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BREAKING THE SAVINGS BARRIER:
How the Federal Government Can Build an Inclusive Financial System

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SUMMARY

This issue brief provides recommendations for federal policymakers to engage with the financial services industry to bring millions of un- and underbanked consumers into the financial mainstream. While as many as 22 million American families are "unbanked," meaning they lack basic checking or savings accounts, millions more are "underbanked," meaning they may own accounts but still rely on alternative financial service providers, such as check-cashing outlets. The issue brief is divided into five parts to answer the key questions about this untapped market: 1) Why is an inclusive financial system important? 2) Who are the unbanked and what keeps them out of the financial mainstream? 3) What is the government doing about this problem? 4) How is the private sector responding to the opportunity? and 5) What more can the federal government do to address this problem?

INTRODUCTION

Most Americans give little thought to the financial system that enables them both to manage their day-to-day finances and to plan for the future. They take it as a given that they have a safe and affordable place to deposit their paychecks, pay their bills, and save for a rainy day and retirement. But as many as 22 million U.S. families—most of them earning less than $25,000 per year—are unbanked, meaning they lack a basic checking or savings account.[1] Millions of others, the underbanked, have a bank account but are not fully integrated into the banking system. They may pay more for basic financial services to an array of alternative financial service providers, including check cashers, payday loan providers, pawn shops, auto title lenders, and rent-to-own stores. These alternative providers may charge high fees, as well as have business models or payment plans that can trap users into a spiraling cycle of debt.

The most significant consequence of our increasingly two-tier financial services system is that large numbers of Americans lack the tools they need to save, build assets, and become part of what President Bush calls "the ownership society," a nation in which citizens—through saving their own money in safe and often tax-benefited accounts—enhance their ability to weather emergencies and to make their own decisions regarding college, retirement, homeownership, and health care.

The exponential growth in recent years of the alternative financial services sector demonstrates the strong demand for financial services by lower-income consumers. Coupled with macro-level changes in technology and demographics, the estimated $78 billion in revenues generated annually by non-bank financial services firms is attracting the attention of traditional depositories. Indeed, there are indications of a growing momentum among mainstream financial institutions to view the un- and underbanked as an untapped market opportunity. Federal policymakers have a role to play in ensuring that the financial services industry moves fast enough and in the right direction, in ways that benefit both banks and the consumers they may seek to serve. Without broad and easy access to the entire financial services system, the ownership society concept cannot be truly inclusive.

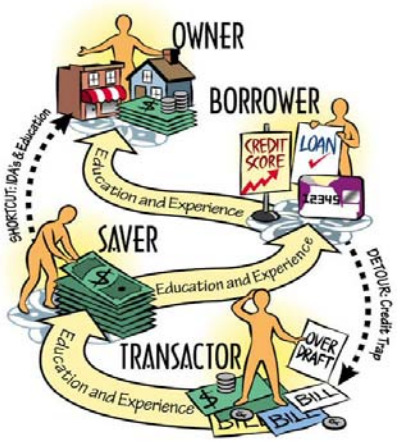
[1] Higher-bound estimates of the number of unbanked consumers were developed by the General Accounting Office (GAO) using data from the 1998 and 1999 Survey of Income and Program Participation (SIPP). (U.S. General Accounting Office 2002). Estimates from the 1998 Survey of Consumer Finances suggest 10 million U.S. households are unbanked. (Aizcorbe et al. 2003)

I. WHY IS AN INCLUSIVE FINANCIAL SYSTEM IMPORTANT?

It continues to be possible—although increasingly difficult—for an individual or household to operate using only cash. Even if paid by check, those checks can be cashed by friends, family, or businesses at the banks on which they are drawn. Purchases can be made with cash, and bills can be paid either in cash or with money orders—and indeed in some communities landlords demand or prefer these forms of payment to checks. Cash can be used to send money abroad, and even international telephone calls can be placed with phone cards paid for in cash.

Nevertheless, having a bank account is important because these accounts provide a gateway for households to enter the financial mainstream and become owners of financial assets. Research shows that those who own bank accounts are more likely to own other assets. One study showed that having a transaction account was a key determinant of whether a family had credit and savings products and life insurance.[2] Another study found that households without transaction accounts are 43 percentage points less likely to have positive holdings of net financial assets, 19 percentage points less likely to hold consumer debt, 13 percentage points less likely to own a home, and 8 percentage points less likely to own a vehicle.[3]

Perceptions follow a similar pattern. Two different surveys of low-income consumers reveal that whether or not they actually owned a bank account, those surveyed believed that having a bank account makes it easier to save.[4]



For most people, owning a checking or savings account is the first step onto the ladder of financial services they will need throughout their lives. The most tangible embodiment of this concept is the Credit Path, a model developed by Alternatives Federal Credit Union in Ithaca, New York, to describe the process by which low-income individuals can progress from meeting immediate transactional needs to building longer-term assets. The model, a metaphor for the progression to financial prosperity, describes a path along which consumers travel, first as transactors, then as savers, then as borrowers, and finally as owners.

Unbanked consumers who rely solely on alternative financial services providers are challenged to progress beyond the transactor stage. These alternative financial institutions do not offer asset-building services such as savings accounts or credit products that can help people build a positive credit history. Many low-income families are already savers, whether or not they have bank accounts. Without a connection to a formal financial institution, however, their savings are at greater risk (including risk of theft, impulse spending, and unintended access by others in the household), will grow more slowly, and will not be readily available to support access to reasonably priced credit. In short, they likely will face more obstacles along the path to longer-term prosperity.

