use banks or fringe banks, and their related experiences and perceptions. While such intensive, small-scale field research does not provide statistically reliable results, it does yield insights into the thinking behind people's financial choices and enriches the portrait provided by the numerical data alone.

In tackling these topics, Buckland takes a balanced and nuanced perspective. Banks and fringe banks are not villains or saints, and their lower-income customers are not ignorant pawns. Many individuals clearly make rational choices to use fringe banks because they face a variety of barriers to using mainstream banks, such as transportation costs or inadequate identification. And Buckland certainly does not romanticize the situation of the people he interviews. As he reports from his field work, 'Substance abuse took a huge toll on the lives of several respondents.'

In analysing possible policy measures that might improve financial service options for the urban poor, Buckland is clear about his fundamental perspective: 'Financial inclusion is a must for all Canadians. . . . And the state has a responsibility to ensure that this can happen.' Specifically, Buckland argues for increasing the pressures on banks to offer financial services that meet the needs of the poor in terms of location, operating hours, and cheque-hold policies, among other things. The fees for basic banking services should be simple, low, and, whenever possible, levied up front. Buckland proposes that the costs associated with this outreach effort might be covered by a 'basic banking' tax on banks. Buckland also analyses four recent innovative initiatives in various Canadian cities to bring marginalized individuals into the banking system. Three of these initiatives involved partnerships between banks or credit unions and community groups. Buckland argues that these pilot programs suggest a direction that public policy could support if financial inclusion is to become the priority he argues it should be.

Hard Choices should be read widely by Canadians interested in poverty issues or the structure of the financial system. One does not need to agree with the author's public policy prescriptions to recognize that the book provides the most comprehensive existing account of what Buckland calls a 'two-tiered' Canadian banking system and why many low-income urban households turn to fringe banks. The book should also greatly interest scholars and policymakers outside of Canada who focus on financial services for the poor in high-income countries, for it frames the issues clearly, provides an excellent overview of the relevant literature, and is a first-rate case study of the Canadian situation.

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Professor and Chair, Department of Economics, Swarthmore College
Author of *Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor*

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HARD CHOICES:
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Introduction

Hard Choices: Financial Exclusion, Fringe Banks, and Poverty in Urban Canada examines financial exclusion among low-income people in inner cities and the resulting hard choices they need to make about their banking. This book seeks to understand why some urban, often inner city, citizens do not have a bank account or access to other banking services. This introduction and chapters 1 through 4 analyse the nature, causes, and consequences of not having access to sufficient banking while living on a low income. In chapter 5 the book takes a prescriptive approach by examining how the policy and practice of banking might be changed to build financial inclusion.

Financial exclusion is the situation faced by people who have no relationship, or an insufficient relationship, with a mainstream financial institution, such as a bank or credit union, to meet all their financial service needs. As a consequence, many people rely for all or a portion of their financial services on fringe banks such cheque cashers and pawnshops. Some argue that financial exclusion is the result of a voluntary decision on the part of the poor consumer. Mainstream bank branches, their services, and their staff are readily available so that consumers can freely choose to use these services, or not. Others argue that it is difficult to make voluntary decisions when they are faced by profound structural obstacles. This group argues that the determinants of financial exclusion lie in structural obstacles created by mainstream banks and, indirectly, by government policy.

Rather than arguing that financial exclusion is caused by one particular reason, this book argues that there are three important elements to financial exclusion: banking operations, citizen's choice, and government policy. Bank operations, including account offerings and branch placement, are guided by the profit goals of the bank's shareholders. Citizens use banking services to facilitate their financial lives, and choose those services based on what is available to them. Finally, through government policy, various levels of government establish the parameters within which banks can operate and consumers are or are not protected.

By *mainstream* financial institution (FI) or bank is meant a bank, trust, credit union, or *caisse populaire* that accepts deposits and is regulated by the federal or provincial governments. Financially excluded people rely for some of their financial services on fringe banks, such as cheque cashers, payday lenders, and pawnshops, or informal financial services through, for example, the corner store, a family member, or a friend. *Fringe banks*, defined as companies that are primarily or exclusively in the business of financial service provision but do not accept deposits or face federal regulations, have been around in the form of pawnshops for centuries. Today they are better known thanks to the rapid and recent growth in the number of payday lender outlets in urban Canada. *Informal financial services* have also been around for centuries and are defined as those financial services that are offered through family, friends, and local retailers, but are not their principal business.

