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Banking for the Unbanked

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The following essay is based on testimony delivered before the Senate Committee on Banking, Housing, and Urban Affairs in May. Footnotes have been omitted.

"Nearly 10 million households — 9.5 percent of U.S. households — lack the most basic financial tool, a bank account," according to the author. "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 savings account."

— BY MICHAEL S. BARR

The consequences of not having access to mainstream financial services can be severe.

First, the "unbanked" face high costs for basic financial services. For example, a 2000 Treasury (U.S. Treasury Department) 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. Regular payments with low credit risk that could be directly deposited into bank accounts, with significantly lower payment systems costs, form the bulk of checks cashed at these check cashing outlets: nearly 80 percent of checks cashed at check cashing outlets are regular payroll checks, and another 16 percent are government benefit checks.

The costs of these basic financial transactions can undermine public initiatives to move families from welfare to work, as former welfare recipients often lack access to the banking system, and pay high fees to cash their checks. High cost financial services can also diminish the effectiveness of the Earned Income Tax Credit (EITC), a tax incentive that rewards work and helps bring families out of poverty. One survey found that 44 percent of a sample of EITC recipients in inner-city Chicago used a check cashing service to cash their government refund check. EITC recipients, lacking savings or access to other forms of short-term credit, are also likely to use high-cost refund anticipation loans.

Second, low-income families need to save to cushion themselves against personal economic crises, such as injury or loss of a job, and to save for key life events, such as buying a home, sending their children to college, or entering old age. Yet low-income families, particularly those without bank accounts, often lack any regular means to save. Bill Gale of the Brookings Institution has shown that, after controlling for key factors, low-income households with bank accounts were 43 percent more likely to have financial assets than households without bank accounts. Moreover, the tax system, through which the bulk of government savings benefits are provided, largely subsidizes savings for higher-income households. The Treasury Department estimates that more than two-
thirds of tax expenditures for pensions go to households in the top 20 percent of the income distribution, while the bottom 40 percent get only 2 percent of the tax benefit. Most low-income workers work for firms without savings plans or are themselves not covered by such plans. Bank accounts can be important entry points for the provision of regular savings plans for low-income workers, for example, through payroll deduction.

Third, the unbanked are also largely cut off from mainstream sources of credit necessary to leverage their hard work into financial stability. Without a bank account, it is more difficult and more costly to establish credit or qualify for a loan. A Federal Reserve study found that a bank account was a significant factor — more so than household net worth, income, or education level — in predicting whether an individual holds mortgage loans, automobile loans, and certificates of deposit. Account ownership in and of itself is no panacea; however, even low-income individuals with bank accounts often lack savings, and turn repeatedly during the year to payday lenders, who charge on average 474 percent APR. Thus, strategies to bring the unbanked into the financial services mainstream need to include initiatives designed to increase savings for short-term financial stability and improve access to less expensive forms of credit where appropriate, as, for example, with overdraft protection or account-secured loans.

**Barriers to banking**

While the financial system works extraordinarily well for most Americans, many low- and moderate-income individuals face a number of barriers to account ownership.

First, regular checking accounts may not make economic sense for many lower-income families. Consumers who cannot meet account balance minimums for a checking account at a bank pay high monthly fees, and most banks also levy high charges for bounced checks that low-income families with little or no savings face a high risk of paying and can ill-afford. Financial institutions may also charge high fees for money orders or other products that their typical customers do not often use.

Studies have confirmed that many of the unbanked would become “banked” if they found a product that worked for them. In fact, the unbanked have responded to account products tailored to their needs. For example, Banco Popular of Puerto Rico introduced Accesso 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 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 cash checks, although the figure may be significantly lower in some inner-city communities. Between 48 and 70 percent of the unbanked have had an account at a financial institution at some time in the past.

Second, many unbanked persons may not qualify for conventional bank accounts because of past problems that these persons have had with the banking system. Nearly seven million individuals are currently recorded as having had their accounts closed for prior problems, such as writing checks with insufficient funds or failing to pay overdraft charges, in the ChexSystem, a private clearinghouse used by most banks to decide whether to open bank accounts for potential customers. Records of prior problems are kept in the system for five years, during which time these individuals will 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 readily and 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 on-line bill payment or automatic money orders, and without check-writing privileges, that pose little risk of overdraft.

