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Banking the Poor

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Low-income households often lack access to banking accounts and face high costs for transacting basic financial services through check cashers and other alternative financial service providers. These families find it more difficult to save and plan financially for the future. Living paycheck to paycheck leaves them vulnerable to medical or job emergencies that may endanger their financial stability, and lack of longer-term savings undermines their ability to improve skills, purchase a home, or send their children to college. Additionally, high cost financial services and inadequate access to bank accounts may undermine widely shared societal goals of reducing poverty, moving families from welfare to work, and rewarding work through incentives such as the Earned Income Tax Credit. This Article calls for the transformation of financial services for the poor. The Article first explores the dual financial services market in which insured depository institutions largely serve middle- and upper-income persons, and check cashers and other alternative service providers largely serve low- and moderate-income households. The Article argues that the social benefits of breaking down barriers between these markets exceed the costs of doing so. The Article also contends that network externalities in electronic payment systems help explain why some technologies that would help low-income consumers have not been as rapidly adopted as would be socially beneficial. In response to this problem, the Article recommends governmental incentives for private sector financial and technological innovation to help lower banking and savings barriers for the poor. Better access to financial services is critical for low-income persons seeking to enter the economic mainstream.

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Introduction

Access to financial services is critical to success in the modern American economy. Most households can take access to a bank account for granted. Yet 22% of low-income families—over 8.4 million families earning under $25,000 per year—lack the most basic financial tool, a bank account. These “unbanked” households and other “underbanked” low- and moderate-income individuals face high costs, relative to their income, for basic financial services. For example, a worker earning $12,000 a year would pay approximately $250 annually just to cash payroll checks at a check cashing outlet. Low-income workers often turn to tax preparation services and costly refund loans to access their government tax refund check under the Earned Income Tax Credit (EITC). The costs of these basic financial transactions can undermine public initiatives that help families move from welfare to work, and can diminish the effectiveness of the EITC in lifting families out of poverty and encouraging workforce participation.

Low-income families, particularly those without bank accounts, often lack any regular means to save. These families, often lacking alternative forms of financial resources, need to save, however, as a cushion against short-term crises, such as injury or job loss, as well as for longer-term goals, including buying a home, sending their children to college, or retirement. Of course, a central reason that low-income people find it

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1 Arthur B. Kennickell et al., Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances, 86 FED. RES. BULL. 1, 9-11 (2000); see also Ana M. Aizcorbe et al., Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances, 89 FED. RES. BULL. 1, tbl.5 (2003) (noting that the percentage of unbanked decreased to 9.1%, though data based on dollars of income are not fully comparable across surveys). The term “bank account” is used here to refer to an account at an insured depository institution, including thrifts and credit unions. A word on scope: This Article focuses largely on basic transactional services and short-term consumer credit. I take up the related question of savings policies in a work in progress with Michael Sherraden, Michael Sherraden & Michael S. Barr, Institutions and Inclusion in Saving Policy (Harvard University, Joint Center for Housing Studies, Working Paper, 2003), and the matter of access to home mortgage credit in another work in progress, Michael S. Barr, Democratizing Access to Capital (Harvard University, Joint Center for Housing Studies, Working Paper, 2003). The boundary between these topics is permeable.

2 See DOVE Consulting, U.S. Dep’t of the Treasury, Survey of Non-Bank Financial Institutions 34 fig.6.5 (2000) [hereinafter DOVE Report] (finding that fees for cashing a $500 check ranged from $8 to $14).
difficult to save is that they have low incomes, but evidence suggests that low-income people can save if they have structured mechanisms to do so. The unbanked are also largely cut off from mainstream sources of credit, whether for short-term consumer borrowing or home ownership, because, without a bank account, it is more difficult and more costly to establish credit or qualify for a loan. Even those low-income persons who have an account may, in effect, be “underbanked”: They may rely on check cashers to cash their payroll checks; they may lack an institutionalized means to save, such as through payroll deduction plans; or they may not have, or may have tapped out, credit cards, and turn to relatively high cost forms of short-term credit, such as payday loans, to meet their liquidity needs.

Alternative financial service (AFS) providers—including check cashers, money transmitters, payday lenders, title lenders, and tax preparation services that provide refund anticipation loans—are providing a wide range of financial services in low-income communities. For example, check cashers provide a means for unbanked employees to convert their paychecks to cash. Payday lenders provide short-term credit to borrowers who cannot access credit cards or are already at credit limits. There are benefits to this market segmentation, and for low-income consumers, it is likely that without such services, they would be even less able to fulfill their financial services needs. Still, such services often come at a high cost to low- and moderate-income borrowers. Some portion of these high costs may be endemic to the nature of the transactions. These are paper- and labor-intensive transactions involving small dollar amounts, conducted on behalf of consumers with low wealth and often uncertain or poor credit history. These transactions are undertaken largely by financial service providers, which, unlike insured depositories, lack direct access to the payments system for check clearance. Moreover, the fixed costs of lending show up in higher prices for loans of short duration and small amounts. Yet some portion of the costs—and consumer problems—can be traced to the patchwork of state and federal law that governs these providers.

While the mainstream financial system works extraordinarily well for most Americans, many low- and moderate-income individuals face a number of barriers to bank account ownership. First, regular checking accounts may not make economic sense for many lower-income families. For example, consumers who cannot meet account balance minimums pay high monthly fees, and most banks levy high charges for bounced checks, which families living paycheck to paycheck can ill afford. Second, many

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3 See infra Section I.B.
unbanked persons may not qualify for conventional bank accounts because of poor credit history or prior problems with managing a bank account. While some persons undoubtedly pose undue risk for account ownership, many could responsibly use bank accounts structured for their needs. In particular, accounts that do not permit overdrafts would reduce the risk associated with customers despite previous problems with the banking system and would diminish the need to sort out customers who had bounced checks in the past, except for those who were judged to have committed fraud. Third, while many low-income communities contain both banking institutions and alternative financial services providers, in some communities, banks, thrifts, and credit unions are not as readily accessible as in higher-income areas. Fourth, financial institutions may be reluctant, given low expected returns, to invest in research, product development, account administration, bank personnel training, marketing, and financial education necessary to expand financial services to lower-income clientele. That is, banking the poor is unlikely to be seen as sufficiently profitable for many banks to incur the up-front costs of entering this market, particularly because most banks are not institutionally organized to focus on this market segment. Fifth, the technologies that would make it less costly for low-income persons to use banking services are subject to positive network externalities. These externalities may slow the adoption of electronic forms of income receipt and payment.

The legal literature on issues regarding access to financial services for the poor focuses largely on debates over usury laws and consumer protections in the alternative financial services sector. In this Article, I hope to shift the debate toward ways in which governmental incentives can harness market and technological forces to expand access to financial services for the poor. The Article begins by systematically exploring the demand for financial services, building on John Caskey's foundational study of the alternative financial services industry and the work of a few other sociologists who in recent years have begun to explore the financial services usage of the unbanked population. I examine the supply of financial services by the alternative financial services and banking sectors.

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7 See, e.g., sources cited infra note 20. Until recently, there has been little research focused on the financial service needs of low-income households. I will contribute to this research in a survey that I will be undertaking in 2005 as the faculty investigator for the Detroit Area Survey.
I next analyze changes in payments and distribution systems that influence the provision of financial services for the poor.

On this empirical foundation, I argue that the federal government should act as a catalyst in encouraging the private sector to transform financial services for low-income persons. The case for governmental intervention rests primarily on four arguments.

First, bank account ownership contributes to optimal income redistribution policies. Bank account ownership (or a similar means of receiving income) can be thought of as logically prior to the receipt of a governmental transfer of income. The Article takes as a given that our society has a goal, as evidenced by such policies as the 1996 Welfare Reform law and the EITC, to increase workforce participation and reduce poverty among the working poor. Generally, providing government assistance in the form of income enhances social welfare more than providing assistance in kind, both because administration is likely to be less costly and because income assistance provides the recipient with the freedom to spend the income however she desires.

Given the high cost of converting income into liquid form, however, promoting bank account ownership for the poor is probably more efficient than simply transferring income. The form in which "income" is transferred changes its value. A governmental check is worth its face value less the cost of converting it to cash. In addition, one unit of in-kind assistance, in the form of sufficient governmental incentives to induce a bank to offer a bank account to a low-income person, would provide the benefit of liquidity to all subsequent income transfers whether from government programs, wages, or other sources. Thus, the concept of income transfers being more efficient than in-kind assistance breaks down when one needs to deliver that income to people in the real world. Moreover, the government saves money by transferring funds electronically, rather than by paper check.

Although paternalism forms the basis of much savings policy, and may be justified under some circumstances, paternalism is not the impetus for favoring subsidizing account ownership. The thrust of the argument in
favor of subsidies for bank accounts is to increase the supply of bank accounts tailored to the needs of the poor, not primarily to change demand of the poor for existing types of traditional accounts that many of them currently do not want or for which they may not qualify.\(^\text{11}\)

Second, high-cost financial services reduce effective take-home pay and thus may undermine employment incentives contained in such measures as the EITC and the Welfare Reform law, although further empirical research is needed to confirm this hypothesis. The costs of changing the delivery system for financial services for the poor are small relative to the likely gains to be had for these programs. More broadly, improved access to bank accounts can reduce the costs of financial services for the poor, expand access to lower-cost forms of credit and increase opportunities for saving—all key to reducing poverty and expanding social mobility.\(^\text{12}\) Evidence to date suggests that low-income people can save, but lack the institutional mechanisms available to middle- and upper-income Americans to do so. Providing a better opportunity for the poor to save is likely both to reduce their short-term exposure to liquidity shocks, and to increase their long-term prospects for building their human capital and saving for homeownership or other assets that can help them get out of poverty.\(^\text{13}\)

The positive network externalities in payments systems that the Article identifies as promising for expanding access to the banking system for the poor—online debit at automatic teller machines (ATMs) and merchant point of sale (POS) terminals, and the automated clearinghouse (ACH) system for direct deposit and bill payment—provide a third justification for governmental intervention.\(^\text{14}\) The social benefits of wide adoption of these systems exceed the private benefits that can be captured by their owners. While many of the network externalities inherent in these systems have already been internalized, further government policies to

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\(^{11}\) See infra Sections I.A, III.A, & V.A (discussing financial services needs of unbanked, inadequacy of existing accounts, and need for reform).

\(^{12}\) Government policies to promote financial services for the poor may also have expressive benefits, by helping to promote the sense that basic instruments for success in our economy are open to the poor. See, e.g., Lawrence H. Summers, Secretary of the Treasury, Remarks at the U.S. Conference of Mayors (Jan. 18, 2000) (describing bank accounts as the “passport” to the modern American economy), available at http://www.ustreas.gov/press/releases/l356.htm. On “expressive” benefits generally, see Elizabeth S. Anderson & Richard Pildes, Expressive Theories of Law, 148 U. Pa. L. Rev. 1503 (2000). But see Matthew D. Adler, Expressive Theories of Law: A Skeptical Overview, 148 U. Pa. L. Rev. 1363 (2000). The content of the “expressive” benefit, if any, depends in part on how its intended beneficiaries view the nature of the benefit. How low-income households would view the benefit of increased access to banking services is one aspect of the questions I will pose in the Detroit Area Survey, see supra note 7.

\(^{13}\) See infra Section I.B (discussing lack of savings mechanism as one cost of being unbanked). I take up the broader question of savings policy for low-income households in a working paper. See SHERRADEN & BARR, supra note 1.

\(^{14}\) See infra Part IV.
reduce these externalities would have wide social benefits and should be adopted. With distributive goals for the poor in mind, I also suggest additional steps. These electronic payment and delivery systems matter in expanding financial services for the poor because they are lower risk and lower cost to consumers, employers, and financial institutions than checks or off-line debit forms of payment systems.

Fourth, the patchwork of state laws governing the alternative financial services sector, gaps in federal law, and complicated regulations governing federal programs may also increase the costs and problems associated with providing financial services for the poor. Regardless of one's views about the merits of income redistribution, one ought to favor certain legal reforms. For example, state geographic restrictions on locations of check cashers needlessly inhibit competition among check cashers in low-income communities. In another vein, complicated federal rules governing the EITC and delays in tax refund processing may drive low-income taxpayers to take out expensive refund anticipation loans offered by paid preparers. Thus, the Article recommends changes in several regulatory areas.

The Article rejects two common approaches to thinking about financial services for the poor. First, the Article disputes the proposition that the financial services currently provided in low-income communities are necessarily efficient or desirable. That is, while there are benefits to market segmentation, there are also social costs to the current system. Second, the Article disputes the proposition that the remedy for perceived problems in the alternative financial services sector is a return to usury laws. Rather, the Article contends that the financial service system could serve at least some segments of low- and moderate-income households better with modest governmental incentives to the banking sector to spur innovation in serving the poor.

The Article makes several key policy recommendations to help transform financial services for the poor.

First, governmental incentives should be offered to encourage financial institutions to offer electronically based transaction accounts designed for low- and moderate-income persons. For example, debit-card-based accounts accessed at ATMs and at merchant POS terminals can be offered at much lower cost, and with lower risk to banks and consumers, than checking accounts. Such electronically based accounts may be particularly suited to low-income unbanked persons. Yet the fixed costs of offering these accounts may currently be too high to be borne by banks and their low-income customers, and banks have been largely unwilling to take on the opportunity costs of shifting bank resources toward serving low- and moderate-income persons. Further technological and financial innovation spurred by these incentives can help to drive down costs, reduce risks, and increase competition.
My view, which I defend in Part V, is that tax credits to financial institutions would be the preferable means for delivering the subsidy. Although tax credits could most readily be employed to create a larger scale initiative, other helpful steps short of a new tax credit could be taken. For example, the Treasury Department’s “First Accounts” pilot could spur experimentation, but needs to be funded on a multi-year basis. The incentives that I propose could also build on revamped governmental programs designed to move federal and state-run government benefit recipients from receiving certain government income transfers by paper check to electronic benefit transfer (EBT). State EBT programs—focused on welfare recipients and other beneficiaries of state-run benefit programs—should shift away from electronic benefit cards towards provision of debit-card based bank accounts that could be used to receive all forms of income transfer as well as privately earned wages. Treasury should enhance the incentives in the federal Electronic Funds Transfer (EFT) initiative—currently focused on moving Social Security recipients, federal retirees, and other beneficiaries of certain federally run programs to direct deposit—for banks to offer low-cost, electronically based bank accounts to a wider range of low-income households, including those who receive the EITC.

Second, taking account of the positive network externalities associated with online debit cards, direct deposit, and bill payment, while recognizing the risk that government intervention in these networks may miss the mark, adjustments may be needed in Federal Reserve Board pricing of both check and ACH services. ACH services are likely still priced too high in relation to checks. In addition, now that VISA and MasterCard have settled the suit brought by Wal-Mart and other merchants alleging antitrust violations arising from the credit card companies’ “honor all cards” policies, federal antitrust officials and the courts should pay particular attention to ensuring that the terms of the settlement foster competition among different electronic payment methods. Depending on how the market evolves in the wake of the settlement, there may also be a case for subsidizing the further expansion of online debit infrastructure.

Third, regulatory reform could play a secondary but useful role in altering the provision of financial services to the poor. For example, both the elimination of anti-competitive restrictions and the more consistent regulation and enforcement of disclosure could reduce some of the costs and problems associated with alternative financial service providers. Moreover, simplification of state welfare-to-work programs and the federal EITC, and IRS steps to facilitate the timely direct deposit of tax refunds, could help to reduce transaction costs, lower barriers to account ownership, and reduce demand for costly tax preparation and refund anticipation loan services. Furthermore, federal banking regulators should
increase attention on how the Community Reinvestment Act (CRA) could encourage banks and thrifts to provide innovative financial services to the unbanked under the existing regulatory framework.

Lastly, studies show that financial education, if coupled with structured opportunities to save, can increase participation in saving plans and increase the level of saving, particularly for low- and moderate-income persons. Financial education is costly, and the benefits of a financially-educated consumer cannot be captured by a financial institution offering education because the consumer may shop for financial services at other institutions. Further, the positive externalities created by the provision of financial education make it unlikely that such education will be offered in a socially optimal quantity by private parties. Although financial education is unlikely to be successful against the backdrop of existing high-cost alternatives, such education focused on new banking products designed to meet the financial needs of the poor may be helpful.

This Article proceeds as follows: Part I describes the low- and moderate-income population who use alternative financial service providers as a substitute for, or in addition to, banks, and explores the costs and benefits to consumers of using this sector. Part II analyzes the alternative financial services industry in depth and proposes changes to regulation of that sector. Part III explores barriers to low- and moderate-income persons using financial services at insured depository institutions and proposes strategies to lower these barriers. Part IV analyzes changes in the payments system and electronic financial services networks that could enhance financial services for the poor. Part V focuses on the Article's key policy recommendations for financial services, savings, and financial education. The Article then concludes.

I. The Unbanked

A. Patterns of Account Ownership

Twenty-two percent of low-income families—over 8.4 million families earning under $25,000 per year—do not have either a checking or

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15 See infra note 567.
16 Throughout this Article, I use the term "unbanked" to refer to individuals who do not have an account (savings, checking, or otherwise) at a depository institution. Despite the scope of the title, I also discuss problems of the "underbanked," those with an account at a depository institution but who also rely for their financial services on other financial services providers (such as check cashers, payday lenders, auto title lenders, refund anticipation lenders, and rent-to-own companies) that largely serve low- and moderate-income neighborhoods. Problems faced by the "unbanked" and "underbanked" overlap significantly but diverge in important respects that I explore throughout the Article. I use the term "bank" generically to refer to all depository institutions, including commercial banks, thrifts, and credit unions. Where differences among these types of depository institutions matter, I use the specific terms.
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Most of the unbanked are low-income: 83% of the unbanked earn under $25,000 per year. The unbanked may be especially concentrated in low-income neighborhoods; in low-income areas of Los Angeles the unbanked represent nearly a third of the population, and the unbanked represent over 40% of the population in low-income neighborhoods in New York.

Among low- to moderate-income families, households are more likely to be unbanked when they have lower incomes, less wealth, less education, are not working, are younger, have more children, rent their home, and are a racial or ethnic minority. Broadly speaking, the most common reason persons cite for lacking a checking account is not having enough money to be able to afford the costs of account ownership. Other factors cited by

17 Kennickell et al., supra note 1, at 2, 12; see also Aizcorbe et al., supra note 1. The GAO, using the 1998 and 1999 Survey of Income and Program Participation (SIPP) estimated that “about 11 million benefit recipients, over half of all federal benefit check recipients in 1998, were unbanked. This estimate is substantially higher than Treasury’s 1997 estimate, which showed that 24% of federal beneficiaries (5.2-6.5 million) lacked bank accounts.” GEN. ACCOUNTING OFFICE, ELECTRONIC TRANSFERS, REPORT TO THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES, GAO-02-913, at 3 (2002) [hereinafter GAO REPORT], available at http://www.gao.gov/new.items/d02913.pdf. GAO extrapolates from its SIPP estimates to suggest that among all U.S. adults, 22.2 million households, or 55.9 million individuals, are unbanked, representing 20% of all households, and 28% of all individuals. Id. at 55-56.


21 See John Caskey, Reaching Out to the Unbanked 22 tbl.2 (Apr. 2001) (unpublished manuscript, on file with author) [hereinafter Caskey, Reaching Out Manuscript]. The most commonly cited reasons for lacking a bank account are “do not have enough money” (about half of respondents in BOOZ-ALLEN HAMILTON, SHUGOLL RESEARCH, U.S. TREASURY, MANDATORY EFT DEMOGRAPHIC
respondents include distrust of banks, not wanting to deal with banks or privacy concerns.\textsuperscript{22}

Efforts to reach the unbanked also need to pay attention to the racial and ethnic composition, and immigration status, of segments of the unbanked. Recent evidence suggests that, irrespective of the race of the individual, families living in neighborhoods with higher concentrations of Blacks or Hispanics are less likely to own a checking account.\textsuperscript{23} Among the banked, low-income minorities are less likely than whites to have a checking account, but more likely than whites (all else being equal) to have savings accounts.\textsuperscript{24} By contrast, proximity to a bank branch seems not especially predictive of being banked.\textsuperscript{25} Low-income immigrants are more likely than other low-income persons to be unbanked. Moreover, significant immigration in the late 1990s may have contributed to the persistence in the size of the unbanked population.\textsuperscript{26}

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\textsuperscript{22} See, e.g., Rhine et al., supra note 20, at 13 (reporting that 30\% of respondents cited distrust of banks, an aversion to dealing with banks, and privacy concerns). These factors counsel caution about new types of accounts in and of themselves being attractive to all of the unbanked, and only some of these concerns might be addressed with increased financial education or exposure to positive experiences with banks. Some portion of the unbanked population may, of course, choose to remain unbanked even if faced with additional options. Still, as I explore more fully below, any bankers’ hesitancy, whether legitimate or not, about having low-income people using bank branches, or low-income consumers’ cultural aversion, if any, to the imposing nature of bank branches, can be mitigated by focusing on all-electronic accounts, which use ATMs and merchant POS terminals to provide access to accounts. See infra Part V. For those seeking to avoid attachment of funds by creditors, or who have privacy concerns, bank account ownership is likely to remain unattractive.

\textsuperscript{23} See VERMILYEA \& WILCOX, supra note 18, at 17-18. Data are insufficient to determine whether the racial neighborhood effect is related to any reluctance by neighborhood merchants to accept checks from minorities or from any person in minority neighborhoods, or is related to consumer preferences, which suggests the need to explore whether discrimination, or shared community-wide practice in poor neighborhoods, may influence the availability of, or individual decisions about, account ownership. See id.

\textsuperscript{24} Id. at 19.

\textsuperscript{25} Id. at 16. This suggests the need to look beyond “bricks and mortar” for explanations of banking patterns, including at the structure of accounts offered.

\textsuperscript{26} See Kennickell et al., supra note 1. Immigrants may face linguistic barriers to becoming banked, in addition to concerns about their immigration status. Surveys of the unbanked thus far have tended to focus more on English- and Spanish-speaking persons than on other immigrant communities. In particular, the Federal Reserve Board’s Survey of Consumer Finances may not fully reflect the high number of immigrants without accounts. As I explore below, low-income immigrant families rely
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While important challenges remain, some progress has been made in recent years in expanding access to financial services. The period 1995 to 1998 marked a decline in the percentage of low-income families who are unbanked from 25% to 22%. This decline in the percentage of unbanked may reflect, in part, strong economic growth during the late 1990s that improved the incomes of households at the bottom of the income distribution for the first time in decades (although these gains eroded in the last two years). Increases in the EITC increased the take-home pay of low-income workers and helped to increase labor force participation. Welfare reform, beginning with waivers for states to use welfare-to-work strategies and culminating with the 1996 Welfare Reform law, increased the percentage of welfare recipients entering the workforce. Greater workforce attachment and higher incomes may have increased the benefits of bank account ownership and also may have provided more low-income persons with the wherewithal to meet bank minimums or afford bank fees. Account ownership grew most quickly among groups at or below the poverty threshold and the next largest gains came from those just over the poverty line.

In addition to these economic gains, advances in technology, the spread of ATMs and POS terminals, and improvements in payments system efficiencies have lowered the cost and improved the distribution of payments systems that could benefit the poor. Some small-scale governmental and private initiatives may have contributed to this trend. The U.S. Department of the Treasury’s efforts to increase electronic payment of federal benefits and a Treasury “First Accounts” pilot project to reach the unbanked have also helped to spur innovation. Recently, partly in response to these government initiatives, some banks, thrifts, and credit unions, as well as community-based organizations, have begun to experiment with products designed to serve the needs of low-income individuals, and to serve the growing Hispanic market in ways that may benefit low-income persons generally. These nascent efforts provide the heavily on financial services (in particular, wire transfers) to send remittances back to family members in their country of origin. Recent efforts to expand financial services for Hispanic immigrant communities, therefore, may be critical to expanding bank account ownership to some segments of the poor. See infra Subsection III.B.4.

27 See Kennickell et al., supra note 1, at 2, 12. The percentage of unbanked families continued to decline somewhat through 2001. See Aizcorbe et al., supra note 1, at 9.


29 Hogarth et al., supra note 20, at 19.

30 See infra Subsection III.B.1.
B. The Costs of Being Unbanked

The consequences of not having access to mainstream financial services can be severe. High-cost financial services reduce disposable income for those least able to afford it. Such services reduce the value of government transfer programs, including the EITC, and may undermine federal and state initiatives to improve workforce participation and reward work. Lack of access to mainstream financial services also undermines the ability of the poor to save and to access credit, reducing their long-term wealth. Low-income people using check cashers may be more susceptible to robbery because they tend to cash their entire paycheck at regular time periods. Additionally, reducing inefficiencies in the payments system for the poor may have modest positive effects on the economy.

First, the “unbanked” face high costs for basic financial services. For example, a 2000 Treasury study found that a worker earning $12,000 a year would pay approximately $250 annually just to cash payroll checks at a check-cashing outlet, in addition to fees for money orders, wire transfers, bill payments, and other common transactions. Almost all of the checks cashed at check cashers pose relatively low risk: Payroll payments—with low credit risk that could be directly deposited by electronic means, instead of by check, into bank accounts, at significantly lower costs to the payment system—constitute 80% of checks cashed at these check cashing outlets. Another 16% are government benefit checks, which again pose low risk. A large portion of these checks could...
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presumably be directly deposited into bank accounts at relatively low cost—if low-income people had bank accounts.\textsuperscript{35}

The costs of these basic financial transactions reduce the effectiveness of federal income transfer programs such as the EITC and may undermine public initiatives to move families from welfare to work. High cost financial services reduce effective take-home pay. Moreover, studies of the EITC suggest that higher take-home pay from the EITC helps to induce labor force participation.\textsuperscript{36} One survey found that forty-four percent of a sample of EITC recipients in inner city Chicago used a check cashing service to cash their government refund check.\textsuperscript{37} Nationwide, in 1999, nearly half of the $32 billion in EITC refunds provided to over 18 million low-income families were distributed through refund anticipation loans, costing EITC recipients $1.75 billion for tax preparation services, electronic filing, and loan fees.\textsuperscript{38} The high price of converting income checks into liquid form (e.g., cash) may reduce the efficacy of the EITC in encouraging workforce participation because it reduces take-home pay (and reduces it more, the more the person earns), or at the very least these transaction costs significantly increase the taxpayer's costs (the "compliance" costs) of the program.

Similarly, although the jury is still out on the long term effects of the 1996 Welfare Reform law, some studies suggest that welfare programs that encourage work, coupled with policies that let families keep more of their earnings before benefits are reduced or eliminated, have helped to increase workforce participation and job retention.\textsuperscript{39} The positive effects of welfare reform on workforce participation and income generation, however, may be undermined by high-cost check-cashing services that reduce the effective income of those who are beginning to earn wages.\textsuperscript{40}

\begin{footnotesize}
35 \textit{See infra} text accompanying notes 401-402 (discussing conversion of checks to direct deposit).

36 \textit{See} HOTZ & SCHOLZ, \textit{supra} note 9, at 49-50 (summarizing wide range of studies finding consistent evidence that EITC increases labor force participation and hours worked, particularly for single mothers). Empirical work is needed to document the labor force effect, if any, of high-cost financial services. In addition to the federal EITC, seventeen states (including the District of Columbia) have state EITCs, usually structured as a percentage of the federal credit. \textit{See CENTER ON BUDGET AND POLICY PRIORITIES, A HAND UP: How STATE EARNED INCOME TAX CREDITS HELP WORKING FAMILIES ESCAPE POVERTY IN 2003} 1 (2003), at http://www.cbpp.org/3-3-03sfp.pdf. The federal EITC was responsible for lifting 4.3 million individuals out of poverty in 1997. \textit{See COUNCIL OF ECON. ADVISORS, ECONOMIC REPORT OF THE PRESIDENT} 114 (1999).

37 Timothy M. Smeeding et al., \textit{The EITC: Expectation, Knowledge, Use and Economic and Social Mobility}, 53 NAT'L TAX J. 1187, 1202 tbl.5 (2000).


40 There is some evidence that check cashers may see the welfare-to-work population as a
\end{footnotesize}
Even in the bulk of states that have moved to EBT for welfare payments, welfare recipients may still face high costs for financial services: First, administrative problems in some state programs make it hard to withdraw sufficient funds for bill payment (e.g., monthly rent). Second, most EBT programs do not link recipients to bank accounts, which means that these recipients need to find other means to convert their work income to cash, to pay bills, to save funds, and to access credit. Third, once welfare recipients are working, payroll checks and EITC refunds to these individuals would push them towards high cost transaction services. In turn, welfare recipients may be dissuaded from opening a bank account because they believe, sometimes mistakenly and sometimes correctly, that their bank account balances will cause them to exceed state welfare program asset limits.

Second, low-income families need to save to cushion themselves against personal economic crises, such as injury or loss of a job, and for key life events, such as buying a home, sending their children to college, or entering old age. Low-income households face key barriers to increased saving, and their low income leaves them little opportunity to save. Because they are poor, they face higher opportunity costs for putting their funds toward savings rather than current consumption. In turn, because the poor accumulate little, financial institutions face high costs in collecting their savings relative to the amounts saved, and will thus be reluctant to expend the resources to open accounts for them or will offer them low returns on their savings, further reducing any incentives the poor have to save. Low-income families, particularly those without bank accounts, often lack any regular mechanism to save, such as payroll deduction plans, further reducing the likelihood that they will do so.

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41 JOHN CASKEY, CONSUMER FED'N OF AM., BEYOND CASH-AND-CARRY: FINANCIAL SAVINGS, FINANCIAL SERVICES, AND LOW-INCOME HOUSEHOLDS IN TWO COMMUNITIES, at i (1997); Hogarth et al., supra note 20, at 8. In some states, account balances will cause recipients to lose eligibility under some circumstances. See CORP. FOR ENTER. DEV., 2002 FEDERAL IDA BRIEFING BOOK: How IDAs AFFECT ELIGIBILITY FOR FEDERAL PROGRAMS 3-5. Where asset limits are a barrier to account ownership, they should be reformed; in other states, financial education for welfare recipients should be undertaken. Similarly, the federal food stamp program, the Supplemental Security Income program of Social Security, and Medicaid contain counterproductive asset limits.

42 I address further policy responses to these issues in an article in progress, see SHERRADEN & BARR, supra note 1.

43 For a fuller exposition of this argument, see generally ABHUIT V. BANERJEE, CONTRACTING CONSTRAINTS, CREDIT MARKETS AND ECONOMIC DEVELOPMENT (MIT Dep't of Econ., Working Paper No. 02-17, 2001).

44 See generally Sondra G. Beverly & Michael Sherraden, Institutional Determinants of Saving: Implications for Low-Income Households and Public Policy, 28 J. SOC. ECON. 4 (1999). One means of changing this pattern is for foundation or governmental programs to provide matching funds; increasing the size of funds saved will make account provision more cost effective for financial...
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In a survey of New York and Los Angeles low-income neighborhoods, 78% of the banked held some form of savings, broadly defined, while only 30% of the unbanked had savings.\(^{45}\) Obviously, the ability to save is a function of income. But differences remain even after controlling for income. Across income ranges, being banked is highly correlated with saving.\(^{46}\) Of course, bank account ownership may well be correlated with willingness and ability to save. Thus, one would need to measure differences in propensity to save in order to determine whether and to what extent account ownership itself is a strong factor in increasing savings.\(^{47}\)

Bank accounts can be important entry points for the provision of regular savings plans for low-income workers through payroll deduction. Still, most low-income workers work for firms without savings plans or are themselves not covered by such plans even when their employers have savings plans. Even the tax system, through which the bulk of government savings benefits are provided, disproportionately subsidizes savings for higher- rather than low-income households. The Treasury Department estimates that more than two-thirds of tax expenditures for pensions go to households in the top 20% of the income distribution, while the bottom 40% get only 2% of the tax benefit.\(^{48}\)

Promoting low-income household savings is critical to lowering reliance on high-cost, short-term credit, lowering risk of financial dislocation resulting from job loss or injury, and improving prospects for longer-term asset building through homeownership, skills development, and education. Evidence to date suggests that low-income individuals can save if given the opportunity to do so, at least if offered a significant matching contribution. Some 73% of federal employees earning $10,000 to $20,000 annually participated in the federal government’s Thrift Saving Plan, which provides a government matching contribution, and over half of those earning under $10,000 also participated.\(^{49}\) The 2001 Survey of Consumer Finances found that 30% of families in the bottom income quintile saved in the prior year, and 53.4% of those in the next quintile institutions and may increase the level of personal saving by low income households. See infra Section V.A.

\(^{45}\) See Dunham, supra note 19, at 39-40.

\(^{46}\) Id. at 41.

\(^{47}\) For evidence that financial planning influences wealth accumulation, see John Ameriks et al., Wealth Accumulation and the Propensity to Plan (Nat’l Bureau of Econ. Research, Working Paper No. 8920, 2002).


