January 15, 1999

Federal Reserve Bank of Cleveland

Bringing the Unbanked Onboard

By Barbara A. Good

Millions of Americans do not have a banking relationship with a traditional financial institution.[1] The "unbanked" —estimated to be 13 percent of American households—use a variety of means to cash checks, make payments, and take out small, short-term loans. Numerous programs and policies have been proposed and implemented to address this issue, but the success rate has not been high.

What are the necessary ingredients of a policy or program that would make the services of traditional institutions be of value to this group? More importantly, is such a policy necessary or merely paternalistic governmental intervention? The answers to these questions are currently being sought by stakeholders in both the private and public sectors.

While the existence of the unbanked population is not new, changes in government policy have required a new look at how the unbanked can be served by both traditional and nontraditional financial institutions. Widespread public awareness of the unbanked was highlighted with the passage of the Debt Collection Improvement Act of 1996 and the initiation of the U.S. Treasury's Electronic Funds Transfer Program (EFT99). The act mandated that all government payments to recipients be delivered via electronic means by the beginning of 1999,[2] while EFT99, which is still being finalized, provides a means for implementing the act.

The act's new requirement, along with the provisions of EFT99, exacerbated the basic dilemma of the myriad of Americans who have not established banking relationships, because under the new law, the unbanked must be paid via electronic methods. In effect, the Treasury must figure out how to abide by the law without causing undue hardship on the recipients of government benefits payments.

■ A Profile of the "Unbanked"

Most unbanked individuals have low to moderate incomes, tend to have achieved below-average education levels, and are more likely to be young and nonwhite. It is estimated that 7 percent of white Americans and 33 percent of nonwhite Americans do not have bank accounts, and that most have incomes less than $25,000.[3] These individuals have been described by the check-cashing industry as "Asset Limited, Income Constrained."

The number of families without checking accounts has decreased in recent years, from 18.9 percent in 1989 to 15.1 percent in 1995. More than half (54 percent) of these families were nonwhite or Hispanic.[4]

It is often difficult to understand why the unbanked are unwilling to use traditional financial institutions in order to address their financial needs, although surveys indicate that there are many reasons. The *Survey of Consumer Finances* has found that the reasons have remained constant over time. Individuals without bank accounts say they do not write enough checks to make it worthwhile, do not have enough money, and/or do not like dealing with banks.[5]

Changes in government policy have required a new look at how the unbanked population can be served by both traditional and nontraditional financial institutions. In this regard, banks must continue to gear products and services around the needs and concerns of this substantial market segment in order to win these potential customers over.

ISSN 0428-1276

Table 1 (at right) illustrates the reasons why many people have chosen not to establish checking accounts, and how these reasons have become more or less prevalent over time. It is interesting to note that there was a significant increase from 1992 to 1995 in the number of respondents who said they did not like dealing with banks. Although the percentage of respondents who do not like dealing with banks increased from 15.3 percent in 1992 to 22.8 percent in 1995, there have been no studies that have dealt with this particular concern. It appears there is a significant problem that traditional financial institutions need to overcome in order to win over the hearts and bank accounts of this group.

John Caskey, a noted expert on the unbanked population, has also conducted a survey and has stated that many people "want to keep their financial records private" and "are not comfortable dealing with banks." From the data collected in his survey, Caskey concluded that unbanked households have limited funds and cannot meet or maintain the account balances required by financial institutions. He also found that they distrust financial institutions and prefer to handle their financial affairs through alternative financial providers.[6] His conclusions provide more evidence that the unbanked have numerous and diverse reasons for avoiding traditional financial service providers.

How the Unbanked Currently Receive Financial Services

The unbanked individual today uses a variety of means and institutions to conduct his or her financial affairs. Rather than using traditional banking institutions, the unbanked use "fringe banks"[7]—primarily check-cashing outlets and pawnshops. Many people use these fringe banks because they are unaware of their alternatives, especially in neighborhoods with few bank branches and in families that never had bank accounts.

In urban areas, check-cashing outlets abound, even in neighborhoods that are served by bank branches. These check-cashing outlets will, for a fee, cash government, payroll, and personal checks. Currently these fees are regulated in only 13 states. This lack of regulation may explain why the cost of cashing checks at these outlets typically ranges from 1.5 percent of the face value for government checks to 10 percent of the face value for personal checks.

Annually, check-cashing outlets cash more than 150 million checks worth more than $60 billion. The number of check-cashing outlets has tripled since 1986 and is now greater than 6,000. This increase is attributed to a number of factors, including the fact that a growing number of services is available to customers at check-cashing outlets. Among other things, these facilities typically sell money orders, phone cards, stamps, and lottery tickets, and also often provide utility bill payment, facsimile, and copying services. Making check-cashing outlets even more attractive is their accessibility: many are open 24 hours a day, seven days a week.