This book is concerned with the situation of financial exclusion for low-income people living in Canadian inner cities. This is not to say that financial exclusion is faced only by these people. The data suggest that some better-off people are, for various reasons, financially excluded. For instance, some who use payday loans are middle-income people who do not get all their banking services from mainstream financial institutions. These people are not the focus of this study. Also, there are, no doubt, poor people in urban suburbs and rural areas who do not have sufficient bank access. This book does not examine these groups, although some of its analysis may be relevant for suburban poor. The financial exclusion situation of the rural poor is not addressed here, and likely their situation is qualitatively different.

Why focus on urban, specifically *inner-city*, financial exclusion? Inner cities (and depressed suburbs) face multiple challenges, including residents with high rates of poverty and an impoverished community economy. These urban neighbourhoods struggle with high rates of unemployment, incidence of low income, and low rates of social indicators such as mean years of schooling and incidence of home ownership. An interesting analysis of a struggling community economy is David

Caplovitz's (1967) *The Poor Pay More*, which studied the spending experiences of residents of a New York City neighbourhood. It found that they often relied on small-sized local retailers and consequently paid more for their goods than if they had gone to larger retailers. The community economic development literature has expanded on this notion of a struggling local economy to add characteristics such as few and poorly paid local jobs, lack of infrastructure, and an unsafe local environment (Loxley, Silver, and Sexsmith 2007; Shragge 1993). Exclusion is more than financial, as it includes exclusion from other retail services, and it is more than consumer related, as it includes exclusion from well-paying jobs and safe and well-constructed neighbourhoods.

The focus on *Canadian* inner cities was justified by the relatively limited amount of analysis available on the topic for Canada. The literature on financial exclusion in the United States has been around for some time (Caskey 1994; Squires 2004; Squires and O'Connor 2001). The British (for example, Leyshon 2004; Kempson and Whyley 1999b) and European (Anderloni et al. 2008; Carbo 2007) literature on the topic is also better developed than that in Canada. Important Canadian studies, discussed in more detail in chapter 2, include both analytical and empirical work by Ramsay (2001, 2003) and Robinson (2006).

Hard Choices is meant to highlight the fact that low-income urban people face difficult decisions about financial services. There has been a growth in the number of fringe bank outlets in many inner cities, while available evidence points to a reduction in the number of mainstream bank branches. As we shall see, fringe bank services often have certain benefits such as convenience and possibly friendlier service than that of mainstream banks. However, in comparison with equivalent mainstream bank services, they are expensive and often unregulated or under-regulated, leading to variable service quality. So where does one bank? At the fringe bank that offers convenience, higher fees, less rigid rules, possibly friendlier and/or shakier service quality? Or does one travel further, to a mainstream bank, in order to pay less but face more rigid rules and staff who are less interested in your business? It is a hard decision because none of the options is good, particularly in comparison with the type of banking that many non-poor people utilize. Banking operations and government policy create a context in which urban residents have limited options, and the banking services they use may reinforce their poverty.

While the book focuses on the relationship between the consumer and the firm, it pays some attention to the structure of financial services markets. Portions of the book, particularly chapter 4, draw on basic concepts from the economics industrial organization (IO) literature to understand financial exclusion, but it is certainly not an in-depth IO study of banking in Canada.

Argument

The argument presented in this book is that financial exclusion has a lot to do with the social and economic context in which people live. That is not to say that individuals have no agency to make choices. Clearly they do. This is no doubt important, but *Hard Choices* is not an examination of the psychological behaviour of a group of people with regard to their financial service choices. That would be an interesting study, and the growing work in the field of behavioural economics is one way in which this might be done. This particular study, however, is one that finds the social and economic context to be important in determining bank choice. Some of the more salient factors affecting financial exclusion are the income and consumption levels of the bottom quintiles of the population; bank policy regarding such things as branch placement and fees and rules for basic banking services; and government policy regarding social entitlements and bank responsibilities. The context of the choice matters. That is the argument in this book and the focus of this study. Getting the context right does not completely resolve financial exclusion, but it is an important factor.

Theory

There is a variety of theories and methods that are used to analyse financial exclusion. They range from neoclassical economic theory to poverty-community analysis to political economy. Owing to the variety of theories and their importance in the examination process, an entire chapter of the book, chapter 2, is dedicated to looking at them. The study gets its theoretical direction from two main sources: poverty-community analysis and institutional theory. *Poverty-community analysis* is an approach that begins with the experiences of low-income people and includes an understanding of the structures that reinforce inequality and poverty. This approach pays particular attention to class, gender, ethnicity, and urban locale as causes of poverty. Here, *institutional theory* refers to analyses that seek to understand the broad context and key institutions involved in the social reality being studied, with particular reference to economic and social issues such as the demand side and the supply side of financial services.

