

## Alternative Financial Services: A Primer

### Introduction

Alternative financial services (AFS) is a term often used to describe the array of financial services offered by providers that operate outside of federally insured banks and thrifts (hereafter referred to as “banks”). Check-cashing outlets, money transmitters, car title lenders, payday loan stores, pawnshops, and rent-to-own stores are all considered AFS providers. However, many of the products and services they provide are not “alternative”; rather, they are the same as or similar to those offered by banks. AFS also sometimes refers to financial products delivered outside brick-and-mortar bank branches or storefronts through alternative channels, such as the Internet, financial services kiosks, and mobile phones.

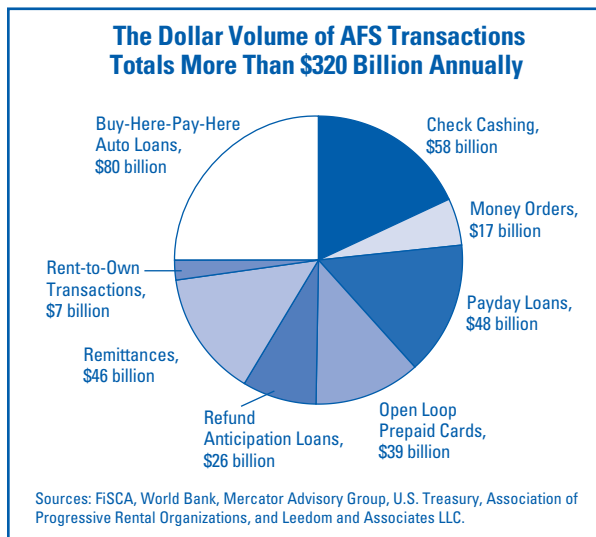
This article provides an overview of AFS and a description of the key products and services in this sector. It is intended as a primer for banks and others who are interested in understanding the competitive landscape in the financial services industry and exploring suitable opportunities in the AFS sector. Because of the large size of the AFS sector, some banks use less traditional products, services, and distribution methods to target new customers, particularly among unbanked and underbanked households.<sup>1</sup>

### AFS Transaction Volume

Data on the volume of AFS transactions are incomplete because of the lack of a clear definition of the term AFS and because this sector is highly fractured among many different providers that are often small or privately held. As shown in Chart 1, the transaction volume is estimated at more than \$320 billion annually. This figure is likely understated, as estimates are not current or available for various AFS segments.

<sup>1</sup> See “FDIC Survey of Banks’ Efforts to Serve the Unbanked and Underbanked, Executive Summary of Findings and Recommendations” (issued February 5, 2009), which describes the extent to which insured institutions reach out to unbanked and underbanked households, the challenges that banks face in serving these households, and innovative products and services that banks have used to overcome these challenges. The Executive Summary defines “unbanked” as people or families who rarely, if ever, held an account at an insured institution. “Underbanked” refers to those with accounts who also rely on nonbank AFS providers for financial products and services, often at a high cost. The Executive Summary can be found at <http://www.fdic.gov/news/news/press/2009/pr09015.html>.

Chart 1



AFS comprise two general categories of products and services: those that are transactional and those that are related to credit. The key products and services offered in these categories are described below, along with examples of the types of companies, including banks, that provide them.

### Transaction Products and Services

#### Check Cashing, Money Orders, and Bill Payment

Financial Service Centers of America (FiSCA) is the national trade association that represents nonbank financial service centers. According to FiSCA, more than 13,000 nonbank financial services companies operate nationwide, providing a variety of financial services, primarily check cashing. FiSCA estimates that financial service centers process more than 170 million checks per year, with a face value of more than \$58 billion. FiSCA also estimates that its members sell money orders with a face value of \$17.6 billion per year, at an average cost of 64 cents each, and they process more than 57 million bill payment transactions, at an average cost of 86 cents per transaction.<sup>2</sup>

<sup>2</sup> FiSCA data points were obtained from the trade association’s Web site at <http://www.fisca.org> (accessed on September 12, 2008).

Table 1

<b>Write-Offs Related to Check-Cashing Operations Tend to Be Low</b>			
	<b>2008</b>	<b>2007</b>	<b>2006</b>
Average face value per check	\$442.30	\$420.96	\$408.87
Average fee per check	\$13.77	\$14.51	\$14.13
Average fee as a percentage of face value	3.11%	3.45%	3.46%
Net write-offs as a percentage of checks cashed	0.31%	0.29%	0.26%

Sources: Dollar Financial Corp. and Securities and Exchange Commission (SEC) 10(k) dated August 29, 2008.

