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**From Unbanked to Homeowner: Improving the Supply of  
Financial Services for Low-Income, Low-Asset Customers**

**Ellen Seidman and Jennifer Tescher**

**BABC 04-4**

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**Joint Center for Housing Studies**

**Harvard University**

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Ellen Seidman is the Senior Managing Director/National Practice at ShoreBank Advisory Services. Jennifer Tescher is the Director of the Center for Financial Services Innovation at ShoreBank Advisory Services.

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## **Abstract**

At least 10 million American households—disproportionately poor, minority, lower income and young—are unbanked. Additional households conduct most of their financial transactions outside of banks even though they may have a savings or checking account. Yet having a relationship with the financial services system can minimize the cost of financial transactions and help turn income into savings, assets and wealth. Are the interests of the financial services system and consumers converging to benefit both?

The paper argues that five factors have contributed to narrowing the gap between supply and demand: technological advances that lower costs and expand consumer access; the federal government's desire to pay benefits electronically; expansion of the alternative financial services sector; the emergence of the asset-building movement; and major demographic shifts. The most significant opportunities for near-term success are in: the workplace as an access point and distribution channel; remittances; stored value cards; bank/non-bank partnerships; and self-service delivery. Cultural, information, and regulatory barriers remain. Nevertheless, if the financial services industry is willing to think and act creatively, it can find profitable ways to meet both the short- and long-term financial needs of low-income consumers.

## **Introduction**

Being poor at the end of the 20<sup>th</sup> Century did not necessarily mean having a low income. In 1998, at the height of the most recent economic boom, the official poverty rate for families had fallen to 10%, from 12.3% at the close of the severe recession of the 1980s. Yet, in the same 15-year period, asset poverty had risen to 25.5% from 22.4% (Haveman and Wolff, 2001).<sup>1</sup>

The asset poor disproportionately belong to minority groups and have lower education levels. In 1998, 45.3% of Blacks and Hispanics were asset poor, compared to 20.5% of white households; similarly, 26.5% of high school graduates were poor, compared to 15.3% of college graduates. Among female-headed households with children, the asset-poverty rate was an astounding 53.7% (Haveman and Wolff, 2001).<sup>2</sup> In real terms, these families are living a paycheck or two away from destitution — from not having enough money to feed, clothe, and shelter their members. With the unemployment rate in the United States climbing from 4.5% in 1998 (the year of these statistics) to the current rate of 6.1%, many asset-poor families have faced this situation (September 2003). Trends in requests for emergency food and shelter bear this out. According to the U.S. Conference of Mayors' 2002 study of hunger and homelessness in American cities, each of the 25 cities surveyed saw an increase in requests for emergency food assistance, with an average increase of 19% over 2001. Requests for emergency shelter increased an average of 19%, with all but three cities citing an increase. These increases follow similarly large increases in every year since 1998 (U.S. Conference of Mayors, 2002).

Over the last several years, it has become increasingly recognized that the financial services system can play a major role in the relationship between income and asset building. Lower-income families with deposit accounts are more likely to own other assets, such as savings or retirement accounts, homes, cars, and life insurance, than are those without accounts (Hogarth and O'Donnell, 1999).<sup>3</sup> According to the 2001 Survey of Consumer Finances, although only 11% of the total population did not have a transaction account, this included

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<sup>1</sup> The cited number is based on the least inclusive definition of asset poverty: a family's total net worth, including both liquid and illiquid assets, is insufficient to meet the basic needs of food, clothes, and shelter for three months. A more inclusive, but more realistic, definition of asset poverty that excludes often illiquid home equity from the calculation showed that 36.8% of households were poor.

<sup>2</sup> Asset-poverty rates were also extremely high among those under 20 (70.7%), those 25 to 34 years old (46.8%), and those without even a high school degree (40.2%).

<sup>3</sup> Lower-income families are defined as those with incomes under 80% of the national median, which in 2001 (the latest year for which data is available) was \$51,407.

almost 25% of non-white or Hispanic households, over 30% of those in the bottom income quintile, and 20% of renters. The reasons cited included not only “do not have enough money,” but also concerns about minimum balances and service charges and a simple dislike of dealing with banks (Aizcorbe, Kennickell, and Moore, 2003; Caskey, 2000). Yet even the poorest of the poor have demonstrated they can save and become owners of major assets such as houses when provided with the appropriate structure and incentives (Clancy, Schneiner, and Sherraden, 2002).

A bank account serves many purposes in today’s economy. It provides an opportunity to receive a paycheck quickly and safely, along with myriad ways of accessing funds, including checks, ATMs, and debit cards. What is particularly important for the purposes of this paper, however, is that a bank account provides an opportunity to save, including saving in very small increments, and to earn interest on those savings. In turn, a banking relationship established through a checking or savings account can provide the account holder with financial education and high-quality credit products, as well as with positive recognition in a credit report.

In summary, the path from asset poverty to homeownership may well be through traditional financial services providers — but only if that sector can rise to the occasion. This will require new product design, improved marketing and outreach strategies, more welcoming customer service, and, especially, buy-in from bank CEOs. Moreover, banks will have to go beyond persuading low-income customers to open accounts; they must also enable and encourage their accountholders to make full and effective use of the broader suite of services — including savings and investment vehicles — that traditional financial services providers can offer. Fortunately, developments in demographics, marketing, technology, and public policy all suggest an increase in the sector’s interest in and ability to serve many of those in the lower reaches of the income and asset scale.

### **How We Got Here**

During the 1980s, a series of articles in the *Atlanta Journal and Constitution* drew the country’s attention to the problems that minorities, particularly African-Americans, were having in obtaining the benefits of the modern mortgage finance system (Dedman, 1998; Dedman, 1992).<sup>4</sup> Although there have always been African-American homeowners, they and other

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<sup>4</sup> The *Atlanta Journal and Constitution* published a series of articles called “The Color of Money” in May 1988. The series was awarded the Pulitzer Prize in 1989.

minority and low-income consumers appeared not to be benefiting from the steady supply of relatively low-cost mortgage money that the mainstream financial services sector, working with the secondary market, was increasingly making available to the rest of the country. Over the next several years, many developments combined to significantly increase homeownership rates among minorities and low-income families, including the greater effectiveness of the Community Reinvestment Act (CRA) and the Home Mortgage Disclosure Act; the rise of effective advocacy targeting this issue by community-based organizations; and external and internal pressures on Fannie Mae and Freddie Mac (U.S. Department of Housing and Urban Planning, 2003).

By the late 1990s, however, new issues and concerns had appeared. Community-based organizations, and then the press and policy makers, became concerned about the quality of the loans supporting those homeownership rates. “Predatory lending,” in which equity was stripped from homes rather than added to it, first appeared in the press in January 1998 and in congressional testimony in March 1998 (Howley, 1998; *The Boston Globe*, 1998; *The Washington Post*, 1998; *The New York Times*, 1998; Congressional Testimony, 1998). New York State’s case against Delta Funding, the Justice Department case against First Alliance, and the Federal Trade Commission and Justice Department cases against Associates First Capital Corp. made it clear that the problem was not confined to a small group of fringe players (Howley, 1998; Mayer and Haggerty, 1998; Rasmussen, 1998; US Court District of New York 2001; US Court District of Georgia, 2001, State of NY Banking Dept. 1999).

A look at the companies charged and the manner in which they did business strongly suggested that technology, which had been critical in expanding homeownership opportunities, also provided opportunities to find the vulnerable and to fund loans with only the most limited assessment of risk — and with virtually no knowledge of the borrower’s circumstances.

The focus on predatory and more costly sub-prime lending, with their increased risk of foreclosure (U.S. Department of Housing and Urban Development, 2003),<sup>5</sup> in turn spawned a deeper interest in how and why homeownership had become a trap, rather than a benefit, for some low-income families. Initial efforts at foreclosure prevention turned into broader post-purchase counseling. By 2000, the Joint Center for Housing Studies at Harvard University was

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<sup>5</sup> Foreclosures increased steadily from 1986 through 1997; although they declined from 1998 through 2000, they increased sharply in 2001 and have stayed at high levels since then.

asking whether homeownership is always a “good deal” for low-income homeowners (Nicolas, 2002). One of the hypotheses explored was that when families become homeowners without any financial cushion to fall back on, problems — such as the major repairs needed by the older houses in which low-income families often live — can lead to disaster, in the form either of a predatory-lending spiral or of direct and immediate foreclosure.