Savings account features have an appeal for the unbanked. In a Treasury survey of unbanked federal check recipients, respondents were aware that an ETA savings feature would only pay a nominal rate of interest (explicitly posed in the survey as "$2 annually on a $100 deposit"), but this feature would account for approximately 25% of the typical respondent's decision on whether to enroll in the ETA.51

Some lower-income individuals use alternatives to bank accounts to facilitate savings. Anecdotal evidence exists that low-income people purchase money orders with their paychecks at the beginning of the month and hold them for later use. In so doing, they convert their income and benefits into a more illiquid and protected form, either for bill payment later in the month or as "savings" for planned and unplanned expenditures in the future.52 Researchers have also found that low-income taxpayers over-withhold their income taxes more frequently than higher income taxpayers; some economists suggest that these taxpayers use withholding as an automatic savings mechanism. This may suggest that demand for savings products among the poor is high enough that some will accept a zero or negative interest rate.53

Third, without a bank account, it is more difficult and more costly to establish credit or qualify for a loan. A bank account is a significant factor—more so, in fact, than household net worth, income, or education level—in predicting whether an individual also holds mortgage loans, automobile loans, and certificates of deposit.54 After controlling for key factors, one study determined that low-income households with bank accounts were 43% more likely to have other financial assets than households without bank accounts.55 Low-income persons without bank accounts face higher costs of credit than low-income persons with accounts,56 and in any event, low-income households generally face higher

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50 Aizcorbe et al., supra note 1, at 5, tbl.1.
51 ED BACHELDER & ISABELLE AGUERRE, DOVE ASSOS., ETA CONJOINT RESEARCH 60 (1999) [hereinafter ETA CONJOINT RESEARCH].
52 Postal savings orders offer protection if lost or stolen and are backed by the USPS.
53 See Jannett Highfill et al., Tax Overwithholding as a Response to Uncertainty, 26 PUB. FIN. REV. 385 (1998).
54 Hogarth & O'Donnell, supra note 20, at 463. There may be personal characteristics of those owning bank accounts—such as propensity to plan, budget, be thrifty, and save—that are not fully captured by this analysis and that may account for better savings and credit outcomes.
56 Credit scoring innovations may increase the benefits of account ownership for low- and moderate-income persons. For example, Experian has developed a credit scoring system using transaction account records. Given the limited credit histories of low-income customers, they are often turned down for loans even though they might be good credit risks, simply because their credit histories are "thin." If the credit-worthiness of low-income customers with bank accounts can be assessed based on transaction performance, they will have increased access to credit. Thus far,
costs of credit than households with higher incomes. In effect, low-income individuals must pay more to transform their labor into productive capital and are thus "under-rewarded for their talent." Moreover, as noted above, the savings products, including bank accounts, that low-income persons can access generally provide low levels of return, which reduces their income growth and may lower incentives to save. This lower saving rate is a problem itself and further increases the cost and reduces the availability of credit to these households, which is at least in part a function of their savings.

Low-income families find it difficult simply to make ends meet each month and lack access to short-term credit at a reasonable cost to smooth out earnings. The main complaint of low-income families, for example, in Caskey's study, was the "insecurity and stress associated with living from paycheck to paycheck." Most low- and moderate-income households manage to spend all their income each month. Bank account ownership will not suddenly change that, but account ownership may make it easier for low-income households to manage their finances, save even if in modest amounts, and access lower-cost forms of credit.

It is difficult to determine causation, but a lack of account ownership is correlated with credit problems. Either unbanked low-income persons have lower propensities to plan financially than other low-income households, or lack of a bank account makes it harder to plan and save. In turn, once credit problems emerge, credit-impaired individuals have a harder time getting access to bank accounts. In Caskey's survey of low-income households, 42% of unbanked households were two months late on bills in the last year, compared with 28% for banked households; 41% of unbanked households were contacted by a debt collection agency in the past year, compared with 25% for banked families. When low-income unbanked families need to borrow, they must turn to expensive forms of credit. Only 14% of unbanked poor families carry credit cards that might help them smooth out payment for short-term increases in consumption or to weather occasional dips in income, while 59% of low-income banked

Experian reports that its credit scoring system is only half as predictive of credit behavior as traditional scores but still provides better information than would otherwise be available for loan applicants with "thin" files, who without more credit information would be turned down for a loan. See W.A. Lee, Debit Scores May Gauge Subprime Market, AM. BANKER, Feb. 28, 2002, at 10.

58 Id. at 27.
59 Caskey, Reaching Out, supra note 20, at 83.
60 Hogarth et al., supra note 20, at 23 (75-83% of low and moderate-income households reported spending all their income each month); Sherrie L.W. Rhine et al., The Role of Alternative Financial Services Providers in Serving LMI Neighborhoods 17-18 (Mar. 2001) (unpublished manuscript, on file with author) (noting that 22% experienced financial distress in past year).
61 See infra note 287 and accompanying text (discussing ChexSystem and related barriers to account ownership).
62 Caskey, Reaching Out Manuscript, supra note 21, at 5.
households carry credit cards. Again, we do not know whether unbanked households without credit cards would be able to handle such cards if they became banked.

Account ownership in and of itself is no panacea, however; even low- and moderate-income individuals with bank accounts often lack savings and turn repeatedly during the year to payday lenders (who charge on average 474% APR), and to other forms of high-cost credit. Low-income families often lack health insurance, and those without savings or access to informal networks of family and friends often use payday loans when faced with expenses related to birth or illness. Individuals may also borrow, of course, for less basic reasons, such as entertainment, splurges, gambling, and the like. Policy cannot, even if it were desirable, easily distinguish between the two kinds of borrowing. In my view, it is appropriate to increase opportunities for low-income persons to borrow at lower cost, even if some portion of the borrowing is taken out for reasons some may disfavor. Thus, I argue in Part V that strategies to bring low-income persons into the financial services mainstream need to include initiatives designed to increase savings for short-term financial stability and to improve access to less expensive forms of credit where appropriate—for example, with overdraft protection, account-secured loans, credit cards or loans with automatic withdrawals from pay directly deposited into accounts, but with significantly longer terms than payday loans.

Fourth, low-income families who cash their paycheck may face high risk of robbery or theft. By transitioning into bank accounts where they can store a portion of their earnings, withdraw funds in smaller amounts,
pay for goods or services directly using debit, and withdraw funds outside of the concentrated time periods during which benefit checks and paychecks are commonly cashed, these families can decrease their exposure to risk of crime.

Fifth, inefficiencies in the payments system impose costs on the national economy. Increasing the efficiency in the payments system for the poor could have modest positive effects on the economy as a whole. A Federal Reserve Board study suggests that the U.S. economy would save over $1 for each check that is converted to an electronic payment. The study estimates savings of $30 billion per year if one-half of current check volume is converted to electronic payment. Check processing costs between 0.25% and 1% of U.S. GDP, in addition to losses from fraud. While low-income check volume is only a small fraction of the total, electronic payments for the poor could help, and, because of positive network externalities, funds spent converting the poor to electronic payment might speed conversion to electronic payments more generally. Helping low-income households to leapfrog over checking to electronic payments, just as some poor countries have been able to leapfrog over conventional telephone lines to cell or satellite phones, may thus have broader societal benefits. These effects, though positive, are of course likely to be quite small in relation to the overall economy.

II. The Alternative Financial Sector

The previous Section summarized the costs of being unbanked. This Part explores in depth the growing number of AFS providers, offering a wide range of services, including short-term loans, check cashing, bill payment, tax preparation and rent-to-own consumer goods, in low-income urban neighborhoods. These AFS providers, and others like them, are currently the only means available for many low-income persons to access

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68 Id.
70 See Swagler et al., supra note 4. I focus on check cashers, payday lenders, auto title lenders, and refund anticipation lenders. AFS also include pawnbrokers. See generally CASKEY, FRINGE BANKING, supra note 6. This Part is largely focused on urban areas. Rural areas have different characteristics. See, e.g., CASKEY, FRINGE BANKING, supra note 6; Michael A. Stegman, Banking the Unbanked: Untapped Market Opportunities for North Carolina's Financial Institutions, 5 N.C. BANKING INST. 23 (2001). Most Native American reservations are essentially devoid of insured depositories. See U.S. TREASURY & HUD, ONE-STOP MORTGAGE CENTER INITIATIVE IN INDIAN COUNTRY: A REPORT TO THE PRESIDENT (2000), available at http://www.huduser.org/publications/pubass/tonestop.html.
basic financial services. Understanding the costs and benefits of such services is critical to assessing the need, if any, for alternatives.

A. Check Cashers

1. Industry Overview

For many years, check cashers have been used by low-income individuals who seek to conduct basic financial transactions such as cashing checks, paying bills and wiring funds. John Caskey referred to these customers as employing the "cash and carry" method of financial management. Upon receiving a paycheck, they cash the check and pay their bills immediately. While check cashers offer essential services, the fees involved in converting paper checks into cash are high, relative to an alternative world in which low-income households would be able to rely more on direct deposit into bank accounts.

The check-cashing industry grew dramatically during the 1980s and 1990s. Today, there are almost 10,000 stores in the U.S. that classify their primary line of business as check cashing, about double the number there were six years ago, and almost five times the number there were fifteen years ago.\footnote{Dove Report, supra note 2, at 13-14. This figure excludes the many thousands of convenience stores, liquor stores and grocery stores that offer check cashing services, for a fee or with purchases, to their customers. While these alternative providers are important financial service points for much of the low-income population, this Section focuses largely on the growing industry represented by "full-time" check cashers that offer a broader variety of financial services.} The industry reports that it processes 180 million checks totaling $55 billion annually, generating $1.5 billion in fees.\footnote{See Fin. Serv. Ctrs. of Am. (FiSCA), About FiSCA, at http://www.fisca.org/about.htm (last visited Dec. 8, 2003).} Most of these checks are low-risk payroll or government benefit checks: 80% of checks cashed at surveyed check cashers in the 2000 Treasury study were payroll checks, while 16% were government benefit checks.\footnote{Dove Report, supra note 2, at 9.} While even payroll checks are not without some credit and fraud risk, average losses from "bad" checks at check cashing firms are low. For example, Ace Cash Express (ACE) reports that 0.5% of the face value of checks bounce, but net losses after collection are 0.2%.\footnote{See ACE Cash Express, Inc., 2001 Annual Report 19 [hereinafter ACE Annual Report].} By comparison, 0.64% of the face value of interbank checks were returned in 2000.\footnote{There were 42.5 billion check payments in 2000 for a total of $39.3 trillion; 0.85% were returned for insufficient funds (some checks were returned more than once). The average value of a returned check was $700. Geoffrey R. Gerdes & Jack K. Walton II, The Use of Checks and Other Non-Cash Payment Instruments in the United States, 88 Fed. Res. Bull. 360, 360, 364-65 (2002).}

Like the banking industry, the check cashing industry has undergone consolidation in recent years. Larger players are benefiting from greater
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economies of scale, shared technology platforms, and their ability to negotiate alliances with service providers (lenders, money transfer services, and ATM networks, among others).\textsuperscript{76} ACE, the largest check cashing chain in the country, grew from 452 outlets in 1995 to 1,163 outlets in 2001, largely through acquiring independent stores and smaller chains. While check cashing remains a fragmented market overall, with 80\% of the market divided among independent operators and small regional chains, national chains such as ACE capture a disproportionate share of check cashing revenues with their strategic and numerous locations, broader product lines, higher volumes, and generally higher prices for check cashing.\textsuperscript{77}

The industry’s growth has been accompanied by growing diversification of the products and services offered. Nearly all respondents to the 2000 survey provided a core of services: check cashing, money orders, and wire transfer.\textsuperscript{78} Many also provided an array of other products including lottery tickets, postage stamps, prepaid telephone cards, payday loans, bill payment, municipal services (such as the paying of parking tickets), and distribution of state benefits. These ancillary services increase revenue per customer while also broadening the industry’s customer base beyond the unbanked population. For instance, Dollar Financial claims that 50\% of its customers have bank accounts.\textsuperscript{79} The most notable development in recent years has been the rapid growth in check cashers offering payday loan products.\textsuperscript{80} For ACE and Dollar Financial, revenues derived from loan products increased from an average of 4\% of total revenue in fiscal year 1997 to an average of 29\% of total revenue in 2001. Nearly 45 to 50\% of revenue growth at these two firms over that period was attributable to the expansion in payday loan originations.\textsuperscript{81}

Check cashers typically have high transaction volumes and high profit margins, but often on a relatively small revenue base. The average chain outlet in 2000 processed over 8,000 transactions per month, for estimated

\textsuperscript{76} For instance, Ace Cash Express has an exclusive agreement with MoneyGram, and Dollar Financial with Western Union, for transmission and receipt of wire transfers. Information on Dollar Financial and Ace Cash Express in this Subsection is drawn from the companies’ annual reports. \textit{See} ACE \textsc{ANNUAL REPORT}, \textit{supra} note 74, at 5; \textsc{Dollar Fin. Group, Inc.}, 2001 \textsc{Annual Report} 10 [hereinafter \textsc{Dollar Annual Report}].

\textsuperscript{77} \textit{See} DOLLAR \textsc{ANNUAL REPORT}, \textit{supra} note 76, at 15 (noting that chains control only 20\% of the market); \textit{see also} DOVE \textsc{REPORT}, \textit{supra} note 2, at 64-65 (revealing that, compared to independently owned outlets, surveyed chains charged on average of 25\% more for check cashing and generated two-and-half times the check-cashing volume). For money orders, surveyed chains charged 20\% less than independently owned outlets, and generated over three times the revenue, \textit{id.} at 37 fig.6.9, 40 tbl.6.8.

\textsuperscript{78} DOVE \textsc{REPORT}, \textit{supra} note 2, at 25.

\textsuperscript{79} DOLLAR \textsc{ANNUAL REPORT}, \textit{supra} note 76, at 6-7.

\textsuperscript{80} For more on the payday lending industry generally, \textit{see infra} Section II.B.

\textsuperscript{81} Author’s calculations based on DOLLAR \textsc{ANNUAL REPORT}, \textit{supra} note 76, at 22, and ACE \textsc{ANNUAL REPORT}, \textit{supra} note 74, at 5.
annual revenue of $242,500. The estimated pre-tax return on sales for these chain outlets was 28.5%. On average, revenues and returns for independent check cashers were far lower.82

2. Customers

Check-cashing industry clientele are drawn, for the most part, from lower-income urban households. ACE describes its core customer group as having annual family incomes of approximately $30,000, and Dollar indicates that its check-cashing customers’ median household income is $22,500. In most cities, check cashers locate in neighborhoods with below-median incomes and above-average minority population shares.83 Dollar describes its store base as a “mix of urban sites, which are located in high-traffic shopping areas, and suburban sites, which are located in strip malls near multi-family housing complexes.”84

Check cashers do not provide financial services to only unbanked consumers, nor do all unbanked consumers obtain their financial services primarily through check cashers. The story is much more complex, and local context seems to matter greatly. In lower-income neighborhoods of New York and Los Angeles, for instance, 71% of unbanked individuals who cashed checks primarily used check-cashing outlets, as did 28% of banked individuals.85 In Atlanta, Oklahoma City, and eastern Pennsylvania, only 17% of unbanked individuals cashed checks at a check cashier; almost half used a bank.86 In Chicago, about two-thirds of all households who accessed some form of financial services at check cashers were found to have bank accounts, but, as one would expect, unbanked households are much more likely to use check cashers than are banked households.87 Banco Popular reports that 38% of the customers at Popular Cash Express own a checking account, and 33% own a savings account.88

82 DOVE REPORT, supra note 2, at 65.
84 DOLLAR ANNUAL REPORT, supra note 76, at 4.
85 Dunham, supra note 19, at 36-37.
86 JOHN CASKEY, FILENE RESEARCH INST., LOWER INCOME AMERICANS, HIGHER COST FINANCIAL SERVICES 22 (1997) [hereinafter CASKEY, FILENE INSTITUTE REPORT]. This finding that half of the unbanked cash their checks at a bank is echoed in a survey of current and former North Carolina welfare recipients. See STEGMAN & FARIS, supra note 33.
87 Rhine et al., supra note 20, at 68. Unbanked households are 14.6 percentage points more likely than banked ones to use check cashers. Unbanked households in LMI areas are 7.6 percentage points more likely to use check cashers than banked elsewhere. Unbanked black households are 17.8 percentage points more likely than unbanked white households to use check cashers. Unbanked Hispanic households are 7.5 percentage points more likely than unbanked white households to use check cashers. Id.
Not all of the unbanked use or pay for these services or pay high fees. While there is great regional variation and much further study is needed, a large portion of the unbanked manage to avoid paying high costs for at least some of their financial services. For example, in one study, Caskey found that only 20%-40% of unbanked survey respondents paid fees to cash checks. In another study, in New York and Los Angeles, more than half of the unbanked reported incurring no cost to cash checks, either because they receive their income in cash or have no income (33%) or cash their checks for free at banks and grocery stores (16%). The unbanked mostly use check cashers to cash checks. When low-income households use banks to cash checks, they usually use the bank of issue, rather than their own or some other bank. Most likely, these represent efforts by workers to cash payroll or personal checks “on-us” at the employer’s bank. For the portion of such checks that are payroll checks, rather than personal checks, direct deposit could become an alternative to check-cashing, or to the costly use of bank teller and processing time (for which some banks are beginning to charge non-customers).

Check cashers appear to capture both some portion of the unbanked population and some portion of the banked population as customers. Why might individuals with bank accounts be drawn to check cashing outlets? Some may be living from paycheck to paycheck, do not have direct deposit offered by their employer(s), and find that they lack sufficient liquidity to wait the two-to-three days for their bank to clear access to funds from a deposited check. Others might regularly wire money to relatives abroad, which, until recent adoption of dual ATM-technology at some banks, was generally less expensive at check cashers than at banks. Still others may not be able to afford the fees or minimum balances associated with checking accounts and thus might own only a savings account without any capacity for transactional services. Some may need to make bill payments by purchasing money orders at a check cashier, either because they live in a neighborhood where personal checks are generally not accepted, or because they do not have a checking account. A portion may favor the more convenient hours, locations, culture, or languages spoken at check cashers, and not be willing to use ATMs.

One attribute that may distinguish some users of check cashers, both banked and unbanked, from other low-income workers who use banks, may be the nature of their work arrangements. Dollar Financial states that “many of its customers are workers or independent contractors who receive payment on an irregular basis and generally in the form of a

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89 See Caskey, Reaching Out, supra note 20, at 83.
90 Dunham, supra note 19, at 53 fig.6.
91 Id. at 36-37.
92 See infra Subsection III.B.4.
check.\textsuperscript{93} Although little independent analysis exists to corroborate Dollar's assertion, it makes sense on its face.\textsuperscript{94} These workers do not have the benefit of a steady relationship with an employer that would tend to support a direct-deposit relationship with a bank, nor do they generally have the employment references that are often required to open a bank account. In addition, many undocumented immigrants work within this informal economy and, in many cases, their undocumented status makes it less likely that banks will open bank accounts for them.\textsuperscript{95} A Treasury study found a significant correlation between outlet location and the percentage of working adults in the neighborhood who annually worked less than fifty weeks total, although the report also found such a connection between outlet locations and low neighborhood income; the two variables are likely correlated rather than independent.\textsuperscript{96} Given that 80\% of checks cashed at check cashers are payroll checks, and another sixteen percentage points are government checks, it should be possible to convert a large portion of these checks to direct deposit if low-income workers had access to bank accounts. Even for part-time workers, large employers or temporary employment firms can convert income checks to direct deposits.

3. Costs

As with most businesses in the retail sector, regional variations abound in the prices that consumers pay for services offered through check cashers.\textsuperscript{97} The Dove survey revealed that, across the four markets studied (Atlanta, Boston, San Antonio, and San Diego), check cashing prices were sensitive to differences in cost-of-living and level of competition. In San Antonio, where wages were lower and AFS competition greater, fees to cash payroll and government checks averaged about 1.5\% of the check face value. In Boston, where higher costs of living prevailed and one chain dominated the AFS market, average fees were 2.5\% of the check value. Atlanta and San Diego fell somewhere in between these figures. Fees to cash personal checks were much higher, but most outlets refuse to cash such checks given their greater risk. Across the four markets, chain outlets charged a higher percentage fee on average than did independent

\textsuperscript{93} DOLLAR ANNUAL REPORT, supra note 76, at 8.
\textsuperscript{94} There is, however, a great deal of evidence that users of check cashers are much more likely to be unemployed than those who use banks. See John Caskey, The Future of Commercial Check-Cashing (Jan. 2002) (unpublished manuscript) (on file with the author).
\textsuperscript{95} For progress in this regard, however, see infra text accompanying notes 298-301 (discussing matricular identification and growth of competition for delivery of remittances).
\textsuperscript{96} See DOVE REPORT, supra note 2, at 49, 54, 57, 60.
\textsuperscript{97} Available sources focus on large chains of stand-alone check cashers and do not reveal a great deal about the variability in pricing for check cashier products, nor do they reflect the differential effects of state regulation on check cashier prices. However, they are sufficient to give a sense of what some consumers pay to access basic financial services in the AFS.
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operators. ACE’s fees for cashing payroll checks average 2.2% of the face amount of the check, and Dollar’s fees average 3.3%. Chain check cashers processed an average of 3,400 money orders per month. Fees for money orders were only fifty to sixty cents, and were lower at chains due primarily to the favorable contracts they are able to negotiate with money order suppliers. Money order fees at check cashers are lower than those charged by most banks, whose customers mostly do not use them. In addition, the U.S. Postal Service, for purposes of comparison, charges ninety cents for a domestic money order under $500, and $1.25 for money orders of $500 to $1,000.

Overall costs for using check cashers vary dramatically by patterns of usage. With respect to bill payment services, only 36% of the unbanked surveyed in New York and Los Angeles overall incur money order or bill payment fees from check cashers. Many of the unbanked in that survey received cash income, had no income, or were able to cash their income checks at banks or stores, often at little or no fee. Of those paying check cashing fees at check cashers, two-thirds incurred costs of less than $100 annually. The one-third of those surveyed who incurred more than $100 annually comprise only 11% of the total unbanked participants in the survey. Thus, the study suggests that, at least in New York and Los Angeles, the highest cost of using alternative financial service providers may be relatively concentrated among a portion of the unbanked.

To get a sense of the costs to a consumer who conducts most of his financial business through a check-cashing outlet, however, consider a customer that Dollar might describe as among its typical clients—a young, immigrant day laborer with intermittent income and a family at home in Mexico. He perhaps earned about $18,000 last year, but some of it was in cash, and some of it was paid in checks that he could cash for no fee at a local issuing bank. Altogether, he used a check cashier to cash $12,000 in checks, at an average fee of 2% of the check face value—$240 total. Once a month, he wires $500 home to his family, at an average fee of $20, or

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98 See DOVE REPORT, supra note 2, at 34, 48-61, 64.
99 See ACE ANNUAL REPORT, supra note 74, at 4; DOLLAR ANNUAL REPORT, supra note 76, at 8. ACE’s average fee has remained flat, while Dollar’s has grown over the last five years. ACE paradoxically imposes surcharges to cash tax refund checks, ACE ANNUAL REPORT, supra note 74, at 5, which are often large and low-risk; ACE’s ability to surcharge for cashing these checks may be derived from its relationship with major tax preparation services. See infra Section II.D.
100 The Dove finding is corroborated by data from ACE, which indicates an average fee of 57 cents per money order in 2001. DOVE REPORT, supra note 2, at 10 fig.1.3, 33 tbl.6.5, 38 tbl.6.6; ACE ANNUAL REPORT, supra note 74, at 24-25. Dollar’s average fee was higher, at 93 cents. DOLLAR ANNUAL REPORT, supra note 76, at 10.
101 U.S. POSTAL SERVICE, DOMESTIC MAIL MANUAL § 816.0 (2002). Because postal money orders are replaced if lost or stolen, they may also be used by the unbanked simply as a store of value.
102 See Dunham, supra note 19, at 55 fig.9.
103 Id. at 35-36, 43-44, 53 fig.6, 56 fig.11.
104 See id. at 14.
$240 annually. His share of the rent is paid in cash, but he purchases three money orders a month to pay the apartment's electric bill, his cellular phone bill, and his car insurance. At fifty-five cents each, he pays $20 for money orders annually. All together, these fees would add up to $500 annually for this low-income consumer, nearly 3% of his annual income.

4. Regulation

The regulatory structure governing check cashing may have some influence on fees. A number of states cap fees that may be charged by check cashers. However, check cashers also partner with national banks, which are permitted to set non-interest charges according to "sound banking judgment"; the Office of the Comptroller of the Currency (OCC) takes the position that state laws limiting or prohibiting such charges are pre-empted.\textsuperscript{105} Other state laws governing check cashers may have an effect on fees. For example, to the extent that they are enforced, state rules limiting the number of check cashers that can operate in a given area may decrease AFS competition and increase check cashing fees.\textsuperscript{106}

5. Reforms

Given the high cost structure of a paper- and labor-intensive industry, it is doubtful that costs of check cashing can be brought down significantly with existing technology.\textsuperscript{107} Reduced state regulatory barriers to entry may help enhance competition if they are accompanied by consistent disclosure requirements and enforcement that would make it easier for consumers to shop for financial services. Some have suggested that banks themselves, with cheaper (direct) access to the payments system, might effectively compete for check-cashing services.\textsuperscript{108} This Article argues that it would be cheaper, and the services provided more useful, if banks were to compete

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\textsuperscript{105} The OCC's position on non-interest charges is functionally similar to a national bank's authority to "export" the interest rate permissible for the national bank to charge in its home location to the state where it is making the loan. See 12 C.F.R. § 7.4001 (2003); see also 12 U.S.C. § 85 (1994) (defining permissible rates of interest as determined by state where bank is "located"); Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299 (1978) (finding that national bank may "export" usury law of state in which bank is headquartered to customers in another state). Exportation is also available to state-chartered banks, 12 U.S.C. § 1463(g) (2003). Interest rate exportation is discussed in further detail below, infra Sections II.B (discussing payday lending) and II.C (discussing title loans).

\textsuperscript{106} See, e.g., N.J. STAT. ANN. § 17:15A-41.e (West 2003) (determining check casher may not be licensed to operate within 2,500 feet of another check casher); N.Y. BANKING LAW § 369 (Consol. 2001) (determining check casher may not be licensed to operate within three-tenths of a mile of another check casher).

\textsuperscript{107} See infra Section IV.B (discussing technological developments). Many of the technological developments thus far employed by payday lenders and check cashers do not seem to have brought down prices for consumers.

\textsuperscript{108} See Caskey, Reaching Out, supra note 20.
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with check cashers by offering electronically based banking services, instead of competing with them as check cashers. Advances in direct deposit, debit card infrastructure, and electronic bill payment will also be required to bring down the costs of income conversion.

B. Payday Lending

Payday lenders provide short-term consumer loans to low- and moderate-income working people who have bank accounts. In the traditional "payday loan" transaction, the borrower writes a postdated (or undated) personal check to a lender. In return, the lender advances the borrower a cash amount equivalent to the face value of the check minus a finance charge. The lender holds the check before either depositing it or, more commonly, receiving cash repayment directly from the borrower, usually on the borrower's payday. In an updated form of the traditional transaction, no check is written; instead, the borrower signs an authorization that permits the lender to debit his bank account on a future date for the amount of the loan plus the finance charge. Loan terms are typically two weeks. Payday lending has become controversial because of concerns that the loans are expensive; that the structure of the product—a short term loan with a balloon payment and high fees—leads to defaults or borrowers falling into a "debt trap" as they repeatedly "roll over" the loan; and that payday lenders use misleading disclosures and aggressive collection.

1. Industry Overview

Commercial check-cashing outlets have been in the United States since the 1930s. Payday lenders, on the other hand, did not operate as a formal industry until the early 1990s, although the short-term lending function has long been filled by pawnshops, auto title lenders, retail installment credit, and loan sharks, to name a few. As Caskey notes, most payday lenders prior to the 1990s were check cashers that made payday loans as a casual extension of their core business; he estimates that there were probably fewer than 200 at the time. By 2000, there were more than 10,000 payday lenders doing business in the U.S., with $2

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109 As an illustration of payday lenders' recent emergence as a formal sector, the Nexis news search service finds no occurrences of the word "payday loan" prior to a few articles in 1994 in some newspapers in the southern U.S. (although as noted in the text, other forms of short-term lending were certainly available). By contrast, the word "check casher" turns up in New York Times articles dating back to the late 1960s—as far back as the database goes.

billion in revenue. Major pawn chains recently have entered the payday lending business.

Payday lenders annually make about sixty-five million loans to between eight and ten million households, totaling more than $10 billion in loan value in recent years. The industry reports gross margins of 30%-45% of revenue, with losses at 1%-1.3% of receivables and return on investment of 24%. As in the check-cashing industry, consolidation has created a few large payday lender chains with an important presence across markets, although the industry overall remains rather fragmented. The three largest "monoline" chains have 2,600 outlets combined. While the payday loan industry nationwide grew significantly in the 1990s, its growth was uneven, with widely varying penetration rates in different states. Florida and Illinois, for instance, are each home to about 500 outlets, while the smaller states of North Carolina and Missouri have 900 and 800 outlets, respectively. The State of California, home to about one in eight persons in the U.S., is home to about one in five of the nation’s payday lenders. As Comptroller of the Currency John D. Hawke, Jr., has noted, "California alone has more payday loan offices—nearly 2,000—than it does McDonalds and Burger Kings . . ." This patchwork of growth and concentration may be related to divergent and changing state regulations governing payday lending.

Payday loan prices in a number of states would have routinely exceeded the statutory limits on permissible interest rates codified in state usury laws. In the 1990s, however, the industry focused on carving out exceptions from these laws for their loans. Moreover, payday lending has occurred at rates above state usury ceilings through arrangements

113 See CFA/PIRG REPORT, supra note 40, at 4-5; Robinson & Lewis, supra note 111, at 9; FiSCA, Deferred Deposit/Pay Day Advance Fact Sheet, available at http://www.fisca.org/defdepfacts.htm (last visited Nov. 28, 2003).
114 See Robinson & Lewis, supra note 111, at 10.
115 CFA/PIRG REPORT, supra note 40, at 4.
118 See supra text accompanying notes 105-06 (discussing state check cashing laws) and infra notes 163-87 (discussing state payday lending laws).
119 CFA/PIRG REPORT, supra note 40, at 27.
between out-of-state banks, thrifts, and payday loan originators. Generally speaking, under the National Bank Act, the payday lender may arrange a loan between the bank and the borrower at terms that are subject to the interest rate ceiling (if any) in the home state of the bank, not to interest rate ceilings of the state in which the payday lender is located. Under many of these arrangements, however, once the loan is booked, the payday lender immediately purchases the entire loan from the bank, with the bank retaining little or no risk. In effect, the lender has “rented” the bank’s name for purposes of making a legal loan. State-level efforts to restrict payday lending had been stymied by partnerships between national and state-chartered banks and thrifts, and payday lenders, many of which have now been shut down by banking regulators.

The advent of bank-nonbank partnerships in payday loan origination has led to increased technological sophistication to compete with payday lenders that approve loans “on the spot.” When a potential borrower completed a loan application at an ACE location, ACE transmitted the borrower’s data electronically to its former partner Goleta National Bank. If Goleta approved the loan, it opened a bank account in the name of the borrower, and activated a debit card and PIN connected to that account. ACE delivered the card and PIN to the borrower, who could withdraw the funds at the store or at another retail ATM. The annual report states that this process, from start to finish, took only twenty minutes.

The drive towards consolidation in the payday lending industry might be expected to improve industry standards. Smaller independent businesses may be more likely to write out loan forms manually, which may increase the likelihood of error and violation of truth-in-lending laws. Smaller firms also may not have access to the TeleTrack service, a tool that many lenders use to reduce their risk by determining whether the applicant has other outstanding payday loans or credit problems. In theory, partnerships with insured depositories could have improved standards, but evidence to date suggests the opposite. For example, a

120 See supra note 105.
121 In January 2002, the OCC directed Eagle National Bank, partner with Dollar Financial Group in such an arrangement, to cease its payday lending operations. Comptroller John D. Hawke, Jr. said: “The bank essentially rented out its national bank charter to a payday lender in order to facilitate the nonbank entity's evasion of the requirements of state law that would otherwise be applicable to it.” Id. For a similar arrangement under which the payday lender assumes most of the loan risk, see CASH AMERICA ANNUAL REPORT, supra note 112, at 27 (“The Bank assigns each advance that remains unpaid after its maturity date to the Company at a discount from the amount owed by the borrower.”). The OCC has essentially shut down payday-national bank partnerships. See infra note 173 and accompanying text.
122 See CFA/PIRG REPORT, supra note 40, at 18-20.
123 ACE ANNUAL REPORT, supra note 74, at 5.
124 TeleTrack is a credit-reporting agency specializing in subprime credit transactions. See CASKEY, FILENE REPORT, supra note 86, at 6.
central basis for the OCC's termination of one bank's payday lending partnership was that the bank was rolling over payday loans multiple times without any assessment of the borrower's ability to repay.125

What explains the incredible boom in payday lending in the 1990s? A combination of factors was at work, probably not dissimilar from the factors that Caskey found were responsible for the rise in check cashing in the 1980s and early 1990s.126 Deregulation in the banking industry increased competition and decreased the availability of less-profitable products, such as short-term, small loans.127 Retailers have largely replaced sales installment contracts with sales by credit cards, limiting financing options for those without credit cards.128 Finance companies, while once essential providers of small loans, over the last decade have focused on home equity financing,129 which can be an important source of liquidity for consumer purchases or debt consolidation, but only for those who are home owners and have equity in their homes. A number of studies in the 1980s and early 1990s found that nearly 20% of U.S. households were credit-constrained.130 Moreover, a growing number of individuals have little to no liquid savings. In a financial emergency, they have no "backup" funds to meet their immediate needs, and may see a payday loan as the only viable solution.131 Moreover, the number of borrowers with adverse credit histories is on the rise.132 Some payday borrowers may be bad risks. Despite the rapid growth of credit card availability, even among low-income families, many of these credit-impaired borrowers are not able to take advantage of credit alternatives such as credit card advances or overdraft lines on their checking accounts. For some credit-impaired individuals, establishing a history of managing a bank account, coupled with financial education may permit them over time to gain access to credit. For others, such access is unlikely ever to occur.