Check-cashing firms vary widely in size from very small mom-and-pop outlets to publicly traded companies. Ace Cash Express, with about 1,700 stores, is the largest check-cashing company.<sup>3</sup> Dollar Financial Corporation is the largest publicly traded check-cashing company, with about 470 stores in the United States. In addition to check cashing, these companies and many other check cashers provide other products and services, including money orders, automated teller machine (ATM) access, electronic bill payment, payday loans or pawnbroking services, and electronic tax preparation and filing. Check cashers also sometimes sell public transit passes, postage stamps, and phone cards; issue motor vehicle license plates and titles; process parking tickets; and provide photocopying and faxing services.

Check cashers typically charge 1 to 4 percent of the face value of the check, depending on the check issuer and subject to limitations of state law. About two-thirds of checks cashed at nonbank outlets are payroll checks; another 18 percent are state or federal benefits checks.<sup>4</sup> Table 1 provides data for Dollar Financial Corporation's U.S. check-cashing operation to illustrate the cost of an average transaction. As the table shows, net write-offs, while increasing, remain less than 1 percent of the face value of checks cashed. This example suggests that, given the generally low-risk nature of most checks cashed, losses tend to be low.

Retailers are increasingly recognizing the revenue-generating potential of check cashing and other transaction-based financial services. For instance, the world's largest retailer, Wal-Mart, opened its first

<sup>3</sup> Examples of companies and banks used in this article are for illustration only. The FDIC does not endorse specific companies, products, or services.

<sup>4</sup> Jennifer Tescher, Edna Sawady, and Stephen Kutner, *The Power of Experience in Understanding the Underbanked Market*, Center for Financial Services Innovation, July 2007.

MoneyCenter in 2002; in fiscal 2008, it cashed 45 million paychecks with a face value of \$17 billion.<sup>5</sup> Wal-Mart currently processes more than 2 million money order, remittance, and check-cashing transactions per week, and the volume of these services grew more than 40 percent in the retailer's 2008 fiscal year.<sup>6</sup> Convenience store chain 7-Eleven Inc. also offers check cashing, money orders, bill pay, and money transfer services in select stores through approximately 2,000 self-service V-Com kiosks.<sup>7</sup>

A number of banks also offer fee-based check-cashing services, frequently with the goal of migrating check-cashing customers to more traditional bank products. For example, KeyBank in Cleveland, Ohio, has been experimenting with fee-based check cashing and other transactional services under a program called *KeyBank Plus*. As of early 2008, KeyBank had cashed checks with a face value of more than \$37 million and incurred only \$10,000 in write-offs. KeyBank expanded the program from 5 branches in one market to 200 branches in six markets, and opened checking accounts for more than 17,000 check-cashing clients.<sup>8</sup> Also, the First National Bank of Syracuse, Kansas, operates an innovative branch in the world's largest beef-processing plant and, among other things, cashes close to 400 payroll checks a week through an ATM (see text box on page 42).

### Remittances

According to estimates from the World Bank, recorded remittances of money from one country to another totaled \$355 billion in 2007, up from \$307 billion in 2006. Remittances are projected to top \$375 billion in 2008.<sup>9</sup> The United States is the leading remittance-sending country. During 2007, U.S. remittances to

<sup>5</sup> Digital Transactions, "Wal-Mart Exec Happy with Money Card, but Stays Mum on Details," March 5, 2008.

<sup>6</sup> Ibid.

<sup>7</sup> V-Com kiosks are advanced-functionality automated teller machines (ATMs) that are owned and operated by Cardtronics Inc. Cardtronics Inc. has not publicly disclosed the dollar volume of transactions conducted through V-Com kiosks.

<sup>8</sup> Information on *KeyBank Plus* was derived from a March 19, 2008, presentation by Michael Griffin, senior vice president, Key Bank, Cleveland, Ohio, to the FDIC's Advisory Committee on Economic Inclusion. Meeting minutes are available at <http://www.fdic.gov/about/comein/minutesMarch1908.pdf>.

<sup>9</sup> See data spreadsheet for Dilip Ratha, Sanket Mohapatra, K. M. Vijayalakshmi, and Zhimei Xu, "Outlook for Remittance Flows, 2008–2010," *Migration and Development Brief 8*, World Bank, November 11, 2008, [http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/RemittancesData\\_Nov08\(Release\).xls](http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/RemittancesData_Nov08(Release).xls).