Up to this point, the focus of the banking and bank regulatory communities had been on the connection between low-income consumers and access to credit. Providing low-income and minority consumers with access to a broader array of financial services was not a priority, and the fact that large numbers of Americans had no connection to a traditional bank was not yet part of the national consciousness. Rather, the general assumption was that low-income consumers had low account balances and high transaction volumes — an unprofitable combination for a traditional bank. Aside from various state laws requiring lifeline banking accounts for senior citizens and/or the poor, banking regulators emphasized the importance of providing loans and investments in low-income communities rather than other types of asset-building consumer financial services. Thus, there were neither private incentives nor public pressure to adequately serve this market.

A variety of changes in the financial services environment ultimately has led to a greater recognition of the plight of the asset poor and the connection between asset building — including home ownership — and access to financial services.

## Changes in the Financial Services Industry and Impacts

MAJOR CHANGES	IMPACTS/CONSEQUENCES
Technological advances reach consumer banking segment	<ul style="list-style-type: none"> <li>• Reduction in the cost of serving the consumer market</li> <li>• Introduction of more efficient retail products</li> </ul>
Direct deposit of federal payments	<ul style="list-style-type: none"> <li>• New research to better understand preferences of low-income consumers</li> <li>• Increased recognition of the unbanked</li> </ul>
Expansion of alternative financial services sector	<ul style="list-style-type: none"> <li>• New concerns over predatory practices</li> <li>• Demonstration of profitability of low-income consumers</li> <li>• Increasing awareness, interest of traditional financial institutions in the market</li> </ul>
Emergence of the Individual Development Account (IDA) movement	<ul style="list-style-type: none"> <li>• Better understanding of the importance of assets and the connection to financial services</li> <li>• Proof that the poor can save</li> </ul>
Major demographic shifts in the U.S.	<ul style="list-style-type: none"> <li>• Confirmation of market potential of Latinos, other immigrant groups</li> <li>• Growing interest from banks</li> </ul>

First, the technology boom that had made the secondary market and consolidation possible began to move more fully into the retail market (Weissbourd, 2002). While Internet banking as a stand-alone business has not met its initial promise, ATM machines (capable of performing an expanding array of functions), direct deposit, on-line banking and, most recently, all types of electronic, card-based products, have brought down the cost of serving the retail banking customer and carry the promise of ever-greater efficiencies.

Second, following the passage of the Debt Collection Improvement Act of 1996, which proposed that all federal payments be made by direct deposit, the Treasury Department (which was charged with the task) realized that many federal benefit recipients did not have bank accounts. Although there is dispute over the precise number of people involved, it was at least 10 million (General Accounting Office, 2002). To develop a strategy for dealing with this problem, Treasury commissioned research that led to a better understanding of why people did not have bank accounts (Dove Associates, 1999; Caskey, 2001; Dunham, 2001). Despite this

increased recognition of the “unbanked,” the Treasury’s ultimate solution, the Electronic Transfer Account, did little to move significant numbers of benefit recipients to direct deposit (General Accounting Office, 2002).

Third, the alternative financial services sector mushroomed throughout the 1990s and has continued to grow. For example, the number of payday lending stores grew from a few hundred outlets in the mid-1990s to over 10,000 by 2000. The number of pawnshops increased from about 4,800 in 1986 to over 11,600 in 2003. Check-cashing outlets (which often also function as payday lenders) proliferated, with especially significant increases in states where payday lending is common, such as Alabama, Kentucky, Mississippi, South Carolina, Tennessee, and Utah (Tanoue, 2002; Caskey, 2003). Research focused on substitute financial services providers — check cashers, payday lenders, pawn shops, and rent-to-own stores — and tallied up the toll taken by the use of these providers on the finances of low-income individuals and communities (Carr and Schuetz, 2001). It also became clear that the sub-prime and alternative financial services sectors could be highly lucrative (Caskey, 2001; Dove Associates, 2000). A few mainstream financial services institutions sought to leverage the growing distribution channel offered by alternative players by buying firms, joining forces in funding (sometimes characterized as “renting their charter”), or adding alternative products to their traditional product lines.

Fourth, the emergence of the Individual Development Account (IDA) movement emphasized the role of assets in poverty alleviation and demonstrated the importance of formal financial mechanisms in facilitating saving (Beverly and Michael, 1999). An IDA is a financial tool — typically a savings account held at a depository institution — that matches the savings of low-income families with additional funds in order to facilitate the purchase of an asset, such as a house, post-secondary education, or small business. The IDA concept (developed by Professor Michael Sherraden and described in his 1991 book, *Assets and the Poor*) took hold rapidly with the development, by the end of the century, of a multimillion-dollar national demonstration project organized by the Corporation for Enterprise Development and funded by a group of foundations. Targeted policy work by these groups and others led to the creation of a federally-funded IDA program and numerous state programs. By 2003, the number of IDAs was estimated at between 20,000 (New America Foundation, 2003) and 50,000 (Bar and Sherraden,

2003) nationwide.<sup>6</sup> These new resources created greater opportunities for understanding how poor people can build assets and how financial services institutions might become part of that process.

Finally (and to some extent unacknowledged until the results of the 2000 Census became available in 2001), the United States was undergoing major demographic shifts. As a result, financial services firms began to focus more heavily on the market opportunities implied by these changes. In particular, the Latino population grew by 58% in the 1990s and now totals 37.4 million, or 13% of the U.S. population (U.S. Census Bureau, 2003). Sixty percent of Latinos were born in the United States and 55% live in the suburbs; estimates of Latino purchasing power exceed \$600 billion annually. Yet a very large percentage of the Latino population — estimates range as high as 36% (including 56% of immigrants) — is unbanked (Aizcorbe, Kennickell, and Moore, 2003). The Asian population also grew very substantially in the 1990s, and the African-American population grew at a rate significantly exceeding that of the non-Hispanic white population. Immigrant and minority populations also tend to be significantly younger than the white population. In combination with ever-increasing information about the profitability of the alternative financial services sector, demographic trends are beginning to cause mainstream financial services providers to focus attention on these formerly overlooked communities.

### **Asset Building and Financial Services: The Demand**

Banks, thrifts, and credit unions can serve the asset-building needs of individuals by providing access to deposit accounts (which are a convenient and safe way to receive and hold money) and to savings accounts (which enable people to save and earn interest, and, through statements, to track their deposits and interest earned). Depository institutions also provide access to the payments system. In addition, many depository institutions provide informal and/or formal financial education, usually in connection with a transaction or proposed transaction, such as buying a home. As highly regulated institutions, they are also more likely to provide loans on responsible terms and reporting that enables consumers to build up positive credit records. Yet a significant number of low-income, low-asset individuals sit on the sidelines of the traditional

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<sup>6</sup> Legislation that has passed the United States Senate and is pending before the House of Representatives would significantly expand federal support for IDAs by providing financial institutions with tax credits for both IDA administration and matching funds. Savings for Working Families Act, Title V of S.272, 108<sup>th</sup> Congress.

financial services marketplace, often because their immediate needs are not met by traditional offerings.

A good deal has been written on this subject over the last several years, most recently in an analysis of the 2001 Survey of Consumer Finance in the January 2003 issue of the Federal Reserve Bulletin by Aizcorbe, Kennickell, and Moore. They found that, of those without checking accounts, 28.6% thought they did not write enough checks to make it worthwhile, but a full 22.6% simply did not like dealing with banks; 10.2% found service charges too high, while only 3.6% cited “credit problems.” However, among the half of the sample currently without a checking account who had had one in the past, 12.8% said services charges were too high and 6.3% cited “credit problems.” It is not only self-selection that keeps people who have had difficulty managing checking accounts out of the banking system. Most banks subscribe to and use ChexSystems, a database that tracks individuals who have had problems (ranging from bounced checks to fraud) managing checking accounts over the prior five years. Until recently, being listed on ChexSystems, no matter what the cause, was sufficient reason to deny an individual an opportunity to open a checking account at the nation’s largest banks (Michelle, 2002; Park, 2003).

### **Why Families Lack a Checking Account**

<b>REASON</b>	<b>Percentage of Respondents</b>
Do not write enough checks to make it worthwhile	28.6%
Minimum balance is too high	6.5%
Do not like dealing with banks	22.6%
Service charges are too high	10.2%
Cannot manage or balance a checking account	6.6%
No bank has convenient hours or location	0.4%
Do not have enough money	14%
Credit problems	3.6%
Do not need/want an account	5.3%
Other	2.1%
Total	100%

(Aizcorbe, Kennickell, and Moore, 2003)

Other studies have expanded on respondents' stated dislike of banks, citing negative experiences in dealing with banks, either in this country or abroad; lack of proper identification; lack of immediate availability of funds; inconvenient locations and hours; difficulty understanding bank fees (resulting in uncertainty and sometimes prior bad experience in using an account); and lack of the full array of services a customer might want, such as inexpensive money orders to pay rent to landlords, who often will not take checks (Caskey, 2001; Carr and Schuetz, 2001; Bair, 2003; Bendixen and Suro, 2002). More subtle factors can also discourage low-income consumers. These include the lack of bilingual front-line and customer service staff, a culture that does not emphasize sales or customer service (and thus is not inclined to reach out either to a stranger walking into the lobby or to someone who does not fully understand the terms of an account), and the intimidating manner in which bank lobbies are physically organized (*Wall Street Journal*, 2003). Finally, surveys and interviews show that privacy concerns keep some low-income families from interacting with mainstream banks. This is a growing area of concern for undocumented immigrants, who worry that their information will be shared with immigration authorities.

