

REACHING OUT TO THE UNBANKED

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Introduction

This paper presents a strategy that banks can use to help “unbanked” households, those who do not have accounts at deposit institutions, to join the mainstream financial system. The strategy seeks to help these households build savings and improve their credit-risk profiles in order to lower their cost of payment services, eliminate a common source of personal stress, and gain access to lower-cost sources of credit. The strategy calls on participating banks to open special branch offices, called “outlets,” that are conveniently located for lower-income households. In addition to traditional consumer banking products, the outlets should offer five non-traditional services:

- Fee-based check-cashing services
- Basic savings accounts that include access to low-cost money orders for making long-distance payments
- Deposit accounts, similar to traditional “Christmas Club” accounts, designed to help people accumulate savings
- Deposit-secured loans to individuals whose credit histories would make them ineligible for mainstream credit
- Formation of partnerships with appropriate community based organizations to create social bridges with the community and to offer budget-management and credit repair seminars

The paper argues that such an outreach strategy is likely to be superior to traditional bank outreach efforts. Under the traditional approach,

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mainly to obtain an acceptable rating under the Community Reinvestment Act, some banks maintain branches in lower-income areas even when these branches do not meet standard profitability thresholds. In addition, some banks offer low-cost “basic” checking accounts intended to meet the needs of lower-income households. The outreach strategy that I advocate in this paper is likely to be superior to the traditional approach in four regards. First, it will draw more of the unbanked into bank branches. Second, it will offer them a set of services better designed to meet their needs. Third, it is better structured to help the unbanked become traditional bank customers. Fourth, it is also likely to be more profitable for banks than is the traditional approach, so banks should be more willing to implement it.

A Brief Description of the Unbanked

Several surveys have examined the socioeconomic characteristics of the approximately ten million households that do not have bank accounts. The surveys find that the unbanked are disproportionately represented among lower-income households, among households headed by African-Americans and Hispanics, among households headed by young adults, and among households that rent their homes (Kennickell *et al.*).

Household surveys have also asked people why they do not have deposit accounts (Booz-Allen, 1997, and Caskey, 1997a). The surveyed families most frequently report that they do not have deposit accounts because they have almost no month-to-month financial savings to keep in the accounts. Other common responses include: “bank fees are too high,” “bank minimum balance requirements are too high,” “we want to keep our financial records private,” and “we are not comfortable dealing with a bank.”

Many of the unbanked report that they encounter few problems from their status (Prescott and Tatar). They have no financial savings so there is no hardship from not having access to a financial institution to safeguard such savings. They have no immediate need for credit or do not find that their unbanked status excludes them from the credit that they do need. Payment services are also not problematic for a variety of reasons. Many receive and make few non-cash payments. Others cash paychecks for free at an accommodating deposit institution, grocery store, or other business. Those making long-distance payments do so by purchasing money orders from the post office or convenience stores.

Such a sanguine outlook is not, however, true for a significant fraction of the unbanked. In large urban areas, surveys indicate that somewhere between 20 and 40 percent of the unbanked pay fees to cash their paychecks, and many of these patronize commercial check-cashing outlets (CCOs). This is not surprising since check-cashing outlets provide a range of convenient payment services in one location. They cash paychecks, they sell money orders with stamped envelopes for making long-distance payments, and they serve as agents for utility bill payments and for electronic money transfer services, such as Western Union. The problem created by the regular use of a CCO is that CCOs are an expensive source for payment services. Outside of a small number of states with strictly binding fee ceilings, most CCOs charge between 2 and 3 percent of the face value of a check to cash it. A family with \$18,000 in take-home pay that uses such CCOs regularly can easily spend \$400 or more of its limited annual income just to obtain basic payment services.

Nevertheless, it is understandable why CCO customers do not go to a bank. Most banks in urban areas won't cash paychecks for people who do not have an account at the bank or who do not have an account with sufficient funds in the account to cover the check. It can be quite costly for someone living from paycheck to paycheck to open a checking account, even one with a low minimum-balance requirement. It is very easy for a person who runs his account balance down to near zero at the end of each pay period to "bounce" checks on the account. Each bounced check can cost the account holder \$25 to \$35. It is also expensive and inconvenient for bank customers without checking accounts to make long-distance payments. Almost all banks charge at least \$1 for money orders, and many charge as much as \$3. Moreover, they do not sell stamps and envelopes in which to mail the money orders so the customer must go elsewhere to meet this need. Finally, banks generally do not transmit payments to utility companies nor do they serve as agents for electronic money transfer services.

