Michigan Law Review First Impressions

Volume 109

2011

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Recommended Citation

Andrew W. Hartlage, *Unclaimed Financial Assets and the Promotion of Microfinance*, 109 Mich. L. Rev. First Impressions 99 (2011).
Available at: http://repository.law.umich.edu/mlr_fi/vol109/iss1/12

UNCLAIMED FINANCIAL ASSETS AND THE PROMOTION OF MICROFINANCE

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Limited access to financial services is a significant difficulty for low- and middle-income families in the United States. Traditional depositary institutions are reluctant or unable to offer financial services to low-balance customers, forcing many to use high-cost alternative financial services providers such as payday lenders and check cashers. These costs are a material drain on the take-home pay and savings of the poor, perpetuating financial instability and, ultimately, aggravating income inequality.

Microfinance can play a vital role in breaking this cycle of financial vulnerability. Microfinance providers offer financial services, most often small unsecured loans, with the aim of poverty alleviation. Although microfinance's best-known examples come from the developing world, according to a keynote speech delivered by Federal Reserve Board Chairman Ben Bernanke on November 6, 2007, a "lively network of programs" operates in the United States today. These programs have achieved some success in delivering credit and offering business-skills education to entrepreneurs in low-income areas, who would ordinarily be excluded from the mainstream banking system.

Though it is uncontroversial that microfinance can be a useful tool in fighting poverty, debate continues as to the appropriate role of profit motive in microfinance. Muhammad Yunus, Grameen Bank founder, pioneer of microfinance, and recipient of the 2006 Nobel Peace Prize, stated in a New York Times op-ed on January 15, 2011, that microfinance providers *must* operate as not-for-profit, as the ever-increasing pressure for returns leads for-profit lenders to eventually raise fees and interest rates to the same oppressive levels as high-cost alternative financial services providers. Others believe that the differing needs of American microfinance customers (for example, training in business regulatory compliance), and the increased costs of serving those needs, make the American microfinance industry structurally less profitable than markets abroad. This lower profitability obliges not-for-profit programs to rely on donors to stay in business.[1]

State governments can effectively promote domestic entrepreneurship in low-income communities and simultaneously fulfill their duties as conserva-

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† Suggested citation: Andrew W. Hartlage, Commentary, *Unclaimed Financial Assets and the Promotion of Microfinance*, 109 MICH. L. REV. FIRST IMPRESSIONS 99 (2011), http://www.michiganlawreview.org/assets/fi/109/hartlage.pdf.

1. *See* Mark Schreiner & Jonathan Morduch, *Opportunities and Challenges for Microfinance in the United States*, *in* Replicating Microfinance in the United States 19, 22 (James H. Carr & Zhong Yi Tong eds., 2002).

tors of unclaimed property, by lending unclaimed financial assets-in-trust at preferential interest rates to in-state microfinance providers. This plan presents an alternative to charitable contributions, though it does not resolve the tension between for-profit and not-for-profit microfinance providers. Such a scheme could be a significant funding source for many microfinance operations in the United States today. Even a small portion of the yearly intake of unclaimed assets would be substantial enough to support fully most microfinance loan portfolios. Also, reinvestment of unclaimed financial assets into the consumer financial system, rather than fiscal redeployment or traditional public fund investment, correctly counterbalances the contraction in consumer credit supply that occurs when these assets leave the balance sheets of financial institutions. Implementation of such a scheme may be accomplished by minor changes to current unclaimed property law.

I. Defining the Opportunity

Every year, states take custody of millions of dollars in unclaimed financial assets, such as dormant bank deposits, unclaimed traveler's checks and money orders, and other unpaid payment instruments. This transfer of custody from holders of unclaimed property, usually banks, to the state administrator is governed in all states by unclaimed property or "escheat" statutes. Under the Uniform Unclaimed Property Acts of 1981 and 1995, adopted by thirty-seven states and the District of Columbia, title in unclaimed property does not fully vest in the state as real property would under traditional escheat doctrine. The state instead acts as custodian of the property and honors claims of original owners or heirs in perpetuity.[2]

Although no states take complete title to unclaimed assets, the Supreme Court has acknowledged that, subject to constitutional limitations, states have wide discretion over the disposal of unclaimed property "[a]s a broad principle of jurisprudence."[3] States use unclaimed property receipts either as general income or as funding for various public projects. The District of Columbia and a majority of states deposit almost all unclaimed property in the state treasury, retaining a nominal amount (fixed at $100,000 in the Uniform Unclaimed Property Act) in a separate fund for the satisfaction of claims. A minority of states hold unclaimed property receipts in an unclaimed property fund, and these monies are either invested on behalf of original owners or used to fund public interest programs. Eighteen states have statutes that allocate some or all unclaimed property receipts for specific purposes such as education (Florida, Nebraska, North Carolina, North Dakota, Oregon, Utah, Vermont, Virginia, West Virginia, and Wisconsin); health care access (Colorado and Tennessee); campaign finance (Connecticut); pensions (Illinois); transportation (Louisiana); legal services (Maryland); historic building preservation (Mississippi); and air cargo hub

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2. *See* UNIF. UNCLAIMED PROP. ACT prefatory note (amended 1995), 8C U.L.A. 88 (2001).