Comparing a typical menu of bank products with the reasons why some Americans choose not to have a banking relationship suggests that the problem may not be lack of demand, but rather the lack of an appropriate and appealing supply. While traditional banking institutions are well positioned to meet low-income families' long-term financial needs, most are ill-equipped to meet their immediate and short-term needs. Traditional checking accounts are predicated on consumer liquidity, a luxury poor people do not generally have. Even banks that have one or two products appropriate for modest-income consumers generally lack a full line of products that would enable consumers to build on their initial successes. In addition, bank branches are often inconveniently located for the poor and do not offer them a comfortable atmosphere. While the financial services industry is quite sophisticated about segmenting upper-income consumers and crafting appropriate marketing messages to reach them, little attention has been paid to outreach efforts at the lower end of the income scale.

Moreover, what is required to encourage asset building among low-income consumers is not merely a more robust set of financial products and services, but a holistic approach to engaging with these customers. Consider, for instance, 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 becoming transactors, then savers, then borrowers, and, finally, owners.

This model is frequently revisited and revised by the credit union, a Community Development Financial Institution (CDFI) and a participant in the Retail Financial Services Initiative.<sup>7</sup> The Credit Path assists Alternatives in product development, cross-selling, marketing, and evaluation, all with the goal of helping customers build assets. In fact, the Alternatives Board of Directors has set the goal of enabling customers to move through the Credit Path, from start to homeownership, in three years.

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 will grow far more slowly and they will face more obstacles along the path to longer-term prosperity. The question is, what can depository institutions, community-based organizations, the government, and others (such as vendors of innovative, cost-reducing products) do to make the financial services system a more fully effective means of asset building for low-income consumers?

### **Asset Building and Financial Services: The Supply**

Traditional depositories face a host of financial, structural, and cultural challenges in serving low-income consumers both well and profitably. The trends described earlier, however — rapid technological change, the rise of the alternative financial services sector, an increased focus on assets, 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 in ways that ultimately may promote asset building. Three recent developments in the marketplace provide a glimpse of the potential:

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<sup>7</sup> The Retail Financial Services Initiative (RFSI) is a three-year project to expand access to financial services and wealth-building opportunities for low- and moderate-income consumers. Organized by the National Community Investment Fund and funded by the Ford, John D. and Catherine T. MacArthur, Annie E. Casey, and Fannie Mae foundations, the initiative has as its goal increasing the quantity and quality of financial services for low- and moderate-income consumers by developing, testing and publicizing replicable business models for serving this market. The initiative was formally launched on January 1, 2003, with a group of 12 community banks and credit unions from across the country. Many of the examples in this paper come from the work of RFSI participating institutions.

***The players are changing.*** The constellation of firms that constitutes the financial services industry continues to grow and shift, creating new opportunities and new leverage points. Companies that used to be considered financial services vendors, providing products for banks to use, are now marketing their products directly to consumers or using other non-bank firms (such as retailers or employers) to market them. In addition, a whole new category of technology “enablers” has emerged, providing enhanced platforms for reaching consumers and moving funds. With the support of the Ford Foundation, in early 2004 ShoreBank Advisory Services will launch the Center for Financial Services Innovation to work within this broad marketplace to find promising innovations that will enhance the interest and ability of the financial services sector to build long-term relationships with low-income, low asset consumers. The Center will also broker partnerships and invest in promising products, practices and partnerships.

***Unconventional partnerships are emerging.*** The growing variety of firms that now constitute the financial services market has led to new, and often unlikely, partnerships. 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.

***Access is growing and changing.*** New partnerships are both being driven by and resulting in a new array of access points for transacting financial business. The functionality of these delivery channels is increasing over time, offering the potential 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 hold promise for engaging greater numbers of low-income, low-asset consumers and presenting them with asset-building opportunities.

The market clearly is moving, increasingly serving the low-income community. Moreover, in some areas, enhanced competition has produced not only lower prices but also significant innovation. A scan of the financial services landscape, coupled with dozens of

interviews with industry actors, points to five broad strategies that hold significant promise for connecting low-income consumers with asset-building opportunities:

- the workplace as an access point and distribution channel
- remittances
- stored-value cards
- bank/non-bank partnerships
- self-service delivery

These strategies speak simultaneously to the immediate and short-term needs of low-income consumers and to the profit-making motive of financial institutions. However, additional innovation and experimentation are needed to ensure a link to asset building. They hold promise because they meet five important tests:

- They leverage opportunities to reduce costs and increase productivity through technology, without requiring the expense of entirely new platforms.
- They have demonstrated a potential to reduce customer acquisition costs through partnerships and technologies that facilitate broader access and reach.
- They do not require wholesale government intervention or subsidy (though some regulatory changes could be beneficial in broadening product functionality and speeding wider industry adoption).
- A significant amount of firm-level innovation is already occurring, and both new and existing players have emerged as potential change leaders.
- Low-income consumers have demonstrated early acceptance of these product innovations.

The remainder of this paper describes each of these strategies, where they seem to be taking hold, and the opportunities for and barriers to their expansion.

## Strategies for Closing the Supply Gap

STRATEGY	KEY OPPORTUNITIES
The workplace as an access point and distribution channel	<ul style="list-style-type: none"> <li>• Provides access to potentially large pools of low-wage workers.</li> <li>• Builds on existing platforms — automated payroll savings, retirement accounts.</li> <li>• Builds on employers’ stake in financial well-being of employees.</li> </ul>
Remittances	<ul style="list-style-type: none"> <li>• Provide consumer entry point that could lead to other financial products.</li> <li>• Reduce costs for financial institutions, fees for consumers.</li> </ul>
Stored-value cards	<ul style="list-style-type: none"> <li>• Meet liquidity needs, transactional preferences of low-income consumers.</li> <li>• Reduce typical account costs for depositories.</li> </ul>
Bank/non-bank partnerships	<ul style="list-style-type: none"> <li>• Increase the reach of depositories while keeping costs low.</li> <li>• Recognize needs, preferences of low-income consumers.</li> </ul>
Self-service delivery	<ul style="list-style-type: none"> <li>• Reduces transaction costs while improving consumer access.</li> </ul>

### **The Workplace as an Access Point and Distribution Channel**

As an institution that features regular contact between the mainstream economy and low-income, low-asset workers, the workplace presents tremendous opportunities to help these employees build assets. Indeed, as the locus for automatic payroll savings plans and retirement savings plans, such as 401(k) accounts, the workplace has long been a favored asset-building channel for higher-wage workers. The same technology that has made this possible, coupled with newer technologies such as payroll cards, provides the opportunity to extend these benefits to lower-wage workers.

The employment relationship has changed significantly over the last 20 years, with more people being employed by smaller entities for shorter periods of time. Moreover, the traditional role many credit unions played for large-scale employers — often providing not only bank

accounts and auto loans but also financial education and even emergency payday loans — is not being replicated among the smaller employers where, increasingly, unbanked individuals and those underserved by the traditional financial services system are employed. At the same time, new research indicates that employers have a stake in the financial well-being of their employees. According to one study, the cost to an employer of an employee who is financially stressed is \$400 annually, primarily in time wasted and absenteeism. Other studies suggest that 20% to 30% of low-wage workers are under financial stress great enough to hurt their productivity. While financial literacy programs can help reduce financial stress, employers whose programs go beyond literacy to connect employees to bank accounts, help them save, and even provide for responsible short-term emergency loans have better results (Filene Research Institute, 2002). For example, Legacy Bank in Milwaukee, Wisconsin, an RFSI participant, has been extremely successful in bringing low-income day-care center owners and employees into the financial mainstream through a combination of workplace-based financial education and strong customer service.

One of the most successful workplace financial-access efforts is the partnership between the First National Bank and Trust of Rogers, Arkansas (an Arvest Bank) and North Arkansas Poultry, a Tyson Food subcontractor with a workforce that consists almost entirely of Latin American immigrants. Before the program started in 1993, employee turnover was over 200% and the bank had few Latino customers in a town whose population was fast shifting to include many Latinos. The bank's partnership with the company consisted of a financial education course taught by a Spanish-speaking bank employee (on company property, on company time, and paid for by the company) along with more targeted outreach by the bank. By November 2000, Arvest had helped more than 700 immigrant families to buy homes, generating over \$20 million in mortgage loans for the bank; meanwhile, the turnover in the plant had declined to 15 – 20% (Schoenholtz and Stanton, 2001).