Chart 2

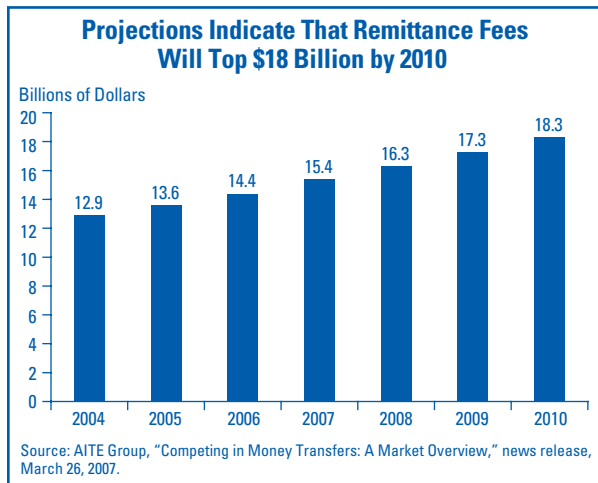
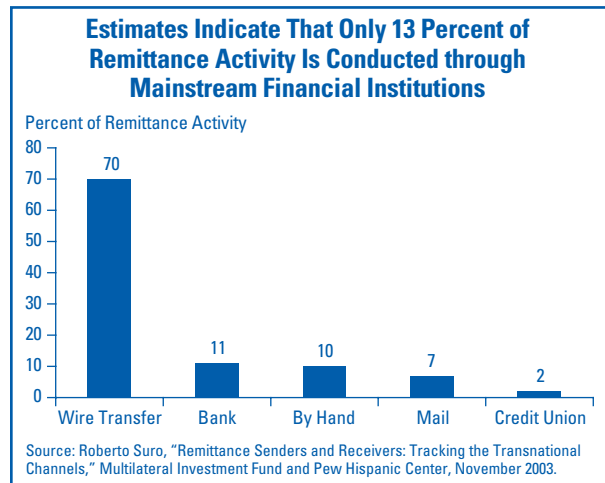


Chart 3



other countries totaled \$46 billion.<sup>10</sup> However, activity has slowed recently as a result of the weakening economy. In a 2008 poll, the Inter-American Development Bank reported that 50 percent of Latin American adults in the United States regularly sent money home, compared with 73 percent in 2006.<sup>11</sup>

The World Bank projects a slowdown in the growth of global remittances in response to the overall economic malaise but explains that remittances tend to be more resilient than other types of inflows, such as private capital or official aid.<sup>12</sup> A market research firm, AITE Group, projects that global remittance flows will reach \$500 billion by the year 2010 and remittance fees will top \$18 billion (see Chart 2).

International remittance activity is conducted primarily outside of banks (see Chart 3). The largest provider of international remittance services is Western Union Inc., with 335,000 agent locations in more than 200 countries. In 2007, Western Union processed more than 167 million customer-to-customer transactions with a face value of \$64 billion. Of that amount, about \$57 billion represented international transfers.<sup>13</sup> Western Union uses its Gold Card product to improve the efficiency of the remittance process. This card stores customer information, eliminating the need for forms

and reducing transaction times. The Gold Card is also a loyalty mechanism, enabling consumers to earn points that are redeemable for goods and services.<sup>14</sup>

Most banks offer wire transfer and automated clearing house (ACH) services as part of their normal course of business for account customers. However, others have specifically targeted international remittance business as an opportunity to generate fee revenue and to cross-sell accounts and other products. For example, Wells Fargo's InterCuenta Express facilitates remittances between the United States and Mexico. To participate, customers must open a Wells Fargo account with at least \$10 and must send money to a bank account in Mexico. Within the first seven months of offering InterCuenta Express, Wells Fargo opened 20,000 new accounts totaling \$50 million.<sup>15</sup> Wells Fargo has also instituted a nonaccount, cash-to-cash remittance product, ExpressSend, targeted to certain parts of the world.<sup>16</sup>

Other options are available for smaller banks that provide remittance services through cooperatives. For example, the Federal Reserve System and Banco de Mexico, the central bank of Mexico, have established Directo a México, an account-to-account service that

<sup>10</sup> See data spreadsheet for Ratha et al., "Outlook for Remittance Flows, 2008–2010," [http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/RemittancesData\\_Nov08\(Release\).xls](http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/RemittancesData_Nov08(Release).xls).

<sup>11</sup> Inter-American Development Bank, "Survey of Latin American Immigrants in the United States," April 30, 2008, <http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=1417613>.

<sup>12</sup> Ratha et al., "Outlook for Remittance Flows, 2008–2010."

<sup>13</sup> Western Union Inc., 2007 SEC Form 10(k), February 2008.

<sup>14</sup> Information regarding Western Union's Gold Card program was derived from the company Web site at <http://www.westernunion.com> (accessed on September 26, 2008).

<sup>15</sup> Information regarding Wells Fargo's InterCuenta Express was derived from 2005 program information contained in a report by Appleseed, "Banking Immigrant Communities, A Toolkit for Banks and Credit Unions," <http://www.appleseednetwork.org/Publications/ReportsToolkits/BankingImmigrantCommunities/tabid/96/Default.aspx>.

<sup>16</sup> Information regarding Wells Fargo's ExpressSend product was derived from the company Web site, <http://www.wellsfargo.com> (accessed February 4, 2009).