President Bush's vision of an ownership society—a nation in which citizens, through saving their own money in tax-benefited accounts, make their own decisions regarding college, retirement, home ownership, and health care—makes this connection even more critical. Policy proposals that rely on accounts to deliver benefits to recipients are multiplying. In the last five years, politicians and scholars across the political spectrum have proposed Personal Re-Employment Accounts, Health Savings Accounts, Retirement Savings Accounts, Lifetime Savings Accounts, Universal 401(k)s, Innovation Training Accounts, Family Development Accounts, Empowerment Accounts, and Parent Accounts. The current debate on reforming Social Security will feature proposals to create privately-controlled accounts funded with some portion of an individual's Social Security tax

[2] Hogarth and O'Donnell (2000).
[3] Carney and Gale (1999).
[4] According to the results of a MetroEdge survey, 70 percent of low and moderate income consumers polled in three cities said that having an account made it easier to save, and 60 percent of those without a savings account felt that having one would make it easier to save. Further, in a 2000 survey of EITC recipients in Chicago, the unbanked were more likely than banked respondents to believe that it is easier for people to save when they have a bank account and that direct deposit is a good idea. (MetroEdge 2003)

payments. While in some proposals the government would establish and fund these accounts, in many cases establishment and funding of the accounts—and access to the advantages the accounts will bring—would remain the responsibility of the individual. Regardless of who is responsible for establishing the account, individuals would have the primary responsibility for managing the account.

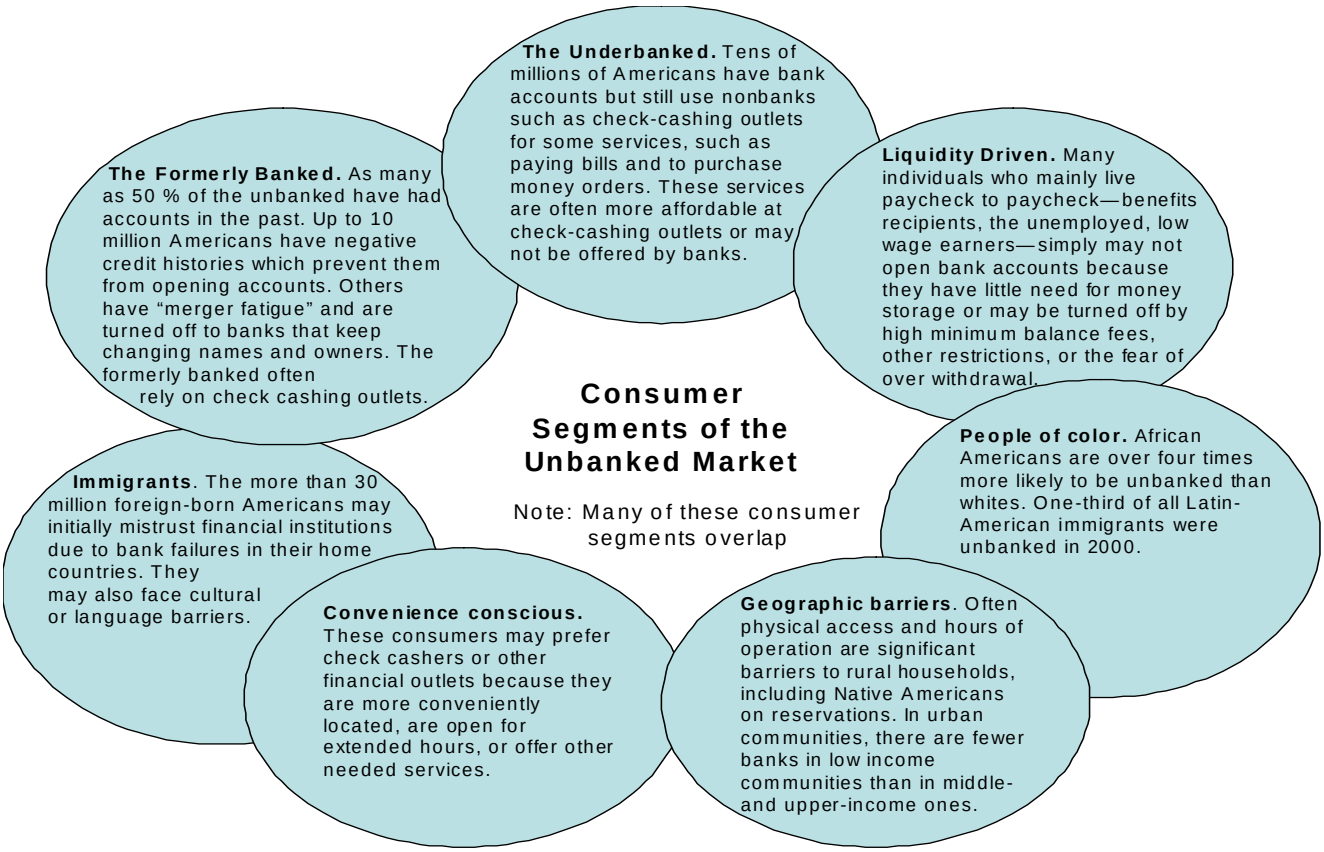
Although an increasing number federal benefits are sent to recipients electronically, in many cases these electronic transactions are not linked to fully-functional deposit accounts. And the benefits are rarely accompanied by the financial education that enables a new account-holder to use a transaction account well. Thus, even as the unbanked have become more adept at using electronic means of payment, they may not have the financial services access needed to make use of account-based systems (tax-advantaged or not) for wealth-building savings and investment— or the practical experience to manage them. Those who most need the benefits could be shut out.

II. WHO ARE THE UNBANKED AND WHAT KEEPS THEM OUTSIDE THE FINANCIAL MAINSTREAM?

In general, the un- and underbanked are most likely to have low incomes, be people of color, and have less education. Furthermore, female-headed households, particularly in Southern states, are more likely to be unbanked than the general population.[5] The unbanked are not a monolithic group, however. The term unbanked is a loose umbrella term that covers diverse groups of individuals who remain outside of the banking mainstream for distinct reasons.

The graphic below describes various segments of the un- and underbanked market and why they remain outside of the financial mainstream. Many of these groups overlap. But it is important to understand the different reasons why these individuals conduct their financial lives outside of the financial mainstream. Any proposed solution must take a multifaceted approach to help people enter or re-enter the financial mainstream.

