



Banking and Community **Perspectives**

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FEDERAL RESERVE BANK OF DALLAS

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***B**ased on a recent FDIC survey, 26 percent of U.S. households, or 30 million, are unbanked or underbanked. In Texas, that figure rises to 36 percent, or 3.2 million households.*



**Financial Access Options
for the Underserved**



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Well-designed financial services and products can help individuals and communities meet financial needs and build assets to achieve economic prosperity. However, millions of consumers, and particularly those with lower incomes and net worth, are still relying on services and products that restrain their ability to accumulate wealth.

Based on the recent “National Survey of Unbanked and Underbanked Households,” by the Federal Deposit Insurance Corp., an estimated 7.7 percent of U.S. households, approximately 9 million, are unbanked. In addition, an estimated 17.9 percent of households, or roughly 21 million, are “underbanked”—they have a transaction account but seldom use it. Alternative financial service providers—payday lenders, pawnshops, check cashing outlets—have become a multibillion-dollar industry by filling a gap that mainstream financial institutions are not meeting.

This issue of Banking and Community Perspectives explores the features and limitations of two of the existing products and services for the financially underserved—prepaid cards and small-dollar loans. We describe the challenges mainstream financial institutions face achieving scale and profitability with these programs and discuss two approaches to meeting these challenges: the use of alternative credit data and credit scoring methods for improved risk assessment of the underserved; and examples of community outreach strategies to connect to these customers.

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Financial Access Options for the Underserved

During the recent economic downturn, the net worth of U.S. households shrank 4.5 percent in just one year, ending in 2008, according to Federal Reserve Flow of Funds data. Household assets were diminishing for the lower end of the net worth spectrum even before the crisis. According to the most recent Survey of Consumer Finances conducted by the Federal Reserve Board in 2007, the median and mean family net worth increased from 2004, when the previous survey was conducted. However, the median net worth for the lowest 25 percent of the distribution of net worth dropped from \$1,900 in 2004 to \$1,200 in 2007, and the mean also fell \$700 from -\$1,600 to -\$2,300 over the three years (Figure 1).

A low level of assets leads to financial vulnerability. Households with lower net worth tend to make lower incomes and struggle to live from paycheck to paycheck. They do not have enough savings to smooth consumption

over time, and they get into debt easily. Without a financial cushion, they fall into a downward spiral when adverse financial conditions or emergencies happen. The opportunities to accumulate wealth by investing in financial and human capital are out of their reach.

For lower-net-worth and lower-income families, one major obstacle to asset building is their sporadic relationship with mainstream financial institutions. The 2007 Survey of Consumer Finances showed that 24.6 percent of U.S. families in the lowest 25 percent of the distribution of net worth did not have any type of transaction account.¹ Millions of families and individuals do not find suitable products and services at banks and resort to alternative financial service providers (AFSPs). Millions of others with traditional bank accounts still rely on AFSPs for financial transactions or credit.²

These consumers end up paying high prices for services and products, and this impairs their ability to repay loans, get out

of debt and build assets. A report by the Brookings Institution estimated that low- and moderate-income households paid \$8.5 billion in fees in 2006 to nonbank check cashers and short-term loan providers.³ Having no access to electronic delivery via depository institutions also restricts the ability to pay bills in a convenient and safe way or to receive government benefits.⁴ In addition, without an active relationship with mainstream financial institutions, access to asset-building products is limited. The dependence on AFSPs can be asset-depleting in the long term.

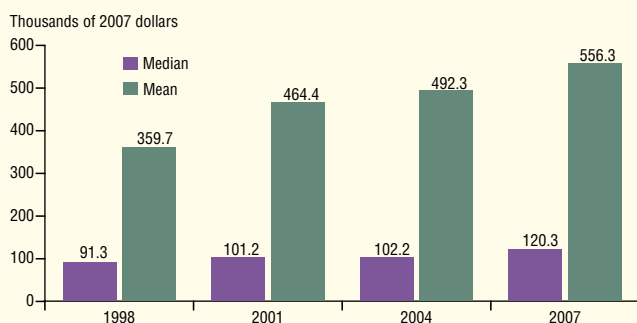
Underserved consumers choose informal financial services and products for a variety of reasons.