## *First National Bank of Syracuse's Innovative Branch in the World's Largest Beef-Processing Plant<sup>a</sup>*

In first quarter 2008, the First National Bank of Syracuse, Kansas, acquired an innovative branch in the world's largest beef-processing plant, operated by Tyson Foods Inc. The plant processes about 6,000 cattle a day and is located close to Garden City, Kansas. Garden City is an agribusiness community that has a large Latino immigrant population. The Tyson plant is the largest employer in the area, with approximately 3,000 workers, or roughly 10 percent of the population of Garden City.

The bank branch in the plant opened on July 1, 2002, and within six months had opened 200 new accounts and had started making consumer and mortgage loans. Tyson has

<sup>a</sup> Donna Tanner (vice president, First National Bank of Syracuse, Kansas) and Rosa Rivera (branch manager, First National Bank of Syracuse, Kansas), discussion with the authors, March 26, 2008.

been an active partner with the branch from the start. All new employees at the plant receive financial education as part of their paid new employee orientation. The orientation covers the basics of banking, including opening a bank account, establishing credit, and purchasing a home. In addition, bank employees conduct weekly financial education presentations in both English and Spanish in the plant's cafeteria. Tyson believes that the branch's presence and the bank's commitment to financial education have been important factors in reducing employee turnover.

A check-cashing ATM in the plant cashes about 400 Tyson payroll checks a week for a fee of about \$2.00 each. Close to one-third of Tyson's employees currently have accounts with First National, and 650 have enrolled in direct deposit. Outstanding consumer and mortgage loans at the branch total \$6.4 million.

uses the ACH payment channel for Mexican remittances. Since almost every bank routinely uses ACH, Directo a México allows banks to establish an international remittance program with no additional setup costs.<sup>17</sup> Small banks interested in providing remittance services can also purchase a ready-to-use turnkey remittance product such as Citigroup's QuikRemit. Citi launched QuikRemit in early 2008; the product is operational in more than 90 countries.<sup>18</sup>

### **Prepaid Cards**

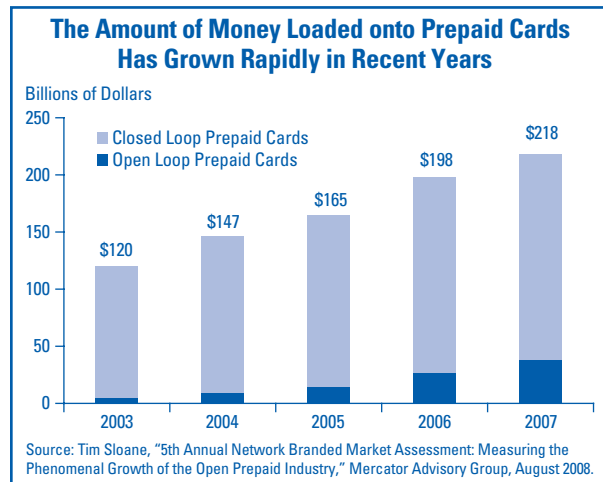
Consumer and issuer acceptance of stored value (prepaid) cards as a replacement for cash and checks has grown tremendously in recent years. The market for prepaid cards, as measured by dollars loaded, has nearly doubled in the past four years (see Chart 4).

Prepaid cards can be "closed loop" or "open loop," which refers to how the cards can be redeemed. In general, closed loop cards can be redeemed only at locations belonging to the issuer or other limited locations and are considered a way to facilitate payments rather than generate fees. As shown in Chart 4, \$179.6 billion was loaded onto closed loop cards in 2007.

<sup>17</sup> Information regarding Directo a México was derived from the central bank's Web site at <http://www.directoamexico.com/en/infobancos.html> (accessed on February 4, 2009).

<sup>18</sup> Citigroup Inc., "Citi Launches New QuikRemit Service, Follows Purchase of PayQuick, Aims to Grow Payment Services," news release, February 8, 2008.

Chart 4



The most common type of closed loop prepaid card is the retail store gift card. In 2007, about \$66.2 billion was loaded onto these cards, which are redeemable only at the issuer's store or Web site.<sup>19</sup> Government agencies are also prominent issuers of closed loop prepaid cards, loading \$61.9 billion of benefits such as food stamps and Temporary Assistance for Needy Families onto prepaid cards in 2007. These cards are typically redeemable in multiple locations, such as supermarkets, gas stations, and pharmacies. Given their limited uses and options for fee generation, closed loop prepaid cards are

<sup>19</sup> In the case of a bankruptcy of the issuing retailer, holders of retail gift cards may lose all or a portion of the value of their cards.

not considered to be alternative financial services for the purposes of this article.

Conversely, open loop cards can be redeemed at numerous locations and typically create opportunities for issuers to generate fee-based income. While the open loop segment, with \$38.7 billion loaded in 2007, is much smaller than the closed loop segment, it grew 44.4 percent in 2007 compared with 4.9 percent for the closed loop segment. Open loop cards are also often referred to as “network branded” because the cards are issued with the Visa or MasterCard logo, allowing users to redeem funds anywhere those cards are accepted. Issuers of open loop cards can be banks or nonbank issuers who can gain access, for a fee, to the Visa or MasterCard payment systems through partnerships with banks.