The relatively high fees that many of the unbanked incur for basic payment services, although cause for concern, may not be the major problem associated with their status. Ethnographic studies find that the unbanked rarely complain about the expense or inconvenience of obtaining payment services (Caskey, 1997b). Rather, they complain mainly about the insecurity and stress associated with living from paycheck to paycheck. This is also true of lower-income individuals with bank accounts who consistently run down their account balances to

near zero at the end of each pay period. In both cases, the individuals commonly speak of feeling physically and emotionally drained from facing frequent personal financial crises and worrying about the ones to come.

Finally, because so many of the unbanked live from paycheck to paycheck with no financial margin of safety, many have been forced by past personal financial crises to miss scheduled payment obligations, such as rental, debt-service, or utility-bill payments. Problems in their credit histories and debt-service burdens leave a large share of the unbanked, and a significant share of lower-income households generally, cut off from mainstream credit. When these households need short-term loans to meet emergencies, they find informal sources of credit or turn to high-cost formal-sector lenders such as pawnshops, car-title lenders, payday lenders, and small loan companies. Interest rates from these lenders are generally over 100 percent APR and often as high as 300 percent.

The Proposed Outreach Strategy

As noted in the introduction, I argue that the most effective and cost-efficient means to bring the unbanked into the banking system should involve five measures. Here I explain each of those measures and their rationales.

Participating Banks Should Open Specialized Bank Branches That Provide CCO Services

The first step in the proposed strategy calls on participating banks to open specialized branches that offer the full range of commercial check-cashing services as well as standard consumer banking services. To distinguish them from other bank branches, I call these specialized bank branches “outlets.” These outlets should cash low-risk paychecks and government checks without placing a hold on the checks even for individuals who lack deposits to cover the checks. Since people without checking accounts who cash their paychecks will need a means to pay bills, these outlets should sell money orders and stamped envelopes in which to mail the money orders and they should serve as an in-person payment point for utility bills, cable TV bills, *etc.* They should also offer a service for transferring funds by wire, especially when the outlets are located in areas with large numbers of recent immigrants.

If the outlets are to be successful, banks must locate them at points likely to be convenient for large numbers of low- and moderate-income

households. The outlets will need to maintain hours similar to those of check-cashing outlets, meaning that they should be open early evenings and on Saturdays. Banks should also post prominent signage indicating that the outlets offer check-cashing services. In many cases, giving the outlets a CCO-type name, such as “Cash Express Center of Bank X,” will serve this purpose.

Opening such outlets serves three purposes:

- By offering CCO services in a bank branch, the bank establishes direct contact with CCO customers. This should help make the unbanked comfortable dealing with banks. Over time, banks can develop relationships with unbanked individuals that the banks can use to encourage them to take steps to build savings and address problems in their credit records. Simply put, banks cannot help the unbanked if they do not get them in the door.
- The establishment of the outlets recognizes that many CCO customers are likely to be slow to open deposit accounts. As noted earlier, many do not have month-to-month savings and see little advantage to a deposit account. Others do not want deposit accounts for fear that their savings might be seized by creditors or might make them ineligible for welfare. By offering check-cashing services, banks can provide high quality, relatively low-cost, payment services to such individuals who remain outside of the deposit system.
- Banks with branches in lower-income areas often report that it is difficult to cover the costs of these branches with traditional services since deposit mobilization is low, transaction levels are high, and loan opportunities are limited. If these branches were able to find new sources of revenue, such as check-cashing fees, this could contribute toward making these branches profitable and encourage banks to open branches likely to attract large percentages of lower-income households.

Banks opening such outlets should be able to set fees for check-cashing services that are somewhat lower than those of most check-cashing outlets and yet sufficiently high to be profitable for the banks. This is true for two reasons. First, the bank outlets, which offer tradi-

tional consumer banking services as well as check-cashing services, should benefit from economies of scope. Earnings from both services can cover many of the same fixed overhead expenses. Second, banks, unlike commercial check-cashing outlets, have direct access to check-clearing systems and a relatively low cost of financial capital. This will eliminate some of the costs that check cashers incur from the need to clear checks through the banking system and obtain working capital.

The Outlets Should Offer “Starter” Deposit Accounts that have Low Minimum-balance Requirements, Cannot be Overdrawn, and Include Access to Low-Cost Money Orders for Making Long-distance Payments

In addition to check-cashing services, the outlets should provide the full range of consumer banking services offered at the traditional branches of the banks that own them. This recognizes that, even in very low-income communities, there will be significant numbers of people who desire traditional deposit and credit services and can qualify for them. To the extent that an outlet can attract such customers, it makes banking services more convenient for some community members and helps to cover the costs of the outlet.

In addition to their traditional deposit accounts, the outlets should offer a low-cost, low-minimum-balance savings account that gives account holders the option to purchase as many as ten money orders per month for no more than \$0.75 each. The outlets should also offer to sell account holders stamped envelopes and convenient processing of utility bill payments. For qualifying households, the savings account should include ATM and debit-card access.