Some key components of the theory used in this book include the geographic locus, the key actors, the relationship between financial exclusion and poverty, and financial service needs. Let us examine each of these in turn.

Geographic Locus and Actors

The approach taken in this study is, in part, rooted in poverty and community studies. The literature is concerned to understand local places and people that struggle with poverty. The primary geographic locus of this book is Canadian low-income inner-city and suburban neighbourhoods. It is understood that these neighbourhoods are located within a wider national and international space. Since banking is regulated at the national level, this book will also be concerned with certain national-level issues. Found in many Canadian cities, the inner city is a region sandwiched between the downtown and the suburbs. It is also a concept that is linked to geographic poverty and marginalization. Of course, inner cities are not static places; over time, some witness improved economic position, and some experience deteriorating position. Some of the neighbourhoods in this study have experienced economic improvement via gentrification. Moreover, some inner city neighbourhoods are better off, and some are worse off. Conversely, as in the case of Toronto, some suburban neighbourhoods are worse off than other suburban and inner-city neighbourhoods.

THE KEY ACTORS

With a root in institutional theory, this study identifies and examines the key actors involved in financial exclusion. The actors that are considered central to the study of financial exclusion in this book are the financially excluded, banks, and government. Chapter 1 and, in particular, chapter 3 examine financially excluded people. Chapter 1 and, in particular, chapter 4, examine banks. Chapters 1 and 5 explore government actors and their policies.

FINANCIAL EXCLUSION AND POVERTY

Urban financial exclusion is closely tied to poverty. That is to say, inner cities in Canada have high rates of unemployment and reliance on social assistance; low incomes and assets; and a low level of education.

Along with low incomes and high unemployment, one finds higher rates of financial exclusion in inner cities. This will be discussed more below. The poverty and financial exclusion relationship is complex, but generally those who are poor are more likely to be those who are without a mainstream bank account and who rely on fringe banks. We do not offer a view on whether one factor – financial exclusion or poverty – causes the other factor, but these factors do move together to a certain extent. If income poverty were overcome in Canada, it would not mean that financial exclusion would be wiped out. Conversely, if there were adequate mainstream bank services in inner cities, it would not mean that poverty would be overcome. However, if income poverty were overcome and mainstream bank provision improved in inner cities, significant strides would have been made to overcome financial exclusion.

Financial Service Needs: Transaction and Developmental

An important distinction is drawn in this book with regard to transactions and developmental financial services. Individuals require financial services to meet daily and weekly needs, and they require financial services to meet longer-term needs. Short-term needs are for cash and bill payment services, and these are referred to as *transaction services*. Long-term needs are obtaining lump sums through savings or credit, and these are referred to as *developmental services*. Of course, financial services can sometime fall between or encompass both of these categories. For instance, a credit card – a lending system – can be used as a means of payment. Conversely, cashing a cheque at a fringe bank that does not require a hold period could be considered a short-term loan.

Nevertheless, it is understood that individuals and households need both types of financial services, transaction and developmental. Generally speaking, fringe banks specialize in transaction services: cheque cashing and bill payments. However, they also engage in lending – through rent-to-own agreements, payday loans, and pawn loans – and, by the definition above, these are a form of developmental service, albeit a very basic one. This is where the categories become muddied because fringe bank loans are small loans that are often for short periods and not tied with the mainstream bank system of credit reporting. Thus these types of loans might be seen more as an elaborate form of transaction service. The small size and short term of the loan makes it not too unlike cheque cashing; a payday loan is for twelve days, while cheque cashing might be considered a five-to-seven-day loan, depending on the hold period at a mainstream bank. On the other hand, repaying a payday loan in a timely fashion is not included in a mainstream bank–related credit report. Therefore, it does not matter how many payday loans are repaid in a timely fashion; the client's credit report will not improve to allow him or her access to cheaper sources of credit.

In addition to offering basic banking services, mainstream banks offer a variety of developmental financial services. Timely repayment of one's credit card, line of credit, loan, or mortgage can improve one's credit rating and allow one to obtain cheaper credit. Thus, using a mainstream financial institution presents scope for developing a relationship that works to the mutual advantage of the borrower (who gets cheaper credit) and the lender (who is better able to identify the creditworthy customers).