On the supply side, payday lending is a highly profitable enterprise,
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with a return on sales of 30%. Check cashers may see payday loans not only as a profitable product, but also as a way to diversify their customer base, especially in light of a long-term relative decline in the market for checks (as compared to electronic payments).  

2. Customers

The first thing that distinguishes payday loan customers from many check cashier customers is that the former must, by definition, have bank accounts. Lenders are generally unwilling to advance funds to individuals who cannot provide them with proof of account ownership. While payday loan consumers are not unbanked, they could well be referred to as "underbanked": They may lack the savings, credit history, or financial know-how to avoid purchasing a high-cost credit instrument.

Customers that use payday lenders tend to be low- or moderate-income, younger than the average age of the population, and otherwise credit constrained. One study found that half the customers surveyed had household incomes between $25,000 and $50,000. Average annual income for customers in studies done by several states was consistently lower, around $25,000 in each case. Most customers were below the age of forty-five. While younger than the U.S. population as a whole, customers were well into their working life.

With respect to ownership of assets and access to alternative forms of credit, the CFSA study reported that 42% of respondents indicated that they owned their home, consistent with the Illinois finding. In Wisconsin, 26% of respondents were homeowners. Some payday borrowers could tap into their home equity for emergency credit, but bad credit records may preclude that option for others, and the sub-prime home equity loans held by some of these homeowners have their own high costs.

133 See Stegman & Faris, supra note 116, at 10.
134 See generally FED. RESERVE SYS., RETAIL PAYMENTS RESEARCH PROJECT: A SNAPSHOT OF THE U.S. PAYMENTS LANDSCAPE (2002) [hereinafter RETAIL PAYMENTS STUDY] (noting the relative decline of checks as compared to electronic payments, despite continued growth in the absolute number of checks cleared).
135 CFSA STUDY, supra note 131, at 28. Results from the survey should be treated with caution. From a random sample of 5,430 payday loan customers, the study surveyed only 427 individuals—not a representative sample. The study was sponsored by the Community Financial Services Association of America (CFSA), the industry trade association for payday lenders. The survey was conducted during the Christmas shopping season.
136 See CASKEY, PAYDAY LENDING, supra note 110, at 10-12. Caskey notes that because the CFSA study interviewed only customers of monoline payday stores, it may have captured a higher-income population than if payday borrowers from check cashing outlets had been included. Id. at 11 n.24.
137 CFSA STUDY, supra note 131, at 29.
138 CFSA STUDY, supra note 131, at 42.
and risks. In the Illinois study, only 11% of customers had a bank-issued revolving credit card, much lower than overall rates reported for the general population even at the lowest income levels. In one study, 56% of payday customers had credit cards, but payday borrowers were three times as likely to have debt payment-to-income ratios of 30% or higher, and four times as likely to have declared bankruptcy, as compared to the adult population at large.

Another study, controlling for socioeconomic variables, indicated that African-American families, families who had bounced one or more checks in the past five years, and families in neighborhoods where new check cashers and payday lenders had opened were significantly more likely to borrow from a payday lender. Some anecdotal evidence suggests that the decision to use payday loans may be influenced more by past credit problems than by income.

In summary, payday loans are not products for the poorest of the poor. But they seem to be an increasingly popular credit tool among a growing moderate-income working population that has credit problems, often has little savings, and may view payday loans as a convenient, or perhaps only, option for accessing cash in a financial crunch.

3. Costs

Payday loans carry high implicit annual interest rates. A 2001 survey of payday lenders revealed that nearly all charged APRs in excess of 300%. The most common APR quoted by lenders was 390%—the equivalent of a $15 fee on a two-week $100 loan. Nearly a third, however, quoted fees that amounted to APRs of at least 500%; the average APR was 470%. At an average loan size of about $300, the average fee for

139 See BARR, supra note 1 (addressing the problem of sub prime home equity lending).
141 Those holding credit cards constitute 28% of the lowest income quintile, 58% of the next income quintile, and 68% of the adult U.S. population. Thomas A. Durkin, Credit Cards: Use and Consumer Attitudes, 1970-2000, 86 FED. RES. BULL. 623, 626 (2000). Credit card holding among low-income families has been increasing, with the advent of risk-passed credit card pricing, at the same time as payday lending. Bank-type credit card holding increased from 2% in 1970 to 17% in 1989 and 28% in 1995, where it remained in 1998; but the share of outstanding balances of those in the lowest income quintile increased only slightly, from 2% in 1970 to 5% in 1998. In the second lowest income quintile, bank-type credit card ownership increased from 9% in 1970 to 36% in 1989, 54% in 1995, and 58% in 1998; the share of outstanding balances increased from 9% to 13% over the period. Id.
142 CFSA STUDY, supra note 131, at 44-46.
143 See Stegman & Faris, supra note 116, at 18 tbl.5.
145 CFA/PIRG REPORT, supra note 40, at 3.
the average loan is about $54.\textsuperscript{146}

These APRs are, of course, high compared to more traditional credit options like credit cards.\textsuperscript{147} This is due, in part, to the higher transaction costs associated with underwriting and servicing payday loans compared to other forms of credit. Payday loans, unlike credit cards, require lenders to interact face-to-face with borrowers each time they originate a new payday loan. They need to conduct more follow up with borrowers than other lenders, and must charge enough to cover loan losses.\textsuperscript{148} Notwithstanding these differences, high store profitability indicates that prices may be higher than one would expect in more efficient segments of the financial services market. Further research is warranted on possible barriers to further price reductions, including the possibility that variations in state laws raise the costs to national chains seeking to pursue payday lending on a national basis; the possibility that disclosures are not adequately policed so that consumers are not fully informed of prices; and the possibility that these price structures are inherent in the labor-intensive nature of the transaction.

Payday lenders argue that their prices are comparable to one possible alternative for a cash-strapped consumer—bouncing a check.\textsuperscript{149} Bounced check fees, according to a Federal Reserve study, averaged $20.73 at banks in 2001,\textsuperscript{150} so depending on the face value of the bounced check, a payday loan could be a more or less expensive short-term option. Moreover, bouncing a check is not the only response other than a payday loan to the problem of credit constraints.\textsuperscript{151} Payday lenders also argue that an annualized percentage rate is not a fair tool for assessing the price of short-term credit.\textsuperscript{152} APRs are widely used for other short-term credit,

\textbf{Footnotes}

\footnotetext[146]{In its annual report, Ace Cash Express notes that its average loan amount in fiscal year 2001 was $269. \textit{ACE ANNUAL REPORT}, \textit{supra} note 74, at 4.}


\footnotetext[148]{The high APRs and balloon payments that payday lenders charge and their loan losses are mutually reinforcing. That is, costly credit induces loan losses. Loan losses increase the cost of credit. \textit{See generally} Joseph E. Stiglitz & Andrew Weiss, \textit{Credit Rationing in Markets with Imperfect Information}, 71 AM. ECON. REV. 393 (1981).}

\footnotetext[149]{The consequence of not being able to pay when a payday loan comes due—unless a rollover occurs—is either bounced check fees paid to one's bank (and the payday lender) or other forms of collection that are even more costly to borrowers.}


\footnotetext[151]{\textit{See infra} Subsection II.B.5.}

\footnotetext[152]{\textit{See FiSCA REPORT, supra} note 127.
Computing charges on an annual basis simply does not make sense in evaluating the real cost of a short term product whose anticipated usage will seldom exceed 14 to 30 days at the most. \ldots [T]here is a theoretical APR for a deferred deposit
however, such as the monthly balance on bank-type revolving credit cards, even though nearly 60% of card holders pay off their balances at the end of each month.\textsuperscript{153}

Many borrowers, moreover, take out payday loans repeatedly throughout the year. The high incidence of loan renewals, or "rollovers," in the payday loan industry is one of its most salient features. Upon maturity of the loan, many borrowers find themselves unable to repay the loan principal in full. As a result, the lender allows them to pay the finance charge on the loan, and to roll the remaining principal—plus a new finance charge—over into a new loan. A "same-day advance" is a functional equivalent of the rollover. The borrower pays the loan in full, but that same day takes out another payday loan in an amount equivalent to the balance paid earlier. Still other borrowers pay off the loan with proceeds from another payday lender.

Evidence from multiple states points to the fact that significant proportions of payday loan consumers roll their loans over on a frequent, if not habitual, basis.\textsuperscript{154} A study of payday borrowers in Illinois found that the median borrower had more than ten loan contracts over a two-year period, and that one-fifth of borrowers had twenty or more contracts in that time.\textsuperscript{155} In Wisconsin, 56% of payday borrowers took out at least eleven loans in one twelve-month period.\textsuperscript{156} In Indiana, 77% of all payday transactions were rollovers, and the average annual number of loan renewals was ten.\textsuperscript{157} In North Carolina, the typical payday loan customer took out seven loans in one year from one lender.\textsuperscript{158} The CFSA study found that three-quarters of payday borrowers rolled over their loan at least once, and that 30% had seven or more rollovers.\textsuperscript{159} Using the

\textsuperscript{153} Durkin, \textit{supra} note 141, at 625 (noting that 58% pay balance in full); see also Thomas A. Durkin, \textit{Consumers and Credit Disclosures: Credit Cards and Credit Insurance}, 88 FED. RES. BULL. 201 (2002) (finding that consumers are generally aware of APR disclosures on credit cards and find disclosures useful).

\textsuperscript{154} See CFA/PIRG REPORT, \textit{supra} note 40, at 7. These statistics may understate the number of rollovers, because the states capture information only on same-lender rollovers, not on customers using multiple lenders. \textit{Id.} at 8.

\textsuperscript{155} See WOODSTOCK INST., \textit{supra} note 64.

\textsuperscript{156} WIS. DEP’T OF FIN. INSTS., REVIEW OF PAYDAY LENDING IN WISCONSIN (2001). This study, among others, does not account for the fact that by only looking within a specified time period, rather than at a specified group of borrowers over time, it discounts the experiences of first-time borrowers who begin borrowing near the end of the period. To the extent that they have similar borrowing patterns to those who borrowed throughout the period, the prevalence of rollovers may be understated. See Caskey, \textit{Reaching Out}, \textit{supra} note 20.


\textsuperscript{158} Stegman & Fais, \textit{supra} note 116, at 20-21. This statistic does not take into account the frequent use of multiple lenders by one consumer either for simultaneous borrowings or for serial borrowing—borrowing from firm \textit{B} to pay firm \textit{A}.

\textsuperscript{159} CFSA STUDY, \textit{supra} note 131, at 39.
Wisconsin statistic as an example, the typical payday loan consumer, who takes out eleven two-week payday loans per year, for the average loan amount of $300, at the average 470% APR from the Consumer Federation of America (CFA) survey, spends nearly $600 annually in fees.

Frequent-use customers are the revenue drivers for payday loan businesses. In North Carolina in 2000, 40% of all payday loan revenues were generated by the 18% of customers who took out an average of at least one loan per month. Each 1% increase in the share of customers who borrow at least monthly from the company increased the outlet’s bottom line by $790.

The frequent use of payday loans should perhaps not come as a surprise. On its face, the typical transaction appears to be the product of underwriting that assumes that the borrower will not be able to repay the loan within two weeks, but will have to rollover the loan. Most lenders would be rightly skeptical that a moderate-income borrower who turns to a payday lender for $300 would be able to afford an additional $50 out of her next paycheck to cover the finance charge, beyond the $300 balloon payment she must make to repay the principal, a mere two weeks hence. If she is in fact able to repay the loan principal and the fee on time, the amount she pays may be enough to send her back to a payday lender when cash runs short before her next pay day.

Over time, one would expect a market with returns on sales exceeding 30% to attract new entrants who charge lower prices, or to convince existing participants to lower prices to attract new customers. Currently, competition takes place for location, convenience, and, perhaps, size of loan. Price competition would lead to downward pressure on prices marketwide, presumably making these loan products more affordable for credit-constrained families. At the same time, however, the available evidence indicates that frequent users of payday loans account for a disproportionate share of industry revenues, and that stores in search of greater profits would market repeated use to more of their clients. If product prices were lowered by an appreciable amount, more customers would be able to repay their loans, and the number using the products frequently to repay prior loans would decrease. However, the number of customers using payday loans for other uses would presumably rise with a decline in loan costs. Consolidation in the payday loan industry suggests that the large chains would increasingly use proprietary technology to

\[160\] Stegman & Faris, supra note 116, at 21.

\[161\] Promoting rollovers was also uncovered in the OCC’s action against Eagle National Bank: “The OCC also found that Dollar actively promoted rollovers of the Bank’s payday loans—without the Bank’s knowledge—by providing an incentive to Dollar’s employees, which resulted in a higher volume of rollovers than new loan originations and a misuse of the loan product for long-term credit.” Press Release, OCC, Fact Sheet: Eagle National Bank Consent Order (Jan. 3, 2002), available at http://www.occ.treas.gov/ftp/release/2002-01a.txt.
deliver loans faster and reduce losses.

Even with greater competition among payday lenders, however, loan prices might remain high, given that borrowers usually are not able to develop positive credit histories. Payday lenders usually do not report these histories to the credit bureaus. Positive credit histories could otherwise be used to lower their cost of borrowing by seeking better rates from competing lenders based on their solid credit history. Moreover, lower prices alone would not address the basic problem created by these short term loans—the debt trap most borrowers find themselves in as they repeatedly rollover payday loans during the course of the year.

4. Regulation.

The regulatory landscape for payday lenders is evolving, as states react in divergent ways to the growth of payday lending, and as the OCC and other federal bank and thrift regulators respond to partnerships between AFS providers and insured depository institutions.

The evidence on the prevalence of rollovers has led many states to adopt limits on the number of consecutive times a payday lender may renew a loan, and has led the industry’s trade association to adopt a four-rollover limit in its “best practices.” But these efforts have been to little effect. These rules leave open a big loophole: They do not bar lenders from accepting cash or a check from a borrower to “pay off” the existing loan and then immediately providing a “new” payday loan. Same-day advances do not appear to be covered under state laws, and the industry “best practices” are silent on the matter. Moreover, the rules do not prevent another firm from providing a payday loan to pay off the first firm’s loans. State-enacted rollover limits, perhaps as a consequence, do not appear to affect the percentage of payday borrowers renewing loans or the average number of loans taken out.

State regulation of price has not fared any better. There has been a great deal of state legislative action over the last few years regarding payday lending, but no clear trend in state laws is emerging; some states tightened restrictions while others loosened them to permit greater flexibility for payday lenders. Seventeen states, Puerto Rico, and the Virgin Islands have small loan interest rate caps or other usury limits that effectively prohibit payday loans; five states have no small loan or usury

162 See BANERJEE, supra note 43, at 15 (noting that competition for the provision of loans reduces ex ante rents, but once loan performance information is captured and not shared, the borrower cannot cheaply switch to a competitor, so ex post rents remain).

163 See CFA/PIRG REPORT, supra note 40, at 7.

164 Id. at 9.

165 Id. at 26-31 (summarizing all state laws relating to payday lending). Since the report, three more states have enacted laws authorizing payday lending. Deferred Presentment Services Act,
cap but require licensing of lenders; and twenty-eight states and the District of Columbia have specific laws or regulations authorizing payday lending.

Of the twenty states and the District of Columbia in CFA’s survey, six states have usury laws governing small loans; two states had no laws governing payday lending; and twelve states (and the District of Columbia) have implemented payday lending laws or regulations.

Table 1. Average Payday Loan APRs by State Regulatory Environment, 2001

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<th>Regulatory Environment</th>
<th>States Surveyed</th>
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<tbody>
<tr>
<td>Usury ceiling on small loans prohibits payday lending</td>
<td>GA, MA, MD, NY, PA, VA</td>
<td>606%</td>
</tr>
<tr>
<td>No usury ceiling, payday lending permitted</td>
<td>NM, WI</td>
<td>504%</td>
</tr>
<tr>
<td>“Safe harbor” permits payday lending, caps fees</td>
<td>AZ, CA, CO, DC, FL, IA, IL, KY, NC, OH, OR, SC, TX</td>
<td>443%</td>
</tr>
<tr>
<td>National average</td>
<td></td>
<td>470%</td>
</tr>
</tbody>
</table>

Source: CFA/PIRG, 2001

In the states surveyed in which usury ceilings were low enough to effectively prohibit payday lending, rates on payday loans to residents of that state were, paradoxically, the highest. Payday lenders in these states were either violating state usury laws or had partnered with insured depository institutions that “exported” the regime of the bank’s home state to originate payday loans, effectively operating outside state usury laws but with added costs incurred to form partnerships with out of state lenders. In the states surveyed that had no usury ceilings for small loans—and therefore effectively lacked any price regulation for payday loans—payday lenders generally charged higher-than-average interest rates on loans. In states in which safe harbor laws or regulations permitted payday lending but capped fees, interest rates were somewhat below average. State usury laws seem to have perverse effects on payday loan pricing and

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166 CFA/PIRG REPORT, supra note 40, at 26.
167 Id. at 27.
168 The CFA/PIRG REPORT survey sample was not representative. Many states were excluded from the survey, different numbers of lenders were surveyed in each state, and within a given state surveyed lenders were often concentrated in one or more geographic areas. The survey nonetheless remains the most comprehensive source of information on interstate pricing differences for payday loans. See id. at 1.
operations, while states with licensing laws fare somewhat better than average in terms of surveyed prices.

State usury and payday lending laws collided with federal bank and thrift regulation as a result of partnerships between payday lenders and a small number of depository institutions. Initially, a handful of national banks were exporting high interest rates to payday lending companies in states with usury laws, thus circumventing those states’ implicit restrictions on payday lending. Some small, state-chartered banks had also become involved in payday lending, as had some thrifts. At first, the regulators issued guidance explaining the risks involved in payday lending. After about a year of experience supervising these partnerships, the regulators became increasingly concerned with the risks involved. The OCC, and then the OTS and Federal Reserve Board, in turn, all effectively ended these partnerships. Today, only FDIC-regulated depositories are still engaged in this market. One state-chartered bank, after being ordered by the Federal Reserve to end payday lending,

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170 See Nicole Duran, OCC Orders Bank To Exit Payday Biz, AM. BANKER, Jan. 4, 2002, at 1; see also CFA/PIRG REPORT, supra note 40, at 21.


175 See REPUBLIC FIRST BANKCORP, Form 8-K, June 27, 2003, at 1 (noting that it ceased its payday lending partnership because of heightened regulatory requirements).

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withdrew from the Federal Reserve System and was approved by the FDIC for federal insurance as a state non-member bank in order to continue to operate its payday lending. What is the basis for shutting down these partnerships? Regulators have cited three basic reasons. First, the OCC has explained that banks should not “rent” their names to payday lenders to evade state usury and consumer protection laws, but should take responsibility as the lender for ensuring proper underwriting and disclosure, as well as appropriate consumer protections. Second, the OCC argued that firms engaged in such partnerships are exposed to “significant reputation, strategic, transaction, and compliance risk” when “nonbank vendors may target national banks . . . in order to avoid state law standards that would otherwise apply to their activities.” Third, the OCC warned that payday lending could be unsafe and unsound. The OCC put national banks on notice that it reserved the right to examine and regulate both the bank and the third party service provider and to assess special fees for such supervision. Using its safety and soundness supervisory authority—rather than any consumer protection rationale—the OCC has now shut down all known national bank-payday lending operations, and the OTS and Federal Reserve have followed suit. It remains to be seen whether the FDIC will find similar safety and soundness concerns after it has experience in supervising banks engaged in these partnerships.

In the meanwhile, questions regarding federal pre-emption are unlikely to go away. Before it had ended national bank-payday

177 See Jonathan D. Epstein, First Bank To Continue Payday Loans, Switch to FDIC Keeps Practice Alive, NEWS J. (Wilmington, Del.), Oct. 15, 2003, at 10B.
179 The OCC warned that:
180 Id.
181 Id.
partnerships, the OCC had taken the position that the National Bank Act did not pre-empt state usury claims against the payday lending partner of national banks.182 Plaintiffs had sued the payday lender under state law. The District Court remanded to state court for lack of federal question jurisdiction183 and ACE settled, agreed to pay $1.3 million in restitution, cease its relationship with Goleta National Bank and comply with Colorado’s licensing and usury laws.184 By contrast, in another case, the same parties successfully argued that the National Bank Act pre-empted state law claims against both the national bank and the payday lender.185 Furthermore, in Anderson v. H&R Block,186 the court held that plaintiffs’ claim that H&R Block and Beneficial National Bank’s refund anticipation loans were usurious was governed by the National Bank Act, but since there was no complete pre-emption, the claims could be heard in state court. The Supreme Court overturned the Eleventh Circuit in Beneficial National Bank v. Anderson,187 holding that the National Banking Act fully pre-empted state law claims for usury pleaded against national banks and thus provided a basis for removal of the case—including supplemental state claims against other defendants—to federal court, where presumably the defendant believes the claims will bear less weight.

5. Reforms

With respect to any remaining bank or thrift partnerships with payday lenders,188 given the bank and thrift regulators’ strong assertions of pre-emption of state payday lending laws affecting insured depository institutions, it is incumbent on the regulators to use their authority under the Federal Trade Commission Act to take action against banks and thrifts that are engaged in “unfair and deceptive trade practices” in the course of

183 Salazar, 188 F. Supp. 2d at 1285-86.
184 Press Release, Colorado Attorney General, Ace Cash Express To Pay $1.3 Million in Restitution to Consumers (May 6, 2002), available at http://www.ago.state.co.us/PRESREL/prsr12002/prsr140.stm; see also supra note 182.
186 287 F.3d 1038 (11th Cir. 2002).
188 Although only FDIC-regulated banks currently engage in payday lending, with heightened regulatory focus on “renting” charters, at least one payday lender sought to own a bank. See Ben Jackson, Can’t Rent? Payday Shop Files To Buy a Charter, AM. BANKER, July 9, 2002, at 1 (noting that Cincinnati BancGroup, a subsidiary of CNG Financial Inc. and an affiliate of Check’nGo, applied to the Federal Reserve Board to buy a bank).
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payday lending activities. Regulators should pay particular attention to the problem of short-term balloon payments, repeated refinancing, and inadequate or misleading disclosures under the Truth in Lending Act (TILA). In addition, greater attention to the CRA service test could help to shed light on bank practices. For example, if repeated rollovers indicate that the lender failed to underwrite the payday loan by determining a borrower’s ability to repay, contrary to safety and soundness guidelines then the bank may have engaged in an “illegal credit practice” for purposes of the CRA. Such an illegal practice should adversely affect the bank’s CRA rating. Congress should also consider legislation mandating that payday lenders report borrowers’ performance to the credit bureaus, so that responsible borrowers have the opportunity to pursue alternative credit products based on their credit history.

With respect to state regulation, the picture is mixed. Although a number of states have sought to invalidate bank-payday lender partnerships, given the Court’s strong interpretation of the pre-emptive effect of the National Bank Act on state usury laws, these laws are unlikely to withstand legal challenge. State regulators are likely to be more successful in directly acting against the non-bank partner in such arrangements. Given the ineffectiveness of state rollover laws, some states are now focusing on legislation that would provide for longer minimum terms for payday lending to prevent short-term balloon loans that are repeatedly refinanced from becoming a “debt trap.”

In my view, over the long term, banks could compete with payday lenders by offering alternative, lower cost and lower risk products. In principle, one such alternative might be bank overdraft protection. Although there is currently much controversy surrounding the adequacy of

191 See infra Subsection V.A.2.
192 See 12 C.F.R. pt. 30, app. B.
193 12 C.F.R § 25.28(c).
194 Indiana has passed a law barring such partnerships. North Carolina has filed suit arguing that its usury laws bar payday lending. See Jackson, supra note 188.
196 See Brown v. ACE Cash Express, CA No. 24-C-01-004036 (Md. Cir. Ct. Aug. 20, 2001); CFA/PIRG REPORT, supra note 40, at 21.
disclosures and the cost of current bank overdraft policies, in theory overdraft policies could be provided at lower cost than payday loans because, since there is no need for face-to-face interaction, the transactions can take place electronically and automatically at low risk and cost to banks. Moreover, repayment of the overdraft could be scheduled so that regular minimum payments (through automatic debiting of the customer’s account) repay the overdraft over a reasonably long time period, rather than the current payday loan of two weeks or bank overdraft practice of thirty days. Overdraft protection should also be disclosed as an extension of credit using APRs consistent with the requirements of TILA.

C. Title Lenders

Title lenders represent a variation on payday lenders. Instead of holding a check or a debit authorization until payday, title lenders hold collateral—in most cases, an automobile title (and/or the keys to the car, or in some cases a device permitting the title lender to disable the car)—for a typical term of one month. Some title lenders loan money collateralized by other household assets, such as appliances. Title loans range from $250 to $1,000, and are generally over-secured. If the borrower fails to repay the loan at maturity, the lender will often extend the loan for another fee, in the same way that a payday loan is rolled over. Should the borrower be unable to make payment, or should the lender decide to stop renewing


199 Drysdale & Keest, supra note 5, at 598.

200 See Holden Lewis, Sale Leaseback: A Dangerous New Form of Consumer Debt, BANKRATE.COM, Apr. 24, 2001, at http://www.bankrate.com/bm/news/pf/20010424a.asp. Appliance title loans often take the form of “sale-leaseback” arrangements, wherein the borrower transfers ownership of the appliance to the lender and then either “repurchases” the item at loan maturity or renews the “lease” by paying the finance charge for an additional fifteen days or one month.
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the loan, the lender repossesses the collateral, sometimes "retain[ing] the proceeds of the sale, even if the value of the automobile exceeds the loan amount."

Some auto title lenders sell repossessed cars in the retail market.

The title industry grew out of pawnbrokers’ efforts to lend larger amounts than televisions or jewelry could collateralize. In a traditional pawn transaction, the pawnbroker makes a fixed-term loan to a consumer who leaves collateral in the hands of the broker. If the customer does not repay the loan at maturity, the collateral becomes the property of the broker. Given the similarity between pawn transactions and title loans, title lenders have been able to claim the advantage of pawnbrokers’ exemptions from, or special limits under, many states’ usury laws, while using quite different underwriting processes.

The title loan industry originated in the southeastern United States, and burgeoned most rapidly in Florida. Between 1995—when legislation was adopted to legalize the industry—and 1999, 600 title loan outlets opened in Florida. In 2000, however, the state passed a new law limiting allowable interest to 30% annually, and the practice has all but disappeared since then. Yet it still thrives in Georgia and Tennessee, the two states that legalized the practice early. Title lenders have sprouted up in other states—for example, in Missouri, Illinois, and Oregon. While no title lenders are publicly held, Title Loans of America is the largest lender. In 1999, the firm had 300 outlets.

Prices for title loans appear to be similar to those for payday loans.
The OCC has found that rates often exceed 25% per month,\textsuperscript{210} for an APR of 300%. In Illinois, for instance, a 1999 survey revealed an average APR of 290% on title loans.\textsuperscript{211} In Florida, the typical fee in 1998 for a one-month $400 loan was $88, or 264% APR.\textsuperscript{212} Some title lenders have developed partnerships with national banks, raising concerns similar to those raised by partnerships with payday lenders.\textsuperscript{213} Several lawsuits and articles document the fact that problems with rollovers are just as prevalent as in the payday lending industry.\textsuperscript{214} As with payday lending, title lending is often undertaken without an assessment of the borrower's ability to repay (other than by seizure of the collateral).\textsuperscript{215} With title lending, however, the borrower risks losing her car, which may be her regular way to get to work, and to transport children to and from school or child care. Alternative credit products or savings might help low-income families to reduce reliance on title lenders.

D. Tax Preparers and Refund Anticipation Lenders

The EITC provided a critical supplement to income for twenty million low-income households this year. While tax preparation firms provide important services to low- and moderate-income persons, tax refund anticipation loan (RAL) fees lower take home pay from the EITC, cutting against the distributive goals of the program, and may somewhat reduce its effectiveness as a work incentive for RAL borrowers, although further empirical research is needed to explore this question.

1. Industry Overview

Tax preparation services can be distinguished from other AFS services in a few important ways. First, they are the only type of provider examined in this Part whose core functions are not usually thought to be providing services for income receipt, conversion of income into cash, bill payment, saving, or credit. Tax preparers do, however, play important roles in each of these financial services. Tax preparers facilitate the taxpayer's receipt of income tax refunds; they help to convert tax refunds owed to taxpayers into liquid form. They transmit payments to Treasury

\textsuperscript{210} Title Loan Programs, AL 2000-11, \textit{supra} note 198, at 2.
\textsuperscript{211} ILLINOIS REPORT, \textit{supra} note 140, at 26.
\textsuperscript{212} Drysdale & Keest, \textit{supra} note 5, at 599.
\textsuperscript{213} \textit{See} Title Loan Programs, AL 2000-11, \textit{supra} note 198 (alerting national banks to OCC concerns over title loan programs, including the involvement of third parties).
\textsuperscript{215} \textit{See} Title Loan Programs, AL 2000-11, \textit{supra} note 198.
for sums taxpayers owe on their tax returns. They arrange for credit to be provided to many taxpayers in the form of refund anticipation loans. Second, tax preparers also cater to middle or upper-income clientele, as well as the lower-income population that is the focus of this paper. Third, they generally cost less on an average annual basis for lower-income clients than check cashers or payday lenders cost for the typical client they serve. In large part, this is because most customers seek their services only once a year, at tax time. Fourth, low-income client use of tax preparation services and refund anticipation loans offered by such preparers appears to be higher among recipients of the federal EITC than other taxpayers, although almost all taxpayers earning under $30,000 per year who file tax returns would need to file a return even absent the EITC.

The federal EITC is a wage subsidy provided to families who earn under about $35,000. In tax year 2001, the credit provided over $30 billion to over eighteen million families through refundable credits against federal income tax. The average family with children that year earned a credit of nearly $1,800. Unfortunately, the credit and its rules can be difficult to understand for families who have complicated living arrangements, such as children who spend time living with a parent and another relative, who have low levels of education, or who do not speak English as their first language.216 Conflicting and complex rules governing different tax provision rules for determining household status, dependents, and the like make tax preparation services attractive. Additionally, low-income families may not understand the refund process or timing, or may worry about increasing IRS audits of EITC claimants.

For the low-income population, tax preparers provide two major products and services. The first is return preparation and filing of what has become for some a complicated task of filing a tax return, including an EITC claim. Typically, preparers will fill out a client’s federal return, the accompanying Earned Income Credit (EIC) schedule, and a state return, if the client is required to file or is eligible for a refund from the state. In most cases, preparers file low-income clients’ returns electronically, so as to expedite the processing of the refund by the IRS. As many as 67 to 68% of EITC recipients hired a commercial tax preparer to prepare their returns, and more than half of all EITC recipients filed their returns electronically.217

216 See HOTZ & SCHOLZ, supra note 9, at 13-14, 32 (stating that most EITC errors result from family status issues). The problem of tax complexity is, of course, not confined to low-income taxpayers, nor are the complexities facing low-income taxpayers confined to the EITC. See generally Janet Holtzblatt & Janet McCubbin, Complicated Lives: Tax Administrative Issues Affecting Low-Income Filers, in THE CRISIS IN TAX ADMINISTRATION (forthcoming 2004).

