FALL 1998

COMMUNIT REINVEST-

cr forum

AN EXCHANGE OF
COMMUNITY DEVELOPMENT ISSUES AND

published by the FEDERAL RESERVE BANK OF CLEVELAND

The "Unbanked" Population
Who Are They and Why Do They Shun Banks?

By Barbara A. Good

Imagine for a moment how difficult it would be to conduct your daily affairs without having a banking relationship. Your access to cash would be limited at best, paying bills by mail would be cumbersome, and you would likely be forced to pay higher interest rates on borrowed money than those with bank accounts.

It's likely not surprising to you that some individuals have chosen not to utilize banking institutions to manage their financial affairs. But recent changes in government policy have required that financial professionals take another look at how the "unbanked" population can be served by both traditional and nontraditional financial institutions. And in the process, many bankers are realizing that an important new market of customers exists that is waiting to be tapped.

A HEIGHTENED AWARENESS

Widespread public awareness of the unbanked population was highlighted with the passage of the Debt Collection Improvement Act of 1996, along with the initiation of the Electronic Funds Transfer Program (EFT99) which implemented the act. The act mandated that, effective January 2, 1999, all government payments be delivered electronically.[1] Its implementation also created a greater awareness of the myriad of Americans who have chosen not to establish accounts at banking institutions to manage their finances.

Under EFT99, government institutions, with the help of banks, were required to establish a method of paying all recipients electronically. But making electronic payments to individuals without bank accounts has proven difficult to accomplish in practice.

Although the U.S. Treasury Department attempted to find a way to meet the requirements of EFT99 without causing undue hardship on recipients, neither traditional nor nontraditional financial providers were able to present a plan that fully addressed either the Treasury's requirements or recipients' needs. In June of 1998, it was announced that *individuals* who receive government payments by check will not be switched to electronic delivery unless they specifically request the change, making electronic delivery optional.

The provisions of EFT99 also attempted to provide a means for individuals to use more traditional financial institutions at a low cost.

continued on page two

continued from page one

The program called for the creation of Electronic Transfer Accounts at federally insured depository institutions specifically so that those without bank accounts could receive their payments electronically. Recipients were to be provided with a card for use at an ATM machine or POS terminal to withdraw funds, and the account was to be offered to the recipient at a reasonable cost with all of the same consumer protections extended to traditional bank customers.

Although the program change and provisions have alleviated the pressure on both traditional and nontraditional financial institutions, the unbanked population's need to cash checks and make payments still exists.

THE UNBANKED POPULATION

Many may be unaware of some of the unbanked population's specific concerns and beliefs about banking institutions. In addition, it may be unclear what services this population has been using to manage their financial affairs, or if these services have been effectively meeting their needs. What's more, many professionals within the banking community may not have considered that the unbanked population represents an important source of potential new customers.

The "unbanked" have been designated by nontraditional providers as Asset Limited, Income Constrained (ALIC). The unbanked population—which has been estimated at 13% of American households—currently utilizes a variety of methods to cash checks, make payments and take out small short-term loans. Surveys show that most unbanked individuals tend to have low to moderate incomes, i.e., less than $25,000.[2] They also tend to have achieved below-average education levels, are younger, and are more often a racial or ethnic minority.

According to the latest *Survey of Consumer Finances*, sponsored by the Federal Reserve System, the reasons many unbanked consumers have decided against utilizing traditional bank services have not changed all that much over time. They feel that they do not write enough checks to make it worthwhile, do not have enough money to open an account, and/or they simply do not like dealing with banks.[3]

John Caskey, author of *Fringe Banking Check-Cashing Outlets, Pawnshops, and the Poor* and professor of economics at Swarthmore College, Swarthmore, Pa., conducted a survey of unbanked consumers and found that many wanted to keep their financial records private and were not comfortable dealing with banks. He concluded that many unbanked households have limited funds and cannot meet or maintain the account balances required by financial institutions. In addition, Caskey found, these consumers harbor a deep-seated distrust of financial institutions and prefer to handle their financial affairs through alternative financial service providers.[4]

THE "FRINGE" BANKS

Typically, unbanked individuals often use what have been called "fringe banks,"[5] such as check-cashing outlets and pawnshops. They use these fringe banks because they are often unaware of their alternatives, especially if they reside in areas with few bank branches, or if they were raised in families that never established bank accounts.

These days, check-cashing outlets abound in urban areas, even in those that are served by bank branches. These facilities will cash government, payroll, and personal checks for a fee. In addition, these outlets also typically facilitate utility bill payment and sell money orders, prepaid long distance and local phone cards, lottery tickets, stamps, and facsimile and copying services.