Payroll cards are the most prominent type of open loop card, with \$15.9 billion loaded in 2007. Payroll cards are often used by companies with large numbers of lower wage or unbanked and underbanked employees as a replacement for direct deposit of paychecks. These cards are typically issued by banks that have a business relationship with the employer.

Another common type of open loop card, with \$5 billion loaded in 2007, is the general-purpose gift card, sold for a fee at retailers or through issuing banks. These include gift cards sold by American Express bank or by other banks that brand them with the Visa or MasterCard logo. Open loop gift cards are typically marketed to the general public as a more flexible alternative to retail store gift cards. General-purpose gift cards are sold in predetermined amounts but can usually be reloaded for a fee.

Another type of open loop prepaid card is the financial services card, which, unlike the general-purpose gift card, is not sold in predetermined amounts. Rather, financial services cards are initially funded and reloaded in amounts determined by the cardholder. Another distinction between general-purpose gift cards and financial services cards is that financial services cards provide features beyond the ability to pay for goods and services, such as direct deposit, ATM access, and bill payment. Moreover, issuers of these cards are beginning to add more advanced features, such as linked savings accounts and credit lines. Given their multiple functions, financial services cards are often marketed as an alternative to a traditional checking account and are frequently targeted to the unbanked or underbanked,

students, and recent immigrants. These cards typically carry monthly maintenance fees and various transaction fees that can be much higher than traditional accounts, but they offer consumers other benefits, such as immediate liquidity and the ability to control spending by limiting the amount of money on the card.

The market for financial services cards doubled in 2007 to \$2.2 billion.<sup>20</sup> Generally, these cards are sold at retailers or over the Internet and can be offered by banks or nonbanks. The Green Dot card, offered by nonbank Green Dot Corporation, is sold online or at retailers, such as grocery stores and pharmacies. Fees include a \$9.95 activation fee, a \$4.95 monthly maintenance fee, and a \$2.50 ATM withdrawal fee.<sup>21</sup> The Green Dot Corporation and other nonbank issuers of network-branded cards gain access to the payment networks through agency relationships with banks; some banks also offer fee-based, prepaid financial services cards directly to consumers. For example, H&R Block Bank, an FDIC-insured subsidiary of tax preparer H&R Block Company Inc., offers the Emerald Card, which allows H&R Block’s tax preparation customers to load their refunds onto a prepaid debit card. H&R Block also offers a savings product tied to the Emerald Card and provides small-dollar loans for qualifying consumers.<sup>22</sup>

### Credit Products and Services

#### Payday Lending

Payday loans are short-term loans typically extended to consumers who have a checking account and can prove that they are employed. A check or debit authorization, which is postdated to the borrower’s next payday, provides security to the lender. Payday loans typically involve low balances, in the \$300 to \$500 range, and have a two-week term coinciding with the consumer’s pay cycle. Most payday loans are made through stand-alone payday stores and multiline financial service centers. In 2006, these outlets generated

<sup>20</sup> Information regarding breakdowns of the types of prepaid cards was obtained from a report by Tim Sloane, “5th Annual Network Branded Market Assessment: Measuring the Phenomenal Growth of the Open Prepaid Industry,” Mercator Advisory Group, August 2008.

<sup>21</sup> Information regarding the Green Dot prepaid card was derived from the Green Dot Corporation Web site at <http://www.greendotonline.com> (accessed on February 4, 2009).

<sup>22</sup> Information regarding the Emerald Card prepaid card was derived from the H&R Block Corporation Inc. Web site at [http://www.hrblock.com/bank/emerald\\_prepaid\\_mastercard/index.html](http://www.hrblock.com/bank/emerald_prepaid_mastercard/index.html) (accessed on October 1, 2008).



Table 2

Small-Dollar Loan Pilot 3Q08: Summary of Loan Characteristics				
	Number of Banks Reporting	Average	Minimum	Maximum
<b>Loans Up to \$1,000</b>				
Loan Amount	22	\$677	\$300	\$1,000
Term (months)	22	10	2	36
Interest Rate	23	17.11	9.65	31.78
Non-Zero Fees (dollars)	10	\$29	\$5	\$70
<b>Loans Between \$1,000 and \$2,500</b>				
Loan Amount	15	\$1,726	\$1,250	\$2,200
Term (months)	14	15	5	21
Interest Rate	15	15.18	9.16	30.13

Source: FDIC.  
 Note: For purposes of determining whether there is a "bright line" for what constitutes a small-dollar loan, banks in the pilot were asked to report on loans above and below a \$1,000 threshold.

about \$42 billion in payday loans, with Internet lenders adding another \$5.65 billion.<sup>23</sup>

