kcFED Payments System Research Briefing

In the Nick of Time: The Rise of Earned Wage Access

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Fintech programs that provide employees access to earned wages ahead of payday have gained popularity during the COVID-19 pandemic. Although consumers benefit from greater financial flexibility, such programs may involve risks.

Goods and services have become increasingly available with the click of a button. Today's consumer can hail and pay for a ride with a mobile app, order food or an item online to be delivered the same day, and message others with the expectation of an instant response. The COVID-19 pandemic has heightened these expectations and accelerated business trends, including providing employees the opportunity to access wages in new ways. Over the last decade, several fintechs have made instant and advance payment of wages possible by partnering with employers as well as going directly to employees. These early and earned wage access (EWA) providers leverage the automated clearinghouse (ACH) rails to either push earned wages directly to a consumer's account or use a debit network to push an instant credit to a debit or prepaid card. EWA programs have gained increased popularity during the COVID-19 pandemic, as many consumers are facing cash constraints that make instant pay services appealing. However, these programs are not without costs.

How workers get paid

The U.S. payroll system as it is experienced today began in the mid-1930s with the signing of the Social Security Act, which collected payroll taxes from workers for the first time in January 1937 (McSteen, n.d.). In 1942, during World War II, the U.S. government implemented a mass payroll tax for employers (IRS, n.d.). Without today's technology, companies took much longer to deduct those taxes from the entire workforce's pay and send the collected taxes to the Treasury. To balance paying workers regularly with handling payroll taxes efficiently, checks became the primary method of disbursing payroll and submitting tax collections. In addition, many companies adopted the two-week or monthly pay cycle that continues today (LaMagna 2018). This pay cycle allows salaried employees to know not only when they will be paid, but also how much. Although hourly employees may have a predictable pay cycle, the amount they will be paid may vary.

In the early 1970s, the efficiency of payroll processing was enhanced with the introduction of the ACH, which enables employees to receive their wages conveniently in a bank account. However, some employees still receive wages by check.

In the current payments ecosystem, employees experience a lag in accessing wages they have already earned; thus, a dollar is not being spent at optimum speed for goods and services.[1] While this was problematic for hourly workers pre-pandemic, the issues are now even more pronounced (Pew Charitable Trusts 2017).

When life happens

According to recent research from the U.S. Financial Diaries project, some working families are cobbling together income from increasingly diverse, unpredictable means, such as delivering food, driving for ridesharing services, and doing odd jobs (Morduch and Schneider 2013). For those without a bank account, receiving payment by checks adds a layer of complexity to accessing earned wages quickly. And when income is lower than expected or emergencies arise, the only alternatives to accessing funds may be costly—for example, running up a high-interest credit card, overdrawing a bank account, or turning to check cashing or payday loan services.

Low- to moderate-income (LMI) consumers with poor credit scores may not have the option of using a credit card to bridge a shortfall. But even for those who do, this option may have drawbacks. LMI consumers often pay higher interest rates and tend to have high revolving debt (Bureau of Consumer Financial Protection 2019). Furthermore, as the pandemic disrupts economic activity and threatens employment—affecting wages—issuers are lowering credit limits and closing some card accounts altogether (PaymentsSource 2020).

Consumers with bank accounts may overdraft them or turn to check-cashing services to cover budget shortfalls. The Consumer Financial Protection Bureau's (CFPB) *Data Point on Frequent Overdrafters* found that hard-hit consumers had a median number of 37 overdraft fees; at the average overdraft fee of $34, they owed nearly $1,300 annually.[2] Although check-cashing services are often used by unbanked consumers, banked consumers who receive paper checks may still choose to use these services, as a paper check can take up to two business days to clear at a bank (Board of Governors of the Federal Reserve System 2013). Fees for check-cashing services vary by provider and by state. Though costly, this alternative is sometimes less expensive than incurring an overdraft fee (Sevron 2017).

Finally, consumers may turn to a payday or title loan in times of need, creating a cycle of debt. The CFPB's *Data Point on Payday Lending* found that monthly borrowers are disproportionately likely to stay in debt for 11 months or longer.[3] Additionally, while auto title loans are marketed as single-payment loans, most borrowers take out more loans to repay their initial debt (CFPB 2016). In some cases, what starts out as a short-term emergency loan turns into an unaffordable, long-term debt load for an already struggling consumer.