Recent history indicates that check-cashing outlets have found a ready market in serving the unbanked population: Annually, these institutions cash more than 150 million checks worth more than $60 billion. What's more, the number of check-cashing outlets has tripled since 1986 to more than 6,000. Their growth is attributed to a rise in the number of households without bank accounts, an increase in low-paying service-sector jobs, and an overall increase in the lower-income population.[6]

It is estimated that the cost of cashing checks via check-cashing outlets is much higher on an annual basis than utilizing and maintaining a bank checking account. Assuming one government check for $500 and two personal checks with a value of $100 are cashed and three money orders are bought monthly, the fees charged could be as high as $26.50 a month. Furthermore, the fees charged by check-cashing outlets, which typically range from 1.5% of the face value for government checks to 10% of the face value for personal checks, are regulated in only 13 states.

Check-cashing outlets also offer payday loans for those consumers needing a short-term loan. Typically, these payday loans are provided at a very high cost, sometimes with annualized interest rates

continued on page seven

4th district

PROFILE

WELFARE-TO-WORK

With the 1996 passage of welfare reform legislation, President Clinton and Congress have set the stage for a significant revamping of the U.S. public assistance system.

Patricia Ross (seated), director of Able One's Moving Company, and Tinita Dancy, a former welfare recipient and now Able One's administrative assistant. Ross, who has hired many welfare recipients in the past couple of years, says businesses that choose to participate in welfare-to-work programs must be willing to train and coach their new employees.

Under the so-called Welfare-to-Work legislation, the federal government has mandated a five-year lifetime limit for receiving public aid. After two years of receiving assistance, recipients must either be working or enrolled in a work-training program. However, individual states can extend the time limit for certain hardships such as physical handicaps or extraordinary child-care situations.

In sum, the overhaul of welfare means that the program will serve as a safety net for low-income Americans in temporary need of assistance, rather than as a lifelong support system. The federal government's message is clear: If you're able-bodied, you're obligated to enter the workforce.

However, the complexities of moving people off welfare rolls and into the workforce is going to require more than signing off on legislation that tightens the flow of public assistance. Proponents of the new legislation note that meaningful welfare reform is dependent on the willingness of private sector employers to hire and train people on welfare.

As an incentive to employers, Congress has allocated billions of dollars in welfare-to-work grants which can be used by states and cities to entice private firms to hire welfare recipients. In addition to federal tax credits, certain states offer incentive programs. In Ohio, those programs include wage subsidies for employers who hire welfare clients, as well as tax credits and child-care credits.

In a departure from its customary role of facilitating loans to small businesses, the U.S. Small Business Administration (SBA) has mounted a campaign to urge private employers to hire welfare recipients. "Welfare, as we've known it in the past, doesn't exist anymore," says Gil Goldberg, district director of the SBA's Cleveland office. "It's very important to understand that, from now on, there will be a limited amount of time that people can stay on welfare."

The agency recently completed a direct-mailing to 10,000 employers in northern Ohio. The mailing highlighted the benefits of hiring welfare recipients. According to Goldberg, his office has received numerous responses from businesses that are interested in participating in welfare-to-work programs. The SBA refers prospective employers to social service agencies, which then refer welfare clients to the employers.

Bettie Baca, a Washington-based senior advisor for the SBA, notes that the new priority in welfare programs is "work first." She explains that "those of us in government and the private sector need to provide a method for people to transition off of welfare and into the workplace. At the SBA, we are the 'work' side of welfare-to-work. We are attempting to match up employers that need workers with county entities that supply job-ready individuals."

Baca concedes that a high percentage of welfare recipients face barriers in their attempts to seek and maintain employment. She says that the key to the success of welfare-to-work will be identifying and addressing those barriers.

Cuyahoga County, which includes the Cleveland metropolitan area, is attempting to ease the welfare-to-work transition through its recently implemented Work-in-Training program. According to Rick Werner, executive officer for community resources, the most common barriers to employment are:

- insufficient child-care resources
- lack of education
- lack of job training
- ongoing substance abuse problems

"Our primary focus is helping our welfare clients to develop job-readiness skills," said Werner. "We are trying to acclimate them to the demands of the workplace. They need to be able to organize themselves, show up for work on time, and remain substance-free."

Patricia Ross, director of Able One's Moving Co., a Cleveland-area moving and storage company, said her firm has hired a dozen welfare recipients through SBA referrals and other welfare-to-work programs.