The workplace can efficiently bring together three parties — worker, employer, and financial institution — that all have an interest in working together to improve the financial status of the worker. For financial services firms, the workplace represents an already heavily automated access point for reaching large pools of underserved consumers. For workers, an employer partnership with a depository institution provides an opportunity to receive earnings quickly and safely, as well as access to the type of structured, automated savings mechanisms

that make asset building more likely. For employers, such a partnership provides an opportunity not only to reduce payroll costs, but also to enhance worker productivity and retention.

### ***The Changing Technology of the Workplace***

Numerous developments have occurred in the way financial services are delivered in the workplace. Two of the most important are direct deposit and retirement saving.

Direct deposit of employee pay became a reality with the formation of the National Automated Clearing House Association (NACHA) in the mid-1970s. A 1998 American Payroll Association survey of employers showed that 56% of employees have their paychecks directly deposited, compared with near-universal usage of this option by workers in Japan and Europe. Both employers and financial institutions favor direct deposit because of the cost savings — an estimated \$1.25 per paycheck for employers and 70 cents per electronic transaction (in contrast to teller use) for financial institutions. Half of the employees who refuse direct deposit do so because they have no bank account (American Payroll Association, 1998). Visa U.S.A. estimates that payroll checks worth \$500 billion are issued each year to unbanked employees (*American Banker*, 2002).

To serve unbanked employees and reduce payroll costs even further, increasing numbers of employers are replacing paper paychecks with electronic payroll cards. A Celent Communications study estimates that 10% of unbanked households were using payroll cards in 2002, with usage expected to increase to 30% in 2005 (Moore, 2002). Currently, more than 2.2 million payroll cards are used, double the number used a year ago (Mayer, 2004). These cards generally take one of two forms. Some are linked to a pooled payroll account owned by the employer or the payroll card operator, while others are backed by individually owned bank accounts. As noted in the stored-value card section below, the cards' utility in moving employees toward building assets depends in part on how the card is structured (Office of the Comptroller of the Currency, 2003).

Employer-sponsored retirement saving plans also have changed significantly over time. Beyond the shift by many employers from defined-benefit to defined-contribution plans, the systems developed by financial services firms to manage retirement plans have reduced administration costs, increased investment options, and facilitated self-service management for employees through the Internet. Yet these benefits often do not impact low-wage workers, either because their employers do not offer retirement saving plans or because they choose not to

participate. Research on savings behavior suggests that saving is more likely when there are automatic mechanisms to facilitate it. For instance, one study found that automatic enrollment for 401(k) plans boosted participation rates from 37% to 86%, with even sharper increases for lower-paid employees (Madrian and Shea, 2000). Furthermore, automatic deduction of funds from an employee's paycheck for placement in a pooled retirement account is feasible whether or not the employee has a bank account.

More recently, a handful of employers have begun experimenting with a new crop of wealth-building products and services for employees. Some are beginning to incorporate college savings plans, known as 529 plans, into employee benefit offerings by holding educational seminars and using payroll deduction to facilitate participation (Clancy, 2003). A 2002 survey of benefits executives from 605 companies with at least 50 employees indicated that 14% currently offer 529 savings plans as an employee benefit or plan to offer them in the next 18 months (MetLife, 2002). Others, like Marriott International, are offering Individual Development Accounts to qualifying employees through partnerships with nonprofit organizations and state governments. Finally, community groups have begun working with employers to provide their employees with information about filing for the Earned Income Tax Credit. At the end of 2003, for instance, Corporate Voices for Working Families, a nonprofit corporate membership organization of 41 large employers, created and distributed an EITC Toolkit to highlight the benefit to employers of helping employees apply for the credit.

### ***Leveraging the Employment Relationship to Build Assets: Moving the Market***

While much has already occurred in the employer-based market, a good deal more needs to be done. In particular, moving from payroll cards, even when account-based, to true participation in asset building will require both structural changes and, more importantly, additional attention to financial education by both financial institutions and employers. Such education will be necessary to ensure that fees are reasonably structured and minimally used. Also, payroll-card functionality needs to be more robust to encourage saving and asset building. For instance, payroll deduction is a powerful mechanism for encouraging retirement savings; it could also be used in combination with a payroll card to facilitate shorter-term saving.

Marketing efforts targeted to low-wage workers by financial institutions and employers also need to be improved. Commercial bankers, who tend to manage employer relationships, need to work more closely with those who know how to market to low-wage workers in order to

increase the acceptance rate of direct deposit and payroll-card products. One possibility would be to build on the employee assistance program model, developing a new component to provide financial information and counseling by pairing expensive human intermediaries with other sources of information available via the Internet or kiosk. Also, more employers could market the Earned Income Tax Credit (EITC) to their low-wage workers, facilitating quick refund receipt and deposit in the short term — and broader financial engagement in the long term — by linking employees with a bank account, payroll card, or other mechanism. ShoreBank was one of the first financial institutions to develop links between the EITC, savings accounts, and direct deposit. In partnership with the Center for Economic Progress (CEP), the bank offers EITC-eligible tax filers free savings accounts that can be opened with direct deposit of the expected refund. Nearly two-thirds of participants were unbanked when they signed up; about one-fifth of them went on to use the account to have their payroll checks deposited directly.

## **Remittances**

Remittances — vehicles for transferring funds from one country to another — are a major product of financial services systems around the world. The worldwide remittance total, acknowledged to be significantly understated, has been estimated at more than \$100 billion annually. In 2002, Latino immigrants in the United States sent approximately \$32 billion home, with almost a third to going Mexico (Orozco, 2003). The average remittance amount to Latin America is \$260, and remittances represent 2% of the region's GDP (Orozco, 2004). While the share of an immigrant's income sent home in remittances varies with the length of time in the United States, it is frequently more than 20%, with lower-income Latinos accounting for the bulk of remittances (Orozco, 2003). According to the Inter-American Development Bank, fees earned annually from remittances exceed \$3 billion (WOCCU, 2003).

Until recently, money transfer agents, such as MoneyGram and Western Union, had an almost complete monopoly on consumer remittances. Fees were high, and unfavorable exchange rates in recipient countries made the total cost even higher. Starting in 1996, however, and especially since the election of Vicente Fox as President of Mexico, banks and credit unions have shown increasing interest in this market, launching a series of cheaper alternatives (Orozco, 2003). In January 2004, following the Special Summit of the Americas, the White House announced its commitment to lower the cost of remittances by half within five years by

establishing a regionally compatible electronic payment system (*American Banker*, 2004; Declaration of Nuevo Leon, 2004). The critical factors encouraging banks and credit unions to move into this market appear to be the demographics of the Latino community, increasing use of ATMs by Latinos in this country and in Latin America (making technological solutions to cost reduction more feasible), and growing acceptance of alternative forms of identification to support opening bank accounts, in particular the *matrícula consular* offered by the Mexican government.

Remittances have the potential to be an important entry point, both for banks and credit unions entering the burgeoning Latino market and for Latinos entering the mainstream financial system. They are heavily used by young, low-income, unbanked Latinos, a customer base that traditional banks have had a hard time attracting. Technology is allowing banks to offer remittances more cheaply than their non-bank competitors, reducing both production and customer acquisition costs. Once these new Latino customers are in the door, firms have the opportunity to provide additional products and services.

As banks and credit unions have entered the remittance market over the past 24 to 36 months, prices have dropped significantly. From November 2001 to November 2002, the average cost of a remittance to Latin America fell from \$17.46 to \$16.02, a 9% decline (Orozco, 2003; *American Banker*, 2003). In general, bank remittance products fall into one of three models, in order of lowest to highest cost: dual ATM or debit cards for the sender and the receiver, with funds available via ATM; banks operating as the money transfer agents, in partnership with Mexican banks acting as the receivers; and traditional wire transfer. Numerous banks, large and small, have created dual ATM card accounts with the expectation that one card will be sent to relatives abroad, who will be able to use the ATMs in their home country. Other notable examples of product innovation include the following:

- In 2000, the World Council of Credit Unions (WOCCU) launched the International Remittance Network (IRnet) in partnership with Vigo Remittance Corporation. Remittances of up to \$1,000 cost the sender \$10. The service provides credit unions a way both to attract new members and to serve people who would otherwise not have access to traditional financial services. During 2002, IRnet wired more than \$50 million, exceeding projections by more than 65% (WOCCU, 2002). The Latino Community

Credit Union in Durham, North Carolina, is an important part of this network, serving over 9,600 Latino customers and sending over \$1 million in remittances to Latin America (mainly Mexico) during 2002, its first full year of operation (*Winston-Salem Journal*, 2003; *Wall Street Journal*, 2003).

