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Determining the most effective financial inclusion products

In the real world, we often find that consumers respond differently from the ways theories predict. The more we are able to conduct rigorous research to better understand what products are most effective, the better we will be at focusing investments on those products.

Imagine you're a low-income worker earning $20,000 per year. You're just making ends meet, but then your car insurance comes due, and you realize that the due date is before your next paycheck comes in. In the past you've borrowed money from friends to cover such short-term needs, but you know that most of them are feeling the pinch, too, so you feel bad asking. So you decide to take out a short-term loan, thinking you'll be able to pay it off as soon as you receive your next check.

This is a decision that twelve million Americans make every year, according to research from The Pew Charitable Trusts. But the average borrower doesn't pay off the loan by the next paycheck. Instead, they end up rolling the loan over and are indebted for five months out of the year at annual interest rates exceeding 400 percent.[1]

While the people who use this type of loan come from all walks of life, it is often low and moderate-income (LMI) populations who get caught up in this cycle of debt, since they are more likely to lack a financial cushion. Forty-four percent of households in the United States do not have enough liquid assets to cover basic expenses for three months in the event of a loss of income, and 65 percent of those fall into the bottom 40 percent of the population in terms of income, meaning that they earn less than $35,000 per year[2]. So if something goes wrong — the car breaks down, one of the kids needs dental work — a family can very quickly go from "okay" to financial desperation. For this reason, efforts to help LMI individuals to build — and maintain — emergency savings have been gaining a lot of support and attention from policymakers, donors, and practitioners interested in promoting financial inclusion.

But what do those efforts look like? Some programs focus solely on savings. Individual development accounts, for example, encourage the creation of a nest egg by matching personal savings with contributions from a foundation or government agency.

Other programs try to target people who are using debt to cover emergency expenses and encourage them to replace that debt with savings. How to do this in a way that leads to the best possible outcomes for borrowers, however, is not clear-cut.

The basic form that many of these products take is this: along with their loan payment each month, the borrower makes deposits into savings, typically a fixed amount or a percent of their loan payment. The savings are then released at the end of the loan. Requiring borrowers to save as part of their loan sounds like a great idea. The lender can use the borrower's savings to partly collateralize the loan, thereby reducing risk, and the borrower ends the loan with a pot of savings that can be put towards other uses. Anecdotal evidence suggests that borrowers like the savings component because being forced to save helps them adhere to their own savings plan.

However, for a borrower paying even a low interest rate, say 14 percent, but receiving an even lower interest on their savings (nationwide average savings yields are currently below 1 percent annual percentage yield), being forced to save rather than being able to put that additional cash towards the loan results in an increase in the amount of money the borrower will ultimately owe on the loan.[3] In other words, products that require the client to borrow and save at the same time actually cost the borrower more money than the loan product on its own.

For opponents of simultaneous borrowing and savings products, therefore, the only such products that are not potentially harmful to the very people we're trying to help are "offset savings" accounts, accounts in which the borrower's interest paid on the loan is completely offset by any savings accumulated — savings yields are as high as loan interest rates. These products, though, are expensive to manage, and so far their reach has been quite limited.[4] So the question becomes whether the benefits of developing a savings habit are worth the costs to borrowers of requiring savings without an offset.

There's no question that it's in everybody's long-term interest to break cycles of debt by encouraging the development of savings. On the other hand, setting aside money for savings might not make sense when there's a loan to be repaid right now. The question of which approach is most beneficial to borrowers is a tricky one, and right now, all these arguments are theoretical. We don't know how people respond to these savings products.

But we do know there's one way to find out — put it to a test. In the real world, we often find that consumers respond differently from the ways theories predict. The more we are able to conduct rigorous research to better understand what products are most effective, the better we will be at focusing investments on those products. Ultimately, although we may disagree on the specifics of product innovation, we agree on the overall goal: improving access to high-quality and affordable financial services for the un- and underbanked.

1. The Pew Charitable Trusts (2012). Payday Lending in America: Who Borrows, Where they Borrow, and Why. http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Payday_Lending_Report.pdf Accessed Dec. 19, 2013.
2. Brooks, Jennifer and Kasey Wiedrich (2013). Assets and Opportunity Scorecard Living on the Edge: Financial Insecurity and Policies to Rebuild Prosperity in America. Corporation for Enterprise Development (CFED). http://assetsandopportunity.org/scorecard/. Accessed Dec. 4, 2013.
3. This of course assumes that the terms of the loan do not prohibit or penalize early repayment. This is usually true of loan products

with a stated pro-poor objective.
4. Examples of such products exist in the UK, Canada, and Australia, and a similar product was recently launched by Citibank (although is currently only offered in the NYC tri-state area). They are, however, usually only attached to mortgages or other higher-value loans. We are unaware of any organization that has attempted to provide offsets for small-dollar credit.

January 22, 2014