"We've had some success stories," said Ross. "It's a tight labor market with high turnover, so we look at the welfare-to-work program as an alternative labor service. From a business perspective, it can make sense to hire people off welfare, because they can often be coached and mentored to adapt to your company's needs. If the company gains a long-term employee, that's worth more than the federal or state hiring subsidy."

Ross notes that employers seeking to hire welfare recipients must be prepared to "be flexible and humanistic." In Able One's case, the firm has dedicated nursery space in its office so that employees can bring their babies to work instead of paying for day care service. She added, "since some of our employees don't have access to laundry facilities, we've contracted with a uniform service so that they have clean clothes."

Although Ross is pleased by her experiences in hiring welfare recipients, she cautions that social service agencies need to do a better job of screening and orienting prospective referrals. "Alcohol and drug dependency are a serious problem among some of the referrals we get," she said. "The county and social service agencies need to help these people with those issues before they send them to employers. In general, we've found that if we have a clean and sober employee, we can work with them."

Werner says it's too early to determine if Cuyahoga County's Work-in-Training program is helping to shrink the welfare rolls, but early results have been positive. "Two years ago, we had about 27,000 families that were collecting public assistance from the county. Now, we're down to about 24,000," Werner said. "Although a large percentage of that decline can possibly be attributed to our healthy overall economy, we are definitely optimistic that we will continue to move people off of welfare and into jobs." ■

in my opinion

GEORGE R. BARANY

Executive Director
Working for Empowerment through Community Organizing (WECO)
Cleveland, Ohio

George R. Barany, executive director of WECO since 1986, has 22 years of experience as a professional organizer. He has developed community economic and industrial retention strategies that have generated more than $30 million in new investment, and has managed the planning, development, and implementation of a wide variety of initiatives, including Community Development Credit Unions, Business Successorship, Individual Development Accounts, and Comprehensive Neighborhood Planning. Barany has also worked with three national community organizing networks and conducted legislative campaigns on state and national issues. He received a bachelor's degree in history from Case Western Reserve University.

Tackling Welfare Reform with the IDA

During this period of robust economic growth, we have an important opportunity to tackle the challenge of welfare reform. And using Individual Development Accounts to assist low-income individuals in asset acquisition appears to be one of the most promising anti-poverty ideas to emerge in the last few decades.

The Individual Development Account in some ways mirrors the programs created by the GI Bill of the 1950s and the Homestead Act of the 1880s, in that it provides an opportunity for economic improvement to those participants who fulfill the program requirements.

Individual Development Accounts (IDAs) are designed especially for those low-income citizens who have no viable savings or are unaccustomed to investing for long-term growth. Many of these Americans find themselves entrenched in government welfare programs, in low-wage jobs with little or no advancement potential, or as a single head-of-household with one or more dependents. For these individuals, IDAs may help to provide a path toward long-term financial stability.

A national experiment using IDAs to increase the wealth of low-income Americans is now underway in approximately 40 test sites across the country. The hypothesis is that people cannot escape poverty without hard assets that can be negotiated in our mainstream economy.

Participants in the program learn to save money in order to acquire one of three major assets: a first home, higher education, or capitalization for a start-up business. Besides saving money, participants must also meet their expenses. Along the way, they develop an understanding of investment and leveraging dollars, as well as of the long-term care and the transactional nature of their assets.

To provide an incentive and develop a discipline toward saving, the program rewards participants with a 2-to-1 dollar match for every dollar saved, up a maximum of $1,500. This reward motivates participants to follow the stringent program requirements and also to realize a previously unattainable ambition.

The experiment is being administered by numerous nonprofit community organizations which recruit participants, implement the IDAs, and provide training, education and counseling. Corporations and religious institutions can also become involved by providing match and administrative funds, educational resources, and financing vehicles for asset acquisition.

In Cleveland, one of the 40 test sites, several nonprofit organizations have joined forces in a four-year demonstration effort to assist and educate individuals with family incomes of no more than 200% of poverty. The 540 participants are expected to develop and adhere to a personal budget, attend monthly economic literacy classes, and make monthly deposits into the IDA. In addition, participants must successfully complete a training program focusing on the particular asset to be purchased. These four requirements are designed to change an individual's cash-based spending habits, fostering a long-term, goal-oriented approach to effective money management.

The Individual Development Account in some ways mirrors the programs created by the GI Bill of the 1950s and the Homestead Act of the 1880s.

The managing partner of the Cleveland IDA project is WECO (Working for Empowerment through Community Organizing), a 27-year-old community economic development corporation. WECO also provides microenterprise training for those participants planning to start up a small business. For participants planning to acquire a home, the Cleveland Housing Network is providing homeownership training, purchase assistance, and rehabilitated houses. Youth Opportunities Unlimited provides career counseling, financial aid assistance and mentoring for individuals with education IDAs.