[5] According to the Federal Reserve's 2001 Survey of Consumer Finances, although only 11 percent of the total population did not have a transaction account, this included almost 25 percent of non-white or Hispanic households, over 30 percent of those in the bottom income quintile, and 20 percent of renters. (Aizcorbe et al. 2003)



Until recently, little was known and much was theorized about the size of these consumer segments and the relative importance of the barriers that keep people outside of the financial mainstream. The conventional wisdom included both supply-side and demand-side factors. In terms of supply, it was thought that the checking and savings products offered by banks and credit unions often do not meet the needs of lower-income consumers. The minimum balance requirements may be too high. Fees are charged for bounced checks. Accounts may not be available for people with poor credit histories and are not available for those who have had previous difficulties managing an account. Possessing the necessary identification required to open an account may also be a hindrance, especially for recent immigrants.

Other barriers commonly cited have to do with consumer preferences, or the demand for financial services.[6] Some studies reveal that lower-income individuals may not be comfortable in banks. They may face language or cultural barriers when walking into a bank lobby, an often intimidating environment. Others may find the products, hours, and locations of banks unappealing and may prefer their local check casher or other financial service provider.

However, a recent survey about the usage of financial services of 1,500 lower-income consumers in three cities has yielded fresh insights into what keeps people outside of the banking system.[7] Perhaps most importantly, the survey revealed that the banked/unbanked dichotomy that underlies the popular understanding of this problem misses the subtleties of consumer behavior. It is common for households to have one foot in the formal financial sector and one foot in the alternative sector. About half of the respondents who lacked bank accounts owned one in the past, while about half of banked respondents also use non-banks for some services, such as cashing checks. Other findings include the following:

[6] For instance, see Caskey (1997).
[7] The survey included households living in low- and moderate-income census tracts in Chicago, Los Angeles, and Washington, DC. See Berry (2004).

- In general, people had an accurate understanding about the relative costs of products provided by banks and check cashers. For many individuals who would be unable to carry sufficient balances to meet minimum requirements or avoid writing checks on insufficient funds, check cashers may be the lower cost option.
- "Hard" barriers to account holding, such as lack of ID or bad credit history, appear to be more formidable than "soft" barriers, such as not feeling welcome or not speaking English.
- A lack of bank branches in lower-income urban communities does not appear to be a significant barrier to using banking services.

While we know far more about the needs and preferences of the unbanked than we did a decade ago, there remains a significant lack of the kind of market data for lower-income consumers that financial services firms use to develop products and services for, and reach out to, upper-income consumers. Financial services firms will need more and better information if they are to successfully reach the various sub-segments of the unbanked market.

III. WHAT IS THE GOVERNMENT DOING ABOUT THIS PROBLEM?

The awareness by federal policymakers of the extent of the unbanked population was heightened in the wake of the 1996 Debt Collection Improvement Act, which required that recurring federal benefit payments be made electronically as of January 1999. The number of federal benefits recipients using Electronic Funds Transfer (EFT) climbed steadily throughout the 1990s, from about 50 percent to 76 percent in 1999. But by 2001, the Treasury Department was still disbursing about 24 percent of all federal benefits by check.

Since not owning a bank account is a primary barrier that prevents someone from using EFT, the Debt Collection Act also required that benefit recipients have access to accounts at a reasonable cost and with certain consumer protections. As a result, the Treasury Department embarked on a campaign to increase account ownership-first among federal benefit recipients, then among other unbanked Americans. A review of these two initiatives, the Electronic Transfer Account and First Accounts, follows.

Electronic Transfer Accounts. The Treasury Department developed the Electronic Transfer Account (ETA) as a low-cost account for recipients of federal benefits, who cannot qualify for or afford a checking account. Individuals can receive their benefits via direct deposit into the ETA, which are offered by banks throughout the United States. The maximum allowable account fee is $3 per month, which must include a minimum of four free withdrawals. Banks are expressly prohibited from offering check writing privileges. The Treasury Department reimburses financial institutions $12.60 for each ETA that is opened.

Relatively few banks have signed on to offer ETA accounts. To date, approximately 100,000 ETAs have been opened, which is about 2 percent of the estimated number of unbanked federal benefit recipients in 1999. In general, many banks view the accounts as unprofitable or as a community service. Smaller banks, and those focused on a specific community or ethnic groups, were in general more willing to promote the ETA than large banks.[8]

Treasury Department officials conducted significant research into consumer preferences and sought the input of bank administrators and consumer groups in the design of the ETA. However, in seeking to create an account that would meet the needs of benefit recipients, financial institution providers, and consumer advocates, the department inadvertently created an account that is not sufficiently attractive to either consumers or bank providers. ETA providers are required to open accounts for any federal benefit recipient regardless of her record of account use in the past. To reduce both the perceived and real risks of opening accounts for just about anyone, the account has no checks or other payment mechanisms and generally doesn't allow for additional funds beyond the federal payment to be deposited. Further, in states that have lifeline banking laws that require banks to offer low-cost, basic accounts, banks were already likely to offer low-cost or free accounts for senior citizens that were more feature-rich than the ETA. Anecdotal evidence suggests that these banks and others might steer potential ETA customers to these other products. This in part would explain why the percentage of federal benefit

[8] U. S. General Accounting Office (2002).

recipients receiving checks continues to decline at a much faster rate than the take-up for ETA accounts and demographic trends.

First Accounts. The Treasury Department later developed the First Accounts program, an $8 million grant program that provided funding to projects seeking to expand access to financial services for unbanked individuals, regardless of whether they were receiving federal benefits. The First Accounts program awarded 15 grants in May 2002 to projects targeting low- to moderate-income individuals in 25 states. Most of the projects were led by nonprofit organizations. Currently, there are no additional funds available for First Accounts grants.

Although the evaluation of the First Accounts program is in the preliminary stages, the program appears to have had a minor impact, possibly because of its modest funding level and the way it was structured as a grant program primarily to nonprofit organizations. While the programs that were funded may have benefited the individuals that were served, these efforts did not spur widespread innovation in the mainstream financial services sector and some of the participating organizations incurred very high costs for the accounts that were opened. The First Accounts program had originally been designed to provide research and development seed funding for mainstream financial institutions to research and develop products for the unbanked market. Whether that structure would have been more successful is, of course, unknown.