217 See BERUBE ET AL., supra note 38, at 2, 10; see also HOTZ & SCHOLZ, supra note 9, at 31 (finding that 56.5% of claimants used paid tax preparers in 1996); Michael A. O’Connor, Tax Preparation Services for Lower-Income Filers. 90 TAX NOTES 231, 232 (2001) (finding that 60% of
Second, many EITC recipients also use refund anticipation loans (RALs) and similar products marketed by many tax preparation services, including the two large national chains, H&R Block and Jackson Hewitt. RALs are quite similar to payday loans in that they provide advances on a borrower’s anticipated income—in this case, a tax refund. In the case of the RAL, the loan is repaid when the IRS issues the borrower’s expected refund. RALs serve three main purposes: First, customers are usually able to receive cash proceeds from their loans within two days or less of electronically filing their tax returns, which is eight to ten days sooner than if they had requested direct deposit of their refund to their bank account, if they had one. They may need the funds for daily needs, to catch up on recurring payments on which they have fallen behind, or to repay other short-term loans. Families who receive the EITC may live from paycheck to paycheck and may be unable to save for large purchases such as a car, and thus many seek assistance in getting quick access to the relatively large refund dollars. Second, RALs also permit taxpayers without bank accounts—and, consequently, without direct deposit capabilities—to obtain their refunds without waiting approximately four to six weeks for a paper check from the IRS. Third, taxpayers who do not

EITC recipients used paid preparers in 1999). Holtzblatt & McCubbin report that in 2000, 64% of EITC claimants reported using a paid preparer (compared to 53% of all filers), and 55% of EITC claimants filed electronically (compared to less than one-third for all filers). Holtzblatt & McCubbin, supra note 216, at 11-12.


219 Eligible EITC recipients may use an “advance payment option” under which they receive up to 60% of their EITC refund spread throughout the year through reduced withholding in their regular paycheck; but, perhaps because of the fact that 75% of EITC filers have more than one source of income and setting advance EITC up with multiple employers would be complicated and might result in incorrect overpayments that would later be subject to recapture, or perhaps because of a desire to have a form of enforced savings for larger purchases the lump sum refund, only 1.1% of eligible EITC recipients used this option in 1998. See HOTZ & SCHOLZ, supra note 9, at 27-28, 54, 61; see also Holtzblatt & McCubbin, supra note 216, at 10 (describing household status and multiple income sources as barriers to using advance EITC payments easily). If the need to speed up the refund to pay for daily needs were the prime motivation for RALs, it is somewhat unclear why more EITC filers do not opt for advance payments, even given the administrative difficulties.

220 The estimate of four-to-six weeks for refunds is from the testimony of Nina Olson, IRS Taxpayer Advocate, before the House Ways & Means Committee in 2001. See 2001 Tax Filing Season: Hearing Before the Subcomm. on Oversight of the House Ways and Means Comm., 107th Cong. 42, 47 (2001) (testimony of Nina Olson, National Taxpayer Advocate, Taxpayer Advocate Service, Internal Revenue Service) [hereinafter Olson 2001 Testimony], available at http://waysandmeans.house.gov/legacy.asp?file=legacy/oversite/107cong/4-3-01/3olso.htm (last visited Mar. 15, 2003). Tax preparation services also offer a product variously known as “refund transfer,” “accelerated check request,” or “refund anticipation checks,” by which unbanked EITC recipients can have their refunds direct deposited to the bank partnering with the tax preparation service, which then cuts a check to the recipient, after deducting tax preparation, administrative, and bank fees. The service permits the recipient to receive his check much earlier than if the IRS were to mail the recipient a check. See BERUBE ET AL., supra note 38, at 2.
have the funds to pay for tax preparation services up-front, but believe that they need help filing for the EITC, find RALs and similar products necessary simply to pay preparers to file for their refund. Tax preparation fees are deducted from the proceeds of the RAL, encouraging tax preparers to work with low-income customers, who in turn can more easily pay for the services provided.221 Thus, the complexity of the EITC and the desire to have forms professionally prepared may itself drive some decisions to take out RALs independent of a desire to obtain a quicker refund. The need for commercial preparation could be reduced for some EITC recipients, who could request that the IRS calculate the credit based on their EIC schedule.222 This is an option that few currently pursue, however, and EIC schedules are quite complicated.223

Tax preparation services and refund loans can consume a nontrivial portion of an EITC recipient's refund. A survey of providers in Washington, D.C. in 2002 found that the preparation and electronic filing of federal and state returns, and associated schedules, cost low-income taxpayers about $100 on average.224 The purchase of a RAL for an anticipated $1,500 refund added roughly $90 to this amount. Thus, for EITC recipients filing electronically and choosing to take out a RAL, total fees would consume an average of 13% of the EITC or nearly 8% of the total refund from the EITC and other credits.225 Annual percentage rates on RALs are generally in the 150% to 300% range, depending on how quickly the IRS processes the refund, and thus how quickly the loan is repaid.226 In addition, for the estimated 22% of EITC recipients who lack a bank account, or four million households, the additional fee to cash a $1,500 RAL check issued by the bank partner of the tax preparer would be

222 See Holtzblatt & McCubbin, supra note 216, at 25.
223 See HOTZ & SCHOLZ, supra note 9, at 59. Calculations became more complicated in 2002, when many low-income families became eligible for a federal child credit with definitions of eligible children that are different from the EITC.
224 BURBE ET AL., supra note 38, at 5. These fees cover preparation of the whole tax return, of which the EITC schedule is only a small part.
225 Id. This is consistent with other estimates. See CHI CHI WU, NAT'L CONSUMER L. CTR. & CONSUMER FED'N OF AM., REFUND ANTICIPATION LOAN REPORTS (2002) (reporting range of total fees from $129 to $429).
226 A recent study reports that APRs are often calculated and posted by some tax preparation services as if the RALs were demand notes, on the basis of repayment in one year, thus significantly understating APRs. WU ET AL., supra note 225, at 6; see also Regulation Z Official Staff Interpretations, 12 C.F.R. pt. 226 supp. I, at 226.17(c)(1)-17 (describing special rules for tax refund anticipation loans and providing that disclosures of APRs be based on the “creditor’s estimate of the time the refund will be delivered”). Banks offering RALs in partnership with tax preparation firms may charge interest at rates permitted by the bank's home state, which permits the banks to make RALs at rates that would exceed state usury caps in the customer's state. See supra Section II.B. (discussing payday loans).
at least $30 on average at a check cashier, despite the low-risk nature of the checks. Another study found EITC recipient use of check cashers to be double that rate, at 44.5%, and CFA reported double that cost for cashing refund checks, at $67 on average.

The refund anticipation and electronic tax preparation and filing industry is growing. The commercial tax preparation firms earned $357 million in fiscal year 2001 from refund anticipation loans, more than double the amount they earned in fiscal year 1998. Given the high demand for tax preparation services by EITC claimants, electronic tax filing and preparation services are disproportionately represented in neighborhoods with concentrations of EITC recipients. Tax preparers that emphasize refund loans are concentrated in low-income neighborhoods. In zip codes with relatively high concentrations of EITC recipients, there are 50% more electronic tax preparation services per filer than in low-EITC zip codes.

RALs are used by a significant portion of EITC recipients. In 1999, 38% of EITC recipients received a refund loan, compared to only 4% of other taxpayers. Seven and one-half million EITC recipients took out RALs. Nearly half (47%) of all EITC dollars were received through a

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228 Smeeding et al., supra note 37, at 1202 tbl.5. Smeeding et al. also find checking account ownership among EITC recipients to be around 40%. Id.

229 WU ET AL., supra note 225, at 9.

230 The industry is dominated by two firms: H&R Block, the leading tax preparation firm in the nation, which partners with Household International on RALs, and Jackson Hewitt, which partners with Pacific Capital Bancorp on RALs. BERUBE ET AL., supra note 38, at 3; see also H&R BLOCK, INC., 2001 ANNUAL REPORT (2002) (revealing that H&R Block made 4.5 million RALs in 2001, generating $133.7 million in gross revenue and $68 million in net profits); HOUSEHOLD FINANCE CORP., 2001 ANNUAL REPORT (2002); David Cay Johnston, New Questions About Block's Lucrative Tax Loans, N.Y. TIMES, July 2, 2000, at C1; Katie Kuehner-Hebert, California Bank Finds Gold in E-Returns, AM. BANKER, Aug. 12, 2001, at 1 (adding that Bank One is also a significant maker of RALs). Check cashers are also beginning to become directly involved in electronic tax filing. See ACE ANNUAL REPORT, supra note 74, at 53; DOLLAR ANNUAL REPORT, supra note 76, at 6.

231 BERUBE ET AL., supra note 38, at 7.

232 Id. at 8-9.

233 Id. at 10-11.
RAL. All told, an estimated $1.75 billion in EITC refunds in 1999 was spent for tax preparation, electronic filing and tax refund loans, by those EITC recipients who use these services. Check cashing fees would add a further $120 million to the total reduction in EITC benefits reaching low-income families without bank accounts.

Commercial tax preparers do provide an essential service to EITC recipients who do not understand how to file for the credit, or who want to have a professional fill out their forms. As well, many EITC recipients who would otherwise be unaware of the credit may learn of it through marketing of tax preparation services in their neighborhoods. Thus, tax preparers may contribute to the high take-up rate for the EITC among eligible persons. Nonetheless, a significant part of the federal government's EITC expenditure is used by low-income families to pay commercial tax intermediaries for filing and refund loans. Viewed as a cost of compliance with the EITC program, EITC claimant expenses for tax preparation and RALs would swamp governmental costs of administering the EITC, although the total operating costs of the EITC program—including both taxpayer compliance and governmental administration—would still be only about half the costs for governmental administration alone of other major low-income programs, such as food stamps and welfare. EITC compliance costs could be reduced.

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234 Id. at 11-14 (listing figures by metropolitan statistical area). The percentages of EITC recipients using RALs vary significantly by region.

235 Id. at 13. The total consists of RALs ($100 average x 39% of 19 million EITC recipients = $750 million), tax preparation and filing ($100 average x 52% of 19 million = $1 billion). Check-cashing fees would add at least $120 million ($30 x 22% of 19 million). Most EITC claimants would need to file a tax return even if the EITC did not exist, so one cannot attribute all of these taxpayer costs to the need to file to claim the EITC. Nonetheless, it is the case that the refund from the EITC and other credits is effectively reduced by the amount spent on tax preparation fees and RALs.

236 Error rates for commercially prepared EITC returns are not on average significantly better than for other EITC returns. O'Connor, supra note 221, at 232. But there is wide variation among commercial preparers with respect to error rates, with large national organizations performing much better than small store-front ones. See Holtzblatt & McCubbin, supra note 216, at 20-21 (noting an eleven percentage point difference in error rates); Janet McCubbin, EITC Noncompliance: The Determinants of the Misreporting of Children, 53 NAT. TAX J. 1135, at 1143 (2000); see also Olson 2001 Testimony, supra note 220 (44% of returns showing computational error and 55% of returns with math error adjustments are commercially prepared).

237 See HOTZ & SCHOLZ, supra note 9, at 12 (arguing that the EITC is "inexpensive to administer," particularly when compared to food stamps, which incurred administrative costs of $3.7 billion in fiscal year 1995, and AFDC, which incurred $3.5 billion in administrative costs). The IRS's costs of administering the EITC, including customer service, public outreach, enforcement, and research are projected to be $154 million in fiscal year 2003. 2002 Tax Return Filing Season and the IRS Budget for Fiscal Year 2003: Hearing Before the Subcomm. on Oversight of the House Ways and Means Comm., 107th Cong. 6, 20 (2002) (testimony of Charles O. Rossotti, Commissioner, Internal Revenue Service). Holtzblatt estimates administrative costs of the EITC to be about 1% of EITC claims, see Holtzblatt & McCubbin, supra note 216, at 14; see also id. at 27 (noting that EITC administrative costs of $145 million equal less than 4% of food stamp administrative costs of $4 billion). Good data do not yet exist on individual compliance costs, as opposed to governmental administrative costs, for either the EITC or other government programs, including data on, for example, time costs for applying to such programs, which are likely to be significant.
Simplification of the EITC could reduce the need for tax preparation services and should remain on the congressional agenda.\textsuperscript{238} With respect to refund loans, some portion of EITC recipients may need their refund cash immediately to meet an emergency expenditure. Many recipients, however, are likely unaware that they could receive their refund within ten to 14 days if they were banked and filed electronically through IRS Direct Deposit. The IRS could diminish demand for RALs by speeding up refunds and advertising refund times. In addition, many EITC recipients are probably unaware that they are receiving a loan against their refund as opposed to an expedited refund itself.\textsuperscript{239} For example, H&R Block was found to have used misleading advertising and to have trained its tax preparers to focus on "rapid refunds" rather than explaining that the products were loans.\textsuperscript{240} While H&R Block changed its practices to clarify the nature of the refund loan transaction, some observers believe that its advertising remained somewhat unclear,\textsuperscript{241} and most independent agents and smaller firms may be able to escape scrutiny altogether. Enhanced disclosure may help avoid some consumer mistakes.

In considering the role of refund loans in the marketplace, it is useful to contrast them with payday loans. Both are an expensive short-term source of credit, used primarily by low- and moderate-income families with no savings. Payday loans arguably represent a product that is absent elsewhere in the marketplace—small unsecured loans for people with blemished credit histories. The main problem is in their structure—a short-term balloon with high fees that often leaves consumers in a cycle of perpetual debt. Refund loans, on the other hand, rarely turn into long-term problems for taxpayers or credit problems for the lender; the loan is fully collateralized by the payment due from the IRS, a reliable payor.\textsuperscript{242} By aggressively marketing RALs, however, and—at least in some well documented instances—disguising their nature,\textsuperscript{243} some tax preparers seem to have capitalized on a lack of information among low-income families. As with payday lending, RALs are offered by tax preparation firms in partnerships with banks. IRS rules bar tax preparers from directly

\begin{flushleft}
\textsuperscript{239} See Joan Koonce Lewis et al., \textit{Refund Anticipation Loan and the Consumer Interest: A Preliminary Investigation}, 42 CONSUMER INT. ANN. 167 (1996).
\textsuperscript{241} WU ET AL., supra note 225, at 22-23.
\textsuperscript{242} Refund loans, however, can cause long-term problems for borrowers when it turns out that refunds do not come, or are smaller than anticipated because of errors or offsets. See id.
\textsuperscript{243} See, e.g., id. at 25-26 (citing a number of recent suits illustrating efforts to disguise RALs).
\end{flushleft}
Banking the Poor

providing RALS, and using the bank charter, among other things, permits tax preparers to offer RALS without needing to comply with local usury laws.

2. Regulation

The IRS role in this area could be critical. The IRS ended its practice of providing notice of anticipated refunds, and an indicator of any offsets for child support or other federal debts, to tax preparers in 1995 in order to reduce fraud and other problems associated with RALS. But the IRS responded in 1999 to congressional electronic filing mandates by again providing tax refund and offset information to preparers as an inducement to expand electronic filing, and to provide the IRS with information on their detection systems. The IRS also delayed EITC refunds in order to conduct basic anti-fraud and error detection. These changes may have increased the supply of tax preparers willing to prepare low-income returns because they could be paid up front from the proceeds of a RAL. The changes also may have increased the demand for RALs as well because delaying refunds exacerbated low-income persons' need for cash.

The IRS regulates aspects of RAL transactions through its oversight of electronic return originators (EROs). EROs are authorized by the IRS to file returns electronically on behalf of taxpayers, and receive a number of benefits from the IRS, including promotional material, permission to use the IRS e-file brand name, and indirect benefit from public service

244 See infra note 253.
245 See Beneficial Nat'l Bank v. Anderson, 123 S. Ct. 2058 (2003) (noting that the National Bank Act pre-empts state law usury claims against national bank that had partnered with a tax preparation firm to provide refund anticipation loans); Cades v. H&R Block, 43 F.3d 869 (4th Cir. 1994) (upholding such partnerships).
247 See George Guttman, IRS Reinstates Debt Indicator To Increase Electronic Filings, 85 TAX NOTES 1125 (1999); Amy Hamilton, Tax Writers Zeroing in on "Rapid Refund Loans," 91 TAX NOTES 189 (2001). Despite the lower risk associated with the RALS when debt indicators are provided, evidence suggests that the re-instatement of the debt indicator only temporarily lowered rates, which have returned to levels close to their earlier, pre-debt-indicator level. See WU ET AL., supra note 225, at 20 (describing pre-indicator RAL fees in the range of $40-$90, 2000 fees ranging $20-$60, and 2001 fees of $30-$90). But see Ernst 2001 Testimony, supra note 218, at 2 (suggesting that IRS mistakes in implementing the debt indicator were responsible for losses to taxpayers and preparation firms in the first year of the program).
248 The congressional mandate that 80% of all taxpayers file their income tax returns electronically by 2007 was a major reason behind the reinstatement of the IRS "debt indicator" tool, which facilitates not only electronic filing but also the underwriting of RALS. See BERUBE ET AL., supra note 38, at 17.
249 The IRS decision in 2003 to require certain EITC filers to undergo time-consuming "pre-certification" is likely to drive more claimants to use tax preparation services and RALS. See News Release, I.R.S., EITC Reform Initiative (June 2003), available at http://www.irs.gov/newsroom/article/omd=110296.00.html. Similarly, the high rate of audits for EITC claimants may increase taxpayers' interest in using paid preparers.
announcements advertising electronic filing. The IRS requires preparers to disclose that “RALs are interest bearing loans and not substitutes for or a faster way of receiving a refund.” The IRS permits RALs to be repaid by direct deposit into special RAL accounts held by the bank partnering with the tax preparer, rather than the taxpayer. The tax preparer (or related parties) cannot make the RAL directly, nor can the tax preparer directly cash a refund check issued to a taxpayer whose return the filer prepared. (A preparer that is also a financial institution may cash a refund check, but not if the preparer has made a RAL.) The IRS also regulates RAL fees. Under IRS rules, authorized providers:

may not base their fees on a percentage of the refund. . . . Separate fees may not be charged for Direct Deposits. An Authorized IRS e-file Provider may assist a taxpayer in applying for a RAL and may charge a flat fee for that assistance. However, the fee must not be related to the amount of the refund or a RAL. The Provider must not accept a fee from a financial institution for any service connected with a RAL that is contingent upon the amount of the refund or a RAL.

The IRS also regulates the advertising of RALs. The IRS “prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement of claim.” In addition, “a Provider must adhere to all relevant federal, state and local consumer protection laws that relate to advertising and soliciting.” Moreover, with respect to RALs, the Provider and financial institution must clearly refer to or describe the funds being advanced as a loan, not a refund. The advertisement on a RAL must be easy to identify and in readable print. That is, it must be made clear in the advertising that the taxpayer is borrowing against the anticipated refund and not obtaining the refund itself from the financial institution.

3. Reforms

The IRS, in responding to congressional pressure to increase e-filing and decrease EITC errors, has helped to create the market for RALs. It

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250 See generally IRS, E-FILE HANDBOOK, supra note 227.
251 Id. at 51.
252 Id.
253 Id. This aspect of the regulation, apparently designed to reduce the likelihood of EROs taking advantage of its tax preparation clientele or seeking to inflate the refund amount, may simply have driven the particular form of bank-ERO-check cashier partnerships currently in use by major preparers, arrangements not necessarily more beneficial to consumers than permitting tax preparers to provide loans directly.
254 Id. at 52.
255 Id. at 74-75.
now bears a special responsibility to help end it.

There are several steps that the Treasury Department and the IRS could take to improve the manner in which EITC recipients receive financial services. First, and most importantly, Treasury and the Congress need to continue efforts to simplify the EITC, for example, by altering the definition of qualifying children. Simplification should help to drive down error rates, which are costly in their own right and more expensive to EITC recipients who take out RALs incorrectly anticipating a refund, and diminish the need for expensive tax preparation services.\(^2\)

Second, the IRS should expand free tax preparation and electronic filing availability;\(^2\) greater availability of these services would, of course, diminish the need to take out RALs in order to pay for preparation services. The biggest barriers to an expansion of free tax preparation services are lack of funds, lack of sites that provide for electronic filing, and, more critically, lack of effective ways to assure the quality of these tax preparation services. Moreover, if Congress wants the IRS to expand e-filing availability, it should pay for expanding the private sector infrastructure necessary to implement it, rather than relying on RAL fees paid by low- and moderate-income tax payers to cover the tax preparers’ costs of implementing e-filing. Congress could appropriate funds for the purpose, or use an e-filing tax credit to offset the costs.

Third, since the IRS now has the technical capacity to split refunds, the IRS should permit refunds to be direct deposited into more than one bank account. If refunds are permitted to be split into more than one account, tax preparers could compete by offering tax preparation services that are paid not out of the proceeds of RALs, but paid directly to them electronically out of tax refunds through direct deposit to them of a portion of the refund, diminishing the risk to the preparer and eliminating one reason to take out a RAL. If this reform is combined with public and private sector efforts to bring EITC recipients into the banking system, the remaining portion of the refund could be direct deposited into the client’s own bank account. Given the large average refund size, the portion deposited into the client’s account might serve not only for short-term needs, but also, for some clients, as a base for savings.


\(^2\) The IRS has a small program to provide matching grants to low-income tax clinics although the clinics are not primarily focused on preparing returns. In fiscal year 2002, the IRS provided $7 million to 127 organizations. Holtzblatt & McCubbin, supra note 216, at 15.
Fourth, coupled with better error and fraud detection and prevention efforts, the IRS can speed up EITC refunds, and do more to encourage direct deposit of refunds into bank accounts, both directly and through employers, commercial preparers, and Volunteer Income Tax Assistance (VITA) sites. Again, if Congress believes that more efficient tax processing, in the form of e-filing and direct deposit of refunds, is in the government's interest, Congress should appropriate funds or provide a credit to pay for these improvements rather than letting them be cross-subsidized by fees from RALs and tax preparation.

Fifth, as explained in more detail below, EITC recipients can become a central focus of efforts to bank the unbanked. The following steps should be taken to accomplish this goal: Treasury should expand its Electronic Transfer Account (ETA) program to permit use of ETAs for EITC receipt. Congress should appropriate more funds for Treasury's First Accounts program to support innovative efforts to reach EITC recipients without bank accounts. The IRS should establish partnerships with large employers to encourage employees to open bank accounts and establish direct deposit of paychecks and tax refunds. Moreover, the tax preparation firms themselves should partner with banks to develop and offer individual, low-cost, electronically based bank accounts for their clients. Their clients could use the accounts to receive direct deposit of their income tax refunds, to withdraw funds at ATMs and POS using debit cards, to save, and for their other financial services needs throughout the year. The tax preparers would gain a new marketing tool and might see higher rates of client retention.

Sixth, the IRS can use its oversight of e-file preparers to improve the market for EITC recipients. Towards this end, the IRS should make enforcement of existing rules, especially regarding advertising, a priority; provide more detailed rules regarding non-deceptive advertising, including disclosures of how the offered product compares with the IRS's current anticipated refund times; and force greater transparency in pricing, including by requiring that RAL funds be provided to EITC recipients in a


259 The IRS Taxpayer Advocate, a congressionally created position heading an independent organization within the IRS, notes that the IRS expects to be able to speed up refunds on electronically filed tax returns to within two to three days of filing. See Olson 2001 Testimony, supra note 220, at 3. The IRS has had a notoriously difficult time, however, with efforts to modernize administration, including refund processing.

260 The Taxpayer Advocate notes that the IRS and the FMS can establish bank accounts for taxpayers who do not have one. Id.

261 See infra Subsection III.B.1.
form that does not require an additional cost to convert to cash. For example, funds could be transferred to debit or stored value cards that can be used at ATMs or POS without cost.

III. The Banking Sector

A. Barriers to Banking the Poor

While changes in the AFS sector could improve the delivery of financial services for the poor, fundamental change would be accelerated by enhanced competition from banks, thrifts, and credit unions using electronically based accounts to serve low- and moderate-income customers. Mainstream providers can offer a range of services to meet the needs of low-income communities. Today, however, while the banking system works extraordinarily well for most Americans, many low- and moderate-income individuals face a number of barriers to account ownership. There are five key barriers: the structure and price of existing accounts, prior credit problems of the unbanked, low perceived profitability of serving the poor, lack of bank distribution systems in low-income areas, and the need for financial education.

First, regular checking accounts may not make economic sense for many lower-income families. Three main problems are high minimum balances, monthly fees, and the risk and cost of bouncing checks. Consumers who cannot meet account balance minimums for a checking account at a bank often pay high monthly fees. Thirty percent of banks offered an account requiring minimum balances for checking, with an average minimum monthly balance of $527, and a monthly fee of $7.12 for falling below the minimum. Another 38% of banks offered fee-only accounts, charging an average of $4.74 per month for checking accounts without monthly minimum balances. The number of banks offering free checking accounts appears to have jumped to 32% of banks by 2001; yet, most of these banks have high minimum balances that low-income

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262 The Federal Reserve Board's 1998 Survey of Consumer Finances asked unbanked individuals why they did not own a checking account. The most cited reasons were not writing enough checks to make an account worthwhile, finding minimum balances and services charges to be too high, not having enough money, and not wanting to deal with banks. See Kennickell et al., supra note 1. It is not possible to determine from the survey whether respondents who indicated that they did not want to deal with banks were motivated by economic reasons, such as high costs and accounts not structured to their needs, or noneconomic motivations, such as cultural dislike of banks.

263 RETAIL FEES STUDY, supra note 150, at 3. The Retail Fees Study excludes "tiered" accounts with complicated balance and fee structure.

264 Id.

265 Id. But see Laura Bruce, Low Fees, More Free Accounts in 2002, BANKRATE.COM (Mar. 28, 2002) (noting that free checking accounts are provided at only 8.7% of surveyed banks), at http://www.bankrate.com/brm/news/chk/20020328b.asp.
persons cannot meet. Free accounts may also be available only to particular segments of the population, such as full-time students and the elderly.

Nearly all banks, including those offering otherwise free accounts, levy high charges for bounced checks or overdrafts that low-income families with little or no savings face a high risk of paying and can ill-afford. Avoidance of these bounced check fees may be an important determinant of the decision to become or remain unbanked. The average fee for checks that “bounce” and are rejected for not-sufficient-funds (NSF) was $20.75 in 2001, and the average fee for overdrafts was $20.50.\textsuperscript{266} In fact, depository institutions target the fee for NSF as a “core fee driver” in generating revenues from checking accounts.\textsuperscript{267} Consumer organizations have become increasingly concerned about “bounce protection” plans offered by some banks without adequate disclosure of fees.\textsuperscript{268} In addition, a customer depositing someone else’s check endorsed to her faces risks if the check turns out to be bad. Customers are charged an average fee of $7.11 by 74.1\% of banks for checks that the bank customer deposits that are, in turn, returned for insufficient funds in the check writer’s account.\textsuperscript{269} Unbanked customers may fear that a large fraction of their income comes from parties whom they have little reason to trust will make payment on their checks.\textsuperscript{270}

Checking accounts are costly for depository institutions to offer\textsuperscript{271} and

\textsuperscript{266} RETAIL FEES STUDY, supra note 150, at 6.

\textsuperscript{268} See, e.g., National Consumer Law Center and the Consumer Federation of America, Comments to the Federal Reserve Board’s Proposed Revisions to Official Staff Commentary to Regulation Z, No. R-1136, Jan. 27, 2003 (arguing that fees for “bounce protection” plans are finance charges subject to disclosure under the Truth in Lending Act), at http://www.consumerfed.org/frbcomments.pdf.

\textsuperscript{269} RETAIL FEES STUDY, supra note 150.

\textsuperscript{270} In fact, Banco Popular’s check cashing outfit finds that a larger portion of their fraud risk comes not from customers cashing someone else’s check, but from instances in which businesses knowingly provide checks to their workers that are not supported by adequate funds in the business’s account or purport to draw on nonexistent accounts. See Banco Popular, supra note 88. As described in the text accompanying note 75, overall losses from such risk are low.

\textsuperscript{271} The Federal Reserve Board’s 1997 Functional Cost & Profit Analysis estimates the fully loaded cost of the average checking account to be $145. FED. RESERVE Bd., FUNCTIONAL COST & PROFIT ANALYSIS 129 (1997). Others argue that variable costs (including front and back-office step functions) are a better measure of the costs of checking accounts; estimates of variable costs are in the range of $48. See Ralph Haberfeld, Cognitive Dissonance, Microeconomics, and Checking Accounts, BANKSTOCKS.COM (Mar. 4, 2002), at http://www.bankstocks.com/article.asp?id=517.
need to be offset with sufficient revenue (from float and fees) that may not be present in accounts that low-income customers could afford to use. In addition to direct fees for servicing the checking account, financial institutions may also charge high fees for money orders or other products that their typical customers do not often use, but that lower-income consumers use frequently. Moreover, banks hold checks that are not “on us” for a matter of days before depositing funds, unlike check cashing outlets; for low-income customers, the few days wait may not be practical.

In addition to fees from checking accounts, banks also usually charge fees for savings accounts. No-fee passbook accounts are available at only 15% of institutions; no-fee statement accounts are available at 17% of banks and savings associations. For other accounts, minimum balances to avoid fees ranged from $157.86 for passbook accounts to $184.42 for statement accounts. Monthly fees of $2.15 for passbook accounts and $2.50 for statement accounts were charged for accounts falling below the minimum required balances.\(^\text{272}\)

There is wide variation in the structure and pricing of accounts and fees across metropolitan areas and states.\(^\text{273}\) Fees for checking accounts also vary by the nature and size of the institution. Multistate banks tend to charge higher fees than single-state banks, including about $3 more for NSF and overdrafts.\(^\text{274}\) Multistate banks are more than fifteen percentage points more likely to offer free checking accounts\(^\text{275}\) but at least ten percentage points less likely to offer free savings passbook or statement accounts.\(^\text{276}\) Large institutions are now more likely to offer free checking accounts, and more likely to impose higher fees than do medium and smaller institutions, but less likely to offer free savings accounts.\(^\text{277}\) The number of large banks reporting that they offer “free” checking jumped twenty-two percentage points from 2000 to 2001, following significant increases in the percentage of small and medium-sized banks offering such accounts in the previous year.\(^\text{278}\) These free checking accounts, however, may still be ill-suited to low-income consumers, given minimum balances and high fees for NSF, overdraft, and deposit returns.

\(^{272}\) RETAIL FEES STUDY, supra note 150, at 5 tbl.3.

\(^{273}\) Id. at 18-62. Empirical research testing this variation against the numbers of unbanked households, and against the presence of alternative financial service providers, could shed light on these relationships.

\(^{274}\) Id. at 8.

\(^{275}\) Id. at 6.

\(^{276}\) Id. at 7.

\(^{277}\) Id. at 10-15.

\(^{278}\) Id.
Table 2. Fee Structure by Size of Institution

<table>
<thead>
<tr>
<th></th>
<th>Large*</th>
<th>Medium</th>
<th>Small</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Checking</td>
<td>46 %</td>
<td>37.6 %</td>
<td>26.3 %</td>
</tr>
<tr>
<td>Free Savings**</td>
<td>0.9-2.1 %</td>
<td>7.8-14.3 %</td>
<td>20.7-20.5 %</td>
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<tr>
<td>Stop-payment order</td>
<td>$21.53</td>
<td>$19.46</td>
<td>$16.69</td>
</tr>
<tr>
<td>NSF checks</td>
<td>$24.70</td>
<td>$22.05</td>
<td>$19.33</td>
</tr>
<tr>
<td>Overdrafts</td>
<td>$25.10</td>
<td>$22.22</td>
<td>$18.56</td>
</tr>
<tr>
<td>Deposit returns***</td>
<td>$5.90</td>
<td>$7.60</td>
<td>$6.82</td>
</tr>
</tbody>
</table>


* Large = > $1 billion. Medium = $100 million to $1 billion. Small < $100 million.

** The first figure in each column of this row represents passbook accounts; the second figure represents statement accounts.

*** While nearly all banks of any size charge for stop-payment orders, NSF, and overdrafts, only 83% of medium-sized banks and 65% of small banks charge customers for deposit items returned.

The structure of these accounts is a key driver in keeping the unbanked out of the banking system. As discussed above, surveys consistently show that the price of account products and minimum account balance requirements are important determinants of being unbanked. Studies have confirmed that many of the unbanked would become "banked" if they had access to a relatively low-cost electronic account of the type that this Article proposes. These accounts could plausibly be offered by financial institutions with modest governmental incentives to cover start-up costs. In fact, the unbanked have responded to account products tailored to their needs. For example, in Puerto Rico, Banco Popular introduced Acceso 24, an electronic account, with no minimum monthly balance, free direct deposit, unlimited ATM access, and a low monthly fee. The bank has enrolled tens of thousands of low-income customers in the product since 1995.