Not surprisingly, lower-income consumers may consider maintaining a regular bank account (especially an account with high minimum balance requirements, high fees for overdraft protection or bounced checks, and delays in check clearance) a burden rather than an

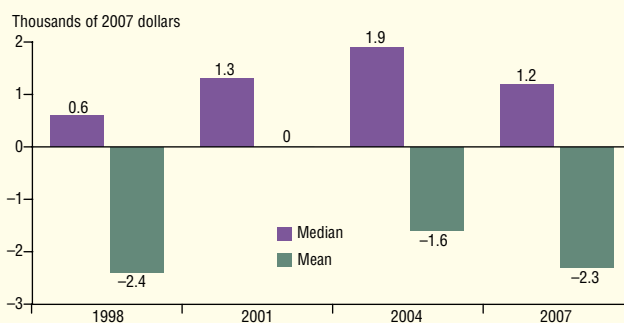
Figure 1

Family Net Worth, 1998–2007

A. All Families



B. Families of Less Than 25th Percentile of Net Worth



NOTE: The median is the midpoint; the mean is the average.

SOURCE: Survey of Consumer Finances, Federal Reserve Board.

asset-building tool. A recent study of low- and moderate-income households in the Detroit area found that lower-income consumers typically have small cash flow, have little to save, and feel that they only need financial services occasionally and can get those at AFSPs. Some with bank accounts choose services and products between the mainstream and alternative financial service sectors based on convenience, account features and privacy considerations. They are comfortable with the products and services offered by AFSPs, and they consider locations and hours at AFSPs more convenient than banks and credit unions.⁵

Some consumers have negative perceptions about formal financial institutions because of bad experience or cultural background. In the case of emergencies, consumers with liquidity constraints and insufficient or blemished credit history may find it easier to get help from family members, friends or high-interest lenders than to obtain any type of loans from financial institutions. A survey conducted by Texas Appleseed in Texas cities found similar reasons why borrowers choose payday lenders over other options.⁶

A better understanding of the specific needs and constraints of consumers with lower incomes and lower net worth will help financial institutions design services and products that can benefit these consumers.

Overview of Existing Products

With millions of consumers potentially benefitting from accessing financial services and products more readily and less expensively, banks and other market players are pondering ways to reach this untapped market. Among the many innovations in financial services and products in recent years, prepaid cards and short-term loans are two products that hold promise for the underserved.

Prepaid Cards

Consumers have funds loaded to prepaid cards and use these cards as an electronic means of payment. The prepaid cards discussed in this article are the reloadable, open-loop prepaid cards, which include

signature-based cards that carry major network brands (Visa, MasterCard, Discover or American Express) and PIN-based cards that use debit networks.⁷ The major difference among prepaid cards, credit cards and debit cards is that prepaid card users pay before spending, while credit card users pay after spending and debit card users pay at the time of spending out of an account.

In 2002, the two largest payment networks, Visa and MasterCard, got involved in the payroll card industry, which has substantially contributed to the rapid growth of the reloadable, open-loop prepaid card market. This segment also has an increasing share of the whole prepaid market (*Figure 2*). Because of the low credit risk associated with prepaid cards, the financial industry considers issuing prepaid cards a promising business that helps generate profits and build relationships with customers. The recent credit crunch made prepaid cards even more popular.