Despite their limited impact, the Electronic Transfer Account and First Accounts programs yielded some positive outcomes. First, the studies that precipitated them raised awareness and understanding of the unbanked issue. Second, lessons from their successes and failures will also inform future efforts to bank the unbanked. For example, financial institutions need to have a greater stake in the results. If they are to serve the currently un- and underbanked market, they need to see the business opportunity and develop products accordingly; pilot programs for a few unbanked people, run primarily by non-profit organizations, are not the research and development that is needed. Moreover, research needs to go beyond account features to take into consideration all aspects of serving the population. This means not only products, but also the entire relationship, from initial outreach to the maintenance of a multi-product, long-term, and profitable relationship.

IV. HOW IS THE PRIVATE SECTOR RESPONDING TO THIS OPPORTUNITY?

Traditional depositories face a host of financial, structural, and cultural challenges in serving low-income consumers both well and profitably. However, a number of macro-level trends— rapid technological change, the rise of the alternative financial services sector and major demographic shifts—are creating new opportunities and incentives for the financial services industry to improve the quality and quantity of financial services available to low-income, low-asset consumers.

The constellation of firms that constitutes the financial services industry continues to grow and shift, creating new opportunities and new leverage points. For example, Wal-Mart not only houses traditional bank branches, but also, itself, offers check cashing, money orders and remittance services, which consumers use to send money electronically to another person.[9] 7-Eleven has been experimenting with advanced, multi-functional ATM machines. H&R Block offers stored-value cards to customers who need a place to have their refunds directly deposited.[10] This growing variety of firms has led to new, and often unlikely, partnerships, such as the one currently thriving among credit unions and check cashers in New York City.[11] Firms that did not know each other two or three years ago are beginning to form alliances—in some cases, specifically in order to reach low- and moderate-income customers. New partnerships are being driven by, and resulting in, a new array of access points for transacting financial business. The functionality of these delivery channels is increasing, offering the potential

[9] Remittances—money sent by immigrants to family members in their country of origin—sent through formal channels totaled $93 billion in 2003, according to the FDIC.

[10] Refund Anticipation Loans (RALs) allow tax filers to borrow against their incoming refund to more quickly receive their refund dollars. These short-term loans can be highly priced, with annual percentage rates in the triple digits. Stored Value Cards are smart cards—such as gift and debit cards—that store dollars in electronic form.

[11] The PayNet Deposit program enables customers of participating credit unions to conduct financial transactions at check cashing outlets via the Point of Banking machine, a "manned ATM." See Jacob (2004).

for integrating both short-term transactional products and longer-term wealth-building products into a coherent system for low-income, low-asset consumers.

Innovation is occurring throughout the industry, at large banks and small credit unions, retailers and non-bank companies, nonprofits and technology firms. In the last two years alone, new products and delivery channels have emerged for sending money abroad, paying employees, cashing checks, storing funds, and making purchases online. All of these efforts hold promise for engaging greater numbers of low-income, low-asset consumers in the financial services system and presenting them with asset-building opportunities.

V. RECOMMENDATIONS: WHAT MORE SHOULD THE FEDERAL GOVERNMENT DO?

The market clearly is moving, increasingly serving the low-income community. Moreover, in some areas, such as remittances, enhanced competition has produced not only lower prices but also significant innovation. But there is still an important role for government: to encourage the financial services market to move faster and in the right direction. Policymakers and administrators should be attentive to industry developments—for example, the tremendous rate of activity and evolving players in the payroll card market[12]—to safeguard consumers without stifling needed innovation. It should provide an appropriate regulatory framework that encourages financial services companies to examine how they are meeting the needs of all consumers, including lower-income ones, at prices and with terms that responsibly reflect both the risk of the product and the need for its financial sustainability at the provider institution. It can leverage its own benefit programs to spur financial inclusion for lower-income people. Finally, the government can more wisely provide limited incentives to financial institutions to spur innovation and entry into this market.

By providing billions of dollars of monthly benefit payments to millions of Americans, the government is already a major supplier of deposits. How can this funding source be better leveraged to encourage banks to view lower-income benefit recipients as potentially profitable customers? The government can also serve as a bundler of demand for financial services, as recipients need accounts to receive their benefits in the quickest and least expensive way. A major challenge is to overcome the cost inefficiencies of small balance accounts from which funds are quickly withdrawn. But with new technologies coming on-line, the biggest challenge in this respect may not actually be cost, but rather in having the imagination and creativity to understand how today's unbanked consumers can become a profitable market.

The range of traditional financial service providers and community development financial institutions—as well as some non-traditional providers of financial services—will all make important contributions in future years to bring the millions of unbanked Americans into the financial mainstream, where they can have the opportunity to save and build wealth. What follows are recommendations for federal policymakers and administrators to help these efforts succeed. The recommendations are grouped into the following four categories:

1) Spur private-sector innovation to improve access to, and participation in, the financial services mainstream.

2) Leverage existing government efforts to increase demand for banking services and enhance the supply of inclusive financial services.

3) Create an enabling regulatory environment to encourage banks to serve underbanked consumers.

4) Support and develop policies to promote inclusive asset building opportunities for all Americans.

[12] Payroll cards allow consumers to access the money from their paycheck using cards that look like bank debit cards.

1) Spur private-sector innovation to improve access to, and participation in, the mainstream financial services sector.

- ***Capitalize an Innovation Fund for financial institutions to facilitate R&D focused on underbanked consumers.***

  The Treasury Department should create an Innovation Fund to spur systemic change throughout the financial services industry by providing seed funding for financial services companies to develop products and services for un- and underbanked consumers. These R&D funds would encourage banks—and other financial services firms—to engage in the kind of intensive research and planning that they perform to develop products and services for higher-income consumers. Unlike the First Accounts program, the fund would not be distributed on a per-account basis, since some of the innovations may be in products or delivery mechanisms that extend the concept of an account. Such an initiative would also have the effect of stimulating increased competition in the industry.