Cultural issues and reluctance to use banks may matter, but many of the unbanked already use, or have used, the banking system. Nearly half the unbanked, according to one study, use banks, thrifts, or credit unions to

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279 See supra note 21 (discussing surveys of reasons for being unbanked).
280 See generally ETA CONJOINT RESEARCH, supra note 51.
281 See infra notes 330-44 (discussing product experimentation and providing limitations on lessons from Puerto Rican market).
282 About 18% of unbanked respondents to surveys reported that they were not "comfortable" dealing with banks. See CASKEY, FILENE INSTITUTE REPORT, supra note 86 (17.6%); Kennickell et al., supra note 1 (18.5%); see also supra note 22.
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cash checks at least some of the time, although far fewer unbanked households in inner city communities use such institutions. Between 48% and 70% of the unbanked have had an account at a financial institution at some time in the past. Existing products, however, are too costly, too risky, or not well-suited to their needs. Moreover, because bank hours and locations may be less convenient for low-income workers than those offered by AFS providers, and branch expansion or longer hours are costly, I focus my proposals on expanding access to financial services through ATMs and other electronic delivery mechanisms that can be expanded to more locations and with longer hours less expensively than bank branches. As discussed below, I propose ways in which such electronically based accounts should be tailored to the needs of low- and moderate-income households if they are to be brought back into the financial services mainstream, or enter for the first time.

While high fees pose one barrier to access for the unbanked, a second barrier comes from difficulties that many unbanked persons may have in qualifying for conventional bank accounts because of past problems with the banking system. The ChexSystem, a private clearinghouse used by most banks to decide whether to open bank accounts for potential customers, records that nearly seven million individuals have had their accounts closed for prior problems, such as writing checks with insufficient funds or failing to pay overdraft charges. Records of prior problems are kept in the system for five years, during which time these individuals will likely be unable to open a conventional bank account at most banks, thrifts, and credit unions. While some individuals undoubtedly pose undue risk for account ownership, many potential customers could responsibly use bank accounts. Banks could obviate this concern by working with the private clearinghouses to better distinguish among types of past problems, by offering accounts contingent on completion of financial counseling, and by offering electronically based accounts with
online bill payment or automatic money orders, and without check-writing privileges, that pose little risk of overdraft.\textsuperscript{289} To date, banks have been reluctant to take these steps because the expected returns from such accounts are low.

Third, while many urban communities contain adequate numbers of both banking institutions and AFS providers, in some low-income urban and rural communities, banks, thrifts, and credit unions are not as readily accessible to potential customers as such institutions are in higher-income areas. A 1997 Federal Reserve Board study found that low-income central city neighborhoods have far fewer bank offices per capita than higher-income areas and those outside the central city.\textsuperscript{290} In Chicago, 40\% of low-to moderate-income neighborhoods had only check cashers, 32\% of low-to moderate-income areas had both check cashers and banks in about equal proportions, and 28\% of low- to moderate-income areas had only banks. Areas in Chicago with only check cashers have a greater percentage of minority households than other low- to moderate-income areas in Chicago.\textsuperscript{291}

Similar patterns may persist in the distribution of ATMs. In New York and Los Angeles, there are nearly twice as many ATMs per resident in middle-income zip codes as there are in low-income zip codes, according to 2000 Treasury Department research.\textsuperscript{292}

Location is simply one aspect of convenience, of course, and bank branches (though not ATMs) lack the convenient hours of most AFS providers.\textsuperscript{293} However, location may be a less important determinant of financial service usage than is commonly thought. One study found that

\textsuperscript{289} Over the long term, the risk of overdraft from checks may be reduced by widespread adoption of check truncation technology, allowing information to be processed and settled electronically rather than by paper, combined with online verification of demand deposit account balances. See, e.g., Priya Malhotra, Visa: Check Verify-Convert Service Catching On, AM. BANKER, Sept. 20, 2002, at 7 (describing online verification system). This technology is nascent, and widespread adoption of check truncation by merchants and of account-verification by banks would be required before checking accounts become sufficiently risk-free as to be reasonable substitutes for online debit card access.

\textsuperscript{290} See R. Avery et al., Changes in the Distribution of Banking Offices, 83 FED. RES. BULL. 707, 723 (1997).

\textsuperscript{291} See Rhine et al., supra note 60, at 15 (noting that areas with only check cashers have an 85\% minority population, compared to a 77\% minority population overall in low- to moderate-income areas).

\textsuperscript{292} The research used MasterCard/Cirrus ATM data. Solid data on the geographic distribution of ATMs nationwide are lacking. POS at retail locations, with cash-back, may make up for some of this lack of ATM access, but data are not available on POS distribution.

\textsuperscript{293} See DOVE REPORT, supra note 2, at 29.
"proximity to the nearest branch was not a significant determinant of whether an individual owned a checking account."²⁹⁴ Another study found that non-bank financial institutions are located closer to bank branches or ATMs than to other non-bank providers.²⁹⁵

Fourth, banks doubt that accounts tailored to low-income individuals will be profitable. As discussed more fully below,²⁹⁶ while a financial institution's recurring monthly costs for administering the account can likely be covered by low monthly fees charged to consumers, at this early stage in the evolution of research and development for low-income products, banks' up-front costs are likely to exceed what most unbanked households are willing to pay. Financial institutions may be reluctant to expend the resources for research, product development, training, marketing, and education, which are necessary to expand financial services to lower-income clientele. Financial institutions may need incentives to pursue research and product development, to be shared widely in the industry, with respect to accounts for low-income customers, particularly for accounts based on electronic payments technology.²⁹⁷ Further market research would help to define the product needs of low-income families and existing products will likely need to be modified to serve this clientele. Marketing of new products to low-income persons and training of bank staff are both critical to the success of any new product; yet, given the expense and the expected low returns, they are often not fully pursued even when financial institutions decide to become involved with offering financial services to low-income customers. If the unbanked do not know about the availability of new products and services, they are not likely to seek out financial services at banking institutions. If local banking personnel are not informed about new offerings, the unbanked will find it difficult to open accounts even where local branches are convenient and accessible. Yet the costs of marketing, training, and education associated with these services—at least until electronic banking services for the poor become widespread—are likely to exceed a price that low-income households could afford.

Fifth, at least for a segment of the low-income population, lack of

²⁹⁴ VERMILYEA & WILCOX, supra note 18, at 14.
²⁹⁵ See DOVE REPORT, supra note 2.
²⁹⁶ See infra notes 310-312.
²⁹⁷ See Sujit Chakravorti & Timothy McHugh, Why Do We Use So Many Checks?, ECON. PERSPECTIVES, Third Quarter, 2002, at 45 ("Consumers, merchants, and financial institutions may be unwilling to invest in emerging payment technologies due to uncertainty about whether they will be widely accepted in the marketplace.") available at http://www.chicagofed.org/publications/economiperspectives/2002/3qepart3.pdf. It may be argued that incentives for research and development would provide indiscriminate subsidies for the banking industry, but I believe an incentive can be structured that benefits low- and moderate-income households even if the results have broader applicability. In fact, broader applicability provides an incentive for participation. I discuss the proposal infra Part V.
financial education with respect to account ownership, budgeting, saving, and credit management is a significant barrier to personal financial stability. The need for financial education may be particularly acute among immigrants and other groups unfamiliar with American banking practices. The benefits of financial education are not likely to be fully captured by any one financial institution or other entity offering education because an educated consumer will shop for financial services among competing providers. Financial education also benefits the financial system as a whole. Thus, education at any scale will likely be under-funded without public or philanthropic subsidy.

Lastly, immigrant communities may face difficulties regarding proper documentation for opening an account, either because they lack such documentation, or they fear that depositories will police immigration laws. Nearly 40% of Hispanic immigrants without bank accounts in one survey cited their immigration status as a major barrier to becoming banked. Treasury has made clear that it is up to banks and thrifts to ensure that their identification verification is consistent with regulators' "know your customer" rules, which have gained heightened significance in the wake of the USA PATRIOT Act. Despite congressional opposition, Treasury indicated that such identification could include consular-issued identity cards commonly used by Mexican residents and other immigrants in the United States. Some banks have begun to accept this form of identification for opening accounts at their institutions. Matricular cards alone, however, will not help immigrants who are not lawfully in the U.S. An IRS-issued individual taxpayer identification number or a social security card is needed for interest-bearing accounts. Moreover, the IRS will no longer guarantee that taxpayer information will not be shared with the Immigration and Naturalization Service.

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300 After some members of Congress raised concerns over the proposal, Treasury issued a notice of inquiry seeking comment on its earlier rule, and then reaffirmed. Press Release, U.S. Dep't of the Treasury, Fact Sheet: Results of the Notice of Inquiry on Final Regulations Implementing Customer Identity Verification Requirements Under Section 326 of the USA PATRIOT Act (Sept. 18, 2003), available at http://www.treas.gov/press/releases/reports/js7432.doc.

B. Governmental Policy and Private Sector Innovation

Despite these barriers, the 1990s witnessed a period of strong economic growth and technological innovation that improved the prospects for banking the poor. During the latter part of the 1990s, governmental policy began to focus on expanding access to financial services for low-income persons, focused initially on recipients of federal benefits and later on low-income persons more generally. In addition, financial institutions began to experiment, in the last two years, with products designed to reach Hispanic consumers, primarily with new techniques to send remittances to family members in other countries in competition with Western Union and other wire transfer services. Innovations in this area hold the potential to assist the unbanked more broadly. Community development financial institutions have also experimented with new products to reach the unbanked. Lastly, financial institutions in other countries have made strides in serving low-income persons. These experiments, although quite small in scope and scale—even cumulatively—are instructive with respect to the potential for financial innovation to help meet the needs of low-income persons.

1. Electronic Funds Transfer '99 and Electronic Transfer Accounts

The Treasury Department’s efforts to increase electronic payment of federal benefits, pursuant to the Debt Collection Improvement Act of 1996, while aimed at a narrower goal—reducing the cost of making federal benefit payments—may also have helped to spur innovation in serving low income households. Under Treasury’s electronic funds transfer (EFT '99) program, direct deposit into bank accounts has increased as a portion of all federal benefit payments from 58% in 1996 to 77% in 2002. This increase in benefit payments reflects an increase in both direct deposit to existing accounts and the percentage of benefit recipients who have obtained bank accounts.

Under EFT '99, Treasury launched the Electronic Transfer Account (ETA), a low-cost electronically based bank account for federal benefit recipients. The ETA provides for a maximum fee of $3.00 per month and no minimum balance, except where required by law. The ETA offers a minimum of four cash withdrawals and four balance inquiries per month, through any combination of ATM and/or teller access (at the discretion of

303 ETAs are individually-owned bank accounts that accept electronic federal benefit, wage, salary, and retirement payments, and other deposits as permitted by the offering financial institution. U.S. Dep't of the Treasury, ETA: Background, at http://www.fms.treas.gov/eta/background.html (last accessed Dec. 17, 2003).
the financial institution), and allows access to the institution's point-of-sale (POS) network, if available. It provides for direct deposit of federal benefits and, at the option of the financial institution, the ETA may cover direct deposit and may be an interest-bearing account. Additionally, the ETA provides the same consumer protections, including those guaranteed under Regulation E, that are available to other account holders at the financial institution. Under the program, Treasury provides financial institutions offering ETAs with a one-time payment of $12.60 per account to offset the costs of opening the accounts. Despite the relatively low reimbursement amount, as of Spring 2002, nearly 600 banks, thrifts, and credit unions were offering ETAs at over 18,000 locations nationwide. Banks may be motivated to participate for a variety of reasons: good public relations from community service, positive consideration under the Community Reinvestment Act, a belief that with reimbursement the product is reasonably profitable, or a desire to reach a new customer segment that may one day need other bank products. Nearly 64,000 benefit recipients have opened these ETAs thus far.

The ETA could presumably make faster progress were additional funds made available for marketing, education, and training. The ETA initiative could also be linked with state EBT programs, discussed below, and the First Accounts pilot to permit a greater range of products to be offered to low-income households, whether federal benefit recipients, state beneficiaries, EITC-eligible taxpayers, or low- and moderate-income families more generally.

For our purposes, the ETA project also revealed important information about the costs of offering electronically based accounts. Based on evidence to date, banks are likely to need subsidies to cover the

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304 12 C.F.R. § 205.6 (2002) (limiting consumer's liability for fraudulent transfers to $50 if timely notice is given to the bank, and to $500 if timely notice is not given).
305 Research conducted for the Treasury Department by Dove Associates concluded that the average cost of opening an ETA account is $12.60. Actual costs vary significantly by institution. The $12.60 does not include costs for marketing, training, education, technology platform changes, or research. Treasury estimates from other account products suggest that marketing ETAs would cost an additional $9 to $11 per account. See DOVE ASSOC'S. & U.S. DEP'T OF THE TREASURY, ETA INITIATIVE, FINAL REPORT 67 (1998) [hereinafter DOVE ETA REPORT].
307 See U.S. Dep't of the Treasury, ETA Reports & Statistics, at http://www.fms.treas.gov/eta/reports.html (last visited Nov. 29, 2003). I was involved in a small experiment that Treasury conducted with the U.S. Postal Service to place ATMs in post offices in several low-income urban and rural areas.
309 See infra Subsections IV.B.2. and V.A.1.
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cost of initiating a program but could profitably offer accounts on a monthly recurring basis. Analysis conducted by Dove Consulting for the Treasury Department examined cost structures for a range of accounts and types of financial institutions. Although cost structures are highly sensitive to precise features of the account and type and size of the institution, anticipated costs for an average financial institution offering an all-electronic account with no teller visits may be instructive. Dove estimated that such an ETA account with a $3.00 monthly fee would produce pre-tax profit of $0.93 per month, excluding costs of research and product development, marketing and education, program start up, account set up and closure, and reclamation costs. Average account set up costs of $12.61 would take thirteen and a half months to recover. A more critical expense, however, is the expense of product development for each financial institution. Dove estimated that ETA products could cost between $64,000 and $148,000 for each financial institution. Even if a financial institution were to open 10,000 ETAs, product development would still cost between $6 and $15 per account. Marketing and education expenses are likely also to be high, as are the costs of training bank personnel about the product.

Anecdotally, banks are reporting to Financial Management Service (FMS) that they are signing up customers who inquire about ETAs for direct deposit into regular banking accounts. This may indicate that a portion of the unbanked federal benefit recipient population can be persuaded to open accounts once they receive minimal education about the benefits of direct deposit. Moreover, banks are attracting these customers without making any changes to existing account structures to induce them to sign up. This group also apparently does not have a prior poor credit history that would militate against a different account structure. (It is not clear, however, that these persons signing up for direct deposit are actually unbanked federal benefit recipients who would have been eligible to open ETAs.)

Although EFT '99 seems to have spurred positive developments for low-income financial services, some consumer advocates have argued that the program has also spurred developments adverse to consumers. In particular, they argue that expensive bank-AFS provider relationships have sprung up to provide federal benefits electronically through check cashers, effectively re-converting the electronic payment from the government to a

311 DOVE ETA REPORT, supra note 305, at 6. ETA monthly revenues were estimated at $3.47, customer service at $1.75, transaction processing at $0.40, and ATM expenses at $0.38.
312 See, e.g., GAO REPORT, supra note 17, at 32-33 (discussing financial institutions' reluctance to market accounts with low profitability).
check, and then requiring holders to cash them for a fee.\textsuperscript{313} Despite the availability of these options, and likely because of their high cost and low benefit, there appears to be little appetite for them among consumers.\textsuperscript{314}

2. Electronic Benefits Transfer

The 1996 Welfare Reform law mandated that states convert from paying federal welfare benefits in the Temporary Assistance for Needy Families (TANF) program by check to making such payments electronically. State electronic benefit transfer programs cover not just welfare payments, but a host of other state programs as well. A 2001 National Automated Clearinghouse Association (NACHA) survey found over forty states, the District of Columbia, and Puerto Rico now use Electronic Benefits Transfer (EBT) to make food stamp payments, and most remaining states have plans to set up EBT programs shortly.\textsuperscript{315} Nearly 80\% of food stamp benefits are now issued using EBT.\textsuperscript{316} One half of NACHA-surveyed states also permit cash benefits to be placed on EBT cards; one third also deliver child care benefits; 20\% place SSI benefits on EBT cards; 15\% use the cards for Medicaid eligibility; and more than one half of the surveyed states also use EBT cards for other programs.\textsuperscript{317} As child-care subsidies have increased significantly as a percentage of TANF spending in recent years,\textsuperscript{318} the EFT trade group has recently launched a campaign to encourage states to deliver federal and state child-care subsidies through EBT.\textsuperscript{319}

\textsuperscript{313} See EFT Requirements of the Debt Collection Improvement Act of 1996 and the Use of ETAs: Hearing on Implementation of EFT Requirements Before the House Subcomm. on Oversight and Investigations of the Comm. on Fin. Servs., 107th Cong. 52 (2001) (statement of Margot Saunders, National Consumer Law Center) (detailing a number of costly bank-check cashier relationships set up for federal benefit recipients).

\textsuperscript{314} See DOVE REPORT, supra note 2, at 27. Although 87\% of surveyed non-bank financial institutions (NBFIs) are aware of direct deposit products that would allow customers to access payments deposited in a bank through the NBFi, only 27\% offer such products. The typical NBFi that offers a direct deposit product has only twenty-two direct deposit customers, whereas these NBFIs cash an average of 700 to 3,400 checks monthly. NBFi managers told researchers that compared to check cashing, these products are less profitable to NBFIs and are more expensive for customers. Id. at 9, 27.


\textsuperscript{316} RETAIL PAYMENTS STUDY, supra note 134, at 67.

\textsuperscript{317} See NACHA EBT SURVEY, supra note 315.


\textsuperscript{319} See David Breitkopf, Trade Group To Push EBT for Subsidized Child Care, AM. BANKER, Nov. 21, 2001, at 10.
Unfortunately, the way EBT has been set up in most states has minimized the extent to which electronic transfer could be utilized as an entry point to banking. Most states do not seek to establish bank accounts for benefit recipients, but instead use a contractor to provide debit-based access to funds held by the state government in a pooled account. Doing this allows states to have the benefit of the “float” on benefit funds before recipients withdraw the funds. Switching to direct deposit of benefit funds into recipients’ accounts would require states to forego the benefit of this float, something that they are unlikely to do at this time given the current fiscal crises in many states. In addition, states hope to minimize administrative costs by having a single prime contractor deliver EBT services rather than seeking out all depositories in the state to offer EBT. The prime contractor approach also may reduce overall costs of educating recipients about accounts by making accounts uniform. If a variety of bank accounts are offered by a range of financial institutions, by contrast, education and marketing costs would presumably increase.

Although nearly all states have focused on a prime contractor model using debit card access for delivering benefits, nineteen states now also permit recipients to have cash benefits directly deposited into a bank account established by the beneficiary. In a recent survey, only 24% of cash benefit recipients in EBT programs had bank accounts, and only 42% of those with bank accounts had benefits directly deposited to those accounts. Perhaps because the prime contractor benefit card model limits access to benefits to the geographic coverage of the prime contractor’s ATMs, about a third of EBT recipients in the survey have had some problem accessing cash, with the most common reasons being that they could not find an ATM or POS that accepted their EBT card for cash withdrawals. Most EBT recipients responding to the survey could not withdraw all of their benefit funds without paying fees or surcharges; of those paying for withdrawals, the most common monthly total for accessing funds was between $2.51 and $5.00. Although the most common choices for usual use of EBT cards were ATMs and POS at grocery stores, survey respondents also frequented check cashers to access their benefits electronically.

States have made a variety of arrangements with respect to charges

320 LEYSER, SELECTED CHARACTERISTICS, supra note 315. A handful of additional states are considering the option. id.
322 id.
323 Id.
324 id.
for ATM and POS usage: Fifteen states permit at least four free ATM withdrawals per month; twelve states permit two to three free ATM withdrawals per month using EBT cards; the rest permit banks to charge fees for any ATM usage. The most common fee for ATM withdrawals, when such a fee is permitted to be charged, was $0.85. Most states permit free POS withdrawals, although some states include these withdrawals in the ATM fee-free limitations or require purchases for cash-back to be fee-free.\textsuperscript{325} Most states permit banks to surcharge for ATM use but discourage merchant POS surcharging; some states have negotiated agreements with banks or networks to refrain from surcharging EBT recipients.\textsuperscript{326}

There is a narrow window within which states could choose to restructure contracts to use EBT to develop banking relationships. Contracts, usually lasting five to seven years, will be up for renewal in most states within the next three years.\textsuperscript{327} States could move towards providing EBT through individually owned bank accounts and negotiate with networks for surcharge-free alliances for EBT-card holders. In so doing, states would be increasing the effectiveness of their welfare-to-work strategies by bringing low-income families into the banking system in preparation for their entry into the workforce. States should permit these families to retain their EBT-issued bank accounts once they make the transition to the working world. This step may decrease the likelihood that new labor force entrants will turn to cashing services once employed and increase the likelihood that they will arrange for direct deposit of their income. Given the high turnover rates of households on and off welfare,\textsuperscript{328} permitting families to retain EBT-issued bank accounts may be important to those families' financial stability. These initiatives could be combined with use of TANF funds for financial education, although TANF funding is tight in the current economic climate. Some states may wish to experiment with using TANF funds to make lump sum deposits into new bank accounts of those moving off welfare as an incentive to open a new account and to begin saving.\textsuperscript{329}

3. Private Sector Innovation in Banking Products

Partly in response to increased information about the unbanked and incentives created by EFT '99 and EBT, a number of banks, thrifts, and

\textsuperscript{325} LEYSER, SELECTED CHARACTERISTICS, supra note 315.
\textsuperscript{326} Id.
\textsuperscript{327} See id. (listing states, 85% of which will be up for renewal); NACHA EBT SURVEY, supra note 315, at 44 (showing that 60% of surveyed states will be up for renewal).
\textsuperscript{328} See generally REBECCA BLANK & RON HASKINS, BROOKINGS INST., THE NEW WORLD OF WELFARE (2001).
\textsuperscript{329} I take up savings policy and discuss Individual Development Accounts and other savings strategies more fully in SHERRADEN & BARR, supra note 1.

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credit unions have begun to experiment with a variety of products designed to serve the needs of low-income individuals. These efforts, though small in scale, suggest that the type of policies that I advocate here could plausibly be undertaken in the real world.

For example, Banco Popular has made great strides in reaching the 50% of Puerto Rican residents who are unbanked. Banco Popular’s Acceso Popular account has a $1 monthly fee, no minimum balance, free ATM transactions, and free electronic and telephone bill payment. To encourage savings, Acceso Popular has a savings “pocket” into which small sums (initially, $5 per month) are automatically transferred from the Acceso Popular transaction account. The savings “pocket” pays modest interest. Funds may only be withdrawn by seeing a teller and account holders must pay a fee to see a teller more than once a month to discourage withdrawals. Banco Popular opened nearly 60,000 such accounts in 2001, with half of those activating the savings “pocket” in their accounts. Many of the account holders open an account to save for a specific purchase, and then close the account once the purchase has been made. Banco Popular has a relatively low cost structure and higher returns from merchant POS fees from these accounts than would a similar institution in the states because the bank owns about half of the ATM/POS infrastructure in Puerto Rico. In addition, the potential market for these products represents a larger share of Puerto Rico’s market than would similar products in the states because such a high percentage of Puerto Rico’s population is unbanked. Nonetheless, Banco Popular’s experience suggests types of accounts that would prove attractive to low-income clientele.

In the states, Banco Popular has focused not on retail banking services but on its over 150 check-cashing outlets and over fifty mobile check cashing vans that visit workplaces, making Banco Popular the third largest check casher in the United States. More recently, it has pursued two additional strategies. Banco Popular has opened a co-branded check-cashing outlet/bank branch in California to give its customers access to other types of services, in the hope that unbanked check cashing customers will be drawn into using banking services. Banco Popular has also offered its Acceso Popular product in the states, as well as a debit-card based account in which customers are given two cards, one for themselves and

331 Banco Popular, supra note 88 (citing Freyre Economic Forecast & Gaither Int’l, A Survey of the Unbanked Households in Puerto Rico (1996)).
332 Press Release, Banco Popular, Banco Popular Launches “Programa Acceso Popular” and Brings it Directly to the Community and the Workplace (May 13, 2002) (on file with author).
333 Banco Popular, supra note 88.
one to send home to relatives who can then withdraw funds without high-priced wire transfer fees. Thus far, the account is linked to remittances to Puerto Rico and to Mexico, where Banco Popular was able to purchase ATM access rights. In Chicago, where Acceso Popular was piloted, 500 accounts were opened, some 80% of which had savings activated, with high average balances of $1,900.\footnote{Ben Jackson, \textit{Popular Aims To Double in U.S.}, \textit{AM. BANKER}, July 15, 2002, at 1.}

Bank One is experimenting with using a broader range of credit criteria and low account minimums for opening checking accounts. Low-income participants have managed to maintain average checking balances of $1,100 and average savings balances of $1,600.\footnote{Bringing More Unbanked Americans into the Financial Mainstream: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 23, 24 (2002) (statement of Jaye Morgan Williams, Senior Vice President, Managing Director of Community Investment, Bank One Corporation).}

ShoreBank, based in Chicago, has focused on bringing EITC recipients into the banking system.\footnote{See Ben Jackson, \textit{ShoreBank Courts Unbanked via Tax Service}, \textit{AM. BANKER}, Dec. 12, 2001, at 6. Shorebank is a Community Development Financial Institution (CDFI), a specialized financial intermediary serving low-income communities. Of the 553 CDFIs certified to date by the Treasury Department’s CDFI Fund, 159 are banks, thrifts, or credit unions offering depository services. In a 2000 survey, 21 CDFIs provided 141,440 checking and saving accounts to low-income customers. These accounts had balances averaging $1,815. These depository CDFIs also offered 985 Individual Development Accounts (IDAs) with an average balance of $395 per account. \textit{Fiscal Year 2003 Appropriations: Hearing Before the Senate Appropriations Subcomm. on VA, HUD, and Independent Agencies}, 107th Cong. (2002) (testimony of Tony T. Brown, Director, CDFI Fund).} In its program, ShoreBank worked with a local voluntary income tax assistance (VITA) organization\footnote{Nationwide, there are only enough volunteer resources at VITA sites to prepare about one-tenth of the seventeen million returns by filers with income at or below the poverty threshold. \textit{Nat’l Taxpayer Advocate, FY 2001 Annual Report to Congress} 50-51 (2001).} to provide tax preparation advice to EITC filers in ShoreBank’s branches. By focusing on EITC recipients, the program potentially reduces transaction costs and increases the likelihood of encouraging account-opening and saving. EITC recipients filing through VITA offices do not face high tax preparation and filing fees, nor do they have an incentive to take out expensive refund anticipation loans to pay for tax preparation services.\footnote{See supra Section II.D.} EITC refunds also present an opportunity for low-income people to open an account in order to save and earn interest, as well as for banks to open accounts given the potential for some interest income.

In the pilot, take-up rates were low but account-holders found participation useful for transactions, savings, or access to credit. Twenty percent of low-income individuals who had their taxes prepared agreed to direct deposit their refund into a savings account with debit card access; of these, 60% of new account openers were previously unbanked.\footnote{See \textit{Bringing More Unbanked Americans into the Financial Mainstream: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs}, 107th Cong. 52, 54 (May 2, 2002).} About
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half of participants used their accounts for savings or transactional purposes beyond simply depositing their refunds. A follow-up study found that 14% of account holders were “savers,” maintaining significant balances for at least six months, while 22% were “transactors,” using the account regularly for direct deposit of paychecks or government benefits, and making regular withdrawals. Twenty-two percent spent funds slowly, while 41% withdrew most of their funds in the first month. Customers believed that the accounts helped them to save; they paid less for preparation of taxes; financial transactions, including ATM use, were “more convenient and less expensive”; and credit card companies began to offer them credit “that might have been denied in the past.”

Larger refunds resulted in a greater desire to open an account; account opening at the time of the refund was critical to interesting new customers; quick refunds through electronic filing were important to customers signing up for accounts; and a number of account holders signed up for direct deposit of paychecks or government benefit checks. ShoreBank has experienced low monthly costs, but the ShoreBank initiative is currently operating at quite a small scale.

Fleet is working with a nonprofit organization, Doorways to Dreams, to create an Internet platform that non-profit providers of individual development accounts can use to reduce the costs of providing accounts for low-income savers. Fleet has also launched a new debit product for the unbanked, Access Advantage, to move an estimated 8,000 employees from payroll checks to bank accounts this year. The accounts carry no minimum balances, no monthly fees, permit no check writing and allow free ATM withdrawal from Fleet’s ATMs, as well as free POS withdrawal. Fleet expects to cut the number of non-customer payroll checks processed by its branches by 216,000 from 1.1 million this year, both to reduce lines at branches, as well as to provide a service to its corporate clients.

(testimony of Fran Grossman, Executive Vice President, Shorebank Advisory Services) (noting that participants in the pilot found reduced refund times from direct deposit, with some receiving their refund in as few as 8 days). Cf. BERUBE ET AL., supra note 38, at 7 (noting regular refund time of 14 days for direct deposit).

Shorebank spreadsheet on file with author; see also DOVE REPORT, supra note 2 (finding monthly costs under $3.00).


See David Wessel, Banking on Technology for the Poor, WALL ST. J., May 2, 2002, at A2; Veronica Agosta, Fleet Hopes Product Turns Unbanked into Customers, AM. BANKER, Apr. 2, 2002, at 2; see also Kevin Harlin, Banks Court Unbanked, TIMES UNION (Albany, N.Y.), Apr. 28, 2002, at E1. In contrast, KeyBank started imposing a $5 fee for noncustomer payroll checks cashed at
Other depository institutions have entered the low-income market by partnering with check cashers or payday lenders or closely following their business model. Union Bank of California, for example, has a check cashing unit, Cash & Save, which charges up to 2% of the check’s face amount for cashing checks. Union Bank attempts to transition some of its check cashing customers to banking products through “transitional” products, such as low-minimum savings accounts, and reports that 40% of its repeat check cashing customers have become banking customers.

Union Bank has also partnered with the non-profit Operation Hope to provide financial education and has a partnership with Nix Check Cashing to provide banking services through check cashing outlets. Bethex Federal Credit Union, a CDFI in the Bronx, New York, has partnered with RiteCheck Cashing Inc., a check cashing chain, to expand its presence in low-income neighborhoods through RiteCheck stores.

Other credit union-check casher partnerships have followed suit. Harris Bank opened a check cashing outlet in Chicago, seeking to encourage its clientele to open accounts at the bank. A pilot moved 8-10% of customers into accounts through financial education and partnerships with community groups. In Atlanta, El Banco de Nuestra Comunidad, a bank-check-cashing partnership provides services beyond those of a typical bank or check cashing outlet—with a children’s playroom, Internet access, free local phone service, an on-site IRS certifying agent, and classes on credit; the institution seeks to function as more of a community center for its immigrant clientele than a financial institution.

Based on the experience to date, efforts to expand access to electronic accounts have had positive but modest effects on account ownership and savings. Partnerships between check cashers and banks appear to be high cost and do not take advantage of electronic payment system or delivery network efficiencies, but may expand the range of financial services offerings available to low-income check cashing customers. Such partnerships may be particularly useful for those who do not have access to direct deposit at work. Strategies involving co-locating check cashing operations and bank branches may be more promising in terms of branches, in part to discourage teller use and in part to encourage new Key account holders. Id.

346 Union Bank’s Cash & Save charges 1.5% for payroll checks and 1.0% for government checks. Caskey, Reaching Out, supra note 20, at 90.


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transitioning customers to banking relationships, but they are also undertaken at relatively high cost. Automated check cashing through ATMs may be a promising strategy to lower costs if anti-fraud measures can be made effective.

4. Remittances and the Hispanic Market

President Bush and Mexican President Vicente Fox have focused on reducing the costs of the nearly $10 billion in annual U.S.-initiated remittances to Mexico. Remittances serve to bolster the Mexican economy, increase the purchasing power of recipients, and finance the growth of micro-enterprises. Remittances from the U.S. to all of Latin America and the Caribbean totaled $32 billion in 2002. While the degree to which Hispanics in the U.S. are unbanked varies significantly by country of origin, on average more than 40% of Hispanic immigrants lack a bank account. Most Latino immigrants send remittances back to their country of origin using wire transfer services, rather than banks.

A growing number of banks have focused on the Hispanic market as a new revenue source. For example, Bank of America has stated that it anticipates growth near its branches from the Hispanic population. In particular, banks have begun to view the market for remittances as a potential growth area. New initiatives may have the potential to expand access to banking services for low-income Hispanics, and these efforts


353 See, e.g., WOODRUFF & ZENTENO, supra note 352, at 5 (reporting that 20 percent of Mexican micro-enterprises studied were funded with remittances, constituting an additional capital investment in these firms of about $1.85 billion).


355 IADB SURVEY, supra note 298, at 7.

356 IADB SURVEY, supra note 298, at 5.


359 See Kuykendall, supra note 357 (finding anecdotal evidence that some large banks
may also have positive spillover effects for other low-income communities. Banks have begun to introduce competition into the remittance market with products such as Bank of America’s “Safesend” card, in which ATM card holders in a dozen U.S. cities can send money to relatives in Mexico by providing them with a debit card to access funds at ATMs. Wells Fargo introduced its own product, Dinero Instante, in which funds can be sent to certain banks and stores in Mexico, for $10 a transfer. Citibank offers similar products and has recently launched a new pilot approach, “Access Accounts,” targeted at Latino immigrants in the U.S., in which U.S. customers are offered a low-cost, all electronic bank account with no minimum balances, and low cost debit-card based transfers to Mexico and other locations. The World Council of Credit Unions has set up International Remittance Network, through which credit union members in the U.S. can send remittances to relatives in Mexico using debit cards, at 33% to 50% lower cost than a Western Union transfer.