QC Holdings Inc. is the largest publicly traded company primarily dealing in payday lending, with 532 stores in 27 states as of year-end 2007. QC Holdings generated \$183 million in payday loan fees on approximately \$1.3 billion in loan volume in 2007. The company reports that the average loan for the past three years has been about \$360, the term has been about 16 days, and the fee has been about \$53. The annual percentage rate (APR) on these loans is approximately 400 percent. The average customer of QC Holdings receives six payday loans per year, and the company reports that gross losses approximated 7 percent of total loan volume in 2007.<sup>24</sup>

Payday loan customers are by definition also bank customers, because they must have a checking account to obtain a payday loan. However, many banks have not been involved in extending small-dollar loans on a large scale, primarily because of concerns about the costs and feasibility of such programs.

To explore the feasibility of banks offering small-dollar loan programs, the FDIC selected 31 banks in February 2008 to participate in its Small-Dollar Loan Pilot Program.

<sup>23</sup> Dennis Telzrow, "Payday Loan Industry," *Industry Report*, Stephens Inc. Investment Bankers, March 27, 2007. A September 6, 2008, article by Bob Driehaus in the *New York Times*, entitled "Some States Set Caps to Control Payday Loans," cites figures from Stephens Inc. indicating that the payday loan industry originated \$50 billion in loans in 2007. However, the FDIC has been unable to obtain the source data for the citation.

<sup>24</sup> Data regarding QC Holdings were obtained from the company's 2007 SEC Form 10(k), filed March 14, 2008.

This program is a two-year case study designed to identify the most effective features of profitable, scalable, small-dollar loan business models for banks.<sup>25</sup> During the first three quarters of the pilot, participating banks originated more than 11,700 loans with a principal balance of \$13.5 million. For banks participating in the pilot, loan balances are typically higher, loan terms are longer, and interest rates are lower than loans offered by payday lenders (see Table 2).

Bankers in the pilot program have indicated that they believe their small-dollar loan programs are an important way to serve their communities and create goodwill for their banks. Most of the bankers view small-dollar loan programs as a long-term strategy intended to attract customers and create relationships. Although many of the programs in the pilot are new, banks with established programs indicate that small-dollar loan customers have tended to migrate to other products, which contributes to profitable relationships over the long term.

#### **Refund Anticipation Loans**

Refund anticipation loans (RALs) are short-term loans, usually 7 to 14 days, offered by tax preparers as a purported way to speed the taxpayer's receipt of a tax refund. They are secured by the expected refund, and the RAL fee is deducted from the refund. Generally, RALs are funded by banks through partnerships with tax preparers. For tax years 2005 to 2007, approximately

<sup>25</sup> More information is available at <http://www.FDIC.gov/SmallDollarLoans>. Also, an article that describes the pilot program and summarizes first quarter results can be found at [http://www.fdic.gov/bank/analytical/quarterly/2008\\_vol23.html](http://www.fdic.gov/bank/analytical/quarterly/2008_vol23.html).

10 million consumers received these loans.<sup>26</sup> The price of a RAL for an average refund of \$2,600 can range from \$58 to \$136.<sup>27</sup> H&R Block Inc., the largest issuer of RALs, issued 3.9 million RALs in fiscal 2007, generating revenues of \$189.8 million.<sup>28</sup>

Although banks do not generally offer RALs directly to consumers, some banks participate in the Volunteer Income Tax Assistance (VITA) program operated by the Internal Revenue Service (IRS). This program offers free preparation of income tax returns for low- and moderate-income people. VITA sites are generally located at community centers, libraries, nonprofit organizations, and other convenient locations. VITA sites are staffed by volunteers, and most locations offer free electronic filing to help taxpayers receive their refunds quickly, in lieu of paying a fee to obtain a RAL.

Bank employees can participate at VITA sites, offering to open checking or savings accounts for customers who can then use the accounts to electronically deposit their tax refund. Customers can also elect to split the refunds between accounts so they can more easily save a portion of the refund. The FDIC partners with the IRS in the VITA program and has issued reminders to the banking industry and others that banks involved in VITA programs may be eligible for favorable consideration under the Community Reinvestment Act (CRA) rules and also are likely to benefit from opportunities to open accounts and provide other banking-related services to underserved consumers.<sup>29</sup>

### Other Credit Products

AFS providers offer a number of other credit products that banks typically do not provide. The following is a brief description of several products that are used when

consumers do not qualify for, or otherwise do not wish to use, credit from mainstream financial institutions:

**Rent-to-own (RTO):** The RTO business sells big-ticket consumer products—such as furniture, computers, appliances, and electronics—under rental-purchase agreements that allow consumers to own the goods at the end of the agreement. According to the Association of Progressive Rental Organizations, a national trade group for RTO firms, the market had 3 million customers and a total transaction volume of \$6.8 billion in 2007. For the past 12 years, revenues have grown at an average rate of about 3.5 percent per year.<sup>30</sup>

