Independent Women's Forum®

POLICY focus
RECIPES FOR RATIONAL GOVERNMENT

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Financial Services for the Unbanked

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IN THIS ISSUE

Introduction

Banking services in America are omnipresent. Most Americans possess checking and savings accounts, use credit cards, and finance major purchases with loans. However, for a surprisingly large share of Americans, the barriers to opening and maintaining bank accounts are too high, making it difficult to function in an increasingly cashless society. Unsurprisingly, these households tend to have low incomes and few financial assets.

The lack of access to financial services doesn't mean they are not needed. A variety of services help fill in these gaps. The public—and policymakers—should be aware of the vital role these services play. While it's tempting to criticize those specializing in serving this population, and to view the fees charged and practices employed as exploitative, these services fill a critical need and must take into account the higher risks and costs of providing these services.

This paper explores how some of the most heavily criticized financial services practices—payday lending, repossession services, and banks levying transaction fees—actually make it possible for vulnerable communities to participate more fully in the modern economy. Without them people would be forced to turn to the black market and be even less likely to have access to banking and loan products.

Policymakers should consider policy reforms to encourage continued innovation in the financial sector and recognize that consumers are best positioned to decide which services meet their needs at any given time, because—despite regulators' best intentions—interventions often restrict consumer choice, ultimately resulting in fewer options and higher costs.

What You Need to Know

Everyone—including the poor—benefits from having access to financial services that enable them to finance small and large purchases and pay for emergencies. These include:

- **Transaction Fees:** Financial institutions aren't charities—they must generate a profit. By employing small fees of ATM use, checking and other transactions, rather than obligating account holders to maintain large cash reserves, banks are able to earn enough to offset the interest gains that banks would otherwise have earned from lending out larger sums of money with interest.
- **Secured Debt:** In the absence of a credit history showing a track record of repaying loans on time, sometimes loan recipients are asked to put up collateral in the event that they are unable to repay a loan. This serves as a guarantee to lenders that someone with less-than-perfect credit has skin in the game, and that a loss may be recouped in the event of a loan default. Although having assets repossessed seems like a harsh punishment, without this security many small businesses and lower-income individuals would be considered too risky to lend to and would be unable to borrow.
- **Payday Loans:** Although the payday loan industry receives its fair share of bad press, the products that it provides enable households to access short-term capital without needing to turn to the black market. The high interest rates charged are commensurate with the risk incurred by the lender.

More Information

Addressing the Needs of the Unbanked Poor

According to a **2015 report** by the Federal Deposit Insurance Corporation (FDIC), 7 percent of households in America—9 million—were unbanked, while 19.9 percent—24 million—were "underbanked," possessing only a checking or savings account, but nothing more sophisticated. And unfortunately, in today's increasingly digital economy, cash is no longer king—it's credit. This means that consumers who don't have access to tools like credit or debit cards face obstacles in trying to purchase everyday essentials like food or medicine. Carrying large sums of cash comes with its own set of risks—not only from theft, but also because being stopped by law enforcement when carrying large sums of cash has been used as **leverage in civil forfeiture proceedings**, even in the absence of wrongdoing.

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Obviously, unanticipated expenses like emergency medical services or a car repair can quickly throw a cash-based individual's carefully calibrated budget into jeopardy—forcing people to make difficult decisions about how to borrow money quickly from unconventional sources. If friends and family aren't willing or able to help, then options are limited… and costly.

While the media and regulators tend to focus on the obvious costs and downsides of some of the services that have emerged to service riskier populations, they overlook the benefits of giving people greater ability to participate in the economy and avoiding potentially worse options.

Pay Day Lenders

Numerous nonprofits and high-profile politicians have demonized the payday lending industry, portraying these short-term, high-interest loans as predatory. Indeed, these loans do come with very high interest rates that quickly add to the initial loan amount; however, borrowers enter these transactions with eyes wide open, well aware of the costs that accompany these loans. A **2017 survey** by the Cato Institute found that of those who have used payday or installment lenders in the past year, 63% believe the lender gave them good information about the fees and risks associated with the loan.

Certainly, these loans are not intended to be a long-term solution, nor are they intended to be used on an ongoing basis; the high interest rates alone should encourage borrowers to pay back the loan quickly, as well as to discourage consumers from making a lifelong habit of obtaining these loans.

Yet many consumers benefit from having this option when they require a larger sum of money than they can otherwise access on short notice; people who turn to these products often have very few options available to them and restricting access to these services or banning them wouldn't mean that the need for their services would go away. Rather, borrowers would likely to turn to riskier options—like loan sharks—or be unable to obtain loans altogether, which could have additional collateral consequences.

As IWF's Patrice Onwuka notes, "When Georgia and North Carolina banned small-dollar loans, consumers **bounced** more checks, filed for Chapter 7 bankruptcy protection at a higher rate, and complained more to the Federal Trade Commission about lenders and debt collectors. At a Federal Reserve center in Atlanta for example, customers paid an extra $36 million per year in bounced check fees after the ban on payday loans was implemented."

> **"While there are many people who use these loans unwisely, there are also many more who use them to get through a tough period—and restricting the options of the many because of the poor choices of a few is an unwise policy decision."**

Rather than throwing up barriers to obtaining these products, the federal government should let consumers decide the services that best meet their needs. While there are many people who use these loans unwisely, there are also many more who use them to get through a tough period—and restricting the options of the many because of the poor choices of a few is an unwise policy decision.

Transaction Fees

The traditional banking model used to require account holders to maintain a minimum balance to keep an account open; unsurprisingly, this prevented many people—primarily low-income individuals who live paycheck-to-paycheck or have uneven income streams—from having access to these services. Just because an individual isn't sitting on a pile of money doesn't mean that they wouldn't be a good customer, however, so banks devised new account structures that would make it cost-effective to offer financial services to lower-dollar account holders.