Enhanced competition from the banking sector has already helped to drive down the cost of sending a Western Union wire transfer to Mexico to about $15, from $25. An impediment to greater competition in this market may be a lack of sufficient ATM and POS infrastructure to compete with Western Union’s strong penetration in Mexico and other recipient countries, although networks appear to be widely available in many parts of Mexico. The Inter-American Development Bank has made a grant to Mexico to improve ATM infrastructure for this purpose. In addition, the U.S. Postal Service offers a product for transmitting funds from U.S. post offices to Mexico, using Bancomer’s 2,300 branches there.

Progress on remittances is important for three reasons: First, given the high costs of sending remittances, the potential savings to be had from utilizing remittance programs are converting users into customers).

360 Breitkopf, supra note 358. But see David Boraks, Safesend Starts Slow, So B of A Tries Harder; Struggles in Drawing Mexico Transfer Biz from Noncustomers, AM. BANKER, Apr. 10, 2003, at 1 (detailing problems Bank of America had in marketing and anticipating changes in response).

361 Wessel, supra note 345; Kuykendall, supra note 357.

362 Kuykendall, supra note 357.

363 Robert Julavits, Citi’s Access Account Targets the Unbanked, AM. BANKER, Nov. 18, 2003, at 3.


365 Wessel, supra note 345. Unfavorable exchange rates embedded in these transactions may make the real cost of wire transfers significantly higher than reported.


367 See PARTNERSHIP FOR PROSPERITY, supra note 351, at 4.

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ATM-based products is large. Second, bank remittance products also have the potential to bring more Hispanics in the U.S. into the banking system. Third, strategies to reduce the costs of remittances have the potential to increase the flow of funds for development into Latin America.

Given the costs of setting up each remittance transaction as a stand-alone proposition, costs could be reduced by establishing a bank account for these customers. Account ownership would let immigrants convert income into cash, save, and pay bills—not simply send remittances. Although problems with account opening documentation will continue to present problems, a number of banks have begun to accept Mexican consular identification documents for Mexican immigrants in the United States seeking to open bank accounts. The strategies that I propose to expand access to bank accounts more generally would help to reduce the costs of sending remittances, and new approaches that a handful of banks are now beginning to explore for remittances may help to open up the banking system to the unbanked.

5. International Experience

A survey of approaches to serving the poor in other countries is beyond the scope of this Article, but I highlight a few here merely to suggest ways in which other countries have addressed similar problems. For example, South African banks were among the first to experiment with using technology to reach the unbanked. More recently, one of South Africa’s largest banks launched a bank that has fifty branches and 100,000 customers thus far, offering a savings account with an ATM card. South Africa is beginning to use its post offices to offer online bill payment. India is also experimenting with using its post offices to connect savings account holders with bill payment and international money transfers. In the U.K., banks have opened three million basic banking accounts, usually without check-writing, for unbanked Britons, regardless of income or credit rating, in response to the government’s 1999 report, Access to

369 See supra Section III.A.
370 See, e.g., Christian Berthelsen, Banking on Mexico, S.F. CHRON., May 14, 2002, at B1; Risa Brim, Bilingual Banking, LEXINGTON HERALD LEADER (Lexington, KY), June 12, 2002, at C1; Laura Mandaro, Mexican ID Gaining Favor with U.S. Banks, AM. BANKER, Nov. 13, 2001, at 2; see also Sam Quinones, Chicago S&L Rides Immigrant Wave from the Start, AM. BANKER, Mar. 4, 2003, at 4A.
Financial Services. Many of the accounts offer bill payment services, and some even allow access via mobile phones. The British government also plans to use post offices to provide banking services.

IV. Payments Systems and Distribution Networks

Expanding access to electronic payments systems and distribution networks is critical to banking low- and moderate-income households. More widespread adoption of these technologies would make electronic banking services more attractive to the unbanked and at the same time make it less expensive and less risky for financial institutions to expand access to banking services for the poor. With expanded electronic networks, both the demand for and the supply of bank services through electronic means to the poor would likely increase.

Checks are costly to process, pose the risk of being overdrafted at high cost to consumers and financial institutions, and cause delay in the availability of funds deposited. By contrast, direct deposit of income is lower cost to employers and permits immediate access to funds for consumers. Low-income persons who have access to direct deposit need not wait for a check to clear if deposited into an account and need not visit a check casher to get immediate access to funds. Yet many low-income workers do not have access to or take advantage of direct deposit, in part because many of them do not have bank accounts. Similarly, online debit for withdrawals at ATMs, and for payment and cash-back at point of sale, offer benefits to both low-income households and financial institutions. Online debit could provide low-income households with a means to access funds and purchase goods and services without the need for checking accounts that are expensive for banks to provide and contain the risk of overdraft. Online debit also saves time for consumers and labor costs for banks, as it reduces the need for teller time in bank branches. If banks offer an account with only debit-card access, low-income persons would have a convenient means for withdrawal and payment. If ATMs are outfitted with the ability to provide money orders, low-income people would have another method of paying bills. In addition, expansion of automatic bill payment through ATMs or internet access could further reduce the costs

375 See Jessica Bown, Banks Which Bar Poor Are Called To Account, SUNDAY EXPRESS (London), June 9, 2002, at Finance 21.
377 Payments systems, such as cash, check, or electronic payment, are a means of transferring value from one party to another. By distribution networks, such as bank branches and ATMs, I mean physical locations for a party to initiate or receive a transaction in the payments system.
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and increase the convenience of paying bills for utilities, rent, and other regular costs, but businesses must overcome high initial costs, customer inertia, and lack of customer access to bank accounts in order to expand direct bill payment. In combination, these technologies hold out the prospect that banks could provide low-cost electronic banking services to low- and moderate-income households.

Despite the potential of direct deposit and online debit, the widespread availability of ATMs, and the emergence of direct bill payment, the expansion of these technologies may be slower than is socially optimal. At least in part, that is because payments systems are characterized by positive network externalities. Private suppliers of network services may be unwilling to pay or lack sufficient incentive to provide the socially optimal level of services justified by those externalities. Payments systems require both buyers and sellers to accept the mode of payment. Sellers will not invest in the infrastructure needed to accept a mode of payment unless many buyers use this mode. Buyers will not choose a mode of payment not accepted by many sellers. If many buyers and sellers adopt the payment system, all users will be better off. But because public benefits to all users of the payment system exceed private ones to each participant deciding whether to use the system, this mode of payment may not be adopted or may be adopted slowly. In general, as electronic modes of payment become more widespread, it becomes increasingly more efficient and cheaper for others to use such payment systems. For our purposes, as networks spread and costs come down, low-income customers could increasingly access these modes of income receipt and payment.

Because the type of payment and distribution system significantly affects the cost and risk of providing financial services, the Article first discusses the network externalities literature, then charts changes in three areas: the processing of checks and the use of debit cards, the expansion of ATM networks, and the potential for direct deposit and direct payment. As payments shift away from paper and toward electronic means of transfer,

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378 Chakravorti & McHugh, supra note 297, at 45. For a discussion of network externalities, see Michael L. Katz & Carl Shapiro, Network Externalities, Competition, and Compatibility, 75 AM. ECON. REV. 424, 424 (1985) [hereinafter Katz & Shapiro, Network Externalities] ("[T]he . . . utility that a user derives from consumption of the good increases with the number of other agents consuming the good."); Michael L. Katz & Carl Shapiro, Systems Competition and Network Effects, J. ECON. PERSP., Spring 1994, at 93, 96 [hereinafter Katz & Shapiro, Systems Competition] ("Since social marginal benefits exceed private marginal benefits—that is, since there are adoption externalities—the equilibrium network size is smaller than the socially optimal network size, and the perfectly competitive equilibrium is not efficient."); Michael L. Katz & Carl Shapiro, Technology Adoption in the Presence of Network Externalities, 94 J. OF POL. ECON. 822 (1986) [hereinafter Katz & Shapiro, Technology Adoption] (discussing "sponsored" network technologies). But see, e.g., S.J. Liebowitz & Stephen E. Margolis, Network Externality: An Uncommon Tragedy, J. ECON. PERSP., Spring 1994, at 133 [hereinafter Liebowitz & Margolis, Uncommon Tragedy] (arguing that most network externalities do not exist, are better explained by other market failures, or are unlikely to result in market failures).
costs and risks decrease, which could significantly benefit the poor if they are brought into the banking system. Payment providers cannot capture the full social benefit of network expansion, however, and so because low-income consumers would likely benefit from network expansion to their communities more than both the average and marginal consumer, these payment systems and distribution networks may not be rapidly adapted to meet the financial services needs of the poor absent the type of governmental intervention often pursued when there are public goods and positive social externalities.379

A. Network Externalities

Network effects occur when the value to each consumer of a product is a function of how many other consumers buy that product.380 Network effects fall into two categories. The telephone provides "direct network effects" because a user's utility increases when other people purchase phones. A phone only has value to the extent that it can be used to communicate with other telephone users. If consumer A possesses the only telephone, the product is worthless. But the usefulness of that phone increases as more of A's friends and family make the same purchase. Consumers are benefited by "indirect network effects," when an additional consumer of the good alters third-party behavior.381 For example, consumer A, who is an Apple Computer user, will benefit if consumer B purchases an Apple Computer because it will increase the likelihood that computer programmers will create more software that their computers can run. The benefit A derives from B's purchase comes indirectly through the incentives it provides for third parties. For both types of network effects, the benefit of a network also increases as it becomes commonplace because the technology becomes easier to access.382

Network effects can give rise to externalities. When B decides whether or not to buy an Apple computer, B will not take into account the additional benefit that A will derive from the purchase.383 Nor will the telephone purchaser necessarily consider the benefit that others will

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379 As discussed more fully below, the argument based on network externalities does not apply with equal force across all of these areas, and it is the case that there are risks that government intervention can exacerbate rather than overcome network externalities.

380 Katz & Shapiro, Network Externalities, supra note 378, at 424.

381 See id.


383 The literature assumes that the transaction costs of negotiations among individual consumers are too high for such negotiations to occur. With respect to the example, it assumes that A is unable to pay B to purchase an Apple computer. If such negotiation occurred, consumers could internalize the network effect.
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receive from being able to call him. When network effects are positive, consumers may also base their purchasing decisions on what their peers are consuming regardless of the quality of the good. This presents the possibility that an inferior product may become an industry standard, deviation from which becomes costly to the individual. 384

Network externality analysis has been employed in antitrust law, 385 and gained prominence in the antitrust suit against Microsoft. 386 The government argued that network effects tend to produce standardization on one format because monopoly profits accrue to the firm that can establish its product as the standard. Firms have incentives to “tip” the market toward an equilibrium corresponding to its product. 387 Once a monopolist is established, network effects pose barriers for new entrants.

Yet network effects may be more benign than this analysis suggests. 388 First, lock-in on an inferior standard is less likely because early adopters will have an incentive to adopt the best technology in order to attract others needed for a network. 389 Moreover, the owner of a superior standard will have a strong incentive to provide subsidies to early adopters because such an owner stands to earn high profits if he monopolizes the market. 390 Second, network effects are posited in high technology industries such as computer operating systems 391 and video players, which feature high rates of technological advancement. As an established network standard becomes out-dated, the market becomes prone to tipping toward the newer, better standard. 392 Third, just as the network effect creates a barrier to entry, the possibility of tipping the


387 Some argued that this occurred when the VCR industry tipped from Beta to VHS. VCRs exhibit direct network effects because users of the same format can exchange tapes, and indirect network effects because ownership of a VCR encourages third parties to open tape-rental outlets featuring that VCR’s format, substantially increasing the value of that format to other owners. See Liebowitz & Margolis, Uncommon Tragedy, supra note 378, at 147-48 (disputing such claims).


389 Id. at 217-18.

390 See, e.g., Microsoft Corp., 253 F.3d at 34.

391 Consider, for example, how the VCR market tipped toward DVD in the late 1990s and the video-game market tipped from Atari to Nintendo in the late 1980s.
market towards a different standard and reaping monopoly profits makes entry more tempting to those with a superior standard. Adherence to the inferior technology represents lost profit to those suppliers with higher quality products, which implies an opportunity for a shift to the superior standard.\textsuperscript{393} The greater the difference in quality between the locked-in, inferior standard and the superior new entrant, the greater the gains to be had from entry.\textsuperscript{394} Fourth, network effects may experience diminishing marginal returns to scale after a critical mass is reached. For example, the addition of the first few telephones to the network dramatically increased its value. But now that the technology is widespread, the network effect of each additional telephone sold is negligible. As the full economies to scale of one network are realized, and the market continues to grow, it may thus be possible for more than one standard to coexist if the market is sufficiently large.\textsuperscript{395}

Application of the network externality arguments to card-based payment systems requires that there be incentives for the three relevant parties to adopt it. Banks must decide to issue the card; consumers must decide to use it; and retailers must decide to accept it. This interaction is exacerbated (or enhanced) by network effects. When any individual decides to enter the card network, the network becomes more attractive to potential future entrants. Each additional consumer who uses a card-based payment increases the incentive for retailers to accept that form of payment. The more retailers that accept the form of payment, the more advantageous it is for a consumer to carry it. The more consumers who want to carry the card, the more advantageous it is for a bank to issue it. The network only has substantial value when it reaches a critical mass of participants, however, so consumers and merchants lack sufficient incentives for initial entry into the network.\textsuperscript{396}

In many networks, this momentary inertia is overcome by one party sponsoring the format. Katz and Shapiro have demonstrated that when a firm owns the property rights to a technology, or when there are barriers to entry, a supplier will be willing to make an investment in the form of reduced pricing to establish the technology as the industry standard. When one form of technology is sponsored and another is not, however, the sponsored technology may be adopted too much from the perspective of social welfare. Katz and Shapiro demonstrated that a rival, non-sponsored

\begin{itemize}
\item \textsuperscript{393} See Liebowitz & Margolis, supra note 389, at 217-18.
\item \textsuperscript{394} See Liebowitz & Margolis, supra note 389, at 4 (1990) ("The greater the gap in performance between two standards, the greater are these profit opportunities, and the more likely that a move to the efficient standard will take place.").
\item \textsuperscript{395} Consider, for example, the coexistence of Apple computers and PCs.
\item \textsuperscript{396} See Ronald J. Mann, Credit Cards and Debit Cards in the United States and Japan, 55 Vand. L. Rev. 1055, 1063 (2002).
\end{itemize}
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technology may fail even when all consumers agree that it is superior.397

B. Checks and Debit Cards

Because payments systems produce network externalities, they often rely on a sponsoring entity to subsidize entry and set uniform rules and prices for network participants.398 With respect to checks, the Federal Reserve Board sponsored and subsidized the check clearance process, beginning at the turn of the last century, helping to establish a nationwide means for transferring funds and ensuring the dominance for decades of check payments.399 Although they remain the dominant form of retail payment, checks declined from 85% of non-cash payments in 1979 to 59% in 2001.400 In 2001, there were seventy-two billion non-cash retail payments, of which over forty-two billion were by check, and nearly thirty billion were by electronic payment.401

A significant portion of these checks could readily be converted to electronic payment. Some 30% of checks that are processed each year are cashed by the bank that issued them ("on-us").402 A portion of these on-us checks represent presentment of payroll checks by workers at their employer's bank,403 checks that could be readily converted to direct deposit with same day availability for workers—and with a concomitant decline in use of expensive bank teller time—as part of a strategy to bank unbanked workers. Some on-us checks, however, represent payment for informal sector or part-time employment that would be more difficult to convert to direct deposit and some of which may persist even if those who deposit them become banked. Nearly 20% of all checks are categorized as income payments from businesses or the government to individuals. These

397 See Katz & Shapiro, Technology Adoption, supra note 378; see also Carl Shapiro, Exclusivity in Network Industries, 7 GEO. MASON L. REV. 673, 676 (2001).
400 RETAIL PAYMENTS STUDY, supra note 134, at 21. Still, U.S. use of electronic payments as a percentage of all non-cash payments is low by international standards. The U.S. has the lowest use of cash and the largest number of non-cash transactions per person per year among the U.S., Canada, Japan, and Europe, but with electronic payments at fewer than 40% of non-cash payments, far lower use of electronic payment than Canada or Europe (where electronic payments make up 67% and 79% of non-cash payments, respectively). DAVID B. HUMPHREY, U.S. CASH AND CARD PAYMENTS OVER 25 YEARS 5 (Conference on Innovation in Financial Services and Payments, Fed. Reserve Bank of Philadelphia, 2002), available at http://www.phil.frb.org/econ/con/innovations/Humphrey.pdf.
401 RETAIL PAYMENTS STUDY, supra note 134, at 15. These figures exclude non-purchase transactions, such as wholesale wire transfers, ACH settlement transactions, and ATM withdrawals.
402 RETAIL PAYMENTS STUDY, supra note 134, at 12.
403 Some banks have recently begun to charge non-account-holders for cashing checks, even those drawn on the bank cashing them. See, e.g., Caroline E. Mayer, Bank Adds a $5 Fee To Cash Paychecks, WASH. POST, Apr. 11, 2003, at E1.
checks could be converted to direct deposit for those who now have accounts or are brought into the banking system.

Among paperless, electronic forms of payment, credit cards predominate. In 2001, there were fifteen billion credit card transactions, or about 50% of all electronic transactions; 8.3 billion debit card transactions, or 28%; and 5.6 billion Automated Clearinghouse (ACH) payments, or 19%. The growth rate for debit cards is faster than that of credit cards, and retail transactions using debit cards grew faster than those using credit cards in 2001. The Nilson Report predicts that debit card transactions will surpass credit card transactions in the next decade. In 2001, there were nearly as many online and offline debit transactions as there were ATM transactions.

Online debit—because it is low cost and low risk—holds out the most promise for expanding bank services to low-income households. Online debit cards can be used at an ATM, or at retail merchants with POS PIN pads for purchases or cash back. Online debit, which is routed through EFT networks, provides real-time settlement. Sales made with online debit result in a transfer of funds instantly, while offline debit presents a risk that the consumer will overdraft and requires the merchant to float the cost of sale for days. Online debit fees paid by the merchant to the card issuer are significantly lower than offline debit. Moreover, because a PIN is required for online debit, fraud rates may be lower than for signature-based cards. By contrast, offline debit cards can be used for purchases at checkouts where Visa or MasterCard are accepted by signing a receipt, do not allow cash back, are routed through Visa and MasterCard networks, use ACH settlement in one-to-three days, and carry fees paid to issuers that are much higher.

Despite the advantages of online debit, offline debit makes up two

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404 RETAIL PAYMENTS STUDY, supra note 134, at 19. ACH specializes in higher dollar-amount transactions than the other payment forms and carries three-quarters of the value of all electronic transactions. Id. ACH is a batch-processed, electronic inter-bank system for transferring value. See FED. RESERVE FIN. SERVS., FEDACH, available at http://www.frbservices.org/Retail/pdf/FedACH-FACT.pdf (last accessed Dec. 17, 2003).

405 See, e.g., David Breitkopf, MasterCard To Provide Debit Settlement for Pulse, AM. BANKER, Feb. 8, 2002, at 16 (citing MasterCard estimate that growth of debit is twice as fast as growth of credit).


408 TONY HAYES ET AL., DOVE CONSULTING GROUP & NYCE CORP., 2002 ATM DEPLOYER STUDY 56 (2002) [hereinafter DOVE DEPLOYER STUDY]; see also Meyer, supra note 69 (describing rapid growth of debit card transactions).

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thirds of debit transaction volume.\textsuperscript{410} Moreover, less than one-third of merchants have online debit capacity.\textsuperscript{411} Offline debit is dominant in the United States, even though other countries generally utilize the more efficient online debit.\textsuperscript{412} Why?

The answer lies in the history of credit and debit cards in the United States. Banks first issued debit cards in the late 1970s, long after credit cards had become common,\textsuperscript{413} and debit cards were slow to catch on because relatively few merchants accepted them.\textsuperscript{414} A major impediment was that, to accept debit cards, a merchant had to purchase POS terminals to conduct transactions.\textsuperscript{415} Visa and MasterCard first resisted offering debit, then in the late 1980s created a joint online debit venture. The project was challenged on antitrust grounds, and the firms settled by ending the venture.\textsuperscript{416} By the mid-1990s, Visa and MasterCard began to focus their attention on using the widespread availability of their credit card infrastructure to offer offline debit. Visa and MasterCard implemented "honor-all-cards" rules that required merchants who accepted Visa and MasterCard credit cards also to accept their debit cards. In addition, Visa and MasterCard imposed a "one price" policy that prohibited merchants from charging a fee to customers for using their more costly, offline debit. Lastly, the firms each made their debit and credit cards physically indistinguishable. Because the higher interchange fees for offline debit could not be passed on to customers, consumers were indifferent to the form of payment, and use of offline debit increased at an inefficient rate.

Because most retailers already accepted credit cards, the infrastructure for accepting offline debit was in place years before online debit became viable. Offline debit, because it did not require a new infrastructure, enjoyed a first-mover advantage over online debit, which

\textsuperscript{410} RETAIL PAYMENTS STUDY, supra note 134, at 19.
\textsuperscript{412} Plastic Pricing — Visa and MasterCard Settle with Retailers, ECONOMIST, May 3, 2003, (reporting that between 54% and 70% of Canadian merchants have POS terminals, compared to only 28% of American merchants).
\textsuperscript{413} See Balto, supra note 411, at 1392.
\textsuperscript{414} Because a payment card network can arise only with concurrent participation by three groups of entities, the institutional environment that will support the deployment of payment cards must be one that includes favorable conditions . . . for participation by financial institutions that issue the cards, by merchants that accept the cards, and by consumers that carry them.
\textsuperscript{415} See, e.g., Barbara Grondin Francelle, Money Market: Debit-Savvy Consumers Ask for Cash Back at the Checkout, CONVENIENCE STORE NEWS, July 14, 2003, at 57 ("[B]usiness needs in the past haven't always justified having the PIN pad.") (quoting a retailer).
required installation of POS terminals. Moreover, even though offline debit was less efficient, consumers did not face any price differential for using offline debit, meaning that true economic costs were not being correctly allocated.\textsuperscript{417} Although consumers increasingly had access to cards that could be used for both ATMs and online debit, retailers faced higher capital costs for online debit and had lower incentives to purchase POS terminals because customers were indifferent to the payment method.\textsuperscript{418}

Competition between Visa and MasterCard, and between offline and online debit, actually results in higher, not lower interchange fees, for both products. Because they do not directly pay them, individual consumers are indifferent to the interchange fee charged by either Visa or MasterCard. Banks, however, which receive revenue from interchange fees, strongly prefer a high interchange fee and will base the decision whether to issue online or offline debit in part on which allows them to charge merchants higher fees. Visa and MasterCard have repeatedly responded to each other's interchange increases by themselves increasing fees.\textsuperscript{419} Merchants cannot respond by discouraging consumers from using these costlier forms of payment by providing a discount to whichever card association provided the lower interchange fee, because, consistent with network theory, the association agreements prohibit them from doing so.\textsuperscript{420}

As the interchange fees for offline debit increase, the profit a card issuer can make from an online-debit transaction appears small by comparison.\textsuperscript{421} Consequently, some issuers who offer cards with both online and offline capabilities charge the consumer a fee for PIN usage, actually promoting use of the more inefficient payment format.\textsuperscript{422} Merchants counter by promoting the consumer's ability to receive cash


\textsuperscript{418} See generally Dennis C. Mueller, First-Mover Advantages and Path Dependence, 15 INT'L J. INDUS. ORG. 827 (1997).

\textsuperscript{419} For example, in 1998, Visa announced that it was increasing its interchange fee by about 20%. In response, MasterCard increased its rate by 9%. Visa answered by raising its fee an additional 5%, and MasterCard responded with another increase. See David A. Balto, The Problem of Interchange Fees: Costs Without Benefits?, EUR. COMPETITION L. REV. 215, 216 (2000); Pete Hisey, How High Can You Go?, CREDIT CARD MGMT., Apr. 1, 1999, at 105.

\textsuperscript{420} The Reserve Bank of Australia has responded by reversing Visa and MasterCard's ban on surcharging customers and requiring a 40% cut in interchange fees. See Robin Arnfield, A Shakeup in Australia's Card Market, CREDIT CARD MGMT., Feb. 27, 2003, at 16.

\textsuperscript{421} See Jeffrey Green, Offline vs. Online Debit, CREDIT CARD MGMT., Nov. 1, 1998, at 17 (stating that offline debit is "cannibalizing" online debit, not because it is more efficient, but because banks prefer to issue offline debit cards to reap higher interchange rates).

\textsuperscript{422} See Burney Simpson, Debit Makes It a Horse Race; Once a Minor Player, the Debit Card Is Now Challenging Credit as Americans' Preferred Payment Card; What's Ahead on the Rapidly Evolving Debit Scene?, CREDIT CARD MGMT., Feb. 27, 2003, at 38.
back with PIN usage. For online debit networks to compete for card issuers, online interchange fees had to rise along with Visa and MasterCard's offline rates. Thus, competition between online and offline debit in attracting card issuers drove up rates for both products.

As the advantages of online debit became more apparent, however, and debit usage increased, offline debit's position as the industry standard became more tenuous. As debit use became more widespread, the potential savings from the installation of a POS terminal increased dramatically. At some point, the savings from accepting online debit would exceed the costs of installing the terminal. The market was prone to tip.

The resulting honor-all-cards rules and the prohibition of surcharging offline debit usage can largely be understood as an effort by Visa and MasterCard to "sponsor" offline debit to extend their market power. The prohibition on surcharges prevented retailers from forcing consumers to internalize the cost of their offline debit usage, thereby dampening consumer demand for POS terminals. The honor-all-cards rules, which effectively tied offline debit acceptance to credit card acceptance, effectively blocked retailers, whose customers demanded the availability of credit card usage, from refusing to accept offline debit. By maintaining a large base of retailers who accept the offline payment format, the incentive for a consumer to demand online debit was maintained at a low level. Visa and MasterCard essentially sought to postpone "tipping" to the more efficient online standard for as long as possible.

This tension came to a head with the recent antitrust suit led by Wal-Mart against Visa and MasterCard. Merchants banded together in a class-action lawsuit (now settled), alleging that the card companies' "honor all

423 Online Double-Digit Growth Loses Its Luster, Bank Network News, Sept. 11, 1998, at 1 (reporting that Wal-Mart is encouraging consumers to use PIN debit by asking them "if they would like to receive up to $100 cash back").

424 Compare Robert A. Bennett, The Retailers' Home Run, Credit Card Mgmt., June 26, 2003, at 24 (reporting that, in June 2003, the typical online-debit interchange fee for a $40 sale was $0.34), with Richard Mitchell, The Debit Card Balancing Act, Credit Card Mgmt., Dec. 1, 1995, at 14 (reporting that, in 1995, online interchange fees typically were $0.02 to $0.08 for a $100 purchase).

425 This is especially true for retailers who deal with a high volume of transactions. For these retailers, only a small percentage of their customers need use online debit for the savings to become substantial.

426 See Liebowitz & Margolis, supra note 389, at 3-4. Liebowitz and Margolis state, "There is no possibility of excess inertia in their model if all participants can communicate perfectly." The prohibition on surcharging offline debit is really a prohibition on a form of negotiation between consumers and retailers and thereby preserves offline debit's excess inertia.

427 Tying in this context is somewhat different to the traditional usage of the term. Tying the purchase of one product to another is anti-competitive because consumers are thereby prevented from purchasing competing products that substitute for the tied good. See N. Pac. Ry. v. United States, 356 U.S. 1, 5-6 (1958). Merchants, on the other hand, are still able to purchase, and still have some use for, POS terminals even if they accept offline debit. The tying of offline debit cards to credit cards, instead of directly preventing the consumption of a substitute good, prevented retailers from removing themselves from the offline debit network.

428 For a discussion of tipping, see Katz & Shapiro, Network Externalities, supra note 378.
cards” policy violated the antitrust laws. The plaintiffs argued that the rules constituted impermissible tying of products and that Visa and MasterCard conspired to monopolize the debit-card market.

The “honor all cards” policy reduced the negotiating power of the merchants with respect to interchange fees because the merchants could not decline to offer offline cards if they wanted to accept credit cards. To keep card issuers in the offline network, Visa and MasterCard increased interchange fees and retailers were in a weaker position to resist. As offline fees increased, online fees increased as well because EFT networks had to compete with offline firms for card issuer share. Industry observers believed that Visa and MasterCard’s “honor all cards” and “one price” policies would have driven out debit cards even though debit cards are less expensive and pose less risk to merchants and customers. Setting network fees within a network for the same product is generally thought of as important to establishing a network. Letting one network set prices in another, however, may drive the market toward a sub-optimal outcome. This instance of path dependence would have done more than created an inefficient standard; an added cost would have been borne by low- and middle-income consumers, for whom offline debit is a particularly poor substitute for online debit.

The parties ultimately settled the suit on the eve of trial. Both Visa and MasterCard agreed to eliminate the honor-all-card rules and to pay several billion dollars in damages. The settlement has the potential to benefit the poor in several regards. The untying of credit and offline debit is likely to result in fewer retailers accepting offline debit and lower interchange fees as Visa and MasterCard seek to preserve their market share. The settlement may lead to the diminution of offline debit and faster growth of its online counterpart.

For low-income customers, the dispute between merchants and the credit card companies had the potential to affect the cost, risk, and availability of financial services. A strong surge to offline debit rather than


430 In re Visa Check/Mastermoney Antitrust Litigation, 192 F.R.D. at 71.

431 See Balto, supra note 411, at 1391; Bills, supra note 411, at 1. For the problem of inefficient outcomes from sponsored technologies in the context of network externalities, see Katz & Shapiro, Technology Adoption, supra note 378, at 825.

432 David A. Balto, Life After the Wal-Mart Case, CREDIT CARD MGMT, Aug. 2003, at 48 (stating that interchange fees for offline debit are likely to decline by one third).

433 But see Frederick H. Lowe, A Lift for Recurring Payments, CREDIT CARD MGMT., July 25, 2003, at 30 (reporting that Visa is predicting that the end of the honor-all-cards rules will boost offline debit acceptance with utilities, who would like to accept electronic payments for recurring bills but do not want to accept credit cards because of their even higher interchange fees).
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online debit means higher prices for all consumers (whether embedded in goods and services or, less likely, explicitly priced for debit card usage), including those least able to afford them. By contrast, most banks do not charge their bank customers for using an online debit card at POS.\textsuperscript{434} Moreover, many retailers permit customers to get cash back using their online debit cards; these transactions are surcharge-free, cost the merchant no more than a standard online debit transaction, and reduce merchant cash-handling costs.\textsuperscript{435} Cash-back transactions constitute 20\% of online debit transactions, or one billion cash withdrawals.\textsuperscript{436} Merchants benefit from the ability of customers to withdraw funds as well. Because the transfer into their account is instantaneous, they lose no interest income due to the float and, unlike a credit card, the customer cannot revoke the transaction.\textsuperscript{437}

A shift to signature-based debit would also increase low-income consumers' risk of overdraft. Offline debit is settled offline—debiting of the cardholder's bank account occurs one to three days later using ACH networks. Online debit is settled online in real time—settlement occurs instantly when the PIN is entered. Online transactions are lower risk to the merchant, issuer, and customer because overdrafts are essentially not possible. By contrast, offline debits can cause overdrafts and result in fees for insufficient funds. The possibility of high overdraft fees make offline debit a potentially worse product for the poor, who, with the risk of overdraft, would need to manage their finances quite carefully.\textsuperscript{438}

Governmental and private sector initiatives to increase the provision of accounts and online debit to the unbanked could aid in overcoming the excess inertia that is impeding the collective switch from offline debit to the more efficient online standard.\textsuperscript{439} With a growing number of welfare

\textsuperscript{434} Eighty-five percent of banks do not charge for POS use, up from 77\% in 1999. Laura Bruce, \textit{Consumers Losing the Fight Against ATM Surcharges}, BANKRATE.COM (Mar. 28, 2002). The banks that do charge for POS do so to drive their customers to use signature debit on which they earn higher interchange fees from merchants.

\textsuperscript{435} D\textit{OVE DEPLOYER STUDY, supra} note 408, at 57; see also Francella, \textit{supra} note 415 (stating that many online debit withdrawals from merchants are free, and those that are not are generally only thirty-five to fifty cents). To the extent that this feature competes with ATMs, online debit may discourage the deployment of additional ATMs. Although this effect will somewhat reduce convenient ATMs access, the added convenience of being able to make withdrawals at most merchants who accept online debit will likely compensate for this loss.