- Almost all of the nation's largest banks have developed new product offerings. For instance, Wells Fargo has been experimenting with remittance products since 1995 through a partnership with Grupo Financiero Bancomer, Mexico's largest bank. In January 2002, it began piloting Dinero al Instante, which allows Mexican nationals residing in the United States to send money from Wells Fargo branches to Bancomer branches in Mexico. Neither the sender nor the receiver needs a bank account to use the service. In June 2002, the bank expanded its InterCuenta Express product, which allows for account-to-account transfer of funds. Both products allow customers to send up to \$1,000 a day for \$10.
- U.S. Bancorp and the Mexican banking alliance known as La Red de la Gente announced a partnership that will permit people in the United States to transfer money to friends or relatives in Mexico for fees as low as \$6. The money can be received in Mexico through savings accounts or picked up in cash at any of the branch locations of La Red de la Gente. La Red was created by Banco de Ahorro Nacional y Servicios Financieros (Bansefi) and 17 other Mexican banking institutions, serves mainly low-income customers and operates in 750 locations (Breitkopf, 2003; *American Banker*, 2003).

### ***Remittance to Relationship: Moving the Market***

External factors have encouraged new market entrants, increasing the supply of less costly remittance products for Latinos. To move the market further, additional experimentation is needed to translate that first product — a remittance — into a broader financial relationship. In October 2002, for instance, Harris Bank in Chicago opened its first Harris Express outlet in a predominantly Latino neighborhood in Chicago, having piloted an in-branch concept the previous summer. The store offers both traditional bank accounts and services similar to those provided by a check casher, including remittances to Mexico for \$12, made possible through a relationship with Mexico's Bancomer. The goal is to move 25% of check-cashing customers into regular banking accounts. Another effort made by the bank — the installation of Spanish-

speaking tellers in 24 special branches — led to an increase in deposits from Latino customers from \$15 million to \$200 million (*Chicago Sun-Times*, 2002).

Partnerships between large financial services firms that have developed low-cost products and other institutions trusted by Latinos are another way of building a broader financial relationship with consumers while simultaneously reducing distribution costs. JP Morgan Chase is using its existing stored-value card platform to offer a card-to-card remittance product with the United Farm Workers of America. Union members who sign up receive two cards, one to keep and one to send to family members in Mexico (who can use the card to access, via ATM, funds transferred by the worker to the card). The bank is hoping to expand the service through a partnership with the AFL-CIO.

Finally, the addition of a structured savings feature would turn what is a purely transactional product into an asset-building opportunity. When loading an ATM card with funds to be sent abroad, the consumer should also be able to designate a portion of the funds to be diverted to a savings or investment product.

While the remittance market appears to be a perfect example of competition at work to the benefit of all, challenges remain, both to the ability of banks and credit unions to offer the basic product, and, more particularly, to the broader goal of using remittances as a path to asset building. In particular, the USA Patriot Act and concerns about illegal immigration are putting pressure on the use of the *matrícula* and raising questions about ongoing acceptance by banks and credit unions of alternative forms of identification from undocumented immigrants. In May 2003, banking and securities regulators issued regulations concerning identification requirements under the Patriot Act for opening bank accounts. These regulations allowed use of the *matrícula*. In June of that year, however, Congress held a hearing questioning this position, and the Treasury Department issued a highly unusual “Notice of Inquiry” on this part of the regulation. Although the regulation has remained unchanged, conversations with regulators concerning the implications of the Patriot Act for the ability of banks and credit unions to serve this market will be needed. These conversations should be aimed at ensuring that the regulations are interpreted in ways that balance concerns about national security and fraud with the need to provide immigrants with increased access to full financial services.

## **Stored-Value Cards**

The first stored-value cards were transit-fare cards and electronic gift certificates. They were, in essence, electronic cash: they could be spent, but not reloaded, and if lost or stolen the owner had no recourse. The acceptance of these cards, which have become increasingly sophisticated, has grown substantially. The value of gift card sales rose from \$33 billion in 2002 to \$42 billion in 2003 (Mayer, 2004). The next iteration arrived with electronic-benefits transfer; welfare recipients (and, later, recipients of food stamps and other government benefits) received cards in lieu of checks. These cards, unlike the original stored-value cards, do not contain the value; instead, they are used to access electronic networks, through which the funds are tracked and stored. Today, the cards are used for a variety of purposes, including both one-time payments, such as insurance claims, and recurring payments such as payroll (discussed above) and child support.

At a minimum, stored-value cards provide financial services firms with a less costly mechanism for offering consumers a basic transaction vehicle and a safe place to store funds, merging the payment and saving applications into one product. More specialized than checking accounts, these cards appeal to cash consumers who prefer a pay-as-you-go structure without the uncertainty of overdraft and bounced-check fees. The portability of stored-value cards and the variety of distribution channels available for selling and loading them provide increased opportunities to reach low-income consumers.

For traditional depositories, these cards offer a promising way to reach a new consumer segment. According to the 2002 ABA Bank Card Survey Report, 21% of bank issuers of debit cards planned to offer stored-value cards in 2003, compared with 9% in 2002 (American Bankers Association, 2002). For non-bank firms, the cards broaden their typical product offerings, enabling them to offer a quasi-savings vehicle. For instance, the nation's two largest tax preparation firms recently established partnerships with stored-value card vendors to enable their customers to receive their tax refunds electronically. H&R Block has partnered with Bank of America, which added functions like remittances and in-branch transactions to its existing card product; the company began piloting the card in three U.S. markets during the 2004 tax season. Jackson Hewitt, meanwhile, has joined forces with Rush Communications, run by rap music impresario Russell Simmons, to offer its customers the Rush Card.

An important distinction among the various kinds of stored-value cards is whether they are linked to pooled accounts, in which the funds of individual cardholders are co-mingled, or to separate bank accounts owned by individual consumers. Individually owned accounts are more expensive to provide and maintain, but they offer FDIC insurance and greater consumer protections against loss or theft.<sup>8</sup> They also afford consumers a potentially tighter connection to asset-building opportunities, although few of the existing individual-account products actually leverage this possible advantage.

### ***From Cards to Savings: Moving the Market***

The lower cost of stored-value cards relative to traditional bank accounts, coupled with the increasing automation of the payment-system environment, has led to significant product innovation. Stored-value cards have important potential benefits for low-income, low-asset consumers. The cards enable customers to move out of the cash economy, using a safer medium of exchange that also makes available to them innumerable products and services that are almost impossible to access with cash. These benefits, however, are only modestly linked to asset-building. They may even have the opposite effect, because stored-value cards often carry high initiation and transaction fees, and may also encourage increased consumption by facilitating purchases that typically require a credit or debit card (such as those made over the Internet). If the cards are truly to mimic bank accounts and start low-income, low-asset consumers on the asset-building path, even greater card functionality is needed. Some potential strategies are:

- Broaden the methods and locations available to consumers for loading additional funds on stored-value cards. This could increase competition between banks and non-banks, creating additional opportunities for low-income consumers.
- Add a longer-term savings component to stored-value cards, which are currently designed only as short-term storage vehicles. Develop a partnership between a card vendor and a low-cost mutual fund provider to enable customers to move funds electronically from the card into an investment account in small increments. Alternatively, set up a structured savings mechanism that automatically sweeps money each month from the card to a savings or investment account.

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<sup>8</sup> Stored-value cards in which the funds are held in a single pooled account with sub-accounts may qualify for pass-through FDIC insurance if the sub-accounts are administered properly.

- Work with regulators to clarify whether and under what conditions FDIC insurance and other consumer protections will apply to stored-value cards. In addition, work with credit bureaus to include ownership of a stored-value card as a positive indicator in credit-scoring models — even if the card itself is not backed by an individually owned account. NetSpend Corporation is one of the first non-bank stored-value card vendors to offer customers the ability to be linked with the credit reporting system. When enrolled in the CredAbility program, customers authorize NetSpend to send a positive monthly report to the credit bureau as an “on-time” payment of the \$9.95 monthly cardholder fee, as if making a utility payment.

