
BRINGING UNBANKED HOUSEHOLDS INTO THE BANKING SYSTEM

John P. Caskey
Professor of Economics
Swarthmore College

A Capital Xchange Journal Article Prepared for

The Brookings Institution
Center on Urban and Metropolitan Policy

Harvard University
Joint Center for Housing Studies

© January 2002

BRINGING UNBANKED HOUSEHOLDS INTO THE BANKING SYSTEM

BY JOHN P. CASKEY
PROFESSOR OF ECONOMICS
SWARTHMORE COLLEGE

I. 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 primary purpose of the strategy is 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
- A basic savings account that includes access to low-cost money orders for making long-distance payments
- Deposit accounts, designed to help people accumulate savings
- Deposit-secured loans to individuals whose credit histories would make them ineligible for mainstream credit
- Budget-management and credit-repair seminars (which could be provided by appropriate community-based organizations with which the outlets can partner)

Such an outreach strategy is likely to be superior to traditional bank outreach efforts. Some banks maintain branches in lower-income areas even when these branches do not meet standard profitability thresholds. These branches are often maintained primarily to obtain an acceptable rating under the Community Reinvestment Act. In addition, some banks offer low-cost "basic" checking accounts intended to meet the needs of lower-income households. The outreach strategy advocated in this paper is likely to be superior to traditional approaches 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, making them more willing to implement it.

II. WHO ARE 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 accounts because they have almost no month-to-month financial savings to keep in them. 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.

A significant fraction of the unbanked do not have such a sanguine outlook, however. 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).¹ This is not surprising since check-cashing outlets provide a range of convenient payment services in one location. They cash paychecks, sell low-cost money orders with stamped envelopes for making long-distance payments, and serve as agents for utility bill payments and electronic money transfer services, such as Western Union. The problem created by the regular use of CCOs is that they 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 \$40 or more since both the check-writer's bank and the merchant who accepted the check commonly impose penalty fees. It is also expensive and inconvenient for bank customers without checking accounts to make long-distance payments. Almost all banks charge at

¹ In a recent paper (Caskey, 2002b), I provide detailed data on socioeconomic patterns in deposit account ownership and the use of commercial check-cashing outlets.

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 are bothered more by 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 rent, 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.² Annualized interest rates from these lenders are generally over 100 percent and often as high as 500 percent.

III. THE PROPOSED OUTREACH STRATEGY

As noted in the introduction, this paper argues that the most effective and cost-efficient means to bring the unbanked into the banking system should involve five measures. Below is an explanation of each of those measures and their rationales.

A. 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, these specialized bank branches can be referred to as "outlets." For a fee, these outlets should offer to cash low-risk paychecks and government checks without placing a hold on the checks even for individuals who

² In a recent paper (Caskey, 2002a), I provide extensive information about the rapidly growing payday loan industry and its customer base.

lack deposits to cover them. 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 should serve as an in-person payment point for utility and other household bills. 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 be open early evenings and on Saturdays. Banks should also post prominent signage indicating that the outlets offer check-cashing services; giving the outlets a CCO-type name, such as "Cash Express Center of Bank X," might serve this purpose.

This type of outlet has three major advantages over a mainstream institution in terms of its ability to reach the unbanked:

- 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. New sources of revenue, such as check-cashing fees, could contribute toward making these branches profitable and might 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 highly competitive with those of most check-cashing outlets and yet reasonably profitable for the banks. This is true for two reasons. First, the bank outlets, which offer traditional 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.

B. 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.

The outlets should offer traditional deposit accounts, as well as low-cost low-minimum-balance savings accounts with, for qualifying households, ATM and debit-card access. To enable households to use the savings account to meet all of their basic banking needs, the outlets need to provide low-cost ways for people without checking accounts to make long-distance payments. A simple solution is to sell money orders for less than \$1 each, as do many CCOs and convenience stores. To ensure that money order sales do not tie up tellers, a bank could automate the dispensing process. The outlets should also sell stamped envelopes in which to mail the money orders and serve as agents for the payment of utility bills.

The rationale for such a package of products 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. Such individuals need deposit accounts that cannot be overdrawn, but that offer an affordable and convenient means for making long-distance payments.

C. 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, similar to a traditional "Christmas Club" account. The rationale is to help people build sufficient savings to provide them with a modest financial buffer that can cushion personal economic shocks. This in turn should help people who must periodically delay paying bills to meet their payment obligations in a timely fashion, improving their credit histories over time and making them eligible for low-cost sources of credit.

There can be many variations in the details of savings-building accounts, but 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

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, however. 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."

D. 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 from non-bank high-cost lenders, such as payday loan firms. These people generally have far higher risk profiles than would be prudent for depository institutions to underwrite. The high-cost lenders 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 subprime 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 provide a beneficial service if it made 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 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 its rent or fix a car needed to get to work. This can lead to compounding crises, such as losing housing or a job. Sympathetic as a bank might be, it cannot prudently make unsecured loans to high-risk applicants in such situations. But by working with a third party, such as a not-for-profit community-based organization (CBO), the bank may be able to 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.

E. 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, both banks and not-for-profit community-based organizations can benefit by partnering with one another. 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 it 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.

Banks should also use the outlets as bases to promote appropriate financial literacy initiatives. The outlets need not conduct such financial counseling programs themselves, however; 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. For one, well-run CBOs will understand the particular financial literacy needs of their communities and have staff that can communicate comfortably with community members. In addition, as not-for-profit organizations, CBOs can apply to philanthropic foundations and government agencies to fund their financial counseling programs.