\textsuperscript{436} \textit{Id.}

\textsuperscript{437} \textit{See RONALD J. MANN, PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS: CASES, MATERIALS AND PROBLEMS} 117 (1999). Also, merchants' cash handling costs are reduced by cash back transactions.

\textsuperscript{438} This comparison may be somewhat overstated, because offline debit could work well with stored value cards as an access mechanism; stored value cards may be an effective alternative payment mechanism for large employers. Still, stored value cards themselves would not increase access to the banking system.

\textsuperscript{439} \textit{See generally} Farrell & Saloner, \textit{supra} note 384 (discussing problem of switching standards).
recipients receiving payments via electronic benefits transfer programs, a merchant with a POS terminal can accept those EBT cards for payment. A similar effect could result from a greater portion of employers paying their workforce through debit cards that could be used at POS terminals. A larger scale initiative to move low-income households into the banking system with bank accounts providing for online debit access could help to push the payment system towards the more efficient online standard. Similarly, governmental initiatives to move the payments system towards online debit could help lower the cost and risk of providing bank accounts to low-income households. Banked households could take advantage of a more extensive POS and ATM network to access funds. The more extensive the network, the lower the unit costs of transactions, and the higher the utility of having a debit card.

One drawback of debit cards—both offline and online—is that existing consumer protection laws expose debit transactions to greater risk than using checks or credit cards. The Truth in Lending Act (TILA) and Regulation Z provide consumer protections for credit card consumers. The Electronic Funds Transfer Act (EFTA) and Regulation E govern ACH or debit card transactions. TILA and Regulation Z provide much greater protection to credit transactions than EFTA and Regulation E do for debit and ACH transactions. TILA and Regulation Z require the creditor to advocate for a consumer in a dispute with a merchant over items purchased by credit, and the consumer may withhold payment on disputed items; no similar protections exist for debit or ACH. Under TILA and Regulation Z, credit card holders' liability for unauthorized use is limited to $50; the test is more complicated for unauthorized use of debit cards and depends on when the consumer notifies the card issuer. Visa and MasterCard have instituted their own policies holding cardholders harmless for unauthorized use of both credit and debit cards. Congress may wish to consider updating these consumer protection laws as online debit and ACH retail transactions become more prevalent.

C. ATMs

Transactions at ATMs are significantly less expensive than transactions with tellers, and the costs of ATMs are significantly lower than the costs of a bank branch. ATMs thus offer an opportunity to deliver

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financial services to the poor at lower cost than "bricks and mortar" branches. Rapid expansion of ATM deployment in the late 1990s has dramatically increased the availability of ATMs.\(^{445}\) That growth is unlikely to continue as the market matures, but widespread ATM networks present possible distribution channels for expanded access to banking services for the poor. Given the economics of ATM placement and operation, which require high volumes of transactions, a strategy for expanding access to banking for the poor using ATMs or POS, or with advanced functions such as bill payment, will likely require some governmental incentives to be viable in some low-income areas with low penetration of these technologies. Moreover, further expansion of ATMs may be contingent on surcharge income, but surcharging would significantly increase the cost of using ATMs for low-income persons.

Bank accounts and ATMs are complementary products that exhibit indirect network externalities. Increasing the penetration of bank accounts will increase the number of ATM users, giving banks a greater incentive to deploy more ATMs. Each individual ATM user is, therefore, benefited by the demand created by other ATM users.\(^{446}\) Studies indicate that increasing the number of depositors increases the likelihood that a bank will adopt ATMs.\(^{447}\) Although ATM dispersal is quite broad now, and network effects from additional users are likely to be low, additional account holders from low-income communities with low ATM penetration would increase incentives to place ATMs in those locations.

ATMs have become increasingly available as a potential source for the delivery of financial services. By 2001, nearly 91% of banks and thrifts were offering ATM services.\(^{448}\) The number of ATMs off-premises of banks, whether deployed by banks themselves or by independent service operators (ISOs), increased dramatically in the late-1990s when Cirrus and Plus ATM networks permitted ATM owners linked to their networks to collect surcharges from ATM users.\(^{449}\) As of June 2001, there were approximately 324,000 ATMs deployed nationwide,\(^{450}\) compared with

\(^{445}\) ATMs exhibited network externalities in the early period of their growth that diminished rapidly once networks achieved scale. See Saloner & Shepard, supra note 382, at 480.

\(^{446}\) Id.

\(^{447}\) Id. at 500.

\(^{448}\) RETAIL FEES STUDY, supra note 150, at 6.

\(^{449}\) See TIMOTHY H. HANNAN ET AL., TO SURCHARGE OR NOT TO SURCHARGE: AN EMPIRICAL INVESTIGATION OF ATM PRICING 1 (Fed. Reserve Bd., Finance & Economics Discussion Series 2001-38, 2000), available at http://www.federalreserve.gov/pubs/feds/2001/200138/200138pap.pdf; DOVE DEPLOYER STUDY, supra note 408, at 1 ("In 1996 the national adoption of surcharging . . . single handedly altered the nature of the ATM industry."); id. at 31 (noting that off-premises ATMs increased at an average rate of 32% between 1999 and 2001); ROBERT E. LITAN, ATM FEES: AN ECONOMIC ANALYSIS (1999) (arguing that surcharging permitted ATM owners to cover expenses of off-premises ATMs, which have lower volumes and higher serving costs than ATMs on bank premises), available at http://www.aba.com/aba/PDF_Files/GR_atmfees.pdf.

\(^{450}\) DOVE DEPLOYER STUDY, supra note 408, at 7; see also Press Release, Dove Consulting,
86,055 offices of the nation’s 9,757 banks, thrifts, and credit unions. After the post-surcharging rush to deploy large numbers of ATMs, deployment has now matured, with net ATM levels expected to remain flat for some time. In fact, banks and ISOs plan to rationalize ATM fleets in the near term by eliminating low-transaction volume ATMs and adding new ATMs in retail locations with “high foot traffic” and where “consumers have a need for cash.” Both banks and ISOs intend to continue modest growth in total numbers.

Over the last decade, ATM cards increased in number from 200 million to 263 million, while transaction volume more than doubled, to 13.6 billion. With 288% growth in ATM deployment, however, transaction volume per ATM has dropped significantly, calling into question the continued ability of revenue to support this extent of deployment.

ATM fees, which drive deployment strategies, have increased steadily over time. Bank fees for its own customer’s use of other banks’ or ISO deployer’s ATMs (“on others” fees) averaged $1.17 per transaction in 2001. Surcharges, or fees charged to a non-customer user of a bank’s (or ISO’s) ATM, grew dramatically in the late 1990s and were charged by 88.5% of institutions by 2001. Surcharge fees continue to increase, averaging $1.32 in 2001. Rates are highest in the Midwest and Southeast


DOVE DEPLOYER STUDY, supra note 408, at 2; see also Dove Press Release, supra note 450.

DOVE DEPLOYER STUDY, supra note 408, at 45.

Id. at 33.

Id. at 47.

Id. at 48.

Id. at 7-8. Average bank monthly transaction volume has held steady at 3,584, while ISO average volume held steady at 600 per month. Industry average transaction volume has nonetheless declined, because ISOs are deploying at a much faster rate than banks, lowering the industry average. Id. at 49-51.

RETAIL FEES STUDY, supra note 150, at 6. “On others” fees are charged by 78.5% of institutions. In contrast, “on us” transactions, by a bank’s customer at the bank’s own ATMs, are generally not subject to fees. Similarly, most banks do not charge an annual fee for debit or ATM cards. Id.


and lowest in New England.461

Where there is intense competition among ATM deployers, surcharging is more difficult to maintain because non-customers are more likely to be relatively close to an ATM owned by their own bank. Thus, surcharging is less prevalent in areas with higher ATM densities.462 Pointedly, ATM densities are lower and surcharging more prevalent in counties and metropolitan statistical areas with higher concentrations of ethnic or racial minorities and in areas with higher concentrations of persons age 60 and older,463 although data on ATM deployment has not been collected on the neighborhood level.

To avoid costly surcharging, low-income persons would need to establish bank accounts with banks that have high penetration of ATMs in communities near where they live or work. The need to use a bank with a strong local ATM presence would complicate efforts to bank the unbanked on a national, rather than local or regional, scale.464 More importantly, the goal of avoiding surcharging conflicts with the goal of expanding deployment. Both on- and off-premises ATMs require significant surcharge income to support themselves.465 The additional security costs associated with deployment of ATMs in high-crime areas would also complicate efforts to serve the poor.

The cost of ATM deployment and operation is a key barrier to using ATMs to serve the poor. Dove reports average monthly costs to own and operate an off-premises machine to be $1,090—or $1,298 once expenses and back office costs are included—although these costs vary widely by

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461 DOVE DEPLOYER STUDY, supra note 408, at 12.
462 HANNAN ET AL., supra note 449, at 2 ("T]he probability of surcharging increases with both the institution’s share of market ATMs and the length of time period since surcharging was first permitted in the state, and decreases with the local number of ATMs per square mile in the market.").
463 [O]ther things being equal, financial institutions are more likely to impose surcharges in markets where people over the age of 59 or belonging to minority groups comprise a greater share of the population. This may reflect a greater willingness to pay for convenient access to cash among these population groups, perhaps due to higher costs of traveling to avoid surcharges or differences in overall cash usage.
464 Some small banks and credit unions are overcoming small ATM footprints by forming no-surcharging alliances with networks, each other, and larger firms. As of 1999, 8,000 ATMs were covered in such alliances. Litan argues that some pre-1996 state laws and network anti-discrimination rules hindered growth of suballiances. LITAN, supra note 449, at 19, 25. By 2001, Dove reported that about 20,000 ATMs owned by 2,000 financial institutions participated in selective surcharging networks. DOVE DEPLOYER STUDY, supra note 408, at 78. No-surcharge alliances are most prevalent in the Pacific region and in New England. Id. at 77. For example, NYCE set up a surcharge-free cooperative in the northeastern U.S., including 456 depositories and 2,726 ATMs. David Breitkopf, Fee-Free ATM Venture Draws Doubt from EFT Community, AM. BANKER, Nov. 29, 2001, at 7.
465 Surcharging represents two-thirds of income; interchange fees one-third. DOVE DEPLOYER STUDY, supra note 408, at 88.
type of deployer and machine.\textsuperscript{466} Off-premises machines generate only $1,075 in revenue.\textsuperscript{467} On-premises machines at banks cost $1,254 and generate revenues of $1,277.\textsuperscript{468} These average numbers mask strong variation, with ISO deployers using lower-cost, lower-technology, lower-rent strategies than their bank counterparts but generating lower volumes and lower revenues.\textsuperscript{469} For large banks, on-premises machines generate revenue of $1,360, cost $1,349, and thus have a profit of $11 per month. Large bank-owned off-premises ATMs generate revenue of $1,835, cost $1,534, and have a profit of $301 per month.\textsuperscript{470} ATM revenue, particularly for off-premises ATMs, is likely to decrease in the future. The volume of transactions from individuals who are not customers of the bank that owns the ATM ("foreign volume") at both on- and off-premises ATMs has been dropping, from 35% in 1999 to 32% in 2002. For off-premises ATMs, foreign volume dropped from 57% of transactions in 1999 to 48% in 2002.\textsuperscript{471} Most deployers now lose money on off-premises ATMs, and credit unions, because of the prevalence of no-surcharge alliances, lose money on both on- and off-premises ATMs.\textsuperscript{472}

Income from surcharging and interchange fees, however, is only part of the profit picture for banks. Banks also use ATMs to provide convenient service to customers, to market the bank’s services to attract new customers, and to migrate its existing customers away from using high-cost branch services towards lower cost ATM services.\textsuperscript{473} Banks view on-us transactions as worth $0.55 per transaction in cost savings in reduced branch time and revenue gains from customer retention and attraction.\textsuperscript{474} Thus, the value to banks of ATMs depends on whether the ATM draws customers away from lower-return bank services and retains or attracts customers who provide opportunities to the bank for higher-return services.

In addition to the basic functions of income deposit and withdrawal, ATMs could be used to provide electronic services of broader potential use to low- and moderate-income individuals. For example, 7-Eleven is

\textsuperscript{466} DOVE DEPLOYER STUDY, \textit{supra} note 408, at 14. Large credit union costs are much higher, at $1624 per month; small ISOs’ costs average \$732 per month. \textit{Id.} at 15.  
\textsuperscript{467} \textit{Id.} at 87.  
\textsuperscript{468} \textit{Id.} at 97. ISOs tend to deploy lower functionality machines costing \$5,000, while banks deploy higher functionality machines costing \$15,000–\$20,000. With five-year depreciation, this results in monthly expenses of \$375 for an on-premises ATM, \$279 for an off-premises ATM for banks, and \$100 for ISOs.  
\textsuperscript{469} \textit{Id.} at 105.  
\textsuperscript{470} \textit{Id.} at 8.  
\textsuperscript{467} \textit{Id.} at 8.  
\textsuperscript{472} \textit{Id.} at 8.  
\textsuperscript{473} See \textit{id.} at 3, 108. While banks value these benefits, ISOs, without any customers of their own, do not benefit from these ATM functions. \textit{See also} HANNAN ET AL., \textit{supra} note 449 (documenting surcharge as strategy for customer retention and attraction).  
\textsuperscript{474} DOVE DEPLOYER STUDY, \textit{supra} note 408, at 108.
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piloting ATMs that cash checks, issue money orders, and wire funds, and 7-Eleven plans to expand the machines to allow customers to shop online.\textsuperscript{475} Fleet is adding automatic bill payment to its ATMs; Wachovia's machines allow customers to buy stamps or add long distance phone time.\textsuperscript{476} Two firms have announced plans to launch programs to allow customers to recharge prepaid cell phone accounts through ATMs, and one is considering adding bill payment, money orders, and money transfer functionality.\textsuperscript{477} Another firm is beginning to sell ATMs designed for low-to medium-volume locations that will be able to cash checks, transfer money, and replenish prepaid cell phones.\textsuperscript{478} These advanced functions could help position ATMs as competitors to both bank tellers and check cashers in providing financial services to low- and moderate-income customers.

Despite the potential for advanced functions, however, more than three-quarters of all ATM transactions remain withdrawals.\textsuperscript{479} Moreover, while nearly 80\% of banks offer deposit taking at their on-premises ATMs, only 17\% offer deposit taking at most of their off-premises ATMs, and fully one third do not offer such services at any of their off-premises machines.\textsuperscript{480} The cost of deposit taking at off-premises machines at present is prohibitively expensive, largely due to the need to physically pick up deposited checks daily for processing and settlement. Now that Congress has enacted the Check Clearing for the Twenty-First Century Act,\textsuperscript{481} ATMs with check truncation technology permitting them to capture check information electronically could process checks without daily physical


\textsuperscript{476} Higgins, supra note 475, at D1.


\textsuperscript{478} See David Breitkopf, \textit{Triton Making Inroads with New In-Wall ATMs}, \textit{AM. BANKER}, Sept. 8, 2003, at 5.

\textsuperscript{479} Withdrawals constitute 77\% of transactions. Other services are mostly traditional banking ones, including deposits (9\%), inquiries (11\%), transfers (2\%), and "other" (1\%). \textit{DOVE DEPLOYER STUDY, supra} note 408, at 9, 59.

\textsuperscript{480} \textit{DOVE DEPLOYER STUDY, supra} note 408, at 104.

\textsuperscript{481} Pub. L. No. 108-100, 117 Stat. 1177 (2003). Under prior law, banks must physically process and transport the check through the clearing and settlement system unless the bank depositing the check obtains a prior agreement from the other banks individually. Given the large number of banks in the U.S., it is infeasible for most banks to obtain such an agreement. The Check Clearing Act permits check information to be captured, stored, and transmitted electronically, with a substitute check printed if the customer desires. See \textit{Check Clearing for the Twenty-First Century Act: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the Comm. on Fin. Servs., 108th Cong. (Apr. 8, 2003)} (statement of Roger W. Ferguson, Jr., Vice Chairman of the Federal Reserve Board), \textit{available at} http://www.federalreserve.gov/boarddocs/testimony/2003/20030408/default.htm.

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transfers, dramatically reducing the cost of providing deposit-taking capacity at off-premises machines.\textsuperscript{482}

While advanced functions could one day prove useful to low-income ATM users, current practice suggests that day is a long way off. Mini-statements and postage stamps currently lead the field in deployment, offered by between one quarter and one third of financial institutions.\textsuperscript{483} Only 6\% of all deployers offer check cashing; 1\% print money orders; and 1\% permit bill payment to third parties.\textsuperscript{484} Some 12\% of ISO deployers dispense phone cards, a device often used by low-income customers, while essentially no financial institutions offer this service.\textsuperscript{485} ATM deployers' stated interest in adding new functionality focuses on marketing, but there is some interest in cash transfers (to compete with wire transfers), check cashing, money order printing, bill presentment and bill payment to third parties.\textsuperscript{486} Only 5\% of financial institution deployers currently use web-enabled ATMs that would permit wide scale, efficient re-programming to support new functions, such as bill payment, although about a third of financial institution deployers plan to upgrade to web-enabled technology within the next two years.\textsuperscript{487} Large financial institutions were twice as likely to see marketing and customer satisfaction as business opportunities than to see advanced functionality as an opportunity.\textsuperscript{488} Citibank, which had piloted ATM bill payment, discontinued its services in 2001, "citing a lack of customer interest."\textsuperscript{489} In the near term, increased ATM functionality is unlikely to benefit the poor absent significant incentives—governmental or market—to include these services.\textsuperscript{490} Yet expanding access to bank accounts for low-income persons may stimulate demand for some alternate ATM services.

In sum, the rapid growth in deployment of ATMs in the 1990s presents a real opportunity for the delivery of financial services to low- and moderate-income consumers. ATMs are far less expensive than bank branches and teller time. ATMs could potentially be used to make deposits of income, convert income to cash, and pay bills electronically or through disbursement of money orders. These three functions are critical financial

\textsuperscript{482} DOVE DEPLOYER STUDY, supra note 408, at 104. The banking regulators would need to consider how such deposit-taking ATMs should be considered for purposes of delineation of the bank's assessment areas for purposes of the CRA. See also infra Subsection V.A.2 (discussing CRA).

\textsuperscript{483} DOVE DEPLOYER STUDY, supra note 408, at 10.

\textsuperscript{484} Id. at 63.

\textsuperscript{485} Id. at 64.

\textsuperscript{486} Id. at 66.

\textsuperscript{487} Id. at 10, 66-67.

\textsuperscript{488} Id. at 18 (reporting that 50\% identified an opportunity in marketing, while 25\% saw one in advanced functionality).

\textsuperscript{489} Id. at 71.

\textsuperscript{490} See, e.g., Banks Once Again Turn to ATMs To Reduce Costs, ATM & DEBIT NEWS, Apr. 10, 2003, at 1.
services for the poor. Absent governmental incentives, however, banks are unlikely to view expansion of ATM availability in low-income areas, and increased ATM functionality useful to low-income consumers, as sufficiently profitable.

D. Direct Deposit and Bill Payment

Advances in the ACH system can gradually make it easier and cheaper to offer banking products, such as direct deposit and bill payment, that could reduce reliance on more expensive comparable transactions conducted by low- and moderate-income households, such as cashing payroll checks and buying money orders. These ACH transactions generally require a bank account. Expansion of ACH (and lowering its price) would make electronically based bank accounts more attractive to and useful for low- and moderate-income households.

While ACH is only the third most commonly used form of electronic payment as measured by transaction volume, ACH carries more than three quarters of all retail electronic payment value ($5.67 trillion). ACH activity consists mostly of direct deposit of payroll, and also of preauthorized bill payment. Direct deposit is already used by more than 100 million individuals in the U.S. and is offered by more than 80% of firms with more than 100 employees. Seventy-one percent of employees who have direct deposit available to them at their work use it. Direct deposits grew by 11.6% from 2000 to 2001, from 3.3 billion to 3.7 billion payments.

The challenge is to bring direct deposit to more workplaces employing low-income workers and to more low-wage workers—including part-time or temporary workers—wherever they work. Direct deposit is cheaper (to banks, employers, and employees) than processing paychecks, involves no risk of bounced, lost, or stolen checks, facilitates

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491 For payroll cards, employers set up a pooled account so no individualized account is required.
492 RETAIL PAYMENTS STUDY, supra note 134, at 19.
493 See NACHA, 2002 ELECTRONIC PAYMENTS REVIEW AND BUYER'S GUIDE: UNDERSTANDING THE ACH NETWORK, available at http://www.roialliance.com/Acrobat/ BG_ACH_Primer.pdf. ACH credit occurs when an originator moves its funds into a receiver's account, for example, in a direct deposit of payroll or a home-based Internet-directed bill payment. ACH debit occurs when an originator, having been pre-authorized to do so, transfers funds from a receiver's account to an originator's account, for example, in a mortgage payment.
494 Id. at 45.
496 NACHA estimates ACH transactions cost 25-30% less than paper transactions for banks to process. Id. at 2. For employers, NACHA argues that ACH can help to reduce administrative and operating expenses, employee time lost cashing checks, and time and cost for paper handling.
saving, and provides same day availability for workers. Banks that currently issue payroll checks for employers and switch to direct deposit services may see reduced lines at tellers on paydays as employees no longer wait to cash their employer’s check “on us” at the issuing bank. Payroll cards are designed for just that purpose. For most banked middle- and upper-income customers, however, checks remain relatively cheap and convenient, and electronic technology for bill payment may appear uncertain, effectively delaying deployment of the necessary infrastructure to reduce costs and increase availability of electronic payments.

Electronic bill payment could be more widely used by consumers—and in particular low-income consumers—at lower cost and risk than checks or money orders. Direct payments totaled $2.6 billion in 2001, a 17.6% increase from 2000. Direct bill payment eliminates postage expense, the risk of late payment fees and interest charges, and charges for checks. NACHA estimates that consumers saved $1 billion in such costs by using direct payment. Direct payment is advantageous for the billing company as well, as it reduces the risk of non-payment and late payment. Moreover, one study found that consumers using direct payments tend to maintain higher balances in their bank accounts and that consumers who use direct payment to put aside funds for saving or investment save $140 more per month on average than consumers who do not use it. Using direct payment may be correlated with a propensity to save, however, so it is difficult to determine whether the institutional mechanism of direct payment bolsters, or simply reflects, savings behavior. Direct bill payment may also increase one’s ability to establish a sound credit history because, unlike information about the payment of bills with cash or money orders, the bank processing the payment regularly captures information about direct bill payment.

As currently structured, direct payment is used by higher income households and direct deposit is offered by large firms. A recent survey of consumers and businesses sheds some light on barriers to expanding direct


497 Recall that 30% of check volume is currently processed “on us.” See supra text accompanying note 402.

498 Chakravorti & McHugh, supra note 297, at 44-45.

499 Press Release, NACHA, supra note 495.

500 DirectPayment.org, Key Benefits, at http://www.directpayment.org/consumers_1_1.cfm (last visited Dec. 5, 2003). NACHA estimates that companies on average save 11.5 cents on reduced processing costs per payment when consumers use direct payment. DirectPayment.org, How To Get Started, at http://www.directpayment.org/companies_2_1.cfm (last visited Dec. 17, 2003).


502 See supra note 56.
deposit and direct bill payment more broadly, including to low- and moderate-income households.\textsuperscript{503} Fifty-five percent of consumers use direct deposit, while 37% use direct payment.\textsuperscript{504} Direct deposit users cite convenience as the most important reason for using direct deposit (71%), followed by reliability (31%), and safety (30%).\textsuperscript{505} Those not using direct deposit feared not knowing how much or when deposits were made, the possibility of mistakes, and security concerns. Non-users did not find direct deposit convenient, because they would still need to go to a bank to get cash. Of the nonusers, 63% do not have direct deposit available from their employer.\textsuperscript{506} Of these, 35% said they would definitely or probably sign up for direct deposit if it were made available at work, and another 30% indicated that they might sign up.\textsuperscript{507}

With respect to bill payment, 37% of consumer respondents use direct payment for one or more recurring payments.\textsuperscript{508} Direct payment has higher penetration for insurance (29%) and securities (35%) than for mortgages (19%), utilities (13%), telephone (10%), cable TV (5%) or other services, suggesting that use of automatic bill payment is linked to income as well as market sector.\textsuperscript{509} Of direct payment users, the potential benefits cited were related to time savings and reduced worry of late payment, while non-users cited concerns that direct payment would not be reliable, would take control away from them with respect to the timing of payments, might diminish their privacy, and might increase the risk of fraud.

On the business side, only 32% of business respondents offer direct deposit to employees.\textsuperscript{510} Direct deposit is offered by 84% of larger companies with 100 or more employees; 61% of those with between fifty and ninety-nine employees, and only 31% of small employers with fewer than fifty employees.\textsuperscript{511} Only 13% of businesses offer direct payment options to customers, although most utility companies offer direct payment to their customers.\textsuperscript{512}

Low-income persons are more likely to work in smaller firms and to have sporadic, part-time, and/or multiple employment, which would complicate efforts to provide for direct deposit. One study found that among the low-income banked population in New York and Los Angeles,

\textsuperscript{504} \textit{Id.} at 3.
\textsuperscript{505} \textit{Id.} at 5.
\textsuperscript{506} \textit{Id.}
\textsuperscript{507} \textit{Id.}
\textsuperscript{508} \textit{Id.} at 12.
\textsuperscript{509} \textit{Id.}
\textsuperscript{510} \textit{Id.} at 8.
\textsuperscript{511} \textit{Id.}
\textsuperscript{512} \textit{Id.} at 16.
40% used direct deposit, some fifteen percentage points below the usage rates for the general public found in the Federal Reserve Board study, while 52% of these respondents received income checks and 8% received cash.\footnote{513 Dunham, supra note 19, at 52 fig. 4.} Of course, none of the unbanked had direct deposit. Moreover, low-income persons may have a heightened need to control the timing of their bill payment—delaying payment on the phone bill to pay the rent, for example—given their low levels of liquidity. Thus, direct bill payment may make sense for only some low-income persons, or with respect to only some critical monthly bills, with discretion retained as to the timing of paying other bills.

More widespread use of direct deposit and electronic bill payment would not only lower payment systems costs overall, but also remove some key reasons why low-income people need to frequent high-cost alternative financial service providers. Given the positive externalities from adoption of ACH, there is some evidence that ACH is priced higher than is socially optimal by the Federal Reserve Board (which despite the presence of private sector competitors, handles 80% of ACH transactions).\footnote{514 Fed. Reserve Bd., Automated Clearing House Operations: About, at http://www.federalreserve.gov/paymentsystems/fedach/default.htm (last visited Dec. 17, 2003); see also GAUTAM GOWRISANKAN & JOANNA STAVINS, NETWORK EXTERNALITIES AND TECHNOLOGY ADOPTION: LESSONS FROM ELECTRONIC PAYMENTS 29 (Nat’l Bureau of Econ. Research Working Paper No. 8943, 2002) ("[T]here may be a need for policy interventions such as aggressive marketing efforts or pricing below marginal cost."); Chakravorti & McHugh, supra note 297, at 44 ("[T]he provision and usage of payment services exhibit network effects."); Katz & Shapiro, Technology Adoption, supra note 378, at 378, at 840 (noting that, given network externalities, "[p]ricing at the marginal cost of production in each period may not be socially optimal"). But see Katz & Shapiro, Systems Competition, supra note 378, at 113 (noting that given informational asymmetries, the presence of network externalities does not imply "a general theory of when governmental intervention is preferable to the unregulated market outcome").} Although ACH prices have been declining, data from 2000 shows that ACH services were still priced at least twenty-four percentage points too high relative to check services,\footnote{515 The unit cost for checks is 150% higher than for ACH (4.0 cents compared to 1.6 cents), and the unit price is 126% higher (4.3 cents compared to 1.9 cents). Press Release, Michael Herd, NACHA, Federal Reserve Check Volume Decreases, ACH Volume Continues To Rise (Aug. 2, 2001), available at http://www.nacha.org/news/news/pressreleases/2003/PR060903/pr060903.htm; see also BAUER & HIGGINS, supra note 496, at 3 (calculating a 12.3% reduction in ACH unit costs annually over the last decade).} if one simply measures the relative price to cost ratios. This rather crude gauge does not take into account, on the one hand, the positive externalities from moving towards wider dispersion of ACH networks or, on the other, the difficulty of assessing price-cost ratios in two-sided networks and the concern that if the Board charged less for ACH services, private sector participants would likely lose the small market share they now have.

In sum, increased efficiency in the payments environment may make it easier to reach unbanked households. Direct deposit holds out the
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promise of reduced reliance on check cashers and the possibility of increased involvement by employers in offering bank accounts to their workers. Efforts should be focused on how to bring direct deposit to a broader range of workers. Payroll cards, through which the employee can access her funds in a pooled account, may prove to be a useful bridge to direct deposit. Given the ubiquitous need to pay utility companies, low-income persons may be well positioned to use direct payment. Expanding the availability of direct bill payment, at least for some common transactions conducted by low-income persons, may reduce the need for cash or money orders. Positive network externalities associated with technological innovation in payments systems suggest that it may be desirable to provide governmental subsidies to financial institutions or to third party providers to increase the speed with which these technologies are widely adopted. Moreover, the Federal Reserve Board should review its pricing for ACH and check clearing services. Given the network externalities of payments systems, the Federal Reserve Board’s historic sponsorship of check clearance systems, and the positive externalities derived from ACH payments, the Board should consider reducing ACH pricing further in order to stimulate accelerated use of direct deposit and direct bill payment, although a full analysis of ACH pricing is beyond the scope of this Article.

V. Transforming Financial Services for the Poor

In Parts I through IV, the Article developed specific policy recommendations with respect to the alternative financial services sector, the banking sector, and the payments system and distribution networks. In this Part, the Article focuses on a cohesive strategy to increase bank account ownership among low- and moderate-income households: First, development of electronically based banking products should be accelerated with a tax credit to financial institutions and the providers of network technologies. Second, the Community Reinvestment Act could shed light on bank and thrift performance in meeting the financial services needs of low-income households. Third, workplace-based and community-based financial education could help to change the financial services and savings behavior of low- and moderate-income households if they are linked to new products and services for the unbanked.
A. **Bank Accounts**

1. **First Accounts Tax Credit**

   a. **Background**

   Treasury’s First Accounts pilot initiative, and similar efforts by philanthropic sources, could play an important role in fostering innovation by the financial services sector.\(^5\) With the government or non-profit funders helping to serve as a catalyst, banks could harness technology to reduce costs, lower risk, and democratize access to financial services for low-income families. Transaction accounts with debit cards but no checks could reduce risk to banks and account holders by preventing accounts from being overdrawn; lower the cost of processing each transaction and increase the efficiency of the payments system by reducing paper checks; expand distribution networks for financial services much more cheaply than branches; and decrease the safety risk to low-income customers who cash their regular payroll or benefit checks and carry large sums of cash.

   The First Accounts initiative grew out of Treasury’s research on the financial services needs of the unbanked for EFT ‘99. Treasury estimated that at least half of the ten million unbanked households do not receive federal benefit payments and thus would be ineligible to open ETAs. In addition, banks participating in the ETA program reported that significant numbers of unbanked persons who were not federal benefit recipients had sought to open ETAs; these persons are part of the likely target market for First Accounts. Treasury research suggests that unbanked persons who do not receive federal benefit payments are, on average, younger, more urban, more likely to be from a minority community, have larger families, and are more likely to be receptive to signing up for electronically based accounts than the unbanked federal-benefit-recipient population.\(^5\)

   As initially conceived, the First Accounts initiative had four main components. First, Treasury would help to offset the costs financial institutions incurred in offering low-cost, electronic banking accounts to low-income individuals. Second, Treasury would help to defray the costs of expanding access to ATMs, POS, Internet, or other distribution points in

\(^{516}\) Congress provided $10 million for First Accounts in 2001, with no restriction on the year in which funds were to be expended. This Section is derived from *Bringing More Unbanked Americans into the Financial Mainstream: Hearing Before the Sen. Comm. on Banking, Housing, & Urban Affairs* 107th Cong. 42 (May 2, 2002) (statement of Michael S. Barr), available at http://banking.senate.gov/02_05hrg/050202/barr.htm (last accessed Dec. 11, 2003). The author developed this program while serving at the Treasury Department.

\(^{517}\) Compare *DOVE REPORT*, supra note 2, at 25-29, with *CASKEY, FRINGE BANKING*, supra note 6; Caskey, *Reaching Out*, supra note 20; Greene et al., *supra* note 20; Hogarth & O’Donnell, *supra* note 20; Rhine et al., *supra* note 20; and Hogarth et al., *supra* note 20.
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low-income neighborhoods with low access. Third, Treasury would support financial institution and non-profit initiatives to provide financial education and counseling to low-income households. Fourth, Treasury would fund research into the financial services needs of low-income individuals and development of financial products designed to meet these needs. The First Accounts initiative focuses on the need for incentives to get financial institutions started in serving low-income households. As discussed above, the costs of research and development, new account opening, expanded distribution, and financial education are serious barriers today to expansion of account ownership. The First Accounts initiative could help to accelerate improvements in this market.