### **Bank and Non-Bank Financial Services Providers: Blurring the Lines**

Some of the most promising — and most controversial — strategies to enhance asset-building opportunities through financial services come in the form of partnerships between banks and non-traditional partners. These partnerships have taken three forms:

*Depository/check-casher partnerships.* The \$250 million SSA Baltimore Federal Credit Union<sup>9</sup> recently expanded its charter to serve the city of Baltimore and has opened Our Money Place, a collaborative financial services center located in a low-income neighborhood strip mall that includes a check casher and a nonprofit community group. To keep costs down, the credit union does not have cash on the premises, but does guarantee its members’ checks to the check casher, who cashes the checks for a reduced fee if a member needs immediate access to funds. The nonprofit, which developed the concept and the collaboration, provides outreach and education. The credit union hopes to expand this partnership citywide by opening other cashless neighborhood contact offices in a church library, the Hispanic Chamber of Commerce, and a senior center (*Credit Union Times*, 2003). More broadly, credit unions have been exploring potential partnerships with check cashers, both individually and through their trade associations.

*Retailer/depository partnerships.* 7-Eleven has begun the rollout of 3,500 Vcom kiosks that cash checks, sell money orders, transfer money abroad, pay bills, and allow for some e-commerce transactions. The retailer has partnered with a wide array of firms for this project,

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<sup>9</sup> SSA Baltimore Federal Credit Union is an RFSI participant.

choosing American Express to provide ATM services. American Express already provides ATM services for about 90% of 7-Eleven's 5,300 stores in the U.S. as a way of creating greater access for customers of American Express Centurion Bank, which operates primarily online.

***Depository/community-based organization partnerships.*** Two California banks, Hawthorne Savings Bank<sup>10</sup> and California National Bank, have each purchased an office of a nonprofit financial counseling center, Operation Hope, and opened branches to reach out to the unbanked. Operation Hope will continue to provide credit counseling and other services at the branches. Operation Hope is also attempting to apply this same strategy in additional parts of the country, partnering with other banks to open high-touch branches in underserved areas.

These examples illustrate an important paradigm shift in which function is emphasized over form. More financial services providers of all kinds are beginning to focus on the methods needed to deliver the right product functionality to low-income consumers, breaking free of the constraints of legacy systems and conventional wisdom in order to better meet customer needs. In some cases, banks are recognizing that they may be better suited to a back-end role, such as processing payments and moving money, rather than the front-end job of attracting low-income customers. In other cases, banks and credit unions are making dramatic changes in product mix and branch operations to better reach the market. While such partnerships present opportunities to better reach and serve low-income consumers, they also require careful strategies to ensure reasonable and transparent pricing and to facilitate true asset-building opportunities.

### ***New Partnerships to Build Assets: Moving the Market***

Accompanying the rapid growth of the non-bank financial services sector has been a growing recognition that check-cashing outlets and similar businesses represent a powerful distribution channel for reaching lower-income consumers. Moreover, a 2000 industry survey of check-cashing customers showed that 49% would use savings accounts if they were available from their regular check-cashing outlets (Eric Mower Associates, 2000). It is the potential combination of transactional and asset-building products and services that holds the greatest promise for meeting the needs of low-income consumers. The most well-known example of this is Union Bank of California's Cash 'N' Save division. Conceived more than 10 years ago and championed by the firm's vice chairman, this banking/check-cashing hybrid operates both in

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<sup>10</sup> Hawthorne Savings Bank is an RFSI participant.

Union Bank branches and in retail locations, offering reduced-fee check cashing and specialized starter bank-account products. The bank reports a 40% rate of converting check-cashing customers to bank-account use. This does not mean that consumers stop using check-cashing services; rather, many continue to use both check-cashing *and* banking services — an important insight when developing new business models for serving LMI consumers.

Technology is an important ingredient in many bank/non-bank partnerships. For instance, a unique payment terminal called a Point of Banking (POB) machine is what facilitates the partnership between Bethex Federal Credit Union, an \$11 million low-income credit union in the Bronx, and RiteCheck, a check-cashing chain with 14 outlets in the Bronx and Manhattan.<sup>11</sup> Bethex customers can complete transactions — including deposits, withdrawals, transfers, and balance inquiries — at RiteCheck locations through the POB, which functions like an ATM with a human teller to accept and dispense cash. Currently, POBs are supported only in the New York area, and a joint industry committee of credit unions and check cashers has been formed to support expansion of the service. POB service is now provided to clients of other credit unions, such as Actors Federal Credit Union, and is available in more than 100 check-cashing outlets. A national expansion could facilitate additional partnerships.

For transaction-based partnerships to lead to asset building, it is critical that non-bank financial services providers be linked to the broader credit-reporting system, such that non-bank financial activity is captured in credit reports and credit-scoring models. For instance, timely repayment of payday loans should be considered an indication of positive credit behavior, so that the consumer can eventually qualify for a more traditional loan.

The current regulatory framework can create obstacles to implementing partnerships between banks and non-banks. This happens, in part, because banks tend to be regulated at the federal level, while non-bank financial service providers are largely regulated at the state level. Moreover, state regulations vary widely. Conversations between industry players and both federal and state regulators could help increase understanding of the opportunities and challenges in this arena, leading to new interpretations that will ease partnership formation. It is critical that, in the course of promoting partnerships with alternative services providers, all parties focus on asset-building and avoid predatory practices.

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<sup>11</sup> Bethex Federal Credit Union is an RFSI participant.

## **Self-Service Delivery: Balancing High-Tech and High-Touch**

The lure of self-service delivery of financial services to low-income consumers is the vastly reduced cost of such transactions. While an account withdrawal at a teller costs a bank approximately \$1.07, a similar transaction at an ATM costs only \$0.27; over the Internet, it costs a mere \$0.015 (Weissbourd, 2002). Today, the attractiveness of self-service delivery has been enhanced by the advent of advanced-functioning ATMs, Internet transactions, and computer kiosks that offer the vision of greater penetration into the low- and moderate-income community.

Financial institutions were virtually the only ATM operators for nearly two decades. That changed when the ban on surcharging by ATM owners was dropped in 1996, leading to increased competition from retailers and other independent operators, who began deploying inexpensive cash-dispensing ATMs in nearly every location imaginable. While the number of ATMs has nearly quadrupled over the past decade, however (to 324,000 nationwide), the number of monthly transactions per machine has been cut in half since 1997 (Higgins, 2002) and the machines have become less profitable to operate. Eager to find other ways to generate fees, ATM operators have been experimenting with dispensing a variety of other financial and non-financial products and services. These include selling postage stamps, phone cards and airline tickets; paying bills; offering overdraft protection; and even sending flowers or buying CDs. While some of the experiments have been mildly successful, the industry has yet to find a new business model that is as popular with consumers as cash dispensing.

There has been a growing realization, however, that (with the addition of a cash acceptor) ATMs could offer transaction services for people without bank accounts. Innoventry, once known as Mr. Payroll, was one of the first companies to develop an electronic check-cashing machine. Several firms have followed suit, particularly in the wake of Innoventry's demise. ATM manufacturer Diebold has been testing an ATM machine that allows customers to purchase money orders to the penny, whether or not they have bank accounts. Diebold's primary competitor, NCR Corp., has developed a machine that revolutionizes the deposit-taking function, and Bank One began piloting the machines last year in Kentucky and Indiana. Deposits, made without envelopes, are scanned by the machine and partially processed, reducing costs for financial institutions and providing the consumer with immediate availability of cash deposits — an important selling point for many low-income consumers. Finally, some former Innoventry

principals have started a new company, CashWorks, that allows retailers to cash customers' checks through a point-of-sale terminal loaded with proprietary software.

One of the most significant developments in the marketplace is the partnership between 7-Eleven, NCR Corp., and transaction processor Certegy Inc. to provide self-service financial transactions in convenience stores. After years of development and testing, 7-Eleven has rolled out the first 1,000 of an eventual 3,500 Vcom kiosks that will cash checks, sell money orders, transfer money abroad, pay bills, and allow for some e-commerce transactions, in addition to providing more traditional ATM services. 7-Eleven stores already sell \$4.5 billion in money orders annually; the Vcoms will reduce transaction costs for 7-Eleven, while increasing revenue by permitting the sale of companion financial services. The fee structure is similar to that of a typical check casher (*Tampa Tribune*, 2002; *American Banker*, 2003). It is still unclear whether the strategy will work. If it is successful, the initiative could increase competition and ultimately bring down costs for the consumer.

Although banks continue to struggle to develop workable business models for online banking, the Internet has emerged as an important delivery channel. Beyond facilitating all sorts of financial transactions, the Internet has, in part, enabled several non-bank financial services firms to move into banking, among them E\*Trade and State Farm. At the same time, efforts by community groups, technology firms, and the federal government to increase computer and Internet access for lower-income consumers have led to the creation of hundreds of community technology centers (CTCs) in low-income communities nationwide.