  The Innovation Fund would provide seed funding for products, services, and relationship development strategies that meet criteria that:

  a) **Create financial opportunities for low-income consumers.** Funded products must result in new and expanded ways for lower-income consumers to build wealth.

  b) **Break new ground.** The product or service must be innovative in terms of reaching low-income consumers and building long-term relationships with them. While the product or service itself doesn't have to be completely new, the way it is structured, marketed, or delivered must be unique.

  c) **Be replicable.** The project should demonstrate the potential to be carried out on a larger scale and in multiple geographic markets.

  d) **Be profitable.** Within some reasonable time horizon, the project should have the potential to result in a profitable (or sustainable) product, service, or practice.

  The Fund would aim to increase the reach of mainstream financial institutions into the underbanked market by encouraging innovation both in how products are structured and how they are marketed and delivered. Ideally, products would bundle multiple functions, including a savings feature where feasible, use incentives creatively, and be competitively and responsibly priced. One example would be an electronic bank account that bundles bill payments, wire transfers, and savings, and creates further incentives for saving through, for example, monthly rewards. In terms of marketing and delivery, the products would be distributed through cost-effective channels that reach large numbers of consumers, be marketed with messages and tactics designed specifically to encourage asset building by the target market segment, and balance self-service delivery with personal interaction.

  The Innovation Fund would invest in new applications of existing technology rather than the technology itself. While banks and credit unions are crucial players in this work, some of the most exciting innovations in financial services, especially those related to reducing the cost of access, are being developed outside the bank—by technology vendors, retailers, and others. Thus, seed funds should be made available on a competitive basis to a broad range of financial services firms, including non-bank companies. Partnerships between, for example, technology firms and financial institutions will likely be critical to this effort and should be encouraged.

  We recommend a pool of $100 million be created for this initiative. Michael Barr, in his paper "Banking the Poor," recommends a tax credit as a vehicle for establishing and delivering funds to financial institutions to spur innovation in reaching the unbanked. Given that the funds would flow to commercial entities, a tax credit may well be the most appropriate (and politically feasible) vehicle. However, because the funds would be limited, some sort of application and allocation system, as with the Low

Income Housing Tax Credit (state-based) or the New Markets Tax Credit (federally-based) would be required, reducing the traditional advantage of working through the tax system to provide self-executing incentives.

- ***Enhance government-sponsored research efforts to yield more and better information about the un- and underbanked market.***

  Little intentional, systematic market research has been conducted to learn more about un- and underbanked consumers and the various sub-segments of that market on an on-going basis. Financial institutions need regular and sound information about this market to separate myth from reality, to make the case for investment in the market, and ultimately to generate the internal resources needed to conduct their own, product-specific market research.

  The major, recurring source of data about the un- and underbanked population is the Federal Reserve Board's triennial Survey of Consumer Finances. However, this survey oversamples upper-income households, which reduces its utility for analyzing the behavior of the typically lower-income un- and underbanked. Increasing the sample of lower-income households, potentially oversampling in geographies known to contain large concentrations of un- and underbanked populations, and asking additional questions that focus on financial services provided by organizations other than traditional banks and insurance companies, could vastly increase the value of the Survey for reaching those currently outside the financial mainstream.

  Moreover, we recommend that this issue be tackled systematically across all the government agencies that sponsor large, national surveys. For example, the Panel Study of Income Dynamics (primarily funded by the National Science Foundation) and the American Housing Survey (conducted by the Bureau of the Census for the Department of Housing and Urban Development) could also be expanded to include questions to increase the understanding of un-banked and underbanked populations. With some coordination and planning, the government can become an important source of data on low-income consumers, with the power to help shift perceptions and ultimately spur financial services companies to conduct their own proprietary market research.

2) Leverage existing government efforts to increase demand for banking services and enhance the supply of inclusive financial services.

- ***Expand the reach of the Electronic Transfer Account and improve its functionality.***

  The Debt Collection Improvement Act of 1996 was the government's attempt to reduce payment processing costs and gain efficiencies by requiring that all federal payments, except tax refunds, be made using a electronic funds transfer (EFT) rather than a paper check. By some measures, this legislation has been a success. In 2003, the Treasury Department made 78 percent of all federal benefit payments electronically, compared with 56 percent in 1996. In addition, the passage of the Act led to an early realization of the plight of the unbanked, raising awareness of what is now widely recognized as an important problem. Finally, it has helped to create further demand for bank accounts and other financial services.

  Unfortunately, the Debt Collection Act was less successful in spurring the creation and use of accounts that better address the needs of unbanked federal beneficiaries. As noted above, only 2 percent of federal benefits recipients have opened an ETA. Yet it is estimated that at least 4.5 million federal benefit recipients still do not have bank accounts.[13] Thus, the ETA continues to represent a potentially useful platform for providing access to financial services—particularly if account eligibility guidelines are expanded and banks are given greater flexibility to tailor the product to meet consumers' needs.

[13] Federal Reserve Bank of St. Louis (2004).

Currently, the ETA is available only to those Americans who receive a recurring federal payment, like Social Security. We recommend that banks be given the option of making the ETA available to a broader segment of unbanked consumers, particularly those who receive tax refunds. Over 20 million lower-income Americans receive a $1,700 average boost to their tax refund from the Earned Income Tax Credit (EITC), a work incentive and income supplement. But an estimated 20 percent of taxpayers earning less than $25,000 per year—a core group of potential EITC recipients—lack bank accounts.[14] Enabling this large pool of consumers to have access to the ETA is a win-win-win: The government reduces its transaction costs, consumers gain a new avenue for saving and investing their refunds, and financial institutions gain a larger and potentially more lucrative market. Numerous financial institutions around the country have begun to recognize that tax time is a powerful moment to talk with unbanked consumers about opening accounts. The ETA would provide them with an additional tool in their arsenal and could encourage more banks to become ETA providers.

Simultaneously, we recommend that banks be given greater flexibility in how the ETA can be structured. As it stands, the account doesn't meet the needs of either consumers or banks very well. For consumers, the account lacks functionality. It is essentially a non-interest-bearing, checkless checking account that can be used solely for the receipt of a recurring federal payment and withdrawal at ATMs or point-of-sale terminals at retailers. For banks, there is an insufficient volume of small accounts, and the accounts are generally considered unprofitable, despite the Treasury Department's one-time payment of $12.60.