Check-cashing outlets are most prevalent in urban and suburban areas. Bars and small grocery stores cash government and payroll checks for a fee in many neighborhoods, both urban and rural. In smaller towns and rural areas, banks also often cash government and payroll checks for known residents as a public service. The risk for the bank is relatively small if identification precautions are observed, and as there are fewer alternatives available to the unbanked in rural areas, this service is considered by the banks as a beneficial community relations practice.

How Expensive Are the Services Provided by Check-Cashing Outlets?

Utilizing the services of check-cashing outlets is costly. Assuming that an unbanked individual cashes one government check for $500 and two personal checks worth $100, and buys three money orders monthly, he or she could pay as much as $26.50 each month. The person would generally pay considerably less for a simple checking account, as low-cost checking accounts with limited privileges are available for under $10 a month at some traditional financial institutions. In addition, the unbanked individual would also be creating a financial and credit history, so that if a loan was needed, he or she could utilize a traditional financial institution and pay a considerably lower interest rate.

Check-cashing outlets also offer payday loans, but they too are extremely expensive, with annualized interest rates often ranging from 213 percent to 913 percent. To someone needing a short-term loan, the quoted fee for a payday advance loan may not appear excessive at first glance, but it quickly increases with any subsequent rollover. Table 2 (at right) shows the annualized percentage rate for a payday loan outstanding for six weeks. As you can see, interest rates quickly increase astronomically.

New Alternatives for the Unbanked

Although check-cashing outlets are providing needed services to the unbanked, they are doing so at higher prices than might be paid to traditional financial institutions. With more than 10 million potential customers at stake, there is a substantial incentive for organizations to provide services that generate revenue and profits while servicing the needs of these customers. EFT99 is also designed to provide a means for individuals to use more traditional financial institutions at a low cost. As of press time, the details of this program had not been finalized.

Under the original provisions of EFT99, specific accounts would be set up for all benefits recipients who did not have an account with a financial institution. These individuals would be given the option to access an Electronic Transfer Account (ETA℠) to receive their payments electronically. The ETA account would be an account at a federally insured depository institution, and the Treasury would designate the depository institution(s) through which these accounts would be offered. Recipients would also be provided with a card that could be used at ATMs and point-of-sale (POS) terminals to withdraw their funds. The ETA would be offered to the recipient at an affordable price with the same consumer protections that apply to accounts at traditional financial institutions.

As conceptualized, ETA accounts are similar in purpose to the "lifeline" bank accounts[8] that have been offered by traditional financial institutions in the past. According to an article recently published by the Federal Reserve Bank of New York,[9] only seven states have enacted legislation creating lifeline banking accounts. And while there is no detailed information available on

TABLE 1 WHY THE UNBANKED DON'T USE CHECKING ACCOUNTS

Reasons	Percent of respondents 1989	1992	1995
Do not write enough checks to make it worthwhile	34.3	30.4	27.1
Minimum balance is too high	7.6	8.6	8.6
Do not like dealing with banks	15.0	15.3	22.8
Service charges are too high	8.4	11.2	7.9
No bank has convenient hours or location	1.2	.9	1.2
Do not have enough money	21.8	20.9	20.5
Cannot manage or balance a checking account	4.6	6.4	8.6
Other	7.1	5.7	3.4
Total	**100%**	**100%**	**100%**

SOURCE: Kennickell, Starr-McCluer, and Sunden (see footnote 3).

TABLE 2 THE COST OF A PAYDAY ADVANCE LOAN[a]

$300 loan for six weeks	
Quoted interest rate: 20% of face value	$60
Set-up charge (weeks 1 and 2)	$15
First rollover (weeks 3 and 4)	$75[b]
Second rollover (weeks 5 and 6)	$75[b]
Total cost	**$225**
Effective annualized percentage rate	**715%**

a. It should be noted that these payday loans are not expected to be rolled over more than a few times. However, the annualized percentage rate would apply if the loan was rolled over every two weeks for one year.

b. Includes both the set-up fee and 20% of the face value of the check.

SOURCE: Author's calculations.

their use, lifeline banking accounts lower the price of payments services for some consumers. In the state of New York, for example, these accounts can be opened with as little as $25, have no minimum balance requirements, and have monthly fees of no more than $3 which allow the user at least eight transactions.[10]

Unfortunately, from the few studies conducted, it appears that lifeline bank accounts have not changed the way the unbanked conduct their financial affairs. Although more costly, check-cashing outlets seem to offer greater convenience than traditional financial institutions in terms of business hours and immediate availability of funds. Whether or not the ETA will be effective in serving the needs of the unbanked population remains to be seen.

