Assembly Committee on Banking & Finance

Informational hearing

The Unbanked and Methods of Access to the Financial Mainstream

The American financial landscape contains a mix of financial services and sectors from banking institutions, investment houses, and check cashing centers. However, when we think of banking and financial services most often we imagine the quintessential bank branch or credit union. Many Americans are so accustom to mainstream banking and electronic transactions that rarely is any thought given to those systems that are outside of the mainstream. In 2003, electronic payments surpassed other types of payments for in-store purchases for the first time in the United States.[1] In an evolving electronic financial world, those with out a banking relationship can loose out on many cost savings benefits.

The unbanked, or those without a transaction account with a financial institution constitute approximately 22 million, or 20% of Americans. This population spends $10.9 billion on more than 324 million alternative financial service transactions per year. BearingPoint, a global management and technology consulting company, estimates that the unbanked population expands to 28 million when you include those who do not have a credit score. In addition, BearingPoint puts the underbanked population, defined as those with a bank account but a low FICO[2] score that impedes access to incremental credit, at an additional 45 million people. Although estimates find that at least 70% of the population has some type of bank account, these individuals continue to use non-bank services, ranging from the purchase of money orders, use of payday lenders, pawn shops or sending of remittances.[3] The Federal Reserve Board has noted that 50% of current unbanked households claim to have had an account in the past.

In California, 28% of adults do not have a checking or savings account, according to the U.S. Census. In San Francisco, the Brookings Institution estimated that one in five San Francisco adults, and half of its African-Americans and Hispanics, do not have accounts. Recent market research indicates that Fresno and Los Angeles have the second and third highest percentages of un-banked residents in the country

Nationwide, the unbanked are disproportionately represented among lower-income households, among households headed by African-Americans and Hispanics, among

---

[1] Dove Consulting

[2] A FICO score is a credit score developed by Fair Isaac & Co. Credit scoring is a method of determining the likelihood that credit users will pay their bills. Fair, Isaac began its pioneering work with credit scoring in the late 1950s and, since then, scoring has become widely accepted by lenders as a reliable means of credit evaluation. A credit score attempts to condense a borrowers credit history into a single number. Fair, Isaac & Co. and the credit bureaus do not reveal how these scores are computed.

[3] Center for Financial Services Innovation, *Making Financial Services Work for Everyone*, October 2005.

households headed by young adults, and among renters.[4] A Harvard Poll of Hurricane Katrina evacuees in the Superdome found that seven out of ten did not have a checking or savings account.

The unbanked poor pay more to conduct their financial lives. Check cashing outlets can charge between 2-3 percent of the face value of a check. So, an individual who makes $30,000 a year can pay $800 a year in fees to cash their payroll checks and pay their bills. The lack of access to mainstream banking cost both consumers and society, as well as, the financial community that misses out on this untapped market.

Families without accounts don't have a safe place to keep their money. They may walk around with wads of cash in their pockets, or keep it at home in a coffee can. Robberies are more prevalent around check cashing outlets. A burglary, or a fire, could cost them their life's savings in a matter of moments. A bank account helps people take the first step onto this path. Without an account, it is much more difficult to get well-priced car loans, credit cards, or mortgages—the exact financial tools needed to climb up the economic ladder. Stable societies are built on financially stable families who have access to high-quality, low-cost financial services.

A 2001 Federal Reserve study on consumer finances asked "Why don't you have a checking account?" The reasons given were:

- Do not write enough checks to make it worthwhile (28.6%).
- Do not like dealing with banks (22.6%).
- Do not have enough money (14%).
- Service charges are too high (10.2%).
- Cannot manage or balance a checking account (6.6%).
- Minimum balance is too high (6.5%).
- Do not need/want a checking account (5.3%).
- Credit problems (3.6%)
- No bank has convenient hours or location (.4%)
- Other (2.1%)

How did we get here?[5]

The general assumption in the past involves low-income customers, who are likely unbanked or underbanked, had low account balances and high transaction volumes, which is an unprofitable combination for the traditional banking model. Unlike a number of other states that required lifeline banking accounts for seniors and the poor, little emphasis was made to service this market. Banking regulators focused on the importance of providing loans and investments to lower-income communities, rather than asset building services.