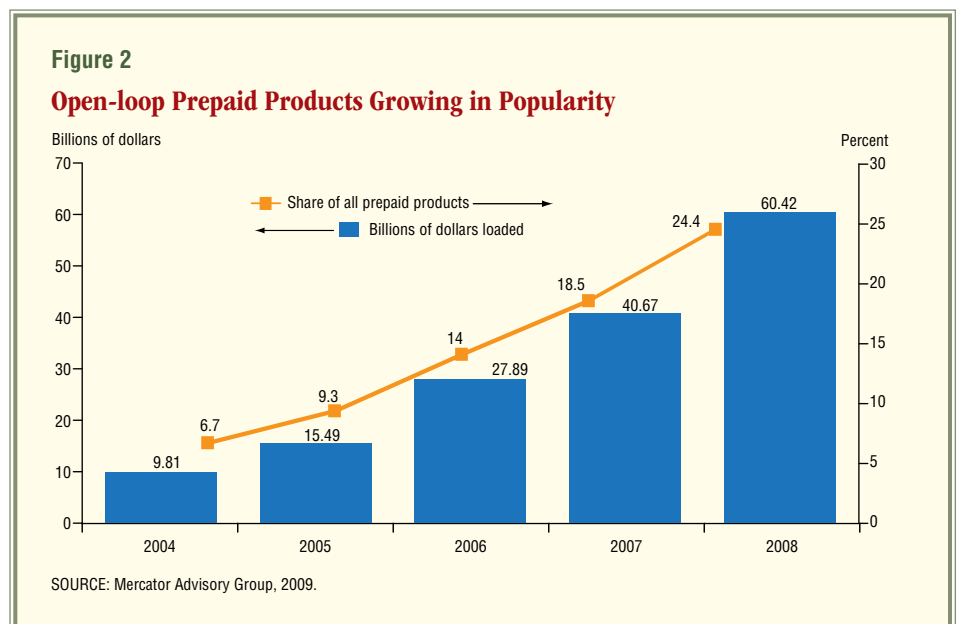
Different types of providers issue prepaid cards to serve different purposes. Employers pay employees with payroll cards in lieu of paper checks. Federal and state governments pay Social Security benefits, state-administered unemployment compensation and court-ordered payments such as child support to recipients through prepaid cards. Banks and tax preparation companies offer customers prepaid cards

to receive tax refunds and other payments. Some banks offer low-cost remittances through prepaid cards, enabling immigrant workers to send money to families in their home countries. Banks, retail stores and other nonbank prepaid card providers offer prepaid products with the basic features of receiving payments, withdrawing cash and making purchases, as well as extra features the providers choose.

The fee structure varies across different products and is determined by individual business models, which involve the providers, issuers, processors and program managers of the card, in addition to networks for payment, reload, debit and ATM transactions.⁸ Some of the most common fee-based features of a prepaid card include:

- Card activation and replacement
- Monthly or annual maintenance
- ATM withdrawal
- Signature transactions
- PIN payment
- PIN-less bill payment
- Remittance
- Card account funding and reloading
- Account statement or balance inquiry

In general, direct deposits are less expensive than loading funds at ATMs. Online account inquiry is usually free, but getting account services by mail or phone may involve



a fee. ATM withdrawal within network and getting cash back at the point of sale are cheaper than withdrawing cash from out-of-network ATMs.

Understanding the terms and conditions of prepaid cards can help consumers choose cards with lower prices for features they value more or use often. Although funds are supposed to be drawn only from a prepaid amount, it is not impossible to overdraw a prepaid card. The delay in processing a payment, the issuer's inadequate authorization system controls and the rounding at ATMs may cause an overdraft.

Some cards may be easily obtained and reloaded at a large number of locations with flexible hours. Some process transactions faster than others. Certain programs offer consumers immediate access to account information while others may not.

Consumer protection features are available for prepaid cards. Network brands such as Visa or MasterCard offer a voluntary Zero Liability policy to protect users against unauthorized use under certain conditions. In addition, if the funds are held in an individual account at an FDIC-insured bank, the funds are insured by the FDIC. When the funds are held in a pooled account, as long as the bank or the program manager keeps good records of the information that can identify individual funds on the cards, the funds are FDIC insured.⁹

Prepaid cards offer convenience, safety and independence, particularly for consumers who do not want to manage or do not qualify for a checking account. Almost all reloadable, open-loop prepaid cards enable card holders to get basic financial services. The Center for Financial Services Innovation estimated that 36 percent of underserved consumers prefer a prepaid card over a checking account, all else being equal.¹⁰ However, there are some caveats about using prepaid cards.

