Better fintech alternatives to high-cost credit are already here

By Todd H. Baker

This article originally appeared in the **American Banker** on May 17, 2017

It's clearly going take quite a bit longer than originally predicted for fintech disruptors to change the financial world. But there are cases where fintech can be truly transformational right now. Take, for example, the most hideously expensive, inefficient and damaging part of the U.S. financial universe — the system of payday, pawn and auto title loans, bank overdraft protection plans and other types of short- term, small-dollar credit (STSDC) provided to low-income working Americans.

A new paper published by the Mossavar-Rahmani Center for Business and Government at Harvard Kennedy School shows that a set of currently available fintech alternatives to STSDC could potentially eliminate the need for products that are too costly for consumers, materially improve the financial resiliency and health of low-income working families, and help employers save money — all without the need for government financial support or new laws or regulations.

The day-to-day financial lives of low-income working Americans have become more and more precarious as income inequality has grown in the United States. In a profound shift from the pattern of the post-World War II period, in recent years the benefits of productivity growth were not shared with labor in the form of wage increases. Battered by economic forces over which they have little control — stagnant real wages, the loss of many higher-paying manufacturing and clerical jobs to technology and foreign competition, the decline of unions, and real estate price inflation in urban

areas — many lower-income Americans are challenged to make ends meet on a consistent basis. Even the smallest change in monthly income or expenses can trigger a crisis.

Currently-available fintech alternatives could potentially eliminate the need for products that are too costly for consumers, materially improve the financial resiliency and health of low-income working families, and help employers save money. Bloomberg News

And financial crises are becoming the norm for low-income working families. A newly recognized factor — the rising volatility in Americans' monthly incomes due to irregular work schedules, bonus plans and temporary bouts of unemployment — is causing unprecedented financial management problems for people who are already living on the edge. Today's low-income working families experience more than a 10% increase or decrease in income in half the months of the year along with large (by as much as 25% or more) variances in monthly expenses. Those working families who fail to find a way to fill the liquidity gap when income and expenses gyrate can find themselves excluded from access to housing, jobs, bank accounts, critical utilities and participation in the credit economy.

One of the consequences of income insecurity is severe personal financial stress that does real damage by shortening lives, worsening health and impairing decision-making — especially financial decision-making. And it's not just a problem for individuals and families. It affects employers' bottom lines too, as distracted and anxious employees have higher rates of turnover and absenteeism, and generally perform worse on the job.

The financial services industry has responded by creating STSDC products that provide quick and easy liquidity injections for cash-strapped borrowers. These products have become a de facto liquidity support system for families dealing with the consequences of income disparity and volatility. While STSDC products satisfy urgent short-term needs, they carry a high price. The severe negative individual, social and economic impacts of this type of high-cost liquidity support have been very well-documented over the years by the Pew Charitable Trusts, the Center for Financial Services Innovation, the Aspen Institute, the Center for

Responsible Lending and the Consumer Financial Protection Bureau, among others.

The growth in STSDC use and the severe recession that followed the 2008 financial crisis triggered a period of increasing government and regulatory attention to the negative effects of STSDC on low-income families, culminating in 2016 regulations proposed by the CFPB to restrict STSDC products. But the recent U.S. election marked the end, for the foreseeable future, of national efforts to use regulation to address the negative impact of these types of products on low-income working families. This means that market-based, private-sector alternatives now offer the best near-term opportunity to help low-income working Americans manage their day-to-day finances without resorting to harmful, high-cost products.

That's where fintech comes in. In our study, we analyzed 50 fintech companies that we believe can deliver a superior substitute for current STSDC products or an effective mechanism for consumers to avoid the use of STSDC products in the first place.

We interviewed the CEOs or founders of 30 of these companies, and placed the firms in six categories, including digital businesses focused on savings, consumer transaction banking, personal financial management/cash flow management, liquidity and financial smoothing solutions, alternative (less costly/better structured) short-term credit, and digital credit building. We found that most are today providing products that represent a meaningful improvement over the broken STSDC system.

Companies that offer liquidity and financial "smoothing" solutions through employers — helping employees manage income and expense variability — made up the category with the most scalable business model and highest consumer utility measured in the study. They include companies such as Even Responsible Finance, Flexwage, PayActiv and Active Hours.

Companies that lend to those with "thin" or "damaged" credit files for short-term needs, but seek to do so more affordably and efficiently than traditional STSDC, also scored well, but with some caveats. They include companies like Ascend, FS Card, LendingPoint, Elevate and Opportun.

The other four categories all had real strengths and were providing good value but need to evolve further before becoming significant alternatives to STSDC for low-income working families.

A low-income working family's net monthly need for a cash cushion can be as high as $700 to $980 (combining below-average income and above-average expense.) Our calculations showed that the fintech product we studied, alone or in combination, should be sufficient to manage that cash need without families resorting to STSDC. If these fintech products were widely available, they could benefit virtually all of the nation's 10.4 million low-income working families and, indirectly, the 47 million individual members of those families.

We also found that providing fintech products through an employer is the best vehicle for disseminating those products to low-income working families. Employer-based distribution can reach very large numbers of workers quickly with effective liquidity and financial management solutions while also providing financial benefits to employers through reduced employee financial stress, improved employee engagement and satisfaction, lower turnover and lower absenteeism. Large companies such as Walmart, McDonald's, Kroger, Home Depot and Target employ a disproportionate number of low-income working people. If superior fintech-enabled alternatives to STSDC were to reach only 15% of the workers employed by large companies (those with over 500 employees) almost 9 million employees would be better off. If these alternatives reached 40% of those employees, the number helped could rise to almost 24 million.

One key takeaway from our study is that private sector companies with large numbers of low-income working families in their employee base should adopt and promote Employee Financial Health Benefit Plans. They can be incorporated into existing retirement-focused plans, as a technical matter, and should include the best fintech products identified in our study. The goal of each employer should be to reduce financial stress and encourage financially healthy behaviors. We recommend that the employer, or sponsor, should subsidize employee fees for participating in such plans, if necessary, because of the hard financial benefits from improved employee financial health.

Fintech-based Financial Health Benefit Plans can be a win-win for employers, employees and communities. It’s time for corporate America to get on board with a fintech innovation that is available today and really works.

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