In addition, the Consumer Credit Counseling Service of Northeastern Ohio verifies income for program certification, provides debt counseling, and works with participants to develop spending plans. And a two-year economic literacy curriculum is provided to all participants by the Urban League of Greater Cleveland.

The more than 500 accounts to be opened over the next four years are expected to create $1,215,000 in new wealth through a combination of personal savings and program match dollars. It is estimated that 70% of these IDAs will be established for homeownership, leveraging approximately $22,896,000 that will be invested in Cleveland-area rehabilitated homes. One-fourth of the accounts will likely be created for education, leveraging approximately $1,890,000 for college or job training. And an estimated 5% of the IDAs will be set up for small business development, resulting in $216,000 microloan dollars.

This innovative effort offers a unique opportunity for community-wide public/private partnerships. Together with local government agencies, corporations and nonprofit organizations can then develop comprehensive strategies to retain the investments created by IDA holders. ■

Please contact the following members of the Community Affairs staff if you have questions or would like additional copies of this publication.

CLEVELAND

Stephen Ong
Assistant Vice President
Corporate Communications
and Community Affairs
(216) 579-2098

Ruth Clevenger
Assistant Vice President,
Community Affairs Officer
and CR Forum Editor
(216) 579-2392

Stacey Conner
(216) 579-2146

Laura Junglas
(216) 579-2023

Jacqueline King
(216) 579-2903

Laura Kyzour
(216) 579-2846

CINCINNATI

Karen Mocker Patton
(513) 455-4281

Candis Smith
(513) 455-4350

PITTSBURGH

Althea Worthy
(412) 261-7943

Staff Writer
Robert Sberna

Copy Editor
Lisa McKenna

Designer
Michael Galka

World Wide Web address:
http://www.clev.frb.org

We welcome your comments and suggestions.

continued from page two

ranging from 213% to 913%. To the uneducated consumer, the quoted rate on a payday advance loan sounds reasonable. But the rate quickly increases with any subsequent rollover. The chart at left shows the annualized percentage rate for a payday loan outstanding for six weeks. As you can see, on an annualized basis, interest rates quickly increase astronomically.

PAYDAY ADVANCE LOAN

$300 Loan for Six Weeks

"Interest rate"— 20% of face value	$60
Set-up charge (weeks 1 and 2)	15
First rollover	75
Second rollover	75
TOTAL COST	$225
Effective APR	**715%**

Another alternative available to the unbanked for short-term small loans are the more than 15,000 pawnshops nationwide.[7] While for many, the image of a pawnshop still conjures images of shady deals and disreputable characters, their presence in society has perhaps become more mainstream. Over the last 10 years, pawnshops have turned up in strip malls and other suburban venues. They no longer lend money only on larger ticket items such as jewelry, but also on small household appliances and tools. Interest rates vary from 3% to 25% per month, depending on state laws.

A pawnshop loan is a relatively simple but costly transaction in which the broker makes a fixed price loan to a consumer who leaves some form of collateral in possession of the broker. If the customer repays the loan and all required fees, the broker returns the collateral to the customer. If the customer does not repay the loan by a specified date, the collateral becomes the property of the broker and the customer's loan is extinguished.

NEW ALTERNATIVES FOR THE UNBANKED

With more than 10 million potential customers at stake, there is substantial incentive to organizations to provide services that can generate both revenue and profits while also serving the needs of unbanked consumers. It is also important that unbanked individuals realize what benefits they are forgoing by choosing not to utilize traditional bank services.

Although the check-cashing outlets and pawnshops are providing needed services to the unbanked, in virtually all cases they are doing so at higher prices than might be paid to traditional financial institutions. Besides its lower monthly cost and its immediate benefit of bill payment, a bank checking account would also allow the unbanked consumer to establish a credit history. And loans provided by traditional financial institutions carry considerably lower interest rates than those offered by alternative outlets.

Although there will likely always be some individuals who choose not to establish bank accounts, many more would be willing to use traditional financial services if they knew they were affordable. An educational effort is required to demonstrate to unbanked individuals that the fees they are currently paying to check-cashing outlets or other fringe institutions are substantially higher than the fees charged by financial institutions to maintain checking and savings accounts.

