

Taking the Poor Into Account

What Banks Can Do To Better Serve Low-Income Markets

By Anne Kim

An astonishing number of American families lack a basic financial asset—a bank account. The Federal Reserve estimates that about 13.2 percent of American households don't own a checking account and that about 9.5 percent of American households hold no bank account at all.¹

The demographics of the “unbanked” are striking:

- ▶ **The unbanked are disproportionately poor.** Four out of five of these families make less than \$25,000 a year, and two out of five families have annual incomes of less than \$10,000.²
- ▶ **The unbanked are mostly minorities.** More than half of all unbanked households are nonwhite or Hispanic, and studies estimate that as many as one-third of all nonwhite households are unbanked.³
- ▶ **Unbanked households are young.** One out of three unbanked families is headed by someone under the age of 35, and more than half are headed by persons under 45.⁴
- ▶ **The unbanked are likely to be less educated than the general population.** For example, one survey of federal benefits recipients found that of those recipients without a bank account, 59 percent had less than a high school education.⁵

Conventional wisdom has held that many low-income consumers cannot afford a traditional bank account because of high maintenance fees. This assumption led to several state and federal initiatives that attempted to encourage banks to offer low-cost basic accounts to eligible participants. These initiatives have not proven successful, however, and mounting evidence indicates that affordability is not the principal reason low-income consumers avoid banks.

For many people, being unbanked is not a question of access, but of appeal. The banking products offered by mainstream banks do not fit the spending and savings needs of low-income consumers, and banks are failing to tailor their products to compete effectively in low-income markets. For example, many low-income consumers generally live paycheck to paycheck and cannot afford to wait for a deposited check to clear. Recent research into the attitudes of low-income consumers toward mainstream

banks also indicates that many potential customers harbor either a distaste for or a distrust of traditional financial institutions. Moreover, recent studies have found that a significant percentage of low-income customers who do have bank accounts rely on fringe institutions for all or part of their day-to-day banking needs.

In fact, low-income workers are increasingly turning to “alternative” financial service providers such as check cashers and pawnshops to supply their banking needs. Although these “fringe” institutions do offer the types of services that low-income consumers want—that is, convenience and easy access to cash—they do not offer the tools for savings and wealth creation that mainstream banks can. Moreover, as James Carr and Jenny Schuetz write, lack of competition from mainstream banks permits fringe institutions to charge extortionate fees.⁶

Mainstream banks can and should compete effectively—and profitably—in low-income markets. But doing so will require a radical rethinking of how banks do business with low-income consumers. Bringing banks to the unbanked will also require the full cooperation of government and community-based organizations to nurture the market and make it work for low-income consumers.

For low-income customers currently served by a lopsided market, more competition means lower prices and better services. For banks, low-income markets may hold tremendous untapped profit-making potential.

The Benefits of Being Banked

Not owning a bank account arguably has few day-to-day consequences. Instead of writing checks, people without bank accounts buy money orders. Instead of making deposits, the unbanked visit check cashers.

Over the long term, however, being unbanked can greatly damage a family’s ability to acquire and accumulate wealth. For example, the fees charged by check cashers can steadily siphon away a significant amount of family income.⁷ According to a 1997 national survey, cashing a paycheck costs an average of 2.34 percent of the face value of the check.⁸ For a worker who takes home \$16,000 a year, these fees would add up to about \$374 a year. Over time, these fees would mount into thousands of dollars—money that could have been better spent on a home, a car, a business, or a diploma.

Moreover, people without bank accounts are less likely to save. Research by Constance Dunham, based on a recent survey by the Office of the Comptroller of the Currency (OCC) in low-income areas of New York and Los Angeles, found that people with bank accounts are more than twice as likely to hold savings as are people who are unbanked.⁹ Moreover, people with bank accounts are more likely to add to their savings on at least a monthly basis. While about half of people with bank accounts added some amount to their savings each month, only 14 percent of the unbanked regularly put aside any money.¹⁰ People without bank accounts also “save” their money in the form of cash under the mattress or as gold or jewelry.