Along with the Internet, however, has come the recognition that most consumers still want access to a range of delivery channels, as well as some human interaction for certain transactions. This is particularly true for the low-income market. For instance, the Latino Community Credit Union in Durham, North Carolina, which has had enormous success in opening accounts for recent immigrants, has used both individualized instruction and incentives (such as raffles in which the prize can only be claimed by using an ATM machine) to convince customers to try the machines and thus reduce teller lines. Conversely, the credit union recently decided to close down the drive-through lane at a new branch it had acquired because it would have compromised the strength of face-to-face interactions with customers.

### ***Self-Service That Is More than Transactional: Moving the Market***

Self-service financial technology is expensive, and it is unlikely that new functionality will be developed or deployed just for low-income consumers. Those who do choose to deploy it are often focused on new fee revenue opportunities rather than on the opportunity to link consumers with broader wealth-building opportunities. For example, as 7-Eleven and its partners reach out to the unbanked, advocates for lower-income consumers need to reach out to 7-Eleven to ensure that transactions are fairly priced and that the machines will provide access to a broader range of wealth-building products and services. Linking 7-Eleven with equally high-profile community and advocacy groups could help the company better understand and reach LMI consumers. Through partnerships with other financial services firms, the company also could expand its product offerings to include a savings vehicle for check-cashing customers. Given the e-commerce capabilities of the Vcom kiosk, a connection to online banking might also be feasible.

The nation's banks have been slow to deploy multifunction ATMs that provide both traditional offerings and cash transaction services, and to increase the presence of such machines in low- and moderate-income communities. Most ATMs run on the outdated IBM OS/2 operating platform. As six of the 10 largest U.S. banks upgrade their machines to the Microsoft NT operating system, they are also expanding machine functionality, offering an opportunity to influence what the machines can do and where they are placed.

It is also important to continue to experiment with Internet and kiosk delivery (tailored for low- and moderate-income consumers) by improving content and linking information and education with the ability to register for products and conduct transactions. Products built on Internet access offer the lowest-cost delivery method, in part because they can leverage existing computers by linking content providers, financial services firms, and the many libraries and community technology centers (CTCs) that provide free or low-cost access to computers and educational programming. An example of this strategy is One Economy, a nonprofit organization working to connect subsidized housing residents with computers and unique, multilingual Internet content geared to lower-income consumers. The organization has developed a new website for consumers, the Beehive, and is searching for financial services partners to transform the site from a passive purveyor of information to an enabler of transactions.

Better data on the nature and extent of low-income consumer demand for self-service delivery could highlight the potential for additional products and services and help firms develop new business models that support their provision. The experience of financial services and technology providers in moving low-income consumers to self-service delivery has been mixed. Finding the right balance between high-tech delivery and high-touch service, while also keeping costs low, will be important.

### **What is Missing?**

Changes in the financial services landscape have led to significant product innovation that has the potential to increase asset-building opportunities for low-income, low-asset consumers, many of whom are unbanked or underserved by traditional financial institutions. A number of barriers remain, however, including: a) cultural and structural barriers within financial institutions; b) a lack of the market data needed to make a business case for outreach; c) business models that require large volumes of customers; d) the need to identify appropriate partners; and e) a regulatory system that does not always keep pace with market change.

## Barriers to Closing the Supply Gap

BARRIERS	KEY ISSUES
Cultural barriers	<ul style="list-style-type: none"> <li>• Conservative culture in banking industry.</li> <li>• High level of risk aversion towards low-income consumers.</li> <li>• Conventional business model may not be appropriate to underserved customers.</li> </ul>
Lack of market data	<ul style="list-style-type: none"> <li>• Insufficient industry information about needs and preferences of low-income consumers.</li> <li>• Scarce information inhibits the development of profitable, non-predatory financial products.</li> <li>• Partnership among government, foundations, and private sectors can increase research (MetroEdge).</li> </ul>
Need to find volume	<ul style="list-style-type: none"> <li>• Typical business models need large volume of customers to compensate for small transaction sizes and low balances.</li> <li>• Despite the decrease in costs, outreach to low-income consumers needs large volumes to be an attractive business strategy.</li> </ul>
Finding appropriate partners	<ul style="list-style-type: none"> <li>• Outreach partnerships with trusted intermediaries.</li> <li>• Technology partnerships with vendors.</li> <li>• Service partnerships with alternative financial service providers.</li> </ul>
Improving regulatory system	<ul style="list-style-type: none"> <li>• Improve consistency of different sources of regulation (federal and state levels) for different layers and products in the market.</li> </ul>

### Cultural and Structural Barriers

This paper has discussed some of the cultural barriers facing low-income consumers as they contemplate participation in the financial mainstream. Cultural barriers, however, also exist within financial services firms. The banking industry is highly regulated, and has long had a

very conservative culture. Banks have a level of risk aversion that can lead to blanket-refusal policies rather than careful risk management.<sup>12</sup> These policies tend to have a disproportionately negative impact on low-income consumers. Furthermore, in a regulated industry, when a new idea (particularly a new product idea) is proposed, the first question asked often is not, “Will it sell?” or “Will it be profitable?” but, “What will the regulators say?” Despite the successes of CRA, the financial services regulatory environment is designed primarily to emphasize safety and soundness rather than community reinvestment.

Firm-level structural issues also come into play. The underlying business model for conventional banking — whose organizing unit is the account — may be antiquated, particularly for serving lower-income consumers. For example, bank structures in which outreach to low-income customers is not aligned with responsibility for profitability can lead to situations in which products are inappropriately promoted to maximize revenue, with little concern about the impact of such products on the asset-building opportunities of low-income customers (*New York Times*, 2003; *The American Banker*, 2003). The recent controversy over “bounce protection” is an example of this problem. Moreover, established firms with large investments in technology and legacy systems are less likely to choose to innovate in order to better reach the low-income market, because the additional cost of systems change makes it harder for initiatives to meet internal hurdle rates.

As the examples in this paper demonstrate, however, 10 years of bank deregulation, the pressures of CRA (and the threat of CRA on the credit union side), the demographics of the immigrant market, and the support of senior bank regulators are definitely eroding this barrier. Speeding up its elimination will require resolution of the other issues discussed here — especially the paucity of market information.

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<sup>12</sup> The use by banks of ChexSystems (a listing of people who have had accounts closed during the prior five-year period for repeated overdrafts, unpaid overdrafts, or fraud, used to deny checking accounts to those on it) is a good example of this problem. Risk management with respect to checking accounts is important to depository institutions, as nearly \$700 million in bad checks was lost in 2001, and ChexSystems was being used by banks as the solution. Following a public outcry that started with an article in the *Wall Street Journal* in August 2000, many banks modified their use of the system. Moreover, in a number of cities, nonprofit entities and banks have joined together in the Get Checking program, a second-chance program that mitigates risk through education, a requirement that balances outstanding on closed bank accounts be repaid, and a modified checking or savings product that enables a new bank to assess the customer’s current behavior before deciding whether to allow the customer a full-service checking account. Get Checking, which started in Milwaukee, is now operating in 37 communities. See “Get Checking, Innovations in Personal Finance for the Unbanked: Emerging Practices from the Field,” Fannie Mae Foundation, 2003. Nevertheless, ChexSystems is still used by many with minimal, if any, analysis of the actual risk being avoided by refusing to open accounts (Park, 2004).

## **Lack of Information About the Market**

Despite a growing awareness of the unbanked and underserved and of their general demographic characteristics, little specialized industry information exists detailing the financial needs and preferences of these and other low-income consumers. Even firms already serving low-income consumers say they lack the kind of attitudinal and behavioral data they need to better customize their products and services. The surprise with which the 2000 Census was greeted is a surface manifestation of this problem. Moreover, market research about low-income consumers is woefully behind that available for middle- and upper-income consumers and those living in suburban communities. For example, Claritas, the country's leading market research firm, classifies the country's households into 66 "clusters," groupings of consumers whose needs, capacity, and behavior are similar enough that businesses depend on them to develop and market products and services. Only three of those groupings cover central cities, where much of the unbanked and underserved population lives. Moreover, Claritas's coverage of rural America is also thin; yet it is clear that large numbers of Latin American immigrants and others likely to be unbanked have moved into rural locations.

Beyond market data, the industry lacks information on the cost structures involved in serving low-income consumers in ways that also promote asset building. Despite significant innovation in the marketplace, much of the experimentation is at too early a stage to yield solid results that could guide the development of new business models. Without this information, it is difficult to make the business case for developing new products to market to and serve unbanked and underserved populations, particularly within institutions that want to make certain that they can make a profit without being accused of predatory pricing.