---

[4] John P Caskey, *Bringing Unbanked Households into the Banking System*, January 2002.
[5] Seidman and Tescher, *Unbanked to Homeowner: Improving Financial Services for Low-Income, Low Asset Customers.* 2005, Brookings Institutions Press. (Guidance for this section)

Greater recognition has occurred in the financial services environment of the unbanked in regard to the asset poor and the connection to asset building.

What has led to this newfound recognition of the unbanked? First, technological innovation that assisted the increase in homeownership through risk-based automated underwriting models began to have an impact on the retail market with a greater use of automated transactions and internet banking. For example, some financial institutions offer full service ATMs that allow the reloading of a payroll card, payment of bills, money order purchase, deposit into a savings account and check cashing service. These electronic systems have brought down the cost of serving retail banking customers and allowing greater innovation relating to expanding services to fringe markets.

Second, the Debt Collection Improvement Act of 1996 required all federal payments to individuals be made by direct deposit. In the process of implementing this new law, the Treasury Department realized that many federal benefit recipients did not have bank accounts. This led to the Treasury commissioning research to examine the reasons why people were unbanked.

Third, alternative financial sectors exploded in growth in the 1990s. The number of payday lenders, check cashing outlets, pawn shops tripled and sometimes quadrupled in locations, particularly in states with relaxed regulation of these types of providers.

Finally, the United States underwent major demographic changes as found in results of the 2000 Census. These changes encouraged financial service firms to focus more heavily on the opportunities presented by these changes. Specifically, the Latino population grew by 58% in the 1990s and by 2004 totaled 13% of the total U.S. population. Sixty percent of Latinos were born in the U.S. with 55% residing in the suburbs with a purchasing power estimated at $600 billion annually. In spite of this sizable economic power, estimates reveal that as many as 34% of Latinos are unbanked. These growing demographic trends have forced mainstream financial institutions to reexamine this once overlooked market.

Products and services currently targeted toward unbanked and underbanked.

The last decade has seen a rise in product offerings to the unbanked population. This section will provide a brief overview of some products and innovative approaches that not only target those without a banking relationship, but target those who may have minimum contact with mainstream banking.

Stored value cards (SVC), specifically, payroll cards have emerged as a growing trend and product marketed to the unbanked and underbanked population. Growing numbers of employers use SVCs as a way to provide employees with wages or other benefits such as flexible spending accounts that pay for out-of-pocket medical expenses. It is estimated that in 2004 2.3 million payroll cards were issued, and the use of these cards may climb to over 6 million workers.[6]

Payroll cards can be a cost-effective way for employers to pay their employees because the cost of loading funds on a card can be less than the cost of issuing a check. SVCs can also be cost-effective for employees, particularly for those employees without a bank account, because accessing funds through a SVC may cost little or nothing while check cashers typically charge high fees for their services.

Once the wages are credited to the account, the wages can be withdrawn using the payroll card at an ATM, which may charge a fee. The card can also be used to purchase goods and services like a debit card. If a payroll card is reported stolen or lost within 48 hours, it will be replaced and the lost pay restored. An employee may incur a fee to replace a card.

University Bank in St. Paul, Minnesota, and Central Bank of Kansas City have emerged as innovators in serving the unbanked through stored value cards.[7] Both institutions tried to create a "personal spend card" which is a stored value card that combined the functions of the single-purpose products that are typical in today's market, while also retaining the ownership and administration of the account underlying the SVC cards The rationale for the multi-purpose card is if the product is to be an alternative to a checking account or ATM-enabled savings account, then it must have the same versatility and functionality.

University Bank began developing its stored value card, which aimed to give customers a banking product that combined the retail features of a bank account—a place to keep money, the ability to withdraw cash, make electronic payments, debit purchases—with the benefits of a credit card—retail and online purchases, flexibility, the absence of cash—but without the risks associated with either one. Once customers had established a relationship with University Bank and accustomed themselves to bank-like transactions through the SVC, the bank hoped users would eventually move into a traditional banking account and on up into other financial vehicles.