We believe the Treasury Department should enable banks to offer customers a range of options with different fee structures, as long as the bank continues to offer at least one low-cost option that is available to any federal benefit recipient regardless of past banking history. By allowing banks to use their standard risk management tools in the account opening process and charge more than $3 a month, banks should be more willing to add important functions, such as additional cash and check deposits and bill payment mechanisms. This arrangement would apply the laws of supply and demand to the challenge of banking the unbanked.

- ***Enable people to open bank accounts, IRAs, and College Savings 529 plans directly on their income tax forms.***

Every year the IRS processes refunds averaging $2,100 for 100 million-plus taxpayers, many of whom are unbanked. With a check of a box, tax filers should be able to open a checking, savings, or IRA account directly on their tax forms. The IRS could achieve this goal in several ways. For instance, the IRS could solicit proposals for private financial institutions to provide low-cost quality accounts nationwide. Or, the IRS could create and maintain a web-based directory of financial institutions that offer low- or no-cost accounts online for tax filers. The directory's url address would be printed on all tax forms and it would be searchable by zip code.

Two challenges would need to be overcome. First, customer identification requirements would need to be met to open accounts via the Internet. Regulations require that banks mitigate their risk against identity fraud, identity theft, and account takeovers. Very few banks currently allow customers to wholly open accounts online. However, the extensive identification information provided through the tax filing process could help banks safely and effectively open accounts for tax filers.

Secondly, it may be challenging to route refunds to IRAs and 529s. A few companies, such as Vanguard and H&R Block, currently allow customers to send their tax refunds to them electronically to be deposited into an IRA, but the practice is not widespread.

The Taxpayer Abuse and Prevention Act would provide low- and moderate- income taxpayers with the opportunity to use their tax forms to open a low-cost bank account into which their refund could be deposited. This legislation, introduced, but not passed, in the 108th Congress, aims to guard EITC recipients against predatory loans, such as refund anticipation loans, and expand opportunities for them to

[14] Kennickell, McCluer, and Surette (2000). Wu and Fox (2003).

join the financial mainstream and facilitate saving. Passage of this bill would go a long way toward increasing access to the financial mainstream.

- ***Encourage state governments to link benefit cards to bank services.***

  All 50 states now administer Food Stamp benefits through Electronic Benefits Transfer (EBT) instead of the traditional paper coupons. Benefit recipients use plastic cards with personal identification numbers (PINs) to purchase eligible foods at authorized stores. States are also delivering other benefits—such as TANF—via EBT. The conversion to EBT has largely been deemed successful. It has saved the federal government money, reduced fraud, and decreased the program's error rate. This success should be built upon by linking these cards to individually-owned bank accounts.

  When the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 mandated that all states convert from sending benefits by check to sending benefits electronically, many advocates hoped the initiative would lead the millions of benefit recipients to set up bank accounts. Instead, as more and more states developed their EBT systems, the states pooled their funds in a central state government-owned account and then provided debit cards to benefit recipients to access these funds. Doing so allows states to enjoy minimal interest float on these pooled funds. States also only need to work with one EBT contractor, rather than working with different banks throughout the state. While benefit recipients can have benefits directly deposited into bank accounts, states have not promoted this option.

  Now that all states are delivering benefits via these cards, they should go one step further to encourage benefit recipients to open actual accounts. The federal government should set a performance measure that by a certain date; an established percentage of each state's benefit recipients must receive their benefits by direct deposit into individually-owned bank accounts. States that meet certain benchmarks on accounts opened could receive TANF bonus awards, which currently reward states for various successes in their TANF programs. These financial incentives could help states make up for the minimal float they would lose from the pooled funds.

- ***Require the inclusion of financial literacy education in kindergarten through twelfth grade curricula.***

  All Americans need the knowledge and skills to navigate the changing financial services industry in order to make good choices for themselves and their families. The Treasury Department recently formed a Financial Literacy and Education Commission to determine how best to build the financial literacy skills of all Americans. Adult financial education usually reaches people already in financial crisis. To reach the most people most efficiently, and before financial damage is done, comprehensive financial literacy education should be integrated into the K-12 curriculum.

  The lack of financial knowledge among American youth is startling:

  > Sixty percent of preteens do not know the difference between cash, credit cards, and checks, and 40 percent do not know that banks charge interest on loans.[15]
  >
  > Of those ages 16 to 22, only 21 percent say that they have taken a personal finance course in school.
  >
  > While students typically do not understand basic aspects of finance, high school seniors do far better at answering questions about income (62.9 percent) and spending, (55.4 percent) compared to questions about money management (45.4 percent) and saving (41 percent).[16]

[15] Based on figures compiled by the Illinois Department of Banks and Real Estate from Family Economics and Financial Education, formerly Family Financial Literacy Project.
[16] Jump$tart Coalition for Personal Financial Literacy (2004).

While these figures are discouraging, research has shown that financial literacy education can help students gain the knowledge necessary to navigate the financial services industry. An 18-month evaluation of the National Endowment of Financial Education's High School Financial Planning Program (HSFPP) demonstrated that students who studied the HSFPP curriculum as little as 10 hours immediately and significantly increased their understanding of money management. In addition, three months after the initial survey, students were found to have improved their financial knowledge, confidence, and behavior significantly.[17] A study by Jump$tart found that mandated financial education "not only increased exposure to financial education, but also systematically altered adult behavior by stimulating saving."[18]

As recently as 2002, of the 48 states with economic standards in the curriculum, 71 percent still awaited implementation. Only four states require that a course with personal finance content be offered, and only four states require that students take such a course in order to graduate from high school.[19] The result: only 15 percent of high school graduates nationally have taken a course covering personal finance basics.

The specific requirements of the various state standards and mandates differ widely; however, interest in financial literacy education is increasing. Congress recently passed the $1.5 million Excellence in Education Act, an addendum to No Child Left Behind, which focuses on increasing economic understanding, but financial literacy education must still compete with 27 other priority areas.

3) Create an enabling regulatory environment to encourage banks to serve underbanked consumers.