These informal savings mechanisms can have multiple disadvantages other than a lost opportunity for earning interest: gold, jewelry, and loose cash can be easily lost or stolen, and jewelry in particular is illiquid and of uncertain value.

The benefits of savings are obvious: Savings provide a financial cushion for short-term shocks and long-term needs and pave the way toward the acquisition of larger assets, such as a home. Moreover, holding savings can have psychological benefits. As Michael Sherraden at Washington University in St. Louis puts it, “Assets change people’s heads.” Much as holding stock can make a shareholder care passionately about the performance of a particular company, owning assets gives people a stake in society and a sense of connectedness to their communities. For the holder of a savings account, interest rates matter. And if interest rates matter, so does the overall health of the economy.

A bank account is the first step toward giving low-income Americans access to the mainstream tools for wealth creation now taken for granted by the middle class. Promoting access to mainstream financial services can both diminish the “wealth gap” between the working poor and the middle class and promote an inclusive society in which all Americans own a capital stake.

Why the Unbanked Are Disconnected

Nonbanks serve as significant providers of financial services to low-income people, even to those who own a bank account. For example, of the low- and moderate-income people surveyed by Dunham, only 65 percent of those with bank accounts primarily used checks to pay their bills. The rest primarily used money orders, cash, bill payer services, or other forms of payment.

No single reason explains why some consumers—and low-income, nonwhite consumers in particular—choose not to use mainstream banks for most of their financial services needs. Several studies have attempted to dissect the banking behavior of low-income consumers, and from these studies emerge three principal reasons why some individuals are either unbanked or underbanked. These reasons are the following: consumer attitudes, attractiveness of services, and relative costs.

Attitudes toward banks. Several studies have found that a significant percentage of low-income consumers dislike dealing with banks. A recent study by Sherrie L.W. Rhine, Maude Toussaint-Comeau, Jeanne M. Hogarth, and William H. Greene for the Federal Reserve Bank in Chicago found that 26 percent of the low- and moderate-income households they surveyed had a “distaste” for a checking account. This distaste, according to the survey, came from either a dislike of banks, a distrust of banks, or a desire to keep financial records private.¹¹ Similarly, according to the Federal Reserve’s 1998 Survey of Consumer Finances, 18.5 percent of unbanked families reported that they “do not like dealing with banks.”¹² John Caskey of Swarthmore College, who surveyed 900 lower-income households, also found results consistent with these findings: 22.1 percent of unbanked households reported a desire to keep their financial records private, and 17.6 percent said they were “not comfortable dealing with banks.”¹³ According to Caskey, the desire to keep financial records private could arise from a number of reasons: a desire to hide assets from creditors or to avoid child support enforcement authorities, who may pursue an individual’s savings to pay back arrearages; a belief that owning significant savings will make a person ineligible to

receive welfare benefits; or a fear that owning a bank account will reveal a person's status as an illegal immigrant to immigration authorities.

Services. Despite common perceptions, lack of access to branches of mainstream banks is not a significant barrier to owning an account, although as Carr and Schuetz write, lack of access does pose a major problem in some communities. According to the 1998 Survey of Consumer Finances, for example, only 1.2 percent of those surveyed cited the lack of convenient hours or locations of bank branches as the reason why they didn't own a checking account. According to another study, the number of bank offices nationwide rose by about one third during the period from 1975 to 1995, and the number of bank branches per capita in 1995 was roughly the same for neighborhoods of all incomes.¹⁴ The study by Rhine et al. in Chicago also found that a majority of the low-income neighborhoods surveyed did have access to banks and, moreover, that in neighborhoods where both banks and nonbanks were present, the ratio of those institutions was about one-to-one.¹⁵

The lack of appeal that mainstream banking services hold for some low-income workers is perhaps best understood by examining the types of services provided by the nonbank institutions that are the banks' principal competitors. In its most recent annual report, Ace Cash Express Inc., which is currently the nation's largest chain of check-cashers, summed up the relative merits of its services versus those of mainstream banks:

