On the Outside

LOOKING IN

Millions of Americans do not use conventional banking services, but is that necessarily bad?

BY ROBERT W. KIDD

A vibrant, 30-something female is buzzing about her home preparing for an evening out. Behind schedule and with curlers in her hair, she frantically applies mascara. Suddenly, she remembers her monthly bills are due. No problem. She calmly sits down at her computer, logs on to her bank's web site, and, voila, those pesky bills are paid. "All in under three minutes" is the commercial's tagline. Clearly, banking must be a snap — just point and click.

Plus, the advantages of having a traditional banking relationship can be significant. A deposit account provides a cushion for financial emergencies, facilitates wealth building, and allows for credit history development. Further, consumer protection laws regulate mainstream financial service providers to shield customers from discriminatory and predatory lending practices. Yet, despite these obvious benefits, roughly 9 percent to 10 percent of U.S. households are "unbanked" — meaning they do not have a checking, savings or other deposit account with a regulated financial service provider like a bank, credit union or thrift. Why do millions of Americans forego the traditional banking system?

Underserved or Self-Served?

Studies consistently reveal that unbanked households share similar socioeconomic characteristics. For instance, they tend to have lower-than-average incomes. The Federal Reserve Board has estimated that 83 percent of households without a checking account earn less than $25,000 annually while 99 percent of households making more than $50,000 do have an account. In addition, the unbanked tend to live paycheck-to-paycheck and spend most of their income each month.

Some claim that the unbanked lack access and are purposely "underserved." They argue that since low- and moderate-income (LMI) customers are less profitable, banks are not interested in serving LMI communities.

To support this criticism, consumer advocates point to studies that show there has been a reduction in the number of bank branches in LMI neighborhoods. For instance, a Federal Reserve Board study, "Changes in the Distribution of Banking Offices," confirmed that while the overall number of bank offices between 1975 and 1995 increased, the number in LMI neighborhoods decreased. However, the authors also point out that the low- and moderate income areas which were losing offices were also experiencing declines in population. In 1975, low-income neighborhoods had the largest number of offices per capita; by 1995, there was relatively little difference across income categories.

The Financial Service Centers of America (FiSCA), a trade organization representing the check-cashing industry, characterizes customers not as "unbanked" or "underserved" but as "self-banked," who "use check cashers to obtain those specific services they need and they pay only for what they use."

Daniel Tatar, an economist and assistant vice president at the Federal Reserve Bank of Richmond, agrees. "We assume that the unbanked need to be in the banking system but I am not certain that they should be. I think there are today some alternative delivery systems that meet certain needs. Some people are making a very rational decision by not having a bank account."

Several surveys of the unbanked reveal that they choose not to have a checking account for a variety of reasons. Most respondents said that they did not write enough checks to make it worthwhile, that they did not like dealing with banks, or that they did not have enough money. Others said that the service charges were too high. Another reason was the desire to keep financial records private and safe from creditors. While a few mentioned they were uncomfortable dealing with banks, 49 percent of the unbanked still cash their checks in banks, even though they do not have a deposit account with those institutions.

Where Do The Unbanked Go?

Unbanked households have the same financial needs as a banked household. The unbanked must still convert their payroll checks into a usable form, such as cash, and pay their monthly rent and utility bills. But if they are not using the traditional banking system, how are they satisfying these needs?

There are approximately 11,000 neighborhood non-bank financial service centers, such as commercial check-cashing outlets (CCOs), in the United States. In addition to cashing their payroll check, a customer may choose from a wide range of other fee-based products and services. For instance, many CCOs sell money orders, prepaid telephone cards, postage stamps and envelopes, mass transit fare cards/tokens, lottery tickets, direct deposit services, photocopier and fax services, and deferred deposit accounts. Many CCOs also accept utility bill payments, process money transfers, exchange foreign currency, collect automobile registration and rent payments for public housing, and provide income tax preparation.

CCOs offer customers ease and convenience as a "one-stop shop" — for a fee of course. For instance, these centers cash approximately 180 million checks a year with an estimated face value of more than $55 billion. The fee revenue for this service alone is estimated to be almost $1.5 billion a year.

However, given the tenuous financial condition of most unbanked, there is obvious concern that these fees are paid by households that can ill afford them. According to economist John Caskey of Swarthmore College, "the problem created by the regular use of CCOs is that they are an expensive source for payment services. Outside of a small number of states with strictly binding fee ceilings, most CCOs charge between 2 percent and 3 percent of the face value of a check to cash it. A family with $18,000 in take-home pay that uses such CCOs regularly can easily spend $400 or more of its limited annual income just to obtain basic payment services."

Pent-Up Demand

Finding opportunities for growth is a chief challenge for banks. "Although mergers will continue to take place, opportunities to create substantial value have diminished and relatively fewer deals will pack the punch of the 1990s," states a recent report from the consulting firm McKinsey & Company. "Executives of large banks must look for new ways to increase earnings." The unbanked population may serve as a growth engine, especially if as one estimate suggests, the unbanked represent a $4 billion market.

A niche market that both McKinsey and Caskey identify as an opportunity for banks is the unbanked Hispanic population. McKinsey's Andres Maldonado and Alejandra Robledo estimate that every year immigrants in North America and Europe send more than $60 billion to their home countries. Over half of all global remittances originate in the United States, and 65 percent of that money goes to Latin America.

Convincing Hispanic immigrants to use the banking system to help handle these remittances and open bank accounts involves more than just hiring Spanish-speaking tellers. According to Tatar, Hispanic immigrants who have experienced Latin America's economic crises firsthand bring with them a lack of confidence in institutional banking systems. This presents considerable challenges for traditional banks in the United States.

Banking The Unbanked

Caskey has outlined a strategy for banks to serve the unbanked. He recommends that banks open "outlets," or special branch offices providing both traditional services and services that nonbank financial service providers offer: one-stop shopping for utility and other household bills, money orders, and wire transfers. It's also important that they locate in areas convenient for LMI households. He believes that since banks benefit from economies of scale, have direct access to check-clearing systems, and have a relatively low cost of financial capital, banks should be able to set fees for services which are highly competitive yet reasonably profitable. Caskey claims that "assuming outlets attract moderately high volume of check-cashing business and that outlets levy check-cashing fees in the neighborhood of 1.0 percent to 1.5 percent, outlets should earn about $100,000 a year from check-cashing and other payment service fees."

Caskey points to Union Bank of California as a noted success story of a traditional firm transitioning unbanked customers into the banking system. In 1993, Union Bank created "Cash & Save" outlets that offer check-cashing services and traditional banking services in LMI areas. Within a few years of patronizing the outlets, 40 percent of its check-cashing customers use at least one traditional bank product.

Whether banks will succeed in providing a compelling option to the unbanked remains to be seen. In the meantime, it is clear to economists like the Richmond Fed's Tatar that check-cashing outlets are meeting a need in the market. But a balance must be struck. "People need choices. Don't take those choices away," says Tatar. But government also "has a responsibility to protect people. You can have viable financial options available as long as they do not exploit. Sometimes these alternative systems are not wrong. What we need to do is find a way to make it fair." **RF**

READINGS

Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner. "Changes in the Distribution of Banking Offices." *Federal Reserve Bulletin*, September 1997.

Caskey, John P. "Check-Cashing Outlets in a Changing Financial System." Federal Reserve Bank of Philadelphia Working Paper #02-4, February 2002.

Tillett, Doug, and Liz Handlin. "Tapping the Potential of the Unbanked: Private Sector Interest Increases." *Chicago Fed Letter*, January 2003.

Visit **www.rich.frb.org/pubs/regionfocus** for links to relevant Web sites.