Perspective

This book is rooted primarily in a reformist perspective. What this means is that it has identified a problem – financial exclusion – and it sees the solution coming from reforms to government and bank policy and practice. The problem is that the banking services available to certain urban residents are inferior to those available to other citizens. This problem is most clearly documented in poverty-and-community studies (chapter 3), but other data (for example, income distribution and low-income head count), discussed in chapter 1, reinforce the difficult economic situation facing certain people.

Change is needed to address the gaps in banking for these people. Reforms are understood to be qualitatively important to building financial inclusion, but they do require the dismantling of the financial services industry. What is required to combat the problem is ongoing attention, participation, and resources from banks and government. This is not to say that radical restructuring is not useful. Indeed, chapter 5 considers some radical restructuring of banking that might address financial exclusion. Some might argue that financial exclusion in Canada can only be addressed through radical restructuring. Some might argue for other reasons, such as the environment, that radical restructuring is necessary. These are legitimate arguments, but this book does not examine them in detail. Rather, it considers reforms that might improve things, on the edges, for people who have been marginalized by financial exclusion.

Approach

Analysis of the problem will be combined with possible solutions. As noted above, the book is primarily rooted in a reformist approach. Chapters 1 through 4 are largely analytical in their approach, and chapter 5 presents prescriptions for improved bank practice and policy with regard to financial inclusion. By combining analysis and prescription, the study seeks to participate in both the critiquing and the 'fixing' of the system. The risk is that the prescriptions are too removed from the reality of the people who are financially excluded or from the challenges of banking. However, it is felt that the risk is acceptable, particularly when it is understood that the prescriptions are put forward here with, I hope, humility and that implementation on a trial-and-error or learning approach is advisable.

The Sub-prime Mortgage Crisis

The U.S. sub-prime mortgage crisis affected economies around the world, including the economy of Canada. The impact was felt by financial institutions, their investors, and their consumers and, through an international recession, by states, workers, and citizens who were well removed from the banks and borrowers involved in the sub-prime mortgages. For many countries of the global North, this has meant higher unemployment, lower economic growth, and worsening poverty rates. The crisis has caused regulators in the United States, and elsewhere, to reconsider the orthodox view that financial sector liberalization is helpful for the economy and not dangerous. In the United States, liberalization is now making room for greater regulation of the financial sector.

Although Canada was affected by the sub-prime mortgage crisis, it was more insulated than some other countries, such as the United Kingdom and Iceland. Canada was affected directly in that the sub-prime mortgage product was used here, though not as extensively as in the United States, and Canadian banks were invested in U.S. bank holdings, though not as invested as other banks were. The indirect impact, through the U.S. recession, is another story. The United States is such a huge trade and investment partner that, indirectly, the Canadian economy was hit hard by its recession.

Canadian banks and the federal government took Canada's relative insulation from the sub-prime mortgage crisis as a vindication of our financial system. Instead of using the crisis as an opportunity to consider the state of its financial system, the federal government used the crisis as an occasion to trumpet its soundness. But what about the fact that there are sub-prime mortgages, sub-prime credit cards, payday loans, buy-back schemes, and other fringe financial services? These financial services may not be as large as the sub-prime mortgages in the United States, but they are similar devices: the suppliers are not well regulated, the services and fees lack transparency for the consumer, and they are high priced. Moreover, it is the most vulnerable consumers who often use these services. The U.S. sub-prime mortgage crisis was a powerful example of how an unhealthy relationship between banks and vulnerable consumers can ultimately cripple an economy. It has also led to a major rethink about economic theory and policy.

Data Sources and Purposes

The primary data for the book come from two sources: national surveys and field methods. The assumption of this study is that the different data offer useful insights for understanding financial exclusion. It is important to understand the purpose and limitations of these different types of data, which relate to the methods used to collect them. The purpose of quantitative methods such as national surveys is to provide data, for predetermined questions, that are representative of a population. The purposes of qualitative methods are quite different; they are intended to shape theory, diagnose problems, or simply ensure that the measurement is made for things that matter to the people being studied.

The few national surveys that have relevance to the study of financial exclusion are primarily referred to in this introduction. One source is the Statistics Canada Survey of Financial Security that was implemented in 1999 and 2005. It asked respondents about their banking and (in 2005) if they used payday loans; it also offers some insight into household finances. There are weaknesses with the survey, which will be discussed. There is a new relevant survey, the Statistics Canada Canadian Financial Capability Survey, which was implemented in 2009, but the data set was not publicly available at the time of writing.

Field research methods are also used, and these are drawn on particularly in chapter 2. These methods include small-sample neighbourhood surveys (which are actually described as a mixed method, having both quantitative and qualitative components) and life histories.