Unlike many banks, check-cashing stores are willing to assume the risk that checks they cash will "bounce." For instance, it is not unusual for a bank to refuse to cash a check for a customer who does not maintain a deposit account with the bank and to require its depositors to maintain sufficient funds in an account to cover a check to be cashed or wait several days for the check to clear. As a result, the Company believes check-cashing stores provide an attractive alternative to customers without bank accounts or with relatively small account balances. Although these customers might save money by depositing their checks in a bank and waiting for them to clear, many prefer paying a fee to take advantage of the convenience and availability of immediate cash offered by check-cashing stores.¹⁶

Dollar Financial Group Inc., which operates the second-largest chain of check-cashing stores in the country, cites similar appeal for its services:

The Company's research indicates that, although approximately 30% of its customers have bank accounts, its customers prefer immediate access to cash without waiting for check clearance. ... The Company believes that many of its customers are workers or independent contractors who receive payment on an irregular basis and generally in the form of a check. The Company's core customer group lacks sufficient income to accumulate assets or to build savings. These customers rely on their

current income to cover immediate living expenses and cannot afford the delay inherent in waiting for checks to clear through the commercial banking system.¹⁷

Although quick access to cash is likely the principal reason for the appeal of nonbanks over banks, nonbanks also open their doors on evenings and weekends and bundle their financial services with a variety of other products designed to lure in customers. Besides check cashing, most nonbanks also offer money orders, money transfer services, and so-called “payday loans,” which are short-term consumer loans with typically high interest rates.

Dollar Financial Group reports that its stores offer “a variety of ancillary products, including photo ID, lottery tickets, electronic tax filing, pagers, cellular phones, photocopy and fax services and pre-paid telecommunication products including local and long-distance phone cards,” all of which, Dollar claims, “assist marginally banked or credit-impaired customers to more effectively manage their personal finances.”¹⁸ And the motto of one nonbank outlet in Chicago, the Currency Exchange, offers to “Get Stuff Done.” This outlet offers not only the menu of services that is standard in Dollar’s stores but also stamps, envelopes, marriage, birth and death certificates, notary services, and car insurance and registration.¹⁹

Fees and financial barriers. As Carr and Schuetz document, nonbank financial service providers are having an increasing “wealth-stripping” effect on low-income neighborhoods. In only the past few years, fringe institutions have exploded in both number and profitability. According to the Financial Service Centers of America, the check-cashing industry’s trade association, check cashers currently process about \$55 billion in checks each year. If average fees are 2.34 percent of face value, revenues for the industry from check cashing alone should total about \$1.3 billion a year.

Many low-income consumers, however, nevertheless perceive the costs of holding a bank account to be too high—at least relative to its benefits. In the 1998 Survey of Consumer Finances, 28.4 percent of unbanked respondents said they didn’t own a checking account because they “do not write enough checks to make it worthwhile.”

Maintenance fees and opening minimum balances are among the most commonly cited barriers to opening and keeping an account. In Caskey’s study, 23.1 percent of those surveyed thought that bank account fees are too high, and 22.1 percent said that “banks require too much money just to open an account.” In the Chicago study by Rhine and colleagues, 62.4 percent of respondents gave one of the following reasons for not owning a checking account: “minimum balance/fees too high,” “not enough money to open an account,” and “do not write enough checks.”

Significant percentages of unbanked consumers also cite a lack of money as the principal reason for not owning a bank account. In the 1998 Survey of Consumer Finances, the percentage of unbanked consumers reporting this reason was 12.9 percent. Lack of money can pose a barrier in several ways: in amassing the opening balance needed for an account; in maintaining a minimum balance to avoid account maintenance fees; in maintaining a sufficient balance to cover any checks cashed by the

depositor to avoid delays while a check clears; and in maintaining a sufficient balance to cover any checks that might bounce. For low-income workers with generally very low balances, these barriers can become quite significant. For example, according to the Federal Reserve, the average monthly balance required by big banks in 1999 to avoid maintenance fees on a basic checking account was \$664.21, and the average required minimum balance to open such an account was \$83.51.²⁰