Meeting a need

The economic effects of COVID-19 have increased employees' need to quickly access earned wages, and prominent EWA providers assert that EWA is a viable option for employees to bridge the gap between pay cycles (Shah 2016). Moreover, EWA providers also assert that these services could help employers attract new talent: for example, hourly wage or gig workers may evaluate job opportunities based on the speed with which they can access their wages. EWA programs may be offered through an employer or accessed directly by an employee, but both methods come with costs.

Earned wage access programs are employer-based services and operate through a contract between a provider and the employer. The contract allows the provider to access an employer's time and attendance records to determine actual earned wages. At the end of a shift, an employee can use the provider's mobile application to access between 50 and 80 percent of their income for that day. The employee pays a fee to access the service that varies based on whether funds are received via the ACH or instantly via a card network. The provider takes on the liability by granting the employee access to wages earned for the day. On payday, the provider collects funds directly from the employer for any earned wages disbursed ahead of payday. An employee can still expect a paycheck from their employer on payday, minus any wages already paid.

Early wage access programs operate through agreements between the provider and the employee, and do not involve the employer. A consumer downloads an early wage access application to their mobile device, establishes an account with basic information (employer, rate of pay, and hours worked), and links a checking account. For these programs, the EWA provider functions more like a lender, providing access to a percentage of wages earned on a given day, as reported by the employee. For an employee to access their wages, they must first upload a copy of their electronic timesheet to the provider's platform. The provider later collects the funds it advanced by debiting the employee's checking account on the next payday. Unlike a lender, these types of providers rely on a subscription or tip model, paid by the employee, for revenue.

Both types of EWA programs have been touted as beneficial options to help employees cover unexpected expenses and avoid high-cost alternatives. But employees face risks due to the nuances and product features of these services. If an employee is a repeat user of these services, the fees they accumulate could rival recurring overdraft fees (National Consumer Law Center 2020). In addition, EWA providers do not have insight into all deductions from an employee's paycheck, such as retirement and healthcare, which could result in the employee overleveraging. Moreover, an employee could "double dip" by using the earned wages program through an employer and then using the early wage app for the same day's wage. This spiral could leave the employee short on payday; when the early wage access program sweeps their checking account, they may incur an overdraft fee.

The Federal Reserve System's response

Innovation has the power to improve the resilience, efficiency, and inclusiveness of the financial system, and solutions for earlier access to wages are evolving. The Federal Reserve continues to focus on how the changing payments landscape can deliver better access, safety, and efficiency. One important aspect to address is how existing payments are processed. For example, the ACH system used by EWA services has already been enhanced to provide two windows for same-day processing of payments. A third window, which will expand processing by an additional two hours, will be added in March 2021.

Earlier access to wages may also be facilitated by the adoption of instant payments, such as those that will be available using the forthcoming FedNow Service and are available today through The Clearing House's Real-Time Payments. As with current Federal Reserve Financial Services, FedNow will be available to institutions eligible to hold accounts at Reserve Banks. Partnerships between banks and nonbanks have the potential to provide innovative end-user services, including to wage earners currently using potentially costly or opaque EWA programs.

Additionally, the Federal Reserve System is studying the potential benefit that a central bank digital currency (CBDC) could provide (Wong and Maniff 2020). Designed appropriately, a CBDC could have features to improve efficiency and access for making routine payments (George 2020). Issues yet to be settled include concerns about privacy and access for consumers who live in rural areas where high-speed internet is not readily available.

In the future, the availability of instant payments may better enable banks to offer services that EWA providers offer, such as earlier access to payroll and push notifications (Board of Governors of the Federal Reserve System 2020). Payroll providers often cite costs, both financial and time, as the reason they are unable to pay employees more frequently (LaMagna 2018). Looking ahead, the proliferation of instant payments, specifically the FedNow Service, will improve payments system efficiency by creating a foundation on which depository institutions across the country and the broader payment industry can build modern, innovative, and safe instant payment services. As instant payment services are more broadly available, payroll providers may see these services as beneficial and begin to leverage them to compete for employers. Employers may do the same to attract and retain employees (Groenfeldt 2019). Ultimately, consumers will benefit from reducing friction points between pay cycles.

Endnotes

[1] According to the Federal Reserve Bank of St. Louis (2020), "The velocity of money is the frequency at which one unit of currency is used to purchase domestically produced goods and services within a given time period."
[2] The CFPB found that 79 percent of bank overdraft and non-sufficient funds fees are borne by 9 percent of account holders (CFPB 2017).
[3] According to the report, 64 percent of new borrowers renewed their payday loan (CFPB 2014).

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