Third, while many urban communities contain adequate numbers of both banking institutions and alternative financial services 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 fewer bank offices per capita than higher-income areas and those outside the central city. 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.

Fourth, financial institutions may be reluctant to expend the resources for research, product development, training, marketing, and education, necessary to expand financial services to lower-income clientele. Financial institutions may need incentives to pursue research and product development with respect to accounts for low-income customers. 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 local banking personnel, are both critical to the success of any new product development, yet given the expense and the expected low returns, 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.

Moreover, at least for a segment of the low-income population, lack of financial education with respect to account ownership, budgeting, saving, and credit management is a significant barrier to personal financial stability. The benefits of financial education are not likely to be fully captured by the financial institution, so such education at any scale will likely need to be funded from sources in addition to the financial institution.

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Expanding access to the financial services mainstream

While important challenges are still largely in front of us, 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 percent. This decline in the percentage of unbanked may reflect in part strong economic growth in the late 1990s that improved the incomes of households at the bottom of the income distribution for the first time in decades.

The Treasury Department’s efforts to increase electronic payment of federal benefits, pursuant to the Debt Collection Improvement Act of 1996, has also helped to spur innovation in this area. 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 percent in 1996 to 76 percent in 2001. This increase in benefit payments reflects in part an increase in direct deposit to existing accounts, and in part an increase in the percentage of benefit recipients who have obtained bank accounts.

Moreover, Treasury launched the Electronic Transfer Account (ETA), a low-cost electronically based account for federal benefit recipients. 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. As of spring 2002, nearly 600 banks, thrifts, and credit unions were offering ETAs at over 18,000 locations nationwide. Over 28,000 benefit recipients have opened these ETAs thus far, and new ETA account holders are being signed up at a rate of over 1,000 per month. The ETA could make faster progress were additional funds made available for marketing and training. Anecdotally, banks are reporting that they are also signing up more than three direct deposit relationships into regular banking accounts for every ETA opened.

More recently, a number of banks, thrifts, and credit unions have begun to experiment with a variety of products designed to serve the needs of low-income individuals. As I mentioned, Banco Popular has made great strides in reaching the unbanked of Puerto Rico. In the states, Bank One is experimenting with using a broader range of credit criteria for opening accounts. Shorebank has focused on bringing EITC recipients into the banking system. Fleet is working with a nonprofit organization, Doorways to Dreams, to create an Internet platform for low-income savers.

A number of banking institutions, including Wells Fargo, have recently begun to work with the Mexican government to accept Mexican consular identification documents for Mexican immigrants in the United States seeking to open bank accounts. Similarly, recent efforts to reduce the costs of sending remittances abroad, such as Bank of America’s dual-ATM card, hold promise for bringing immigrant communities into the banking system. President Bush and Mexican President Vicente Fox have made progress on reducing the costs and increasing the benefits of the nearly $10 billion in annual U.S.-initiated remittances to Mexico issue an important part of their mutual agenda.

First accounts

In this regard, Treasury’s First Accounts initiative could play an important role in fostering innovation by the financial services sector. With the government helping to serve as a catalyst, banks can 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 can 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 availability 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 10 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.

As initially conceived, the First Accounts initiative had four main components: First Accounts. Treasury would help to offset the costs financial institutions incurred in offering low-cost, electronic banking accounts to low-income individuals.

Access. Treasury would help to defray the costs of expanding access to ATMs, POS, Internet, or other distribution points in low-income neighborhoods with low access.

Financial Education. Treasury would support financial institution and nonprofit initiatives to provide financial education and counseling to low-income households.

Research. 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 Account initiative properly 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 Account initiative can help to accelerate improvements in this market.

Treasury issued a request for proposals under the First Account program in December 2001. The Department received 231 responses 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. As reported by the Department, the results of the first round of funding are impressive. The challenge going forward is to continue funding the First Accounts initiative at sufficient levels and for a sufficient time to help transform the market for low-income financial...
services. Only a sustained commitment to the First Accounts initiative will provide financial institutions with sufficient incentive to make the necessary investments in research, technology platform changes, training, marketing, and education necessary 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.