First, prepaid cards are not always cheaper than a checking account. The costs depend on the intensity of monthly card use and the fee structure of the particular prepaid card program. Although using a prepaid card may be significantly less costly than using check

cashers,¹¹ the fee structure of prepaid products is quite complex and consumers may not easily find a suitable card or the most economical way to use the card. The cost of prepaid cards, when properly used, is usually between the costs of check cashers and a checking account. The good news is that the increased competition in the prepaid market, driven by increasing demand and supply, has forced the industry to provide products with lower fees. For example, Walmart—with its sheer volume of consumers using the Walmart MoneyCard, a reloadable prepaid Visa card—has led the industry in lowering fees and providing a more consistent fee structure.¹²

Second, although prepaid cards help prevent consumers from falling deep into credit card debt that may ultimately hurt one's credit score, card users still pay multiple fees for basic services. And unlike on-time credit card payments that build better credit, most prepaid card activities are not reported to credit reporting agencies and will not help consumers to access affordable credit in the future. Moreover, some tax preparation companies market prepaid cards for receiving a tax refund but then offer options for high-interest refund anticipation loans, which can be asset depleting. As the prepaid card market evolves, the competition may drive more providers to add consumer-friendly asset-building features, such as lower fees, savings options, rewards programs and credit-building functions.

Finally, as the use of prepaid cards prevails and the transactions become similar to a checking account, the prepaid card industry is subject to an increasing number of regulations, such as privacy laws, anti-money-laundering laws and banking laws. In addition, payroll card issuers must comply with state labor laws. These regulations not only affect the industry, but also have implications for consumers. For example, some consumers deliberately choose prepaid cards for anonymity. Prepaid card users are now obligated to provide more personal information and be more scrutinized as they receive more protection as a result of regulations. Also, prepaid card issuers may use

As the prepaid card market evolves, the competition may drive more providers to add consumer-friendly asset-building features, such as lower fees, savings options, rewards programs and credit-building functions.

private ChexSystems to screen out consumers who have had fraudulent behavior with bank accounts in the past.¹³

Short-term Loans

In the event of a job loss, a car repair, an illness or a family emergency, those without a financial cushion have limited options. Cash-strapped consumers may overdraw their bank account, misuse fee-based overdraft programs offered by banks or go to payday lenders or a pawnshop for immediate access to cash. None of these options are ideal because of the high costs. Also, many payday loan borrowers are not able to repay the loan within a short time and have to roll it over or apply for new loans, which can lead to chronic debt.

Millions of people take out a payday loan every year. Despite the apparently large demand for affordable short-term loan products and the asset-stripping nature of the existing alternatives, mainstream financial institutions have hesitated to enter the arena. A 2008 FDIC survey of depository institutions showed that less than 18 percent of banks identified expanding services to unbanked and/or underbanked individuals as a priority in their business strategy.¹⁴ Being subject to strict usury laws, many banks are concerned about the profitability of the small-dollar loan product.

In February 2008, the FDIC started a two-year Small-dollar Loan Pilot Program, which was designed to illustrate the profitability of affordable small-dollar loan programs for banks. According to the FDIC's report summarizing the first year of the program, a few participating banks have set short-term profitability as their business goal, but most of the banks aim for long-term relationship building, and some banks offer the product in partnership with consumer and community groups solely for goodwill or favorable Community Reinvestment Act (CRA) consideration.¹⁵ Since the inception of the program, most pilot banks have not made profits on the small-dollar loan product. However, the program has shown potential for banks to expand consumer portfolios, which could lead to mutual benefits for the consumers and the industry in the long run (see box titled "Small-dollar Loan Program at Amarillo National Bank").

Banks take part in the pilot program voluntarily. Some participating banks had existing programs, but most (23 out of 31) did not have similar programs before. Many banks targeted the product to lower-income borrowers, college students, military personnel or members of the immigrant community.

Not all financial institutions offering small-dollar loans participated in the FDIC pilot program, even though some banks use the guidelines of the program to design their products. For example, H&R Block Bank offers a small line of credit with an affordable interest rate to clients of their tax-filing service. The clients can qualify for the loan if they pay off any outstanding balance and either make a savings deposit that exceeds the minimum requirement or set up a payroll direct deposit to the prepaid card on which they receive their tax refund.