IV. WHY IT IS REALISTIC TO EXPECT BANKS TO IMPLEMENT THE PROPOSED OUTREACH STRATEGY

Banks may well be interested in implementing the outreach strategy advocated above. Many banks currently maintain traditional branches in lower-income areas. Often, these branches book

few loans and mobilize little in the way of deposits.³ Banks maintain such branches even when they do not meet standard profitability thresholds because they want to ensure smooth community relations and an acceptable rating under the Community Reinvestment Act (CRA).⁴

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. Like many check-cashing outlets, the outlets should be small, perhaps no more than 1,000 square feet. The outlets should have flexible staffing and could utilize "souped-up" ATMs, currently manufactured by a small number of firms, to cash paychecks and dispense money orders. Such ATMs may be able to reduce significantly staffing costs for the outlets.

Well-located outlets should have strong revenues. Assuming that they attract a moderately high volume of check-cashing business and that the outlets 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 (tellers can serve check-cashing and banking customers from one facility), the outlets should be at least 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. It currently has 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 they partner with CBOs to provide seminars on basic financial management. The only service discussed above that the outlets have not provided is deposit-secured emergency loans for individuals unable to pass traditional credit screening criteria.

Union Bank considers its Cash & Save outlets successful 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. The outlets, especially those located in the heavily trafficked discount stores, have attracted large numbers of check-cashing customers. Moreover, the bank reports that about 40 percent of its check-cashing customers have used at least one traditional bank product (deposit account, credit card, etc.) within a few years of beginning to patronize the

³ The *New York Times* recently profiled one such bank branch (Barnes, 1999).

⁴ The Community Reinvestment Act places far more emphasis on banks' loans, especially mortgage loans, to lower-income and minority households than on their delivery of deposit and payment services to lower-income communities (Stegman and Faris, 2001). Nevertheless, banks are conscious that closing branches in "underserved" lower-income or minority communities might be adversely noted in a CRA report. More importantly, community activists might cite such closings in an effort persuade bank regulators to rule against the bank in matters requiring regulatory approval.

Cash & Save outlets. Second, although the bank has not provided data on the financial performance of the outlets, bank managers report that several of the outlets are very profitable. The most profitable outlets are those that were designed to have the appearance of check-cashing outlets rather than bank branches. These are located in high-traffic areas and have achieved a very high volume of check-cashing business.

While continuing to operate its Cash & Save outlets, in 2000 Union Bank unveiled a second strategy to combine check-cashing and banking services. Union Bank formed an alliance with an established check-cashing firm in California and purchased 40 percent of the firm's equity. Subsequently, the check-cashing firm placed Union Bank ATMs in its lobbies. The ATMs can take deposits as well as dispense cash. In addition, tellers at the CCO can use an internet connection to Union Bank to help people open bank accounts, apply for loans, and conduct other consumer banking transactions while standing in the CCO.⁵ Obviously, such a CCO/bank partnership approach could be tailored to deliver all five of the services that I argue should be part of a comprehensive outreach strategy.

V. CONCLUSION

If this outreach strategy were widely implemented, it still will not reach all of the unbanked. Nor will it succeed in helping all of the ones that it does reach to build savings, improve credit histories, and lower the cost of their 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.

⁵ A small credit union in New York City, Bethex Federal Credit Union, also initiated a partnership with a local check-cashing firm. The arrangement enables the firm's outlets to provide Bethex's members with a variety of services, including the ability to obtain cash from their accounts, make deposits, and cash checks (Stegman and Lobenhofer, 2001). Bethex pays the CCO a fee for handling these transactions on its behalf.

REFERENCES

- Barnes, Julian. "A Bold Investment Yields Paltry Returns: Lone Bank in Poor Neighborhood Fails to Attract Customers," *New York Times*, November 6, 1999.
- Booz-Allen & Hamilton Shugoll Research. "Mandatory EFT Demographic Study," A report prepared for the U.S. Department of Treasury, September 15, 1997.
- Caskey, John P. *Lower Income American, Higher Cost Financial Services*, (Madison, WI: Filene Research Institute) 1997a.
- _____. "Beyond Cash-and-Carry: Financial Savings, Financial Services, and Low-Income Households in Two Communities," A report for the Consumer Federation of America, December 1997b.
- _____. "The Economics of Payday Lending," unpublished manuscript dated January 2002a.
- _____. "The Future of Commercial Check Cashing," unpublished manuscript dated January 2002b.
- Kennickell, Arthur et al. "Recent Changes in U.S. Family Finances: Results from the Survey of Consumer Finances," *Federal Reserve Bulletin*, Vol. 86, No. 1, January 2000, pp. 1-29.
- Prescott, Edward S. and Daniel D. Tatar. "Means of Payment, the Unbanked, and EFT '99," Federal Reserve Bank of Richmond *Economic Quarterly*, Vol. 85, No. 4, Fall 1999, pp. 49-70.
- Stegman, Michael and Jennifer Lobenhofer. "Bringing More Affordable Financial Services to the Inner City: The Strategic Alliance between Bethex Federal Credit Union and RiteCheck Check Cashing, Inc." Center for Community Capitalism, the Kenan Institute of Private Enterprise, University of North Carolina at Chapel Hill, August 2001.
- Stegman, Michael and Robert Faris. "Toward a More Performance-Driven Service Test: Strengthening Basic Banking Services under the Community Reinvestment Act," A working paper of the Center for Community Capitalism at the Kenan Institute of the University of North Carolina, dated October 2001b.