3. Standard Oil Co. v. New Jersey, 341 U.S. 428, 435–36 (1951).

development (North Carolina).[4] Ohio deploys unclaimed property to promote both home ownership and minority-owned businesses.

Available figures show that the amount of unclaimed financial assets taken in and retained by states is significant. In 1991, states together took custody of $1.2 billion in unclaimed property. Recently, Oregon reported that it acquires $50 million in unclaimed property every year. It is likely that a significant portion of this total flows from unclaimed financial assets. Moreover, in spite of efforts by states and private companies to locate original owners, only a small portion of unclaimed financial assets are returned. Using overall unclaimed property return rates as a proxy for financial asset return rates, returns over a given year equal only 25 to 30 percent of the amount of new unclaimed property transferred to state custody.

These factors together make unclaimed financial assets a lucrative source of state revenue and, in turn, represent a significant funding opportunity for microfinance providers. Even a portion of these receipts would be enough to underwrite the portfolios of most U.S. microfinance providers. For example, ACCIÓN Texas and Louisiana, the largest microfinance provider in the United States, had a total active portfolio of $20.3 million as of year-end 2009. Lending even a small percentage of this total to microfinance providers could reduce these lenders' overall dependence on donations and free up resources for expansion into new areas or additional non-lending programs, such as basic business training.

II. The Unintended Consequences of Financial Asset Escheat

The current custodial system of unclaimed property disposal imposes economic costs on consumers by constricting the supply of credit. These costs come about as states convert unclaimed financial assets into other forms of property upon transfer. The effect of this constriction weighs disproportionately on the poor, and the unclaimed property programs of most states do little to mitigate or compensate for these adverse effects. By distributing a portion of these resources to microfinance initiatives, states can begin to meaningfully address financial access issues that breed financial instability among low- and middle-income families.

Most banks use customer deposits as the raw materials for lending. Low- or non-interest bearing deposits, such as demand deposits and savings deposits, are particularly important to lenders due to their low cost. The more low- or non-interest bearing deposits held by a bank, the higher the bank's flexibility to either lend to higher-risk customers or reduce customer lending rates. Additionally, banks are attracted to consumer-held savings and demand deposits because they are stable. Absent a bank run, these deposits are unlikely to be withdrawn all at once, allowing banks with large balances of such deposits to expand lending to more customers at lower interest rates. However, these low- or non-interest bearing deposits are also the financial assets most commonly forgotten or lost by consumers, and therefore are among the most common assets to end up in administration by state governments. Once assets are transferred, banks may no longer use

4. Fifty-one jurisdiction survey on file with author.

these monies for lending, which both constricts the supply of credit and increases the banks' average cost of funds.

The negative effects of this credit reduction fall disproportionately on borrowers who either lack collateral or earn income that is insufficient or too irregular for traditional borrowing. When bank profitability falls, the first customers to feel the effects are low-income customers that in most cases offer the lowest marginal revenue—few banks are willing to upset high-balance, higher-value customers through increased fees or cutbacks in customer reward programs. Not only are the poor most likely to suffer from a reduction in credit supply, but they also feel the effects of higher interest rates and fees most acutely, as such costs represent a larger proportion of their income. This combination of factors drives many low- and middle-income customers away from the traditional banking system to high-cost alternative financial services providers, such as payday lenders and check cashers.

Among the states that use unclaimed property receipts as a general source of income, few states take steps to counteract this policy's negative effects on the poor. One method to restore credit supply is to redeploy unclaimed property into the financial system. Only Ohio has a program that uses unclaimed property proceeds to extend credit; however, this program offers bonding guarantees to qualifying minority-owned businesses and does not, as such, reach businesses or entrepreneurs excluded from the traditional banking system.[5] A second method to alleviate the effects of credit tightening is to compensate lower-income families with social benefits. Although some states set aside a portion of unclaimed property receipts for projects that indirectly benefit low-income families, most states do not.