Banks, thrifts, and credit unions could, under the First Accounts initiative, experiment with a wide variety of techniques to expand access to the unbanked, and to provide an increasing range of services to the underbanked. Low-cost electronic transaction accounts can be attractive to the unbanked and can be offered at reasonable cost. 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 attractive to the unbanked and low-cost. Similarly, low-income individuals need a convenient and low-cost means to pay bills, automated money orders, online bill payment, alternative means of foreign country remittance, and other low-cost payment methods can help to reduce the cost of basic transactional services for the poor.

In addition, the First Accounts initiative has the potential to help spur "leapfrogging" in technology for low-income financial services, in analogous ways to how the Internet and cellular telephone technology have permitted developing countries to leapfrog in telecommunications infrastructure. To offer a few examples that could be subjected to the test of market feasibility: With sufficient incentives, providers of the network infrastructure for debit and credit cards, or providers of back-office data and information processing functions for banks and mutual funds, may be induced to explore ways that low-income customers could be served by financial institutions on shared technological platforms. As access to the Internet expands in low-income communities, e-finance can increasingly be made available to the poor at Internet kiosks. Or companies that are exploring ways to expand the use of cellular phones to transact financial services for high-income clientele could be encouraged also to focus attention on expanding banking account access for the low-income market that currently utilizes pre-paid cellular phones.

The First Accounts initiative can also help to spur employer-driven (or union-driven) strategies to expand access to banking services. Large employers can reap significant benefits from moving more of their workers to direct deposit of payroll, driving down their payroll processing costs, increasing the effective take home pay for their workers, and reducing problems from theft or fraud associated with checks. Employers can help to reduce costs for reaching their unbanked employees with financial education and marketing of new products. Moreover, many employers have already become active in educating their workers about advanced payments under the EITC. 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 based payroll systems for their clients' 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.

**Conclusion**

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. The First Accounts initiative is an important part of catalyzing 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, First Accounts and related initiatives can help to transform financial services for low-income persons. Such a transformation is a key to promoting greater economic opportunities for low-income communities in the twenty-first century.

Michael S. Barr joined the Michigan Law faculty in fall 2001. He earned his B.A., summa cum laude, from Yale University, an M. Phil. in International Relations from Magdalen College, Oxford, as a Rhodes Scholar, and his J.D. from Yale Law School. Barr was an articles editor for the Yale Law & Policy Review, and was active in the homelessness clinic and in the Lowenstein Human Rights Clinic, where he co-directed the Haitian Centers Council v. McNary, challenging U.S. policy of repatriating Haitian refugees. He was co-recipient of the 1992 Human Rights Award of the American Immigration Law Association, and co-recipient of the Charles G. Albom Prize for appellate advocacy. Barr served as a judicial clerk for Justice David H. Souter of the Supreme Court of the United States, and for Judge Pierre N. Leval of the Southern District of New York. His wide experience includes serving as: special adviser and counselor on the Policy Planning Staff of the U.S. State Department, focusing on human rights and international organizations; Treasury Secretary Robert E. Rubin's special assistant, advising the secretary on national policy issues; and deputy assistant secretary of the Treasury for community development policy. He helped to negotiate final passage of the financial modernization law, and to enact over $25 billion in initiatives for low-income communities. From 1999 to 2001, Barr also served concurrently as special adviser to the President, responsible for the federal government's policies with respect to the District of Columbia. In the spring of 2001, Barr was a visiting fellow at the Brookings Institution, where he remains a nonresident senior fellow. In addition, he has served on the board of the Telecommunications Development Fund, a publicly-chartered investment fund focused on early stage technology firms, and on the advisory boards of D.C. Agenda and of George Washington University's Center for Excellence in Municipal Management. He is a term member of the Council on Foreign Relations, and a member of the bars of New York and the District of Columbia. Professor Barr's research and teaching interests include financial institutions, community development, and international law. He has written on access to capital, international labor and environmental rights in trade agreements, refugee law, and health policy.