Because the check-cashing industry saw a major source of its income potentially disappearing with the provisions of EFT99, the National Check Cashers Association has lobbied dozens of banks to allow its members to serve the unbanked. As a result, Citibank has contracted with check cashers to establish them as distribution points for Electronic Funds Transfer (EFT) accounts.[11] The proposed system utilizes a debit card carrying the logos of Citibank and NCCA and guarantees that recipients' funds flow through federally insured accounts. The cards are to be available at check-cashing outlets only, have no savings features, and do not provide free transactions.[12]

Western Union has also introduced a product that will allow customers to receive federal benefits electronically at its 23,000 retail offices nationwide. "Western Union Benefits Quick Cash" is already in use and can be set up over the telephone. Under the program, benefits recipients submit payment information and authorizations to Western Union. After a six- to eight-week processing period, the recipient receives his or her federal benefits through Western Union via a membership card. Recipients may then receive their full benefits in cash, less a $7.50 service fee, at any location, 24 hours a day, seven days a week.

The unbanked population and the requirements of EFT99 have caused the Treasury to forge unprecedented relationships with these alternative providers of financial services. Although the costs to consumers may be higher than if they used traditional financial institutions, many unbanked customers prefer the convenience regardless of the extra costs.

How Do You Turn the Unbanked into the Banked?

There are numerous policy implications embedded in this issue, as some consumers, primarily low-income families, pay relatively higher prices for access to payment services. This is not an isolated issue, as low-income families often pay relatively higher prices for goods and services, but in this case there is no economic reason for them to continue to pay higher prices. Lower-priced financial services are available to these consumers, but they may not be aware of their options.

Educational programs have not been effective in changing the financial habits of the unbanked. What may be required is changing the ways services are provided by traditional financial institutions to lower-income families. The conveniences provided by check-cashing outlets, although costly to their customers, may help these customers to justify the costs. If in one stop a consumer can cash checks, buy money orders, pay utility bills, buy lottery tickets and stamps, and do all these things outside of the normal banking hours, it may be worth the extra expense. For many lower-income families, the immediate availability of funds can also offset the fees for cashing checks. But while the unbanked are able to accomplish their immediate goals, they are not building a financial history which could help them save money in terms of lower interest rates if they need to borrow money for a larger purchase in the future.

Grassroots community organizations need to get involved in promoting the advantages of building a financial and credit history, as well as in teaching the unbanked how to use and manage a checking or other transaction account. Churches and schools could provide a forum for these purposes, as they have already established trust within the community. In order for traditional financial institutions to gain customers, they must establish a level of trust with these potential new customers.

Although there will always be some individuals who choose not to establish bank accounts, many more may be willing to use traditional financial services if they knew they were affordable and if the services were convenient to their schedules. It may be necessary for traditional financial institutions to view the provision of their services in a slightly different manner to attract these customers. While the unbanked are not the traditional target customers of financial institutions, they are potential customers in need of financial services. By offering these individuals accounts and services geared to their needs and concerns, banking institutions should find the unbanked population to be an attractive and untapped market that may use a growing number of fee-based services in the years to come.

Footnotes

1. A traditional financial institution for the purpose of this commentary is a commercial bank, a savings and loan association, or a credit union.

2. The only exception noted was that tax refunds did not need to be issued in electronic form by January 2, 1999. The payments that were included, however, were salary, benefits, vendor, and miscellaneous payments. These payments are disbursed either by the U.S. Department of the Treasury or by other agencies with delegated or statutory disbursing authority.

3. See Arthur B. Kennickell, Martha Starr-McCluer, and Annika E. Sunden, "Family Finance in the U.S.: Recent Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 83, no. 1 (January 1997) p. 7.

4. Ibid.

5. See Booz-Allen & Hamilton and Shugoll Research, Mandatory EFT Demographic Study OMB #1510-000-68, Department of the Treasury Financial Management Service, p. 21.

6. See John Caskey, *Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor*. New York: Russell Sage Foundation, 1994, pp. 73–79.

7. The term fringe bank was coined by Hyman Minsky and popularized by John Caskey in his book *Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor*.

8. Lifeline bank accounts are low-cost, limited-service accounts offered to customers of traditional financial institutions in states that have passed legislation requiring their provision.

9. See Joseph. J. Doyle, Jose A. Lopez, and Marc R. Saidenberg, "How Effective Is Lifeline Banking in Assisting the 'Unbanked'?" Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, vol. 4, no. 6 (June 1998).

10. State of New York Banking Department, *Basic Banking Accounts/Lifeline Banking Accounts*, 1996, cited in Doyle, Lopez, and Saidenberg (footnote 9). Also available at http://www.banking.state.ny.us/bba.htm, January 1999.

11. See Shelly Branch, "Where Cash is King," *Fortune*, June 8, 1998, p. 201.

12. Fees have not yet been announced.

Barbara A. Good, formerly a payments system specialist at the Federal Reserve Bank of Cleveland, is now a freelance writer.

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

Return Service Requested:
Please send corrected mailing label to the above address.

BULK RATE
U.S. Postage Paid
Cleveland, OH
Permit No. 385