Given the standard fee structure charged by mainstream banks, relying on nonbank institutions for financial services can, in some instances, be *cheaper* than holding an account at a traditional bank. Dunham, for example, found that many people do not incur costs to cash checks or purchase money orders and that, of those who do, the majority pay less than \$100 a year.²¹ For many unbanked individuals, the most significant expense for financial services is the cost of money orders, which in Dunham's study cost an average of about \$1 apiece.²²

Because the average low-income consumer does not purchase very many money orders a month (about two a month, on average, according to Dunham), it is possible for a low-income consumer who can avoid check-cashing fees to spend very little on financial services. For example, a consumer who only purchases four money orders a month at \$1 each would spend less than \$50 a year. This amount is significantly less than it would cost, on average, to open a basic checking account at a large mainstream bank. According to the Federal Reserve, the average monthly fee charged by big banks for a non-interest checking account in 1999 was \$8.20—or \$98.40 a year.²³

Another significant financial barrier that Caskey cites is bounced check fees. For low-income workers with small deposits and little financial cushion, even a single bounced check or an inadvertent overdraft can mean substantial penalties. The Federal Reserve reports that the average insufficient funds fee charged by big banks in 1999 was \$23.51 and that the average overdraft fee was \$23.55.²⁴ Caskey's survey found that of those unbanked individuals who cited high bank fees as a barrier to owning an account, 18.5 percent specifically cited bounced-check fees as a principal concern.²⁵

Current Efforts To Connect the Unbanked

To date, government initiatives to bank the unbanked have focused primarily on lowering maintenance fees. But because of their focus on cost alone, these initiatives have not met with a great deal of success.

Electronic Transfer Accounts. As part of a strategy to implement the Debt Collection Improvement Act of 1996, which mandated the electronic payment of all federal payments (except income tax refunds), the Treasury Department initiated a voluntary program called Electronic Transfer Accounts (ETAs). ETAs would have enabled unbanked individuals who receive government benefits to do so by electronic direct deposit. Banks that offer ETAs may charge no more than \$3 a month in maintenance fees and are entitled to receive a one-time reimbursement of \$12.60 from the government for each ETA opened. In addition, ETA holders are entitled to four free withdrawals a month and do not need to meet minimum balance requirements.²⁶

So far, ETAs have not been widely adopted. One year after its initial unveiling in July 1999, only about 1,000 ETAs had been opened, with nearly 900 of them at a single bank, the Banco Popular de Puerto Rico in San Juan.²⁷ The number of open accounts as of April 2001 was fewer than 9,000 nationwide, and approximately 1,100 ETAs had been closed, mostly by the customers themselves.²⁸

This lack of popularity is not surprising to some experts. Edward Prescott and Daniel Tatar, for example, predicted that ETAs would have little appeal for two reasons: the accounts do not provide holders with check-writing privileges, so users need to withdraw cash in order to pay bills in person or purchase money orders; and ETAs would require low-income consumers who don't currently pay for check-cashing services to spend \$36 a year in fees that they can currently avoid.²⁹ ETAs should not, however, be discarded entirely; if better adapted to the needs of low-income consumers, they can potentially become an attractive product.

First Accounts. Following on the heels of the ETA initiative was First Accounts, a program similar to ETA that was targeted toward low-income individuals who don't receive federal benefits. Although the 2001 budget included \$30 million for this initiative, which began only very recently, the program is already under attack from the Bush administration and may not survive the president's proposed budget cuts.

Lifeline banking statutes. At least seven states have enacted "lifeline banking" laws, which either monitor the level of banking fees charged by state-chartered banks or mandate the creation of low-cost accounts.³⁰ New York law, for example, requires banks to offer low-cost accounts that can be opened for as little as \$25 with no minimum balance requirement and a maximum monthly fee of \$3.³¹ No evidence indicates, however, that lifeline banking statutes have had much impact in reducing the numbers of the unbanked.

Bringing the Unbanked into the Mainstream

Understanding the financial services needs of low-income consumers is key to crafting an effective strategy for connecting the unbanked. Reaching the unbanked will require not only lowering the relative cost of mainstream banking services, but changing consumer attitudes towards banks and providing services tailored to low-income customers' needs.