Many credit unions offer small-dollar loans to their members. REAL Solutions in Texas works with the National Credit Union Foundation and the Texas Credit Union League to help credit unions offer loan products with a cap at 18 percent.¹⁶ The product also has a savings feature to help members save for emergencies and graduate from borrowing multiple

Small-dollar Loan Program at Amarillo National Bank

Amarillo National Bank (ANB), a family-owned local community bank in Amarillo, Texas, is one of the 31 banks that participated in the FDIC Small-dollar Loan Pilot Program. For more than 100 years, ANB has been offering small-dollar loan products to customers walking into one of its 14 branches.

"ANB does not segment or penalize people who need loans of any sizes," Vice President and CRA Officer Lilia Escajeda said. "We may not make a profit on these loans, but we believe many of the borrowers will come back and bank with us in the future."

ANB charges an interest rate up to 18 percent and provides counseling to customers to stay away from higher-priced loan products as such businesses proliferate in the area.

The delinquency rates of the small-dollar loans offered by ANB are not significantly higher than that of the regular portfolio.

Escajeda said that ANB's commitment to local communities and the personal touch of the service may explain why ANB has more than 50 percent of the local deposit market.

short-term loans. In southern Illinois, Catholic and Community Credit Union partners with the Catholic charity Society of St. Vincent de Paul to provide affordable small-dollar loans to borrowers to help cover moving expenses, pay for home and auto repairs or pay off a payday loan.¹⁷ The State Employees' Credit Union in North Carolina offers a variety of small-dollar loan products with affordable rates.

The small-dollar loans offered at banks and credit unions are much more affordable than a typical payday loan. The national average interest for a \$100 loan at a payday lender is around \$16, which can be translated into annualized rates of interest well above 300 percent.¹⁸ At banks and credit unions, the annual percentage rate on small-dollar loans is capped at 36 percent, and other fees are small. The loans are mostly closed-end installment loans with a term of multiple months. Each payment is low, which eases the stress on borrowers to repay the loan. Borrowers do not have to pay a lump sum within a short period, as is the case with a payday loan or a checking account overdraft fee.

Many borrowers choose payday lenders because of the expedience. With streamlined underwriting, the small-dollar loan programs offered by banks and credit unions can also process loan applications in a fast manner if the borrowers' documents are complete.

Getting a small-dollar loan at a main-

stream financial institution can help build credit. With improved credit, consumers can get loans at a better interest rate in the future. Some borrowers prefer payday lenders because they do not want their payday loan repayment activities reported to a credit bureau, but many others need the link to build credit.¹⁹

A savings feature is another important element of some small-dollar loan products. Unlike high-interest payday loans, which drive up the demand for further loans and exacerbate the financial strain on the borrowers, an emergency savings account through financial institutions could ultimately reduce future short-term credit needs. Not all small-dollar loan programs by banks or credit unions require the establishment of a savings account for borrowers. However, as more financial institutions get involved, the competition is likely to drive continuous improvement in product design and services.

Alternative Credit Scoring

Reaching the underserved requires better information and particularly accurate assessment of the creditworthiness of this population. Automatic underwriting and scoring models enable competitive and expedient lending. Consumers with sound credit histories can access competitive financial products, but consumers with thin or no traditional credit history struggle to obtain affordable credit. They are

also locked into the situation because, without credit use, they are not able to build or improve their credit. Lower-income groups, the younger population and immigrants represent the majority of these consumers.

As the banking industry explores new markets and reexamines existing credit scoring models, it becomes clear that the traditional credit score is not sufficient to accurately evaluate the financial risk of the underserved, a significant proportion of whom are potentially creditworthy borrowers. The opportunities to attract these customers are growing with alternative credit data and new technologies.

Some of the alternative data—such as utility, telecommunication, payday loan and small-business loan payments—are similar to the traditional credit data because they are usually recurring and due after receiving the services or loans. Other nontraditional data are not so “credit like” but can also inform lenders about consumers’ payment habits, such as payments for insurance, rents, savings plans, childcare and health care. Public records provide another source of credit information. For example, bankruptcies, liens and judgments depict derogatory history of consumers’ economic behavior; professional and occupational licenses, and real property deeds suggest positive behavior; address instability, utility disconnects, felony convictions, evictions and foreclosures reflect life stress.