- ***Significantly enhance and make explicit the role of bank regulatory agencies in promoting responsible and asset-building financial services to lower-income families.***

The mandate of the bank regulatory agencies is to ensure the safety and soundness of financial institutions and to enforce consumer protection laws. These regulatory agencies should also have a mandate to promote responsible financial services to lower-income individuals that promote savings and asset building. For example, regulators could undertake to gain a more complete understanding of the actual risk profile of products and services provided to lower-income customers and communities in comparison to products and services provided to more traditional bank customers, and to use such enhanced understanding in both guidance to and regulation of financial institutions. Each of the regulatory agencies has a community affairs staff, and members of those staffs already are involved in educating financial institutions about serving lower-income populations and in bringing financial institutions and community outreach partners together. These efforts should be supported and better integrated into the supervisory activities of the regulators.

A recent effort by the Federal Deposit Insurance Corporation (FDIC) demonstrates the benefits that can result when regulatory agencies take on this expanded role. The Chicago Region of the FDIC's Community Affairs Program recently launched the New Alliance Task Force to help banks reach and profitably serve the growing and underbanked Latino immigrant population. In the past two years, the Alliance—composed of 34 banks, private mortgage insurance companies, secondary market companies, the Mexican consulate and government agencies—have met regularly to explore effective outreach and financial education to reach this market and develop new products aimed at Latinos. In particular, the group has pioneered the creation of mortgage products for potential homeowners who don't have Social Security numbers but instead pay taxes using Individual Taxpayer Identification Numbers (ITINs). The Alliance also clarified bankers' understanding that it is indeed acceptable to open bank accounts for individuals who present a Matricula Consular, the identification card issued by the Mexican government. Thanks to the effort, in the past two years, participating banks have opened 50,000 new accounts totaling $100 million (with an average account balance of $2000).

[17] Danes (2004).
[18] Bernheim, Garrett, and Maki (1997).
[19] National Council on Economic Education (2003).

- ***Continue to review and update the banking regulatory framework in ways that balance support of private-sector innovation with the protection of consumer interests.***

  Banking looks little like it did 20 years ago, yet the regulatory framework as it relates to the provision of basic financial services has not kept pace with these changes. Financial transactions increasingly take place outside the bank branch, electronic payments have eclipsed checks, and new products like stored-value cards are challenging the very definition of terms like "deposit" and "account."

  These innovations are still in their early stages, but hold the potential for both promise and peril for un- and underbanked consumers. For instance, stored-value cards could indeed become alternatives to bank accounts, particularly with the addition of certain enhancements. They clear away many of the obstacles identified by the unbanked in accessing and using traditional deposit accounts, while offering financial services firms a less-costly tool for serving those with lower average balances. However, consumer protections for stored-value cards are uneven and unclear at best and generally less than debit cards tied to traditional accounts.

  Similarly, regulators have to figure out how to promote partnerships between banks and non-banks, such as check cashing outlets and convenience stores, which are joining forces to provide a more responsive range of distribution channels to un- and underbanked consumers. For example, credit unions and check cashers in New York have pioneered the use of the point-of-banking machine to facilitate deposits for credit union members at check cashing stores, providing immediate liquidity of funds and greater convenience for consumers. At the same time, partnerships between banks and non-banks to facilitate payday loans have at times had extremely negative consequences for consumers.

  Regulators do not have an easy job in this rapidly changing environment. We encourage them to tread carefully on these and similar issues, encouraging innovation on the one hand while protecting consumers on the other.

- ***Maintain the Community Reinvestment Act (CRA) and strengthen the service test to encourage more retail banking activities aimed at lower-income, underbanked consumers.***

  Created in 1977, the Community Reinvestment Act is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods. Banks are examined on the extent to which they fulfill these needs. In the last year, some of the bank regulatory agencies have proposed or made changes that reduce the number of banks subject to a full CRA exam and that dilute further the importance of the service test, which focuses on the provision of basic banking services to underserved consumers.

  Under CRA, small banks face a streamlined exam and are not subject to the service test. Prior to 2004, bank regulators considered "small" institutions to be those with assets of $250 million or less. But in 2004, the FDIC introduced a proposal that would change the definition of "small" bank to include those FDIC-regulated banks with less than $1 billion in assets[20] The FDIC's proposed change would mean that fewer than 5 percent of all FDIC regulated banks in the U.S. would be subject to the full CRA exam. In order to partially address the lack of focus on services and investments in small bank exams, the FDIC proposed that banks with assets between $250 million and $1 billion would be subject to a new community development criterion that would allow banks to choose among community development lending, services, and investments to apply to their CRA exam. This means that banks could play to their current strengths, ignoring possibilities to provide basic financial services or build bank branches in lower-income areas.

[20] The old definition also considered banks to be "small" if they were part of a holding company less than $1 billion in assets. The new OTS rule and FDIC proposal (which has not yet been instituted) would limit the definition of small to $1 billion regardless of holding company size.

Further, a new rule by the Office of Thrift Supervision (OTS) changes their definition of "small" bank by raising the asset size threshold to $1 billion for OTS-regulated institutions. Under a new OTS proposal released in December 2004, even large banks would not have to participate in the service test. The OTS has proposed a change to the way that large bank CRA results are calculated.[21] Under this new proposal, banks could opt to base 100 percent of their score on lending and not include services or investments at all.

Currently, under the service test, regulatory agencies look at a variety of criteria, including branch locations and closings, the availability and the effectiveness of alternative systems for delivering retail financial services, and the range of services provided and how they are tailored to meet the needs of consumers in the assessment area in question. According to an analysis conducted by Michael Stegman of the University of North Carolina's Center for Community Capitalism, the service test is administered subjectively and is considered to be an "easier" part of the test than the lending and investment tests. A more rigorous service test with performance-based measures, including consideration of who is actually served and specific standards and benchmarks for retail banking services, would put it on the same footing with the lending and investment tests and focus more attention on bank activities in this arena.

CRA has had an enormous impact in broadening access to credit for low- and moderate-income consumers. We believe CRA can have the same positive impact on retail financial services, providing new opportunities for saving and asset building for the underbanked while simultaneously opening new markets to the financial services industry. For this to happen, the service test must be strengthened for all institutions. At a minimum, the service test's ratio of 25 percent of a bank's CRA score for large bank exams must be maintained. Rather than weakening a test that already gets less attention than lending, services should be more prominently addressed in CRA exams.