With time, the results of new innovations should lead to a growing understanding of the business models that reach consumers most successfully and are also financially viable. The key will be developing mechanisms for sharing this information among the wider financial services industry, because success often breeds competition. In addition, the combined efforts of the government, foundations, and the private sector are beginning to make a major improvement in this situation. One example is MetroEdge, a market research firm created with the support of foundations and ShoreBank. MetroEdge has developed specialized analytical techniques to uncover business opportunities in often-overlooked urban and ethnic markets.<sup>13</sup> Its analytical

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<sup>13</sup> Claritas has partnered with MetroEdge to serve clients interested in both suburban and inner-city markets.

and survey work, available on a commercial basis to financial services providers, as well as to localities and others interested in making the case for serving the low-income population, will help firms develop financial products and services that meet the needs of low-income consumers (Berry, Herman, and Wright, 2003).

### **Need to Find Volume**

Typical business models for serving low-income consumers require large volumes of customers in order to compensate for what are generally believed to be smaller transaction sizes. Entrepreneurs and established firms alike, however, are struggling to find large-enough pools of low- and moderate-income customers to make their models work — particularly as some Internet-based strategies have failed to attract adequate numbers of customers.

Many bank costs are essentially fixed on a per-transaction or per-account basis. Thus, administering a savings or checking account has certain fixed costs related to opening the account, maintaining records, and sending statements. If the account is large and transactions few, the funds in the account, which often earn no or low rates of interest, can be an important source of relatively inexpensive funding for the institution. If balances are low and, in particular, if low balances are combined with frequent transactions, the account is less profitable. The technological innovations of the past 10 years, including those discussed in this paper (such as ATMs, direct deposit, Internet banking, and the use of debit cards), have the potential to reduce costs significantly, thereby making accounts profitable at lower balance levels. However, the smaller margins still demand larger volume to make outreach to low-income consumers an attractive business strategy.

The role of bank legacy systems should not be underestimated. These systems, which are embedded in bank operations, not only make the creation of new types of products difficult and expensive but, perhaps more importantly, make it difficult to accurately track the profitability of innovative products and services. For example, many banks still use systems that evaluate the profitability of a checking account of a given size without differentiating whether the account owner uses a teller or an ATM to transact business (even though it is clear that ATM transactions are far less expensive). Even more sophisticated systems rarely evaluate customer profitability over time, or take into account reduced marketing expenses when customers are reached through word-of-mouth or by other inexpensive means. Because it can take several years for low-income, low-asset consumers to be ready for the credit products banks consider most profitable,

and, conversely, because word-of-mouth can be a highly successful marketing strategy in low-income communities, these failings of legacy systems can be significant barriers unless a bank believes it is guaranteed a large market.

The workplace and bank/non-bank partnership strategies described above are the most likely to be able to overcome the customer volume hurdle, as they both present opportunities for reaching large numbers of consumers through established non-bank platforms. Moreover, the high level of interest of banks in serving the Latino market (after the 2000 Census revealed the market's large size and high rate of growth) demonstrates that this barrier can be overcome with the right data. The challenge will be to move the products, strategies, and enthusiasm shown for the Latino market into other underserved markets whose size and growth potential are less dramatic.

### **Finding Appropriate Partners**

As discussed above, some of the most promising strategies for serving the low-income, low-asset population involve bank/non-bank partnerships. These can include outreach-focused partnerships with trusted intermediaries such as employers, community-based organizations, unions, educational institutions, and churches; technology partnerships with vendors; and service partnerships with alternative financial service providers who have been offering some products — such as non-account-based check cashing — that meet the needs of the low-income population, but are not normally considered bank products.

Each of these three types of partnership presents special challenges. The issues regarding trusted intermediaries revolve around interest, competence, scale, and culture. Simply put, the intermediary must be trusted by both sides. Not only do consumers need to believe in the intermediary's good faith; the bank also needs a demonstration that the intermediary is actually able to successfully perform the outreach function that will bring good customers to the bank. This often requires not only good intentions but, increasingly, the ability of the intermediary to effectively perform such services as financial education, credit counseling, and mortgage origination. Particularly when the intermediary is a not-for-profit entity, developing such skill, especially at scale, requires funding on other than a per-closed-transaction basis. More effective deployment of the bank funds used to meet the investment test under the CRA to invest in groups able to perform well for both the community and the bank could help overcome this partnership challenge.

Vendor partnerships present a different kind of challenge. Here, the issue is frequently that the innovation occurring at the vendor level cannot find the right audience within the bank. This results, in part, from a lack of understanding on both sides of the possibilities of new technology; it also is due to the fact that those in the bank most interested in serving low-income consumers often have little interaction with the bank's retail activities. Even when such contacts are made, those in retail banking often have little interaction with the areas of the bank responsible for operations and technology. This is a challenge that requires both better internal communication within the bank and a fuller understanding, by champions of outreach, of the importance of systems and operations.

Finally, partnerships with alternative financial services providers raise difficult challenges with respect to understanding, culture, and community relations. Many alternative service providers have established niches in financial services areas that banks find excessively risky (such as check cashing) or too expensive on a transaction basis (such as small loans). Yet, these providers have proven themselves exceptionally profitable because of sophisticated risk-management systems, lower cost structures, and an ability to charge prices that, for both regulatory and cultural reasons, banks do not find appropriate. The latter practice, of course, has earned alternative providers the enmity of community groups and, often, the disdain of bankers. Learning how to partner with high-quality alternative providers whose systems can help banks expand their suite of products for the low-income community while avoiding the negatives (including pricing above the appropriate risk-adjusted level) could make an important contribution to successfully moving low-income, low-asset consumers onto an asset-building path.

### **Improving the Regulatory System**

The regulatory system that governs retail banking at depository institutions (and parallel activities at alternative financial services providers) is a complex combination of federal and state regulation. Even if it were perfectly attuned to the needs of low-income, low-asset consumers (which it is not), the current system is extremely difficult for financial institutions, consumers, and entrepreneurial technology providers to navigate.

The pieces of the system that are particularly in need of attention in this context are the laws and regulations governing consumer protection and related issues at the federal and state levels and the differential manner in which they are enforced with respect to different types of

providers. For example, although the Patriot Act has imposed new identification requirements on banks and credit unions (as well as securities firms) for people opening “accounts,” these requirements do not apply to check cashers. The manner in which usury ceilings and other interest-rate based regulations are established and enforced is the genesis not only of very different patterns of payday lending across the country (Caskey, 2001), but also of the entire controversy about whether banks are improperly “renting their charter” when they fund third parties engaged in payday lending. The question of whether “bounced check” plans are really payday loans in disguise and, if they are, what rules should govern them, is an example of the system’s complexity and confusion.

Perhaps even more important to regulatory consistency is the differential manner in which enforcement of identical laws occurs. Depository institutions are subject to regular examination by federal and frequently state regulators, during which their compliance with consumer laws and regulations is assessed. Although the bank regulators have a bias toward requiring an institution to fix problems when they find them rather than punishing wrongdoers, the relatively constant oversight and scrutiny (plus the threat of the occasional spectacular enforcement action when things have gone very wrong) tend to keep depository institutions on the conservative side of the limits of consumer protection laws. On the other hand, enforcement of consumer protection and licensing regulations with respect to alternative financial services providers is, in most states, a complaint-based system. Relatively small budgets in both the state enforcement agencies and, at the federal level, the Federal Trade Commission mean that complaints must reach a very high level before meaningful action is likely to be taken. Although class action lawsuits and lawsuits brought by state Attorneys General fill some of the gap, they too require a high volume of problems in a single entity to be cost-effective.

Another area where clarification and perhaps revision is needed relates to the definition of “account” for deposit insurance purposes. The tension is between the cost-effectiveness of the use of sub-accounts for such purposes as payroll cards and Individual Development Accounts and the desire to make certain that the beneficiaries of such sub-accounts have the same protections and opportunities as other full-fledged accountholders.

## **Conclusion**

The success of alternative providers has demonstrated that there is a large market for financial services within the low-income community and that it is possible to tap into it profitably with the right combination of products, services, and marketing. At the same time, a confluence of demographic, technological, competitive, and public policy events has made the mainstream financial services community more interested in serving this market with an array of products beyond credit. Despite these positive developments, however, many barriers to asset building by the unbanked and underserved remain. These include outdated banking regulations, the conservative culture of traditional institutions, a need for better market data, and the lack of business models that adequately address the true potential of the lower-income market. On the other hand, a number of innovative programs have shown that it is possible to overcome these problems, especially by focusing on creative strategies such as workplace distribution and education, remittance provision, stored-value cards, bank/non-bank partnerships, and self-service delivery.

This is, therefore, a good time to be hopeful about market opportunities to put low-income, low-asset consumers on an asset-building track with mainstream financial institutions. Furthermore, the positive developments described in this paper — already under way in the market — can be greatly encouraged by initiatives that will improve the regulatory system, assist providers in forming creative partnerships, provide better market data, and help the mainstream financial services industry to understand the challenges and opportunities presented by the unbanked, underserved, and lower-income market.

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