These alternative data are now collected by multiple credit bureaus and data warehouses. Credit scoring companies work with the data suppliers and incorporate this alternative credit information into new credit scoring models.²⁰ These models have sophisticated algorithms that can sensitively gauge the influence of the new elements on risk assessment and proved to be strongly predictive after validating with performance data. The new models are able to score 60 percent to 90 percent of consumers with no or thin traditional credit, depending on scoring models and industry segment. The inclusion of the alternative data enables some consumers with thin traditional credit and a subprime traditional score to move into the prime category. A

large number of consumers with no traditional credit were deemed creditworthy. A report by VantageScore shows that 26.5 percent of “new entrants” are consumers with good or excellent credit scores in the new model.²¹

New regulations have been developed to authorize and standardize the reporting and use of alternative credit data. In April 2008, the Federal Housing Administration (FHA) provided guidance to lenders and underwriters for establishing and evaluating nontraditional credit histories and also described FHA’s “acceptance of those enterprises that can develop a verifiable credit history, no less than 12 months in duration, for borrowers with limited traditional credit.”²² Now, more and more top mortgage originators, financial institutions and credit card issuers are using credit scores generated by these new models in underwriting consumers with limited traditional scores. The adoption of credit scores based on broader credit data across the population will be possible with more consistent data collection and verification, modifications in data processing infrastructure and regulatory support.

Community Strategy

There is no consensus on outreach to the underserved population. However, for some cities and neighborhoods, a strong nonprofit organization is essential. The relationship between a nonprofit and a low- and moderate-income community is often rooted in trust. Citibank, in partnership with the YWCA of Metropolitan Dallas, recently launched a Client Savings Program that capitalizes on that trust. The YWCA serves as the bridge between its existing client base and the bank’s services. The goal is to foster asset building and improve credit scores through no-fee savings accounts. The YWCA opens the account and monitors the client’s performance through an online real-time platform, and Citi volunteers provide additional interactive financial education to the client when requested. The pilot program is mutually beneficial. Citi expands its client base by serving traditionally underserved customers; the YWCA introduces its clients to yet another asset-building strategy; and the

The inclusion of the alternative data enables some consumers with thin traditional credit and a subprime traditional score to move into the prime category.

clients begin a savings program, improve their credit scores and journey into mainstream banking.

Another example of community strategy is the Bank On Program now launched by several municipalities and counties across the country. The program’s aim is to help local or regional government leaders develop and implement initiatives to connect residents to mainstream financial services and products. The program is driven by partnerships among governments, community-based organizations, financial institutions and regional regulators. The effort involves developing products, creating service pathways and conducting outreach campaigns.²³ Different entities assume different roles: Elected officials serve as campaign leaders and provide staff support; financial institutions provide expertise in product design, participate in outreach and manage customer databases; community organizations engage consumers through their network, provide financial education, assist data tracking and act as service providers; and regulators provide regulatory guidance and support.

In Texas, Bank On Houston was launched in January 2009. The program is a collaborative effort that offers low-cost starter checking accounts to the unbanked, helping them protect their money and take a first step toward wealth

and asset building. Dallas, Central Texas, Bryan and San Antonio are also planning Bank On campaigns.

Conclusion

Communities with healthy financial markets are stronger and more sustainable. Millions of consumers, particularly those with lower incomes and lower net worth, would benefit from affordable services and products for meeting financial needs and building assets. For consumers, merely having access to certain financial products and services is not enough. They need to know how to manage their financial products and understand their rights and obligations to fully benefit from the opportunities offered by financial institutions.

Products and services for the underserved and lower-asset population must be fairly priced, easy to understand and financially beneficial. The success of these initiatives will also require institutional support and oversight by policymakers and regulatory agencies.

Notes

¹ Transaction account is defined in the survey as a category that comprises "checking, savings and money market deposit accounts; money market mutual funds; and call or cash accounts at brokerages."