**Buy-here-pay-here (BHPH):** BHPH is a form of auto financing, generally for credit-impaired borrowers, that is similar to the RTO business. With BHPH, the dealer finances the sale of a used car and usually requires the borrower to return to the dealership weekly or biweekly to make payments. BHPH is a fractured industry with few large or publicly traded participants, making it difficult to estimate transaction volume. However, according to a 2002 report by an industry consultant, BHPH transactions top \$80 billion per year.<sup>31</sup>

**Pawn lending:** Pawn lending is a short-term, secured lending transaction in which the lender typically takes physical possession of the item securing the loan (often jewelry or other personal goods). The lending agreement allows the pawn lender to take possession of and sell the collateral if the borrower does not meet the terms of the agreement. Recent estimates of the overall scale of pawn lending are not available. However, the largest publicly traded pawn lender, Cash America International Inc., with 500 stores in 22 states, reported making \$514 million in pawn loans in 2007, with APRs ranging from 12 to 300 percent.<sup>32</sup>

**Auto title lending:** Auto title lending is similar to pawn lending, except that title lenders make short-term loans that are secured by clear car titles. Interest rates on title loans are restricted in many states. The industry is fractured and limited largely to small, privately held compa-

<sup>26</sup> Treasury Inspector General for Tax Administration, "Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services," Reference Number: 2008-40-170, August 29, 2008, <http://www.ustreas.gov/tigta/auditreports/2008reports/200840170fr.pdf>.

<sup>27</sup> Chi Chi Wu and Jean Ann Fox, "Coming Down: Fewer Refund Anticipation Loans, Lower Prices from Some Providers, but Quickie Tax Refund Loans Still Burden the Working Poor," National Consumer Law Center Inc. and Consumer Federation of America, March 2008.

<sup>28</sup> H&R Block, SEC Form 10(k), June 30, 2008.

<sup>29</sup> FDIC, "Volunteer Income Tax Assistance: Potential CRA and Business Opportunities May Start Before Tax Season," Financial Institutions Letters, FIL-97-2007, November 7, 2007; "Volunteer Income Tax Assistance: A Reminder and Update About Potential CRA and Business Opportunities," January 16, 2007; Financial Institution Letters, FIL-5-2007, January 16, 2007; and FDIC, "FDIC Encourages Taxpayers to Take Advantage of IRS Programs and Save More of Their Refunds," news release, January 16, 2007.

<sup>30</sup> Information regarding RTO statistics was derived from the Association of Progressive Rental Organizations Web site at <http://www.rtohq.org> (accessed on October 22, 2008).

<sup>31</sup> Brian Grow and Keith Epstein, "The Poverty Business: Inside U.S. Companies' Audacious Drive to Extract More Profits from the Nation's Working Poor," *Business Week*, May 21, 2007. This article used information from Christopher M. Leedom, "Analysis of the Buy Here-Pay Here Capitalization Market," Leedom and Associates, LLC, December 2002, to derive figures on the BHPH industry.

<sup>32</sup> Cash America, SEC Form 10(k), February 29, 2008.

nies. Publicly available data are limited, but in 2005, the Center for Responsible Lending (CRL) and the Consumer Federation of America (CFA) reported some state data regarding car title lending from various sources (2003–2005 data). The CRL and CFA reported that there are more than 900 pawnshops (most engaging in title lending) in Alabama, more than 272 title lending licensees in Mississippi, more than 230 title loan locations in Missouri, and about 116 title loan offices in one county in Tennessee. They also noted that car title loans are a \$20 million industry in California, according to one lender's estimates.<sup>33</sup> In addition, a recent Public Action Foundation and Woodstock Institute report on automobile title lending in Illinois found that 63 title loan companies were operating 260 storefronts throughout that state in 2005.<sup>34</sup>

## The Future of AFS

Innovation is constant across AFS, and many products, processes, and technologies are emerging that could significantly transform this sector. A complete discussion of innovations is beyond the scope of this article, but key trends for banks and others to watch include expansion of cellular (mobile) phone financial services and person-to-person (P2P) lending.