The rationale is simple. Many lower-income individuals have a history of writing checks that bounce or fear that they will write such checks in the future. This is understandable for someone who draws down his or her account balance to near zero each month, but it can result in large “NSF” fees. Such individuals need deposit accounts that cannot be overdrawn, and yet that offer an affordable and convenient means for making long-distance payments. A simple means to meet this need is to offer a non-checkable transactions account and sell low-cost money orders for long-distance payments. A bank offering this product could automate the dispensing of money orders to speed the process.

The Outlets Should Offer Accounts Specifically Designed to Help People Build Savings

In addition to the savings account described above, the outlets should offer a “savings-building” account. Although there can be many variations in the details of savings-building accounts, research on consumers' savings behavior indicates that these accounts should have several key features. First, in opening such an account, an individual should pledge to make regular fixed-value contributions to the account over a specified time period, usually a year. The timing of these contributions should closely coincide with the individual's receipts of income. Second, the bank should permit the required periodic contributions to be small, perhaps as little as \$20 a month. Third, if possible, contributions to the account should be automatic. The contributions, for example, could be linked to a member's direct deposit of her salary, or a check-cashing customer might agree to deposit \$10 each time he cashes his biweekly paychecks. Fourth, a savings-building account should be a separate from other accounts that the individual might own. This helps separate the funds psychologically from savings for short-term transaction purposes. Finally, there should be some financial penalty if the account owner closes the account early or if she fails to keep her commitment to make specified deposits at regular intervals. In imposing this penalty, such as loss of accumulated interest, the bank should probably show some flexibility. It might, for example, permit one or two missed deposits before the penalty takes effect.

The psychological basis of these rules is obvious. People have a hard time saving on a discretionary basis, so they save most effectively when the act of savings is relatively unconscious and the savings are viewed as “locked away.”

The Outlets Should Offer Deposit-Secured Emergency Loans to Individuals Whose Credit Histories Make Them Ineligible for Traditional Mainstream Credit

Although the outlets can compete with commercial check-cashers, in most cases they will not be able to provide traditional loans to people currently borrowing in the alternative financial sector (AFS). These people generally have far higher risk profiles than would be prudent for depository institutions to underwrite. AFS firms can provide credit to this population group by adopting labor-intensive risk-control procedures, such as prompt and persistent in-person debt collection. The outlets could try to follow a similar path, but collecting unsecured sub-

prime debts requires specialized skills that bank outlet employees are unlikely to possess or develop quickly. More importantly, in many cases it is doubtful that a bank outlet would be providing a beneficial service if it were to make short-term high-cost loans to financially hard-pressed individuals. This could simply worsen the borrowers' financial distress and the costs of the resulting consequences.

In some cases, however, bank outlets should be able to use creative means to meet customers' legitimate credit needs. Banks with branches in lower-income communities frequently report that many of their customers with good credit records occasionally seek unsecured non-revolving loans of under \$1,500. Commonly, banks do not offer such loans because the processing and monitoring costs are high relative to the size of the loan. But with credit scoring and other cost-saving technologies, the outlets may be able to make fast-disbursing small-value loans with fees that are attractive to both the customers and the banks.

Customers with impaired credit histories will also have legitimate needs for credit. To help meet this need, the outlets should offer deposit-secured loans to customers unable to pass standard credit-risk assessments. An outlet could, for example, issue a deposit-secured credit card to a customer. Or it could make a nonrevolving loan against the balance that a member has accumulated in a savings-building account. When the customer repays the loan, his or her savings are still in place. Moreover, if outlets offer such loans, customers may be more likely to agree to lock away their savings in savings-building accounts.

The outlets might also consider partnering with a philanthropic foundation or community-based organization to arrange collateral for high-risk emergency loans to individuals without savings. As noted earlier, many lower-income households without financial savings face periodic financial crises caused by unexpected expenses or interruptions in their incomes. When such a disruption occurs, the family may not be able to pay the rent or fix a car needed to get to work. This can lead to compounding crises, such as eviction or job loss. Sympathetic as a bank might be, it cannot prudently make unsecured loans to high-risk applicants in such situations. But working with a third party, such as a not-for-profit community-based organization (CBO), the bank can help. The CBO, for example, could raise funds from philanthropic foundations and place these funds on deposit at the bank. A family with a poor credit record needing an emergency loan could apply to the CBO. If the CBO approved the loan application, the bank could book the loan using the CBO's deposit as collateral. Using such a process, the bank outlet could help meet some families' legitimate needs for

emergency loans. By working with a bank, a CBO can leverage the funds that it raises for such emergency loans and benefit from a bank's expertise and efficiency in administering loans.