Credit-tightening also affects the minority of states that retain, rather than spend, unclaimed property receipts. In these states, unclaimed property does, in some sense, return to the financial system: fund administrators may invest in securities and may reinvest or spend any investment income. However, in most states, statutes restrict the investment of public funds to low-risk asset classes such as federal, state, and local debt; investment-grade, commercial fixed income; and bank certificates of deposit.[6] Investments in public-sector and commercial debt do not balance the localized contraction in consumer credit supply that results from unclaimed financial asset transfer to the state. Even investments in bank certificates of deposit, which would theoretically restore liabilities to bank balance sheets, do not adequately replace lost consumer deposits. This is for three reasons. First, the size of these placements is often limited by state statutes requiring that all investments in certificates of deposit be either covered by federal deposit insurance (currently capped at $250,000) or secured by collateral.[7] Second, these deposits are held at a much higher cost than comparable consumer-held demand and savings accounts, since unclaimed property fund administrators must invest at or near the highest available rates of return or face potential scrutiny from state inspectors general and other auditors. Finally,

5. *See* OHIO REV. CODE ANN. §§ 122.71–.941, 169.05 (LexisNexis 2007 & Supp. 2010).

6. *See, e.g.*, VA. CODE ANN. §§ 2.2–4501 to –4518, 22.1–145, 55–210.19 (2006).

7. *See, e.g.*, N.C. GEN. STAT. § 147–69.1(c)(5) (2009).

these deposits are a less stable source of funding, as they are vulnerable to rate undercutting by competitors.

III. Employing Unclaimed Financial Assets to Promote Microfinance

To support microfinance, state governments should create separately managed funds of unclaimed financial assets. States would then lend the monies held in these funds to microfinance lenders that agree to conditions designed to promote in-state financial access, such as minimum lending levels to in-state customers. By lending to private operations rather than establishing government-administered direct lending programs, states can avoid the inefficiencies and potential conflicts of interest arising from state-controlled lending. Also, unlike direct lending schemes, states would be insulated from individual credit losses; states would instead assume the credit risk of the overall microfinance institution. In return, states can expect some nominal direct return as interest, as well as secondary benefits from increased domestic economic activity, job growth, and decreased reliance on public benefit systems. States unable to find enough microfinance providers to lend the entire balance could simply invest any surplus in traditional assets, just as they would invest unspent revenue in the state general fund.

States have two options to create a microfinance promotion fund using unclaimed financial assets. The best option for a particular state will depend on whether unclaimed property receipts are held in an unclaimed property fund or have been transferred to the general fund. States that already transfer most unclaimed property to the state general fund may amend their respective unclaimed property laws to allocate a portion of yearly unclaimed property receipts, for example the first five million dollars in receipts, to a separate microfinance promotion fund. A larger transfer in the first year of operation could seed the fund and build enough capital to attract microfinance lenders. In many respects, this approach is similar to the one already used by several states to support the public projects mentioned in Part I. A drawback of this method is that the expansion of financial access may compete with other domestic interests for unclaimed property receipts, which could politically complicate passage of the proposal. The minority of states that hold unclaimed property in a fund, rather than transfer the balance to the state general fund, have an additional option. They can amend the laws governing the unclaimed property fund administrator (usually the state treasurer) and permit investment of a portion of the fund, for example, up to 5 percent, in debt issued by in-state microfinance providers. This method is less likely to face resistance from any existing political interests, as the unclaimed property fund has not been generally available due to the various statutory restrictions on investment described in Part II. In 2005, a similar amendment was passed in North Carolina, which opened 20 percent of the state unclaimed property fund to several additional asset classes, including equities, investment trusts, and private placements.[8] Although the North Carolina amendment did not specifically set aside money for redeployment

8. *See* Act of July 27, 2005, Sess. L. No. 2005-252, 2005 N.C. Sess. Laws 591 (codified at N.C. GEN. STAT. § 147-69.2(b) (2009)).

in low-income communities, the possibility of such a use has been recognized.[9]

Conclusion

States have much to gain by promoting microfinance and expanding financial access. Microfinance extends affordable financial services to low- and middle-income communities and fosters entrepreneurship, lessening the financial vulnerability that afflicts many low-income families. States gain these benefits at low cost. Substantial microfinance portfolios may be fully supported with only a modest allocation from a state's yearly unclaimed financial-asset receipts or with equally modest amendments to the asset allocation policy of a state's unclaimed property funds. This use respects the role of low-cost deposits in fueling lending and redeploys credit to those most affected by constrained credit supply. Through the promotion of microfinance, states can contribute to a larger national effort to expand financial access, combat poverty, and eradicate income disparity.

9. *See* Michael A. Stegman, *An Overlooked Source of Domestic Market Capital: Can Anyone Spell Escheats?*, Cmty. Dev. Inv. Rev. (Fed. Reserve Bank of S.F.), Jul. 2007, at 85, *available at* http://www.frbsf.org/publications/community/review/062007/stegman.pdf.