By lowering the amount of reserves that an account must have—and then charging for various transactions such as a small monthly fee if a balance falls below a certain threshold, a fee if another bank's ATM is used, or an overdraft fee if the account becomes overdrawn—the bank is able to offset the cost of providing services to these accounts.

> **Keeping consumers in the official banking system, rather than forcing them into the gray cash-based economy, is a good thing.**

Without a doubt, these fees are an annoyance. However, the tradeoff is that by using these tools, banks still consider low-dollar accounts a viable product to offer to individuals that might otherwise not be eligible for banking services altogether. Keeping consumers in the official banking system, rather than forcing them into the gray cash-based economy, is a good thing.

Although the federal government might be tempted to impose restrictions or controls on these fees, doing so means that policymakers would presume to dictate how much a business should charge for its services—also known as price-fixing. Unfortunately, if banks take in less money through these fees, they'll find new sources of revenue either by charging consumers more elsewhere or by cutting costs and services, which would be a bad outcome for these under-served populations.

Secured Debt

In some instances when receiving a loan, a borrower may be asked to put up an asset (like a car or some other piece of property) as collateral to guarantee repayment; this is also known as secured debt. The lender places a lien on the property, and should the debt not be repaid, the lender takes possession of the asset in question and may sell it to recoup the money. Because the lender has a greater guarantee that the loan will be paid back, these loans often have better terms—such as a lower interest rate—than an unsecured loan.

The most common forms of this in the consumer space are mortgage loans and auto loans—although this business model is also used by pawn shops and title loan companies. Although having assets repossessed seems like a harsh punishment, without this security many small businesses and lower-income individuals would be considered too risky to lend to and would be unable to borrow.

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Other Financial Options

Fortunately, the private sector has an incentive to work with this underserved population—the prospect of future customers. Accordingly, a number of products offer options that are tailored to individuals with greater income volatility and lower account balance requirements.

- **Bare-bones bank accounts** with low initial deposit requirements can provide basic services—and while the trade-off may sometimes include monthly maintenance fees if account balances fall below a certain threshold, the cost of these maintenance fees is often lower than the transaction costs that are tacked onto services like check cashing.

- **Prepaid credit cards** enable consumers to load a card from a recognizable payment provider (Visa, Mastercard, or American Express) with cash at a point of purchase—which are widely available at convenience stores and gas stations. By using the card, consumers no longer have to carry large amounts of cash with them, streamlining shopping for basic goods and services.
- **Short-term loans**, be they through payday lenders, title loans, or something similar, can be a way for individuals to obtain access to a greater amount of capital than they might otherwise be able to access from friends and family. These products often come with high interest rates, and as such can get very expensive if they're not paid back in a timely fashion; they are not intended to be a long-term solution. This higher rate is directly correlated with the risk of lending to someone with poor or nonexistent credit.

These solutions, however imperfect, are the first step in getting individuals and households who are outside the financial sector into the system—creating habits that can be built upon and eventually lead to greater inclusion.

While well-intentioned actors—including nonprofits and government agencies—may call for greater regulation of this sector, it is inevitable that mandating the provision of low- or no-cost services to these consumers will result in fewer options for all financial customers in the future, as financial institutions scramble to spread risk to other parts of their portfolios and to make up losses elsewhere.

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Who Are the Unbanked & Underbanked?

The FDIC's 2015 w contains a wealth of information about the consumers who do not participate in the banking system—some by choice, but most by circumstance. From the report:

- The most commonly cited reason was "Do not have enough money to keep in an account." An estimated 57.4 percent of unbanked households cited this as a reason and 37.8 percent cited it as the main reason.
- A higher proportion of unbanked households that previously had an account cited high or unpredictable fees as reasons for not having an account (33.8 and 31.5 percent, respectively), compared to those that never had an account (23.1 and 17.7 percent, respectively).
- Other commonly cited reasons were "Avoiding a bank gives more privacy," "Don't trust banks," "Bank account fees are too high," and "Bank account fees are unpredictable." Of these, the most cited main reasons were "Don't trust banks" (10.9 percent) and "Bank account fees are too high" (9.4 percent).

Why consumers say they do not participate in the banking system

57.4%
Not enough money to keep in an account

33.8%
High bank fees

10.9%
Don't trust banks

What You Can Do

Get Informed

Learn more about financial service issues. Visit:

- Independent Women's Forum
- Heritage Foundation
- Cato Institute
- American Enterprise Institute

Talk to Your Friends

Help your friends and family understand these important issues. Tell them about what's going on and encourage them to join you in getting involved.

Become a Leader in the Community

Get a group together each month to talk about a political/policy issue (it will be fun!). Write a letter to the editor. Show up at local government meetings and make your opinions known. Go to rallies. Better yet, organize rallies! A few motivated people can change the world.

Remain Engaged Politically

Too many good citizens see election time as the only time they need to pay attention to politics. We need everyone to pay attention and hold elected officials accountable. Let your Representatives know your opinions. After all, they are supposed to work for you!

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ABOUT INDEPENDENT WOMEN'S FORUM

Independent Women's Forum (IWF) is dedicated to building support for free markets, limited government, and individual responsibility.

IWF, a non-partisan, 501(c)(3) research and educational institution, seeks to combat the too-common presumption that women want and benefit from big government, and build awareness of the ways that women are better served by greater economic freedom. By aggressively seeking earned media, providing easy-to-read, timely publications and commentary, and reaching out to the public, we seek to cultivate support for these important principles and encourage women to join us in working to return the country to limited, Constitutional government.

We rely on the support of people like you!

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