### Mobile Banking

Banks and others are actively seeking to leverage advances in wireless telecommunications to offer financial services through mobile phones. Cell phones could prove to be an important tool for financial companies to engage consumers, particularly in nations with developing economies and large rural populations. For example, MasterCard, the Inter-American Development Bank, mobile phone providers, banks, and others have partnered with GSM Association, a global trade group for wireless carriers, to test cell phones as a vehicle for international remittances.<sup>35</sup>

Domestically, the proliferation of mobile phones in the United States increases the attractiveness of mobile

banking. According to one estimate, the overwhelming majority (88 percent) of Americans will own a cell phone by 2012.<sup>36</sup> Mobile network providers, technology service providers, nearly all of the 20 largest U.S. banks, and many regional and community banks have started planning, piloting, or deploying mobile banking applications.<sup>37</sup> For example, Bank of America introduced mobile banking nationwide in May 2007 as part of its online services and now has more than 1 million active mobile banking customers.<sup>38</sup> Bank of America's mobile services are free and currently allow users to check balances, view 70 days of transactions, transfer funds, pay bills, and locate ATMs.<sup>39</sup> While mobile banking is currently not a fee-generating service, it may provide a new, convenient, and perhaps preferred delivery channel, particularly for younger consumers. Bank of America reports that two-thirds of its mobile banking users are under 35 years old, and four out of five are under 45 years old.<sup>40</sup>

### P2P Lending

P2P lending refers to Web site platforms that apply an operational and legal structure to personal loan transactions between individuals. Some P2P platforms, such as VirginMoney.com, facilitate and formalize loan transactions between borrowers and lenders that know each other. Other models, such as Prosper.com and Lending Club Corp., serve as online loan auction sites, where borrowers post the purpose of their loan and the terms that they are willing to accept. After viewing these loan requests, lenders bid for all or a portion of loans, depending on their risk/return appetite and desire for diversification. Some P2P models bypass banks, while others rely on bank partners as intermediaries to fund loans and then sell all or a portion to individual lenders.

P2P lending is a new concept, with an estimated volume of just \$600 million in 2007.<sup>41</sup> Moreover, like many innovations, business models are evolving. For

<sup>33</sup> Amanda Quester and Jean Ann Fox, "Car Title Lending: Driving Borrowers to Financial Ruin," Center for Responsible Lending and Consumer Federation of America, April 14, 2005.

<sup>34</sup> Woodstock Institute and the Public Action Foundation, "Debt Detour: The Automobile Title Lending Industry in Illinois," September 2007, [http://www.responsiblelending.org/research/?issue=Issue\\_cartitle&pubtype](http://www.responsiblelending.org/research/?issue=Issue_cartitle&pubtype).

<sup>35</sup> GSM Association, "Global Money Transfer Pilot Uses Mobile to Benefit Migrant Workers and the Unbanked," news release, February 12, 2007; and "GSM and IDB to Drive Mobile Financial Services to Latin America," news release, September 25, 2008.

<sup>36</sup> Catherine Graeber, "Raining on the Mobile Banking Parade," Forrester Research Inc., September 18, 2007.

<sup>37</sup> Bob Egan, *Mobile Banking Evolution: Issues and Considerations for 2008*, TowerGroup, November 2007.

<sup>38</sup> Bank of America, "Bank of America Reaches One Million Active Mobile Banking Customers," news release, June 11, 2008, [http://newsroom.bankofamerica.com/index.php?s=press\\_releases&item=8186](http://newsroom.bankofamerica.com/index.php?s=press_releases&item=8186).

<sup>39</sup> Information derived from Bank of America's Web site at <http://www.bankofamerica.com> (accessed on October 16, 2008).

<sup>40</sup> Bank of America, news release, June 11, 2008.

<sup>41</sup> Kathy Chu, "Peer-to-Peer Lending Hits Its Stride," *USA Today*, December 25, 2007.



example, early P2P platforms had few restrictions on borrower eligibility, which resulted in adverse selection problems and very high loss rates. In general, borrowers must now meet certain minimum creditworthiness requirements. In addition, some investors viewed the lack of liquidity for these loans, most of which have a minimum three-year term, as undesirable. As a result, Lending Club Corp. recently gained approval from the Securities and Exchange Commission (SEC) to operate a secondary market system to enable its lenders to trade loans among themselves.<sup>42</sup> Prosper.com also recently filed with the SEC to form a secondary market and amended its filing to allow banks to sell previously funded loans on the Prosper platform.<sup>43</sup>

### Conclusion

This article provides a current snapshot of key AFS products and services, but emerging products and technologies could transform this sector. Banks are encouraged to monitor AFS trends to gain an understanding of competition in the financial services industry as well as to identify emerging markets, products, and delivery channels that may be appropriate for a given bank's business plan. Banks involved in offering AFS need to

be aware of and adhere to applicable laws, regulations, supervisory policies, and sound business practices related to consumer protection and safety and soundness. Banks that have questions about, or are considering engaging in AFS directly or through third-party arrangements, are encouraged to contact their regulator.

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<sup>42</sup> Daniel Wolfe, "New Approach Puts Secondary Market to Work in P-to-P," *American Banker*, October 15, 2008.

<sup>43</sup> Daniel Wolfe, "Prosper, Forming Secondary Market, Halts Applications," *American Banker*, October 16, 2008; and Daniel Wolfe, "Prosper to Open Secondary Market to Bank-Issued Loans," *American Banker*, December 8, 2008.