Second chance checking accounts have also emerged as a growing product for those individuals who had a bank account in the past but incurred several overdraft charges that made them risky customers to banks. Legacy Bank of Milwaukee, Wisconsin, originally designed its Financial Liberty First Accounts for those customers who never had a bank account, but this soon changed into a product to capture those customers who are underbanked.[8] Part of the design this particular account included early monitoring by the bank for potential problems that customers may face, such as overdrafts. This approach known as tech-meets-touch is a system that combines electronic monitoring of accounts with employee to customer outreach if a problem is spotted. Legacy Bank has a strict intervention policy that requires financial education classes in combination with credit counseling if they have more than three overdrafts. This program effectively used

[6] Diane E. Lewis, *Its all in the Card.* Boston Globe. February 15, 2004
[7] From Margins to the Mainstream: A Guide to Building Products and Strategies for Underbanked Markets. National Community Investment Fund..
[8] Ibid.

community partnerships to overcome three of the most important barriers to becoming banked: financial illiteracy, market penetration, and a lack of trust among customers. The success of Legacy is rooted in its institutional strategy to reach the unbanked. The bank estimates that one-third of overall staff time goes into reaching out to the unbanked through classes, new accounts, monitoring and account administration.[9]

An early innovation in providing asset-building opportunities for the underbanked include Individual Development Accounts (IDAs). IDAs represent one of the first attempts to create a vehicle for underbanked individuals and families to save and build assets. By rewarding participants with matching money added to their monthly savings, IDAs programs promote home ownership, educational attainment and economic independence. There appears to be more than 500 IDA initiatives in existence in communities across the country, with at least 15,000 people saving in IDAs.[10] Though they vary in design and implementation, IDAs are dedicated savings accounts that match participants' contributions to the account. Participants have a strong incentive to save as their contributions are matched at very favorable ratios by government, philanthropic and private-sector institutions. The programs have a cap on matching funds and a vesting period in which to earn them. The participants can withdraw their own funds before the vesting period is completed, but will lose the matching money. Participants can only withdraw the matching money for an asset purchase, such as paying for college, buying a home or starting their own business. While eligibility guidelines vary by program and by region, IDAs are generally available to those with household incomes below $35,000 a year. An additional component of IDA programs is financial education and counseling to help participants manage and repair their credit, set a budget and savings schedule, and prepare to purchase and manage an asset.

As individual IDA participants have succeeded in buying homes, starting businesses, going to college and saving for retirement, they have helped to prove that lower-income, underbanked families can and will save if given the appropriate access, ease and incentives. Within the American Dream Demonstration (ADD), a 13-site IDA demonstration that began in the late 1990s, participants accumulated an average of $700 per year including matches. More importantly, as their savings increased, participants were more likely to achieve their monthly deposit targets, demonstrating that their saving behavior, like that of wealthier individuals, is influenced by the incentives they receive. Financial institutions play a variety of roles in IDA programs, from providing the accounts to holding the pooled matching funds, to providing financial coaching and making financial contributions. IDA-sponsoring institutions are overwhelmingly commercial banks and thrifts (81%), with credit unions making up the remaining total (19%). Citigroup, Bank of America and others have been at the forefront, serving as depositories for IDAs and providing matching funds.

The Federal Deposit Insurance Corporation (FDIC) offers a financial education program, Money Smart, that encourages participants to open an account. This program provides

[9] ibid.
[10] Center for Financial Services Innovation, *Marrying Financial Transactions with Asset-Building Opportunities.*

participants with financial literacy skills to assist them in making informed financial decisions. The program consists of 10 instructor-led training modules that cover various topics. The FDIC does not look to Money Smart to encourage the opening of an account but to give participants the skill needed to make the most appropriate decisions based on their circumstances which may not be a bank account.[11]

The success of innovative product solutions has built upon successful models that incorporate some key concepts related to the unbanked. Some of those strategies have included:

- Developing an understanding of the needs and demographics of the unbanked market by acknowledging that the unbanked are not just people with less money.

- Mimicking the transactional aspects of non-traditional products, such as payday loans, while limiting their predatory aspects. Several banks and credit unions offer competing products for payday loans and check cashing services.

- Understanding that families living paycheck to paycheck access to cash is critical. Institutions seeking to service the unbanked have had more success when designing products that take into account the need for quick cash as small dollar amounts.

- Monitoring and early intervention to preemptively engage with customers before a problem reaches unfixable proportions. Early monitoring reduces risk for the institutions while helping a customer develop good financial habits.

- Products that meet immediate needs, such as payroll cards, check cashing services, starter accounts and others should serve as entry points to more traditional products that help with long-term asset building needs.