- ▶ **Traditional banks must adapt to a nontraditional market, either by offering nontraditional services themselves or partnering with institutions that do.**

Mainstream banks must explore how they can tailor their fee structure and services to customers who need ready access to cash from their paychecks, are likely to keep very low levels of deposits in their accounts, and are unfamiliar with or distrustful of traditional banking services. One potential way to do this, as Caskey proposes, is for banks to open "outlets" in low-income areas that provide check cashing, money orders, and other non-mainstream services, as well as more traditional products such as savings accounts. Union Bank of California is one bank that Caskey cites as a model of

this type of outlet. Union Bank's twelve "Cash & Save" outlets, which are located primarily in Los Angeles and San Diego and which began operating in 1993, offer a creative combination of check-cashing and banking services in the same location. Among the banking services offered are low-cost, modified savings accounts, called "Nest Egg" accounts, aimed at helping check-cashing customers build savings. According to Union Bank officials, Cash & Save has become extremely popular with customers and is expected to become highly profitable for the bank as well.

Union Bank has also become one of the first banks to partner directly with check cashers to offer "one stop" banking services. In 2000, Union Bank became the part-owner of Nix Check Cashing, a chain of some 47 check-cashing stores in California, and is intending to use this alliance to "cross-sell" some of its more traditional savings products to Nix's existing customers.

Because partnerships between check cashers and banks do not have the effect of introducing additional players to the market, it is possible that such alliances will not result in increased competition and, consequently, in lower fees. These partnerships can, however, expose low-income customers to savings products with which they may otherwise not be familiar. Moreover, partnerships such as the one between Union Bank and Nix are preferable to other recent alliances between banks and check cashers that do not promote savings or result in lower fees. Check cashers in New York, for example, have partnered with a major national bank to offer a special debit card for customers who receive federal benefits electronically. The debit card can be used for cash withdrawals or for purchases at participating stores but amounts not withdrawn are not federally insured, do not earn interest, and are not otherwise treated as "savings." Moreover, the fees charged for cash withdrawals are the same as—or even higher than—fees for standard check-cashing services.³² Although alliances between banks and check cashers have mixed potential, encouraging the right kinds of partnerships may nonetheless be worthwhile.

- ▶ **Government can promote competition in lower-income markets by providing judicious incentives to mainstream banks to enter the market.**

As Carr and Schuetz propose, government can fund pilot programs to demonstrate how banks can compete effectively and profitably in low-income markets. Moreover, regulators should review existing rules to consider whether banks are unduly impeded in their ability to offer nontraditional services or to partner effectively with nontraditional institutions. Government should also consider raising the profile of the Community Reinvestment Act, which was enacted to encourage banking activity in low-income communities, as a lever to prompt action from banks.

- ▶ **Community-based groups can work to educate consumers about the relative costs of financial services and the benefits of savings.**

As the research discussed above seems to indicate, banks may need a makeover of their image among low-income consumers. While better targeted marketing can

correct some of these perceptions, community-based groups can also do much to change consumers' view of mainstream banks. Some low-income consumers, for example, may be avoiding banks due to a misapprehension of asset and income eligibility requirements for federal benefits. Many consumers may also need help with simple budgeting techniques in order to manage a bank account effectively.

Conclusion

The growth of mutual funds, IRAs, 401(k)s, and other tools for personal wealth creation have resulted in a broad-based democratization of wealth that has never been seen before. The Federal Reserve estimates that about half of all American householders are stockholders—a 50 percent increase over the last decade and a historic high.

But the other half of Americans holds no such wealth and without the right help could fall further behind. The increasing reliance by working poor Americans on check cashers is a distressing sign that they may well be growing less connected to mainstream financial banks, rather than more so. Moreover, the growth of the check-cashing industry and its profiteering cousins (e.g. pawnshops, payday lenders, and other “fringe” institutions) indicates the emergence of a second-class system of financial services for poor Americans—and one that diminishes wealth rather than promotes its accumulation.

Reaching out to the unbanked will have what some call a “double bottom line” benefit: by effectively entering low-income markets, banks can not only make profits for themselves but can create a great deal of good for low-income consumers and their communities.

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Endnotes

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