² An estimated 7.7 percent of U.S. households (approximately 9 million) are unbanked, and an estimated 17.9 percent of households (roughly 21 million) are underbanked, according to "FDIC National Survey of Unbanked and Underbanked Households," Federal Deposit Insurance Corp., December 2009, www.economicinclusion.gov.

³ For more details, see "Banking on Wealth: America's New Retail Banking Infrastructure and Its Wealth-Building Potential," by Matt Fellowes and Mia Mabanta, Brookings Institution, January 2008.

⁴ The Debt Collection Improvement Act of 1996 mandated that government benefits such as Social Security, Supplemental Security Income and federal retirement payments be made by electronic transfer to save costs by phasing out paper check payments.

⁵ "And Banking for All?" by Michael S. Barr, Jane K. Dokko and Benjamin J. Keys, Federal Reserve Board, Finance and Economics Discussion Series Working Paper no. 2009-34, August 2009.

⁶ "Short-term Cash, Long-term Debt: the Impact of Unregulated Lending in Texas," Texas Appleseed, April 2009, www.texasappleseed.net.

⁷ Open-loop cards can be used anywhere the network is accepted, in contrast to closed-loop cards, which can only be used at one merchant.

⁸ For more details, see "Demystifying Prepaid Cards: An Opportunity for the Community Development Banking Institution Sector," report by the National Community Investment Fund, 2009.

⁹ See "Stored Value Cards and Other Nontraditional Access Mechanisms," New General Counsel's Opinion No. 8, FDIC Financial Institution Letters, FIL-129-2008, Nov. 13, 2008, <http://www.fdic.gov/news/news/financial/2008/fil08129.html>.

¹⁰ "CFSI Underbanked Consumer Study," Center for Financial Services Innovation, 2008.

¹¹ See a cost comparison in "Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked," *Community Developments Insights*, Comptroller of the Currency, June 2005, p. 11.

¹² Since March 2009, Walmart charges customers \$3 to purchase and activate the Walmart MoneyCard, waives the reloading fee of \$3 with direct deposit or check cashing, and charges no overdraft fee or insufficient funds fees. For more information, go to www.walmartmoneycard.com.

¹³ Having bounced checks does not usually disqualify an applicant for a prepaid card.

¹⁴ For more information, see "FDIC Survey of Banks' Efforts to Serve the Unbanked and Underbanked," Federal Deposit Insurance Corp., February 2009, <http://www.fdic.gov/unbankedsurveys>.

¹⁵ For more details, see "The FDIC's Small-dollar Loan Pilot Program: A Case Study After One Year," *FDIC Quarterly*, vol. 3, no. 2, 2009, www.fdic.gov/bank/analytical/quarterly/2009_vol3_2/SmallDollar.pdf.

¹⁶ REAL stands for relevant, effective, asset-building and loyalty-producing. The program in Texas is supported by a grant from the Texas Credit Union Foundation.

¹⁷ For more details, see "Charity's Micro Loans Compete with Payday Lenders," by Jean Morisseau-Kuni, *Bridges*, Federal Reserve Bank of St. Louis, Fall 2009.

¹⁸ "The Hidden Costs of Payday Lending," by Don Baylor, *Texas Business Review*, April 2008.

¹⁹ Payday loan activities are usually only reported to Teletrack, a nontraditional consumer credit information bureau used by payday lenders. In recent years, the payday loan industry has partnered with alternative credit reporting agencies and provides borrowers options on reporting their loan activities.

²⁰ Examples of credit scores based on both traditional credit data and alternative data include VantageScore, FICO Expansion score and RiskView score by LexisNexis.

²¹ For more details, see the webinar "Credit Scoring in Volatile Times," VantageScore, June 29, 2009, www.vantagescore.com.

²² Federal Housing Administration mortgagee letter 2008-11, April 29, 2008, www.hud.gov/offices/adm/hudclips/letters/mortgagee/.

²³ For more details, see "Reaching Unbanked Consumers: The Bank On Cities Campaign," a presentation by Heidi Goldberg from National League of Cities in San Antonio, Sept. 1, 2009, http://www.tax-coalition.org/events/aug2009/materials/Bank_On_Cities.pdf.