- Leveraging public and private partnerships to assist in reaching out to customers and to ensure long-term success.

Obstacles to reaching the unbanked.

As the Center for Financial Services Innovation (CFSI) points out, a major hurdle for addressing unbanked populations is the tendency to view the population as a group who all share the same problem. CFSI continues:

> *Low-income consumers are not a homogeneous group, and a one-size-fits-all strategy in marketing and product development for low- and moderate-income consumers runs the risk of appealing to no one in particular. In addition to the remarkable demographic diversity in this market, we have also seen that there is*

[11] Angela Lyons and Erik Scherpf. *Moving from unbanked to banked: Evidence from the Money Smart program.* Financial Services Review. 2004.

> *substantial diversity in attitudes, preferences, and experience. For example, for the half of unbanked households that have had a bank account in the past, the issue is winning back those whose experience with the system has not been positive—a fundamentally different marketing challenge from attracting those who have never had a bank account. Customers who find managing a checking account difficult may require a different set of products and services than customers who routinely make payments with checks. Financial education curricula also need to be tailored to the needs of individual groups. Curricula developed to bring the unbanked into the banking system need to differ from curricula for segments that were formerly banked, although both need to offer preventive tools designed to address account management issues.*

Other, less obvious, factors can also discourage low-income consumers. A lack of bilingual frontline services coupled with a culture that does not emphasize customer service. Also, some surveys suggest that the unbanked are concerned with privacy issues, particularly with undocumented immigrants who may fear repercussions for not possessing the appropriate identification.[12] As Seidman and Tescher note:

> *Comparing a typical menu of bank products with the reasons why some Americans choose not to have a banking relationship suggests that the problem may not be lack of demand, but rather the lack of an appropriate and appealing supply. While traditional banking institutions are well positioned to meet low income families' long-term financial needs, most are ill-equipped to meet their immediate and short-term needs. Traditional checking accounts are predicated on consumer liquidity, a luxury poor people generally do not have. Even banks that have one or two products appropriate for modest-income consumers generally lack a full line of products that would enable consumers to build on their initial successes. In addition, bank branches are often inconveniently located for the poor and do not offer them a comfortable atmosphere. While the financial services industry is quite sophisticated about segmenting upper-income consumers and crafting appropriate marketing messages to reach them, little attention has been paid to outreach efforts at the lower end of the income scale.*

Alternative Credit Data

A growing option and trend for both the unbanked and underbanked is the use of alternative credit data. An estimated 32 million Americans have credit files that do not have sufficient information to calculate a standard credit score. Obviously, a lack of credit information can leave otherwise qualified persons outside the credit system that enables people to buy houses, cars, or in some cases simply open a bank account.

In recent decades, access to credit has dramatically expanded for the great majority of Americans with the spread of automated "credit scoring" systems that make credit decisions easier and more consistent. For many of those outside the credit fold, the

---

[12] Seidman and Tescher, *Unbanked to Homeowner: Improving Financial Services for Low-Income, Low Asset Customers.* 2005,

dilemma is in one sense simple and difficult in another. It is simple in that the problem of access is often a problem of information. That is, many of those with a credit disadvantage lack information in their credit files (are “thin-filed”) or lack files altogether (“null-filed”). The problem is complex in that access to credit, at reasonable prices, requires payment information, which, in turn, requires credit. One solution to this hurdle is to use payment information not from lenders but from providers of “credit-like” services. These services, such as utilities, are often supplied in advance of payment, are automated and recurrent, and thereby provide sufficient information to establish patterns. Alternative or nontraditional data provide lenders with information to help evaluate the risk of lending to a consumer. [13]

The Federal Reserve Bank of Boston has revealed some companies have recently begun utilizing or investigating credit scoring models relying on alternative credit data:

• In 2005, MassHousing, the housing finance agency for the state of Massachusetts, became the first nationwide lender to qualify borrowers using a credit scoring system based on alternative sources of credit data. The scoring system, *Anthem*, was created by First American CREDCO.

• Pay Rent, Build Credit (PRBC), considered an alternative credit bureau, also calculates a credit score based on alternative data. Consumers can have Third parties (lenders or service/product providers) report payment data to PRBC, or consumers can report their data directly and have a third party verify the information. PRBC has obtained letters from the Federal Reserve and other government entities stating that lending institutions may receive credit under the CRA when they serve as a conduit for rental payment information.