Treasury launched the First Accounts program in December 2001.\textsuperscript{518} The Department received 231 responses seeking nearly $130 million in funding from a wide variety of organizations: banks, thrifts, and credit unions; employers and labor and employer organizations; community based organizations; state and local governments; and others. Treasury provided $8.35 million to fifteen projects seeking to bring over 35,000 individuals from twenty-five states into the banking system.\textsuperscript{519} Credit unions make up one third of the awardees, and other non-profits more than one half, while only two banks were awardees. Awardees focus on providing financial education and low-cost electronic accounts to the unbanked. A number of awardees will work with employers to expand banking access. Some of the funds are ear-marked for capital expenditures on ATMs, or, in one case, new branches, in low-income areas. In this initial round, funding per account appears high, although strategies, cost structures, other funding sources, the extent to which capital outlays are included, and the intensiveness of financial education vary significantly across chosen programs. The average award per account forecasted to be opened is $237.78, with wide variation among awardees, ranging from a remarkably low $23.13 to an astonishingly high $1,468.32.\textsuperscript{520} Given the small amount of funding available and the large number of organizations funded, Treasury will have difficulty determining from this pilot phase whether a given strategy is sustainable at scale. A more focused effort in a handful of metropolitan areas might have led to adoption of new technologies by major firms, not to mention more useful data.


\textsuperscript{520} Author's calculations based on data from the Treasury website, available at http://www.treas.gov/offices/domestic-finance/financial-institution/fin-education/firstaccounts/grantawards.html (last accessed Dec. 11, 2003). It is difficult to assess whether awardees' forecasts of numbers of accounts to be opened are likely to be accurate.
b. First Accounts Tax Credit

A challenge going forward is to fund First Accounts at sufficient levels and for a sufficient time to help transform the market for low-income financial services and drive down costs. Only a sustained commitment to funding the First Accounts initiative, or other governmental or foundation support, would provide financial institutions with sufficient incentive to make the necessary investments in research, technology platform changes, training, marketing, and education to serve low-income unbanked and underbanked households. Over time, as financial institutions become expert at serving the low-income customer segment, the need for governmental incentives may become less important.

First Accounts, private-sector efforts to expand banking services, and employer-driven strategies to serve the unbanked could be brought to scale by developing a tax incentive for financial institutions to offer low-cost electronic accounts for low-income persons. Financial institutions could receive a tax credit equal to a fixed amount per account opened. Roughly speaking, the amount of the credit would be calculated to cover the average administrative cost to an average bank of offering the account, taking into consideration research and product development, account opening and closing costs, marketing and financial education, and the training of bank personnel. Banks would report quarterly to the Treasury Department on the number of accounts geared to low- and moderate-income persons that the banks had opened and would receive a corresponding credit to their quarterly estimated taxes. Using the Dove analysis conducted for ETAs 522 would suggest that the tax credit be set at an amount between $20 and $50 per account opened. If the initiative reached three million households, or about one third of the low-income unbanked, a reasonable goal for at least the first five years of the program, the tax credits would cost only $60 to $150 million.

Banks, thrifts, and credit unions could, under the First Accounts Tax Credit, experiment with a wide variety of techniques to expand access to the unbanked and to provide an increasing range of services to the

521 See Michael Stegman, Savings for the Poor: The Hidden Benefits of Electronic Banking (1999). Credit unions, which are not-for-profit corporations, could not directly take advantage of tax credits. It is possible to structure the tax credit so that for-profit subsidiaries or credit union service organizations could receive the tax credit for their services on behalf of the credit unions in offering the accounts. It would also be reasonable, however, to take the position that credit unions, which are tax exempt, 12 U.S.C. § 1768 (2000), because their mission is to serve "people of modest means," 12 U.S.C. § 1751 (2000), should be able to pass on the benefits of tax exemption to low-income persons by offering accounts tailored to their needs.

522 See supra note 305.
underbanked.523 Low-cost electronic transaction accounts can be attractive to the unbanked and can be offered at reasonable cost.524 Banks may wish to experiment with accounts with savings features, including payment of interest or separate savings “buckets” within accounts; these features are also likely to be low-cost and attractive to the unbanked.525 Similarly, low-income individuals need a convenient and low-cost means of paying bills; automated money orders,526 online bill payment, debit-card-based foreign country remittance, and other low-cost payment methods can help to reduce the cost of transactional services to the poor. Dove estimated that adding a savings feature to an electronic account would cost approximately $0.06 per month. Adding ACH bill payment would cost $0.65 per month. Adding the ability to accept additional direct deposits beyond federal benefit payments would decrease net costs by $0.11 per month because of added float income.527 Financial institutions could also seek to expand ATM availability in low-income neighborhoods, including by co-locating with post offices.

In addition, the First Accounts Tax Credit has the potential to help spur “leapfrogging” in technology for low-income financial services, adopting low-cost, high-technology solutions without using older, more expensive institutions.528 To offer a few examples that could be subjected to the test of market feasibility: With sufficient incentives, the infrastructure for financial transactions may be induced to explore ways that low-income customers could be served by financial institutions on shared technological platforms, reducing research and development costs and technology platform change costs for each firm.529 As access to the Internet expands in low-income communities through efforts to bridge the

523 Treasury’s notice of funds availability (NOFA) issued in December 2001 barred using First Accounts funds for IDA matches or to increase services to those with bank accounts, see U.S. Dep’t of the Treasury, supra note 518. In my view, neither prohibition is required by the congressional appropriations, and neither serves an important program interest.

524 See ETA CONJOINT RESEARCH, supra note 51; ETA WATERFALL ANALYSES, supra note 310.

525 See ETA CONJOINT RESEARCH, supra note 51; ETA WATERFALL ANALYSES, supra note 310. Savings features boosted take up rates by up to one-third and accounted for one-quarter of the reasons why an individual might sign up for electronically-based accounts.

526 CASKEY, FILENE INSTITUTE REPORT, supra note 86, found that 69% of surveyed unbanked persons used ten money orders per year, and 39% used more than thirty money orders per year to pay bills.

527 ETA WATERFALL ANALYSES, supra note 310, at 4.

528 Another example of leapfrogging is the developing world’s adoption of cell phones without installing a widespread wire-based phone network. See CLAESSENS ET AL., supra note 373, at 12 (“Mobile phones have made telecommunications available even to the world’s poor, partly because of the widespread creation of telecenters and public call offices.”); Simon Romero, A Cell Phone Surge Among the World’s Poor, N.Y. TIMES, Dec. 19, 2000, at C1.

529 The Doorways to Dreams demonstration project, which has developed an Internet platform for data management in IDA programs, is one such example. See Doorways to Dreams, What Is D2D Fund?, at http://www.d2dfund.org (last visited Dec. 5, 2003).
“digital divide,” e-finance can increasingly be made available to the poor at Internet or other kiosks.\textsuperscript{530} Companies that are exploring ways to expand the use of cellular phones to transact financial services for high-income clientele could be encouraged to focus attention on expanding bank account access through pre-paid cellular phones commonly used by low-income persons, perhaps with pre-authorized debit for cell phone fees.\textsuperscript{531} Smart cards can be used even by unbanked customers to conduct an increasing array of bank-like transactions at relatively low cost.\textsuperscript{532} Similarly, payroll cards might serve as a useful starting point in the U.S. towards providing an increasing range of financial services—including bill payment and savings—to low-income persons.

A First Accounts Tax Credit could also help to spur employer-driven (or union-driven) strategies to expand access to banking services. Employer-driven strategies to bank the unbanked have three potential strengths: large-scale, consistent access to workers, a structure for providing regular savings through direct deposit, and the ability to offer financial education. Large employers can reap significant benefits from moving more of their workers to direct deposit. Direct deposit would drive down their payroll processing costs, increase the effective take-home pay of their workers, and reduce problems from theft or fraud associated with checks. Employers can help to reduce costs for reaching their unbanked employees with financial education regarding new products.

Many employers have already become active in educating their workers about advanced payments under the EITC, or have become involved in wide scale efforts to hire former welfare recipients as part of a national welfare-to-work strategy.\textsuperscript{533} At the same time, financial institutions already provide important payroll and other banking services for employers, and some have been experimenting with employer-focused, debit-card or stored-value card-based payroll systems for their clients’

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\textsuperscript{530} See, e.g., Value Transfer System for Unbanked Customers, U.S. Patent Application No. 20020082962 (June 27, 2002).
\textsuperscript{531} Perhaps the Open Mobile Alliance could serve as a forum for this purpose. See Open Mobile Alliance, Homepage, at http://www.wapforum.org (last visited Dec. 5, 2003).
\textsuperscript{532} For example, South Africa is using stored value cards to expand banking services in remote areas. The cards can be used to receive income, transfer payments, or establish savings for particular purposes. CLAESSENS ET AL., supra note 373, at 36. Mondex e-cash, being used in the Common Market for Eastern and Southern Africa, permits individuals to transfer value between cards and to download value using a phone. Visa Horizon, being used in Ghana, is an offline payment card. Visa Cash in South Africa is being used for transit fares in South Africa. Modex e-cash will be offered through South Africa’s post office savings banks, with bill payment and savings pools. In Indonesia, MasterCard, Cirrus, and BCA are issuing an on-line debit card. Visa Cash in the Philippines can be loaded with value or used to make payments over the Internet or through mobile phones. The CashCard in Singapore permits loading value through mobile phones; the cards are expected to permit bill payment by mobile phone in the future. Id. at 65-69.
\textsuperscript{533} UPS, Bank of America, and Hewlett-Packard are among those U.S. corporations actively and successfully participating in the welfare-to-work program. See generally The Welfare to Work Partnership, Homepage, at http://www.welfaretowork.org (last visited Dec. 8, 2003).
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employees. These employment relationships may provide a solid foundation for encouraging direct deposit into low-cost electronic banking accounts and systematic savings programs for low-income workers.

Employers are increasingly moving towards the provision of electronically based payroll services. In one model, employees are given a smart card that can be used at ATMs or POS by banked or unbanked employees. Banked employees can direct deposit funds from their smart cards to their personal accounts; unbanked employees can simply withdraw funds through an ATM or POS. By 2002, 10% of unbanked workers used payroll cards. Employers could work with banks to make available all-electronic bank accounts through which they could use their payroll cards.

In sum, tax credits should also be used to foster employer-based strategies to reach the unbanked through payroll-based accounts. Employers already have some incentives to shift workers from check or cash payment to payroll cards or direct deposit. Payroll cards themselves will help to reduce transaction costs associated with converting income to cash and, if linked to bank accounts, these cards could open up access to depository institutions for low-income workers. These accounts could then be used to meet other core financial services needs, including savings and bill payment. These efforts, given employers' economies of scale and institutional strength, may present the greatest opportunity to shift large numbers of low-income workers to account ownership. Yet there are reasons to suggest that employers are unlikely to capture the full benefit of their employees shifting to bank account ownership with direct deposit. Subsidies to such employers would help them to internalize more of those benefits.

c. Objections and Responses

The tax credit proposal could be criticized in two layers. The top layer of potential criticism follows from the subsidy being a supply-side rather than demand-side mechanism to reach the poor with banking services. Supply-side approaches are preferable to demand-side efforts only under conditions in which efficiency in provision outweighs potential windfalls.

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534 See, e.g., Press Release, Ceridian, Washington Inventory Service Picks Ceridian for Pay Card Services (June 14, 2002), at http://www.ceridian.com/corp/article/1,2868,10963-52751,00.html; COMDATA, How To Use It: Comchek eCash Cardholder User Guide, at http://www.ecash.comdata.com/ec-howtouseit.html (last visited Nov. 24, 2003). A drawback of this card is that account balances must be checked prior to using ATM or POS using a Voice Response Unit (VRU) reached through a “1-800” number; if a withdrawal is requested when funds are not sufficient, a fee is assessed.

to suppliers and the costs of the mechanism. In the other layer of potential criticism, the tax credit proposed must be judged as an in-kind mechanism as opposed to a direct cash transfer. An in-kind approach will be warranted if consumption externalities outweigh the deadweight costs from substitution effects and the costs of administrating the program. I address the costs and benefits of a supply-side, in-kind subsidy, particularly drawing attention to the conditions for optimality of such a program as compared to a demand-side program or direct cash transfers.

A demand-side, in-kind program is typically manifested in voucher programs. The tradeoff between demand and supply approaches builds on three issues. First, the relative efficiencies of demand compared with supply programs depend on the elasticity of supply in the sector. If supply is inelastic, a voucher program will raise the price of the good provided to those not holding vouchers, thereby reducing welfare. In the case of low-cost electronic banking accounts, it is reasonable to think that the supply of accounts is characterized by a single fixed cost for start-up and low marginal costs for additional accounts. Thus, supply is likely to be highly elastic. If supply is perfectly elastic, there is no welfare difference in a supply-side subsidy or a demand voucher.

Second, there is a danger that subsidies for the provision of low-cost banking accounts could provide a windfall to financial institutions who would offer such accounts without the tax credit. It is difficult to know the extent of this problem without more empirical evidence. There are some small-scale private sector initiatives in serving low-income customers, but it is difficult to assess the motivation for them. Some of these may have been undertaken in response to government programs (EFT ‘99, EBT, First Accounts) or regulation (CRA). Others have been underwritten by philanthropic contributions. The remaining may have been motivated by perceived future profits, either from the customers served themselves, or perhaps from providing positive public relations about the bank that attract other, more lucrative, customers. I have suggested that network externalities may slow the adoption of technologies that would better serve the poor; to the extent that these technologies are employed for that end, the tax credits are less likely to result in windfalls rather than in

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537 For example, the Section 8 program, established by the Housing and Community Development Act of 1974, provides vouchers to low-income residents that can be used to rent apartments from private landlords. See 42 U.S.C. § 1437f (2003).
538 Inelastic supply implies that the quantity suppliers are willing to provide does not change when the equilibrium price in the market changes. This is often considered a short term effect.
539 STIGLITZ, supra note 536, at 400-01.
540 On this problem more generally, see, for example, Martin Feldstein, A Contribution to the Theory of Tax Expenditure: The Case of Charitable Giving, in THE ECONOMICS OF TAXATION (H.J. Aaron & M.J. Boskin eds., 1980) (showing that government spending may decrease private spending).
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internalizing some of those externalities. An extreme form of misallocation of subsidy may result in over-supply of services. Conversely, demand voucher programs can also exhibit unwanted windfalls. Individuals may qualify for vouchers who would otherwise not be target audiences for supply-driven mechanisms.

Third, one must consider the costs of demand compared with supply programs. I have proposed a supply-side subsidy rather than a demand-side subsidy because I believe that it is more likely to induce a change in the nature of financial services offered to low-income consumers at lower cost. If low-income consumers were given a voucher for financial services, they would need to invest in sufficient, costly information-gathering to be able to find an adequate banking product for their needs, and financial services are notoriously difficult for most people (poor and non-poor) to understand. Since the voucher would offset some of the costs of existing services, financial products might not evolve to meet the needs of other low-income persons. Significant collective action and free rider problems would further hinder the ability of consumers to appeal for innovation. Without the development of new low-cost electronic banking accounts, the demand vouchers’ value would be limited to its face value. Of course, financial institutions, knowing that low-income consumers had a financial services voucher, may invest more in learning about low-income consumers and developing products for that segment of the market. It is possible that a similar result to a demand-side subsidy could be obtained, but the administrative costs of delivering the financial services voucher to millions of low-income households are likely to be much higher than the administrative costs of tracking account opening by financial institutions who already have established relationships for reporting to the IRS (and many of whom have such relationships for reporting to the FMS).

The subsidy is administered through the tax code, rather than as a grant program. Tax expenditures have been criticized as complicating the tax code, reducing the base in ways that require increasing tax rates that

541 See STIGLITZ, supra note 536, at 128.

542 Consider the job training market. Holland suggests that one key advantage of a subsidy to employers over a tax credit for individuals for education expense is that in the tax credit program, it is impossible to disentangle the target audience, as the “price” to everyone is the same. This creates an excess cost for providing training to those in need. See Daniel M. Holland, An Evaluation of Tax Incentives for On-the-Job Training of the Disadvantaged, 2 BELL J. ECON. & MGMT. 293 (1971). The realization of benefits only to target individuals is important for both supply and demand side programs. Since the in-kind approaches are essentially symmetrical, identification of the “subsidy base,” i.e., the target group of individuals whom the program seeks to benefit, is tantamount to identification of the “negative income tax base.” See A.B. Atkinson & Joseph Stiglitz, The Design of Tax Structure, 6 J. PUB. ECON. 55, 74 (1976). Thus, the incidence of the program is the essential trait to gauge.

543 Holland’s empirical estimates of the job training market find little difference between the administrative costs of job training tax credits for individuals and those of subsidies to employers for training programs. Holland, supra note 542, at 301-02.
are themselves distortionary and as costly to administer.\textsuperscript{544} Tax expenditures are not necessarily more or less efficient than grant programs. However, the fixed cost of tax administration by the IRS and of tax compliance by corporations is already in place and is unlikely to be affected in any significant way by the additional tax expenditure. I am proposing that the Treasury Department's Financial Management Service compute the amount of the tax reduction owed to each financial institution and administer the program because the FMS already has developed a system for tracking ETA accounts opened by financial institutions for federal benefit recipients under the EFT '99 program. This aspect of the tax expenditure, which replicates core functions of a grant program, is unlikely to be significantly different were the financial institutions to be given a grant instead of a tax credit. Raising funds to pay for a grant program (through tax increases, borrowing, or other spending reductions) would produce similar distortions to those required to run the program through the tax system.

The alternative to some form of in-kind program is a direct cash transfer.\textsuperscript{545} There are three main critiques that have been raised regarding in-kind transfers versus cash transfers. I will describe the critiques and then offer a theoretically motivated response to why the costs of the in-kind program should not be greater than the benefits. First, generally speaking, in-kind subsidies are thought of as less efficient than cash subsidies because the recipient may only use the in-kind subsidy for specified purposes.\textsuperscript{546} To the extent that the recipient undertakes the specified actions to the same degree as the recipient would have if given a cash grant, the in-kind subsidy does not change behavior but costs more to administer, it is argued, than a cash transfer. To the extent that the subsidy changes behavior, the subsidy does not increase the welfare of the recipient to the same degree as if the recipient had been able to use the funds that the in-kind subsidy represents to pursue her own preferences. A typical approach to quantifying the benefit of an in-kind program is through the Hicksian measure of what an equivalent cash grant would have to be to equal the in-kind subsidy. For example, one study of public tenant houses calculated that 16-20% of the mean subsidy value was lost in


\textsuperscript{545} Over 70% of U.S. welfare benefits are allocated through in-kind programs. STIGLITZ, supra note 536, at 397.

\textsuperscript{546} See, e.g., id. at 254-65 (presenting arguments concerning the substitution versus income effect).
benefit to the recipients.\textsuperscript{547}

The second criticism of in-kind plans over cash transfers is simply that they are paternalistic in telling the heterogeneous recipients that they should derive utility in particular from the provision of the service for which the in-kind benefit is intended.\textsuperscript{548} In-kind mechanisms are disparaged for passing judgment that individuals should value the particular benefit more than they might value other benefits with which they could have spent an equivalent cash transfer.

Third, in-kind programs are often more administratively costly than direct transfers.\textsuperscript{549} The marginal cost to the government of increasing the dollar amount of income transfers to the poor is low.

As I will argue below, however, we must consider the externality of banking services on the cost differential between the value of the government’s check and the realized benefit to the individual.\textsuperscript{550} The process of converting the government check to cash (or stored value) reduces the income transfer. However, to make this argument fully, I first establish the theoretical basis for when an in-kind program can compete with cash transfers.

There are primarily two arguments that an in-kind benefit may be larger than an equivalent cash transfer, even taking account of added costs and substitution effects. First, in-kind programs may generate “consumption externalities.”\textsuperscript{551} Consumption externalities are benefits accruing because the in-kind program exists. Here, the externality is the fixed investment leading to a new form of permanent low-cost electronic banking accounts. If it were possible to transfer “cash” to each individual, the recipients would have the benefit of the cash instantaneously. The tax credit program proposed would establish permanent access to low-cost banking, however, which would reduce the consumer’s costs of cashing checks, storing value, and paying bills into the future. Moreover, banking services help other government programs work more effectively.

More pointedly, the argument in favor of income transfers as compared with in-kind subsidies breaks down when one analyzes how “income” gets transferred.\textsuperscript{552} The federal government does not transfer

\textsuperscript{547} Michael P. Murray, The Distribution of Tenant Benefits in Public Housing, 43 ECONOMETRICA 771, 783 (1975).
\textsuperscript{549} See, e.g., STIGLITZ, supra note 536, at 349.
\textsuperscript{550} Income can be a bad reference point for evaluating utility of the poor since utility comes from consumption and not the cash transfer. See Daniel T. Slesnick, Consumption and Poverty, 106 ECON. J. 1527, 1528 (1996). In the case here, the income transfer is not even a fair assessment of the cash received, since it is conveyed to the individual in a form that requires it to be converted to cash, extending this divergence of utility measurement.
\textsuperscript{551} See, e.g., Browning, supra note 548, at 579.
\textsuperscript{552} The public finance literature tends to assume that recipients of income transfers bear no
income as cash. Nor, for that matter, do states. Income can be transferred as a direct deposit to a bank account, to a debit or stored value card, or as a check. Transferring income to low-income persons through a government check not only costs the government more than an electronic transfer, but also transfers less value to low-income persons than a direct deposit of that income into the recipient’s bank account. Electronic bank accounts lower the cost of redistributing wealth. If such accounts are subsidized for low-income households, the resultant savings may outweigh the cost of the subsidy. Moreover, once established, these accounts provide a repository for the receipt of other federal or state government income transfers and private earnings in the future. Further, as I have argued, the accounts, once provided, may increase opportunities for low-income families to pay their bills automatically, to budget and save, and to build positive credit histories and obtain access to credit.

The second situation in which a cash transfer would be less efficient relative to an in-kind program involves screening and targeting. In-kind transfers have been shown both theoretically and in practice to be effective at screening the target service provided, and thus reaching the target recipient base. Criteria for the in-kind efficiency outcome are worth considering in the context of banking. The ability of an in-kind program to screen in the optimal potential beneficiaries may require that the good provided be in some ways an “inferior good,” a good to which a higher-income individual would not immediately be drawn. In the current market, such a goal would be achieved by offering a product that does not permit check writing. This result runs contrary to the claims by some that in-kind redistribution programs increase or distort the quality of the goods that low income individuals might choose for themselves. Along these lines, the greater the divergence in goods that can be provided to differentiate the target audience, the greater the effectiveness of the program will be.

In sum, there are grounds for believing that the tax credit proposal suggested here would be more efficient than a grant program, a demand-side voucher, or a cash transfer. An additional reason for favoring a tax credit to financial institutions for providing financial services, over the alternatives is, of course, that tax incentives for such purposes are more

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555 See Nichols & Zeckhauser, supra note 554, at 375.
likely to be politically feasible to enact in today's environment, than cash assistance. Political feasibility, like other forms of feasibility, ought to be considered in weighing policy options.

2. The Community Reinvestment Act

The Community Reinvestment Act (CRA) could also help to focus banks and thrifts on opportunities to provide bank accounts to low-income persons. Under CRA,\(^{556}\) federal regulators evaluate bank and thrift performance in serving their communities.\(^{557}\) Given the high up-front costs associated with the accounts, and the low expected returns, however, CRA by itself is unlikely to change behavior. CRA has arguably helped to expand access to credit for homeownership in low-income communities.\(^{558}\)

The CRA service test, however, which evaluates bank and thrift performance in meeting transaction, savings, and other community needs, has received inadequate attention from bank regulators in CRA examinations. Michael Stegman has documented that banks rarely receive "needs to improve" ratings on the service test, and the service test is often used to increase the overall score of borderline banks.\(^{559}\) Examiners should focus on the extent to which banks and thrifts are actually attracting low-income customers with innovative retail products and services. Given the importance of technology in serving low-income clients in a cost-effective manner, service examinations should move away from an overwhelming focus on bank branches towards a more quantitative and qualitative assessment of the extent to which technology-based products are expanding access for low-income persons.\(^{560}\)

The 1995 regulations provide sufficient flexibility for analysis of an


\(^{558}\) See LITAN ET AL., supra note 557, at ES-3.

\(^{559}\) See MICHAEL STEGMAN & ROBERT FARIS, CREATING A SCORECARD FOR THE CRA SERVICE TEST (Brookings Inst., Policy Brief No. 96, 2002) (revealing that only fifteen CRA examinations out of nearly 2,000 conducted over the last five years have resulted in a rating of "needs to improve" on the service test, and no bank has ever earned a "substantial noncompliance" rating on service activities).

institution's performance, but agency examination procedures provide insufficient guidance as to how to measure an institution's activities in ways that actually matter to low-income consumers. The service test, in practice, has received perfunctory attention from examiners, with public evaluations containing little or no analysis of whether low-income consumers actually use bank or thrift products or services. Examinations under the service test could be vastly improved by taking three steps.

First, examiners should evaluate the extent to which institutions offer low-cost accounts and other products designed to meet the account needs of low-income individuals. Low-cost electronic accounts with direct deposit, little or no risk of overdraft, the opportunity for the accumulation of savings, and bill payments or electronic money orders may hold special promise in this regard. Some institutions have gone further, by providing financial education and matching funds for Individual Development Accounts. Regardless of the form of the account, examiners should attempt to make a qualitative judgment about the range of product offerings of the institutions, based on the existing state of research into low-income consumer needs, and taking into account the costs to institutions of providing accounts and the requirements of sound banking practice. Such qualitative assessments are, however, difficult to apply consistently across examiners and agencies.

Second, banks and thrifts should be evaluated based on the number of low- and moderate-income account holders at their institution, whether in a traditional, or more innovative, account. Quantitative measures of usage should provide a portrait of an institution's performance under the service test, and data collection on the numbers of accounts provided should not in and of itself be burdensome. Requiring data collection and reporting with respect to the income of account holders could become significant burdens on some banks and thrifts. Banking agencies might consider permitting institutions to use certain assumptions about their customers' incomes based on the accounts offered. For example, for reporting purposes, a holder of a specialized banking account with no checking privileges might be presumed to be low-income. In addition, bank accounts opened at branches in low- or moderate-income areas, or held by individuals residing in low- or moderate-income areas since statement information is readily kept by most institutions, might be presumed to be held by individuals of low- or moderate-income. A formula based on the percentage of low-income population in the census tract could also be used. For other institutions that already collect information on income of account holders for other purposes, such as cross-marketing, reporting of income might not be more burdensome than geographic-coding of accounts. Information on account usage is critical to meeting the financial services needs of low-income communities, and the agencies should work closely with banks and...
thrifts to determine the least burdensome way to collect this essential information.

Third, the agencies should give negative consideration to activities that undermine the provision of quality services to the poor. For example, participation by banks or thrifts in arrangements with affiliates or other parties that do not provide adequate consumer protection, or raise compliance, operational, or other risks, should receive negative consideration as part of the performance context under the service test.\(^5\) Agencies should ensure that banks and thrifts are not merely “renting” their names or charters to these firms, but are engaged in appropriate monitoring and supervision of practices, and that the practices comply with applicable law. This may require targeted, risk-based examination of these parties or affiliates, as has been conducted by the OCC with respect to national bank relationships with payday lenders.\(^6\)

3. State Policies and Welfare Reform

As discussed above,\(^5\) states should integrate access to financial services as a core element of welfare-to-work strategies. High cost alternative financial services undermine efforts to improve workforce participation by reducing effective take-home pay. Lack of structured savings mechanisms makes it less likely that new entrants into the workforce will save against liquidity crises from job loss, injury, or other family emergencies, and makes it more likely that such crises will push families back onto the welfare rolls.\(^6\) Over the longer term, lack of access to bank accounts and savings mechanisms will reduce the ability of low-income families to save for homeownership, skills development, or their children’s education.\(^6\) As a first step, states (and other workforce development providers) should encourage account ownership. First, states

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5 For example, OTS gave Crusader Bank a “needs to improve” rating in 2000 in part because of its payday lending operations; Crusader abandoned its payday lending relationship in 2001. CFA/PIRG REPORT, supra note 40, at 20, 24.

6 See OCC, Third-Party Relationships, supra note 172 (advising national banks on risk management in dealing with third parties); OCC CONSENT ORDER, supra note 178 (ordering bank to cease making payday loans through third party).

563 See supra Subsection III.B.2.

564 Social insurance (unemployment insurance, for example) could also be used to serve this function, spreading the costs of those risks from those least able to afford them to society at large, but increasing and widening the scope of social insurance at this time seems politically infeasible. Moreover, social insurance may crowd out private savings. See, e.g., COURTNEY COILE & JONATHAN GRUBER, SOCIAL SECURITY INCENTIVES FOR RETIREMENT (Nat'l Bureau of Econ. Research, Working Paper No. 7651, 2000), available at http://dsl.nber.org/papers/w7651.pdf (last accessed Dec. 11, 2003).

should shift EBT to individually owned accounts and permit former welfare recipients to retain accounts after they move into the workforce. Although such a shift might prove costly to states in the short-run (because of lost "float" income), over the long term it is likely to further welfare-to-work goals. Second, states should assist former welfare recipients with having EITC returns directly deposited into a bank account. Third, state welfare initiatives should increasingly include Individual Development Account (IDA) programs.\textsuperscript{566} As part of the federal reauthorization of the 1996 Welfare Reform law, Congress should make funds available to states for these financial services initiatives.

B. Financial Education

Studies find that financial education can sometimes help to change the financial behavior of individuals, particularly low-income persons.\textsuperscript{567} Financial education can increase participation in saving plans and increase the level of saving. However, financial education conducted apart from changes in the availability of product offerings is unlikely to be successful.\textsuperscript{568} Moreover, financial education can be costly, and education focused on low-income persons is unlikely to be undertaken in a significant way absent governmental and nonprofit support. The Treasury Department could expand existing efforts to financial literacy\textsuperscript{569} by supporting community-based financial education focused on account ownership and savings. Education is most successful when it focuses on life decisions that the individual is facing: for example, how to improve credit standing to purchase a home, or how to save for college. America Saves, sponsored by the Consumer Federation of America, which combines financial education with low-income savings plans building on self-identified savings goals, might serve as a model for increasing savings

\textsuperscript{566} Some states have linked financial services access goals to state fiscal management needs. For example, New York enacted a law under which banks that open new branches in designated low-and moderate-income neighborhoods receive property tax abatements as well as the potential for deposits of state funds. Thus far, eight banks have opened branches in these areas. See Amanda Fung, \textit{N.Y. Development Program Gains Traction}, AM. BANKER, Dec. 3, 2001, at 6. For other state asset building strategies, see generally CORP. FOR ENTER. DEV., STATE ASSET DEVELOPMENT REPORT CARD (2002).


\textsuperscript{568} See JAMES J. CHOI ET AL., \textit{DEFINED CONTRIBUTION PENSIONS: PLAN RULES, PARTICIPANT DECISIONS, AND THE PATH OF LEAST RESISTANCE} 4 (Nat'l Bureau of Econ. Research, Working Paper No. 8655, 2001) (noting that one third of self-reported undersavers said that they intended to increase their savings but almost none of them did so).

among low- to moderate-income families.\textsuperscript{570} Non-profit and faith-based organizations can play important roles in partnering with financial institutions to expand financial education to low-income households. In addition, workplace financial education could be funded as part of tax credits covering the administrative costs of setting up payroll direct deposit and savings plans for low- and moderate-income workers.\textsuperscript{571}

VI. Conclusion

Low- and moderate-income households who use alternative financial service providers pay a high price to convert their income into cash, pay their bills, and obtain credit, and they lack a regular means to save. The high cost of alternative financial services undermines key income redistribution policies for the poor, including the EITC. Existing banking products are often not well designed to meet the needs of the poor, and few banks compete with alternative financial services providers for low-income customers, particularly in low-income neighborhoods. The cost to individual financial institutions of research, product development, account administration, staff training, marketing and financial education with respect to new financial products for the poor, relative to their expected financial return, means that the market is unlikely to change quickly on its own. In addition, network externalities in electronic payments systems and distribution networks suggest that net social benefit could be obtained through further expansion.

Financial and technological innovation has been a hallmark of U.S. financial markets. Financial institutions can harness that innovation to meet the needs of low-income Americans. Governmental incentives appear to be important to catalyze private sector efforts to use financial and technological progress to expand access to financial services for low- and moderate-income families. By helping these families to enter the financial services mainstream, the policies outlined here can help to transform financial services for low-income persons. Such a transformation is a key to promoting greater economic opportunities for low-income households.

\textsuperscript{570} See Ben Jackson, \textit{Programs Tout Financial Literacy for All Ages}, \textit{AM. BANKER}, Apr. 5, 2002, at 5.

\textsuperscript{571} This approach builds on SIMPLE 401(k) plans, savings plans offered by small employers, which include a small credit offset for plan administration.