The Outlets Should Seek Community-Based Partners and Offer Financial Literacy Programs

As the previous example makes clear, in launching outlets to serve the unbanked, banks can benefit by forming partnerships with not-for-profit community-based organizations. A partnership with an appropriate CBO can bring a number of benefits to the bank and the CBO. Most importantly, if the CBO is well respected and well connected in the community, it can help overcome any distrust that the community might have of the bank's motives in opening the outlet. The CBO can also benefit from the partnership because it enables the CBO to bring sophisticated financial services to the targeted neighborhood in a short time period. Some CBOs have tried, as an alternative strategy, to start their own credit unions. Most of these credit unions, however, remain very small with limited management capacity and can offer only a very restricted range of consumer financial products.

In addition to forming a partnership with a CBO to launch outlets to serve the unbanked, banks should use the outlets as bases to promote appropriate financial literacy initiatives. This is not to say that the outlets should conduct such financial counseling programs themselves. Not only are such programs costly to offer, but banks may not be the appropriate institutions to deliver the information. Community-based organizations are likely to be more effective. Well-run CBOs understand the particular financial literacy needs of their communities and have staff who can communicate comfortably with members of their communities. In addition, as not-for-profit organizations, CBOs can apply to philanthropic foundations and government agencies to fund their financial counseling programs.

Why it is Realistic to Expect Banks to Implement the Proposed Outreach Strategy

The paper argues that banks may well be interested in implementing the proposed outreach strategy. Currently, many banks maintain traditional branches in lower-income areas. In many cases, these branches book few loans and mobilize little in the way of deposits. Banks maintain such branches even when they do not meet standard profitability thresholds because they hope to obtain an acceptable rating under the Community Reinvestment Act (CRA).

The outreach strategy advocated above is not only likely to better meet the needs of many lower income households, but it is also likely to offer a better return to banks than does the traditional approach while continuing to count towards a favorable CRA rating. There are a number of measures that banks can take to ensure that they earn a relatively favorable rate of return from the outlets. The outlets should be small, perhaps taking no more than 1,000 square feet, as do many check-cashing outlets. The outlets should have flexible staffing and banks should consider using “souped-up” ATMs to cash paychecks, dispense money orders, and initiate utility bill payments within the outlets. If the ATMs are successful, they could reduce significantly staffing costs.

Well-located outlets should have strong revenues. Assuming that they attract a moderately high volume of check-cashing business and levy check-cashing fees in the neighborhood of 1.0 to 1.5 percent, the outlets should earn about \$100,000 a year from check-cashing and other payment service fees. In addition to this income, the outlets will earn income from their traditional banking services. If these two businesses can be combined in one outlet with substantial economies of scope (the same teller can serve check-cashing and banking customers from the same facility), the outlets should be moderately profitable.

There is already some evidence that the outreach strategy that I advocate can be successful. In 1993, Union Bank of California began to open “Cash & Save” outlets that offer check-cashing services and banking services in the same location. As of early 2000, it had twelve such outlets located in areas convenient for low- and moderate-income households. In addition to cashing paychecks for nondepositors for a fee that ranges from 1.0 to 1.5 percent, the outlets offer the full range of traditional CCO and consumer banking services. They also offer a savings-building account that includes access to low-cost money orders and partner with CBOs to provide seminars on basic financial management. The only service that I advocate that the outlets have not provided is deposit-secured emergency loans for individuals unable to pass traditional credit screening criteria.

Union Bank evaluates the success of the Cash & Save outlets by two criteria. First, the point of opening the outlets was to test the bank's ability to serve check-cashing customers and to help the customers become regular banking customers. By this criterion, Union Bank calls its Cash & Save outlets a success. The outlets, especially those located in the heavily trafficked discount stores, serve large numbers of check-cashing customers. Moreover, the bank reports that about 40 percent of its regular check-cashing customers will use at least one tra-

ditional bank product (deposit account, credit card, *etc.*) within a few years. Unfortunately, the bank does not report more detailed information about its ability to help check-cashing customers make the transition into regular bank customers.

The second criterion that Union Bank uses to judge the success of the outlets is their profitability. Bank managers report that the outlets are profitable, but have not provided detailed financial information on their operations. The most profitable of their Cash & Save outlets have very high volumes of check-cashing business. These same outlets, however, have generated only very modest levels of deposits; customers have opened relatively few deposit accounts at these outlets and the accounts tend to have very small balances. In fact, in these outlets almost 90 percent of the revenue comes from check-cashing fees.

Conclusion

Even if this strategy were widely implemented, it would not reach all of the unbanked. Nor would it succeed in helping every customer to build savings, improve credit history, and lower the cost of financial services. Nevertheless, with almost ten million unbanked households in the U.S., even a modest rate of success could mean significant improvements in the quality of life for hundreds of thousands lower-income families.

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