4) Support and develop policies to promote inclusive asset building opportunities for all Americans.

For unbanked and underbanked Americans to meaningfully participate in the Ownership Society, well-designed policies are needed to help all Americans build savings and assets. Those policies must address two key elements. First, they must establish a universal platform or infrastructure that can facilitate lifelong account-based asset accumulation. Second, they must create incentives that will draw the private sector into the system, capitalizing on public subsidies while closing the supply gap for the underbanked.

- ***Support the passage of the Aspire Act.***

Under the America Saving for Personal Investment, Retirement, and Education (ASPIRE) Act, every child born in 2006 and beyond would automatically receive a $500 deposit into a Kids Investment and Development Savings Account ("KIDS Account") once a Social Security number is issued. Children from households below the national median income would receive a supplemental deposit at birth and would be eligible to receive dollar-for-dollar matching funds up to $500 per year for voluntary contributions to the account, which cannot exceed $1,000 per year. All funds would grow tax-free. Access to the account prior to age 18 would not be permitted, but kids—in conjunction with their parents and financial educators at school—would participate in investment decisions and watch their money grow. These accounts would be held by the federal government the first 18 years, with management of the pool of assets contracted out to one firm.

Passage of the ASPIRE Act would draw the attention of financial institutions to lower-income consumers, who could begin to amass sizeable balances in their accounts. This focus could result in financial institutions designing and offering more and complimentary products to low-income consumers.

[21] Currently, large banks are graded on CRA based on lending (50 percent), services (25 percent), and investments (25 percent).

- ***Ensure all account-based policy proposals are accessible and understandable to all Americans.***

  As discussed in the first section of this paper, policy proposals that would use accounts to deliver benefits to recipients are multiplying. All of these proposals—whether for health savings accounts or private, Social Security accounts—should be crafted to be accessible and understandable to all Americans, including those who may lack experience with traditional accounts.

  To ensure the creation of an inclusive system, accounts should meet the following criteria: 1) have a simple structure; 2) provide choice, but not an overwhelming variety of choices that would be hard to manage; 3) include an educational component to raise awareness of the accounts and how to manage them; 4) draw on community-based organizations to educate and train their constituents to take advantage of the accounts; 5) are progressively funded, when appropriate; and 6) are automatically opened for all individuals, when appropriate, so that they need to "opt out" rather than "opt in."

- ***Help more Americans start and contribute to retirement plans.***

  Participation rates, contribution rates, and levels of retirement savings for those near retirement are all significantly lower for lower-income workers. Currently, only about half of all workers—the vast majority of them higher-income—have an employer-provided retirement plan. Moreover, two-thirds of the $120 billion a year in federal tax subsidies for retirement savings (for both employer-provided and private savings plans) benefit the most affluent 20 percent of Americans. To encourage greater retirement savings for low-income persons and help bring them into the financial mainstream, policymakers should consider several proposals:

  a) *Improve the "Savers Credit."* This voluntary federal income tax credit is meant to encourage low-income workers to contribute to existing retirement products. However, only a small proportion of those technically eligible receive the full benefit. William G Gale, J. Mark Iwry, and Peter R. Orzag of the Brookings Institution recommend several ways to strengthen the credit—such as making it fully refundable and permanent—so that it will accrue greater benefits to more lower-income individuals.[22]

  b) *Encourage firms to adopt "opt out" instead of "opt in" policies for defined contribution plans.* Most workers must actively choose to participate in a company 401(k). Many workers, especially low-income workers choose not to but would choose to if enrollment were automatic. Recent research has shown that automatic enrollment causes more workers to participate and build savings.[23]

  c) *Create a system of "Universal 401(k)s."* Mike Calabrese of the New America Foundation and Gene Sperling of the Center for American Progress have proposed a nationwide system of fully portable retirement savings or "career" accounts that are both tax-subsidized and automatically deducted from one's payroll. These accounts would be similar to government-facilitated 401(k)s in which the government would match voluntary savings by individuals with a refundable tax credit that would be deposited directly into workers' accounts.[24]

  d) *Support state-led efforts to extend retirement coverage to more Americans.* Washington State and several other states have proposed "Voluntary Retirement Accounts," state-sponsored, universal, portable, 401(k)-style accounts to make it easier to help businesses overcome the cost and complication of administering pension plans. If a company chooses, it could opt into a system that would be administered by the state's retirement system. Washington advocates estimate that start-up costs would be $5 to $10 million but that the program would eventually be self-sustaining. Because Voluntary Retirement Accounts are a new type of pension vehicle, Congress will have to pass

[22] Gale, Iwry, and Orzag (2004).
[23] Choi, Laibson, and Madrian (2004).
[24] Sperling (2004).

authorizing legislation allowing participants to benefit from the tax incentives afforded participants in existing plans.[25]

CONCLUSION

To build assets, accumulate wealth, and engage in the mainstream economy, people need a full array of financial services. Yet tens of millions of lower-income Americans do not have bank accounts, let alone access to the broader range of savings and investment products that more affluent people use to build wealth. Lower-income consumers spend billions each year on basic financial services, including check cashing, bill payment, and remittances abroad. Still, they are faced with an inadequate supply of well-designed, reasonably priced financial products and services that simultaneously meet short-term needs and connect them to opportunities for longer-term wealth creation.

Technology is restructuring the financial services industry, creating new products, partnerships, and access points that respond to the demands of lower income consumers more fully and at lower costs than ever before. Market-based solutions are now within reach to promote significant asset building among lower-income people. The challenge for policy makers is how to bring these to scale—or, to put it another way, how to move the market to increase the supply of wealth-building products and services tailored to this under-served group. The recommendations proposed here are a way to start to catalyze millions of Americans to enter and participate in the financial mainstream, to invest in themselves and their family's futures.

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[25] See various papers by the Economic Opportunity Institute at: http://www.econop.org/Policy-WVA.htm

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