• In 2004, the Fair Isaac Corporation launched its *Expansion Score*, combining alternative data such as payday loan payments and product purchase-payment plans with traditional payment data.

• Fannie Mae, Freddie Mac, and CitiMortgage are jointly testing the usefulness of the alternative data collected by PRBC for use in their own credit models.

• Bank of America has examined the use of alternative data by using it in conjunction with its existing credit evaluation processes for some customers.

• Some national payday lending chains have started collecting the repayment information of customers that can printed out and used by the customer to show a history of repayment of loan obligations.

• In 2005, Experian announced that it has begun incorporating phone bill payment data into its scoring models.

---

[13] Sara Burr and Virginia Carlson, *Utility Payments as Alternative Credit Data: A Reality Check.* The Brookings Institution Metropolitan Policy Program. March 2007

The use of other sources of credit data is not without concerns. Consumer advocates are concerned that alternative credit data could turn out to be used disproportionately by high cost lenders. Advocates suggest that it is necessary to make certain that both low cost and high cost lenders reach out to borrowers with alternative sources of credit data. Because credit scoring models are proprietary, it is not always clear what data is being used in the calculations and how much weight is being given to each source. It is therefore theoretically possible for a lender to unfairly lock consumers into low scores and high interest rates. Advocates are also concerned about the potential misuse of alternative credit scoring models for non-credit purposes. Credit scores today are used for such purposes as initial employment and job retention and to determine insurance eligibility and prices. Advocates argue that the use of alternative credit scoring models for these other purposes should be limited to situations where the accuracy, relevance, and predictive value of the data have been proven.

An additional set of concerns focuses on data sharing. The potentially large number of companies that could potentially report and process alternative credit data raises questions about privacy and the potential for identity theft. Some advocates also suggest that under current law, the *accuracy* and *completeness* reporting standards for data providers are not as clear as the standards for credit bureaus and require clarification. Advocates maintain that this is of concern because alternative data providers generally do not use alternative data themselves and, therefore, have less incentive than providers of standard data to report accurate and complete information.

Conclusions and policy recommendations.

Many of the issues associated with the unbanked and underbanked community have been left to the market place outside of the legislative arena However, in years past attempts have been made to address singular objects or product solutions.

Assemblyman Benoit introduced AB 822 in February 2005. As amended on May 2, 2005, AB 822 would have allowed employers, if voluntarily authorized by an employee, to transfer wages to a payroll card that can be used to access funds at an ATM, provided that the employee was entitled to at least one pay card transaction without charge per pay period. AB 822 was held in the Assembly Labor Committee.

Even without AB 822, some California employers are already using payroll cards to provide wages to their employees. It is unclear at this time how many California employers are offering payroll cards and how many employees are using them. Based on what the Assembly Committee on Banking and Finance staff has learned, employers who offer payroll cards are issuing them only when employees voluntarily agree to accept them and at least one transaction per pay period is provided at no cost to the employee.

Assembly bill 588 (de Leon), of 2007 states legislative intent to examine issues relating to alternative credit data. At this time, it appears that Assemblymember de Leon and other Legislators are interested in finding solutions for people who have a lack of traditional credit data.

The Chair of Banking and Finance, Assemblymember Ted Lieu has introduced AB 1502, a bill designed to bring banking services into underserved communities that typically have a large number of unbanked populations. AB 1502 would create a Banking Development District program in California. The goal of this legislation is to spur increased and enhanced banking services in under-served communities that will spur greater financial inclusion. The desired outcome is that more Californians will enter the financial mainstream and build savings and wealth through participating banks' offerings and marketing of appropriate transactional, loan, and credit products that can lead to longterm wealth building opportunities.

The Banking Development District program will make available a range of state—and potentially—local government incentives available to participating financial institutions. The legislation is inspired by New York State's Banking Development District program.

While many financial institutions may see the long-term business potential of under-served area, they may have a short-term concern that it would take a number of years before they can attract enough retail deposits to become viable. Those concerns are magnified by the fact that lower income workers often need to use banking services in off-business hours because they work in multiple jobs, making it more difficult for them to attract customers. The incentives provided through the program aim to help banks get over these short-term obstacles, enabling them to branch into neighborhoods with long-term business potential or better serve low-income consumers with existing bank branches.