While the unbanked are not the traditional target customers of financial institutions, they are potential customers in need of important financial services. By offering these individuals accounts and services geared around their needs and concerns, banking institutions should find the unbanked population to be an especially attractive and virtually untapped market that will utilize a growing number of fee-based services in the years to come. ■

Barbara Good is a payments system specialist at the Federal Reserve Bank of Cleveland. This article was excerpted from an Economic Commentary *article that will be published in early 1999.*

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

2. See Arthur B. Kennickell, Martha Starr-McCluer, and Annika E. Sunden, "Family Finance in the U.S.: Recent Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 83, no. 1 (January 1997), pp. 1–24.

3. See Booz-Allen & Hamilton and Shugoll Research, Mandatory EFT Demographic Study OMB #1510-000-68, Department of the Treasury Financial Management Service, pp. ES-3, 21.

4. See John Caskey, *Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor*. New York: Russell Sage Foundation, 1994.

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

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

7. See Sarah Jay, "A Clean, Well-Lighted Place for Loans," *The New York Times*, August 19, 1997, p. D-1.

Business Access to Capital and Credit Focus of Federal Reserve System Academic Conference

WASHINGTON—The Federal Reserve System is sponsoring a research conference, *Business Access to Capital and Credit*, on March 8–9, 1999, in Arlington, Va.

The conference, held at the Sheraton National Hotel, 900 S. Orme Street, will feature 17 research papers followed by discussants' responses and general discussion. Topics include the many aspects of the small business lending relationship, minority access to capital and credit, microlending, credit scoring, effects of bank consolidation, and more. Representatives from academia, financial institutions, nonprofit organizations, foundations, government, and various regulatory agencies are invited to attend the conference.

Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, is scheduled to speak at the luncheon on Tuesday, March 9.

The conference registration fee is $295. For conference registration information, contact Lori Carrington, Division of Consumer and Community Affairs at the Board of Governors, at (202) 452-3378 or Mia Worlds, Community Affairs at the Federal Reserve Bank of Dallas, at (800) 333-4460, ext. 5377 or (214) 922-5377.

Members of the media are invited to attend the conference free of charge. Please indicate your plans to attend by calling Allison Cline at (214) 922-5253.

Credit Access for Women-Owned Businesses

The Federal Reserve has produced a videotape designed to heighten awareness among lenders about the business opportunities available to them in lending to businesses owned by women.

Businesses owned by women represent one of the fastest growing sectors of the nation's economy. Between 1987 and 1996, the number of women-owned businesses grew 78% nationwide, outpacing overall business growth by nearly 2 to 1.

The videotape, titled *To Their Credit: Women-Owned Businesses*, features successful women business owners describing their experiences in obtaining bank credit. To potential entrepreneurs, the tape stresses the need for future commercial borrowers to build a relationship with the lender and to have a comprehensive business plan prepared prior to approaching a lender. To potential lenders, the tape focuses on the profitability this fast-growing segment of the economy offers financial institutions.

In viewing the 30-minute program, future women entrepreneurs should recognize the many informational resources available to help them including:

- Women's Business Development Centers
- Small Business Administration Women's Business Centers
- Federal Reserve Bank Community Affairs Offices

The videotape is available through FVS Media for a nominal fee. The telephone number is (800) 555-5471.

The Federal Reserve Bank of Chicago and the Women's Business Development Center also produced a publication that covers access to credit issues. The publication, *Access to Credit: A Guide for Lenders and Women Owners of Small Businesses*, can be obtained by contacting the Federal Reserve Bank of Chicago's Public Affairs Office at (312) 322-5111.

Evaluating Mortgage Loan Applications

Fannie Mae has a new publication for first-time homebuyers. The brochure provides information on the roles that credit scoring and automated underwriting play in helping lenders evaluate mortgage loan applications, including:

- What is a credit score and why is it used?
- What information is needed to create a credit score?
- How can the consumer make sure the information that is used to determine the credit score is correct?
- What is automated underwriting and how is it used to evaluate a mortgage loan application?
- What can an applicant do to demonstrate his ability to repay a mortgage loan and increase the likelihood that he will be able to obtain a mortgage?

For further information, contact Fannie Mae's Consumer Resource Center at (800) 732-6643.

A Guide to Community Development Loans

The second edition of *Principles & Practices of Community Development Lending* is targeted to lenders and their community development partners who want to increase their knowledge of how to evaluate and make community development loans. This guide develops a method for analyzing community development loan proposals and includes a helpful list of public and private credit programs for those seeking project financing.

To order, contact the Federal Reserve Bank of Minneapolis, Community Affairs, P.O. Box 291, Minneapolis, MN 55401-0291. There is a $25 charge for this publication in addition to a shipping fee. Make checks payable to the Federal Reserve Bank of Minneapolis. For more information, contact the Minneapolis